4.
UNEMPLOYMENT, SKILLS AND DISADVANTAGE

The upturn in the economy is flowing through into the labour market. The number of jobs is rising and the number of unemployed is slowly falling. While this should continue, unemployment is likely to remain stubbornly high for the next three years.

Policy changes cannot be expected to offer a quick fix to unemployment. However, there are ways to ensure that more people share the gains of the economic recovery.

A key way to raise employment, and economic growth generally, is to increase the level of skills in the labour force. Raising skill levels will also go a long way to dealing with disadvantage.

Higher pay for skills will encourage education and training. A competitive environment and the ability to bargain flexibly will stimulate firms to offer appropriate training for their staff.

A responsive and efficient education sector is necessary to improve the skills of the future workforce.

Skill development and labour-market adjustment will take time.

An early strategic issue for the Government is the process of managing education and welfare policy. This will require careful coordination and priority setting.

Employment is growing . . .

Economic growth is being reflected in the labour market. Employment has been growing since December 1991. In the year to June 1993 total employment rose by 17,100 (or 1.2%). It increased most in manufacturing (16,600), community, social and personal services (14,000), and construction (5,200). Over this period, the number of full-time jobs increased and part-time employment fell. This may be due to firms turning existing part-time jobs into full-time employment.

... and unemployment falling slowly.

The unemployment rate peaked in September 1991. Over the last year unemployment fell by 3,000. The fall in unemployment has been less than the increase in employment, mainly because the working-age population is growing.

This is projected to continue . . .

Employment is projected to grow by 20,000 to 25,000 per year. Wages on average are expected to rise in real terms, although real wage growth for people with few skills is expected to be slow. Unemployment is not expected to fall rapidly because the number of people looking for a job is projected to increase. This is both the result of demographic factors and in response to improving employment prospects.

... although there is some uncertainty about how the reformed labour market will respond.

Considerable uncertainty exists, however, over the nature of future responses in the labour market. For example, increased competition for goods and services, and the flexibility allowed under the Employment Contracts Act, could lead firms to respond more rapidly than projected, leading to faster economic and employment growth. On the other hand, a re-emergence of wage indexation could lead to slower growth in jobs for the low-skilled.

Domestic and international forces are . . .

There are two strong forces operating on the New Zealand labour market:

- ❑ Economic reform has changed the pressures on the labour market substantially over the past 10 years.

- International forces are affecting the types of skills required by employees, and the wages firms can pay in order to match the quality, standards and prices of international competitors.

... increasing the value attached to skills.

Both these forces are increasing the value attached to skills, ideas and more flexible production. Jobs are increasingly knowledge and technology based, with competitive advantage becoming increasingly dependent on quality, marketing and product development. With the prospect of continuing rapid technological change, people can expect to repeatedly train and learn new techniques and approaches throughout their working lives.

THE IMPORTANCE OF SKILLS

Through lack of skills some groups will not share fully in the growth.

Solid economic growth is under way and will lead to a higher standard of living for many New Zealanders. The challenge now is to achieve even stronger growth and have more people share in it. At present there is a substantial risk that, because they lack skills, three groups will receive only limited benefits from growth over the next few years. These are the long-term unemployed, low-skilled workers, and those caught up in intergenerational cycles of disadvantage. The stronger growth is, however, the greater will be the benefit to these groups through increased employment opportunities.

Better skills are essential.

Better skills are central to achieving stronger growth in the longer term, and to ensuring that the benefits are more widely shared.

Skills are more than just qualifications.

The skills needed for better economic performance should be seen quite broadly. They go beyond formal qualifications and include motivation, responsiveness and the capacity to learn. These attributes are shaped by many influences: the orientation of the economy, family experiences, schools, the community and the workplace.

Stronger growth

Skill shortages pose a potential threat to continued growth. Shortages are already emerging. More firms are reporting that it is harder to get skilled staff than are saying it is getting easier.

Quick responses to skills shortages reduce their impact.

The appearance of skill shortages is not necessarily a matter for alarm since they are to be expected in any dynamic economy. The extent to which skill shortages constrain growth depends on the speed of response to them: whether firms undertake more training; whether the wages of more-skilled workers rise relative to unskilled workers thus reinforcing the value to people of acquiring those skills; how quickly the education and training institutions respond to shortages; and how immigration policy operates.

Skills increase productivity, which is central to growth.

Over the longer term, productivity growth will be the prime determinant of economic performance. People's abilities, skills, education and motivation all contribute to their productivity, as do the quality of their management, and the plant and equipment they work with.

A more productive workforce improves the ability of New Zealand firms to compete internationally and to expand output, employment and incomes. Higher productivity growth therefore leads to stronger growth in incomes.

Low incomes

Wage growth is likely to be slow for the low skilled . . .

Despite the sustained economic growth now forecast for the next few years, many people may experience only slow wage growth. This will result from their low productivity (reflecting their work history and low skill levels), and the fact that, while high unemployment exists, there will be considerable competition for jobs.

... but economic growth and higher skills will eventually raise their incomes.

Higher economic growth should create more job opportunities in the service sector for people with limited skills. At the same time, better education and training should then reduce the number of people seeking such low-skilled jobs. An increased supply of jobs for people with few skills and a reduced number of people looking for them should eventually increase the real wages of this group of people.

While real wage growth for low-skilled jobs may be limited for some time, this will allow more people with few skills to gain work. Getting people into jobs will provide them with the opportunity to gain experience and acquire more skills, making advancement into better-paying employment more likely. This will happen a lot faster if firms are under pressure to invest in their staff.

Those with higher skills will get higher pay.

As a result of international forces and domestic reforms, skilled workers are likely to see their wages increase faster than those of the low-skilled. This differential is important in encouraging people to improve their work skills. While the income gap between skilled and unskilled is likely to increase, skill acquisition amongst the unskilled will help ensure that they have the opportunity to move into higher income groups over time.

Unemployment

Numbers of very long- term unemployed are increasing . . .

Around 76,000 people have been unemployed for at least six months according to the Household Labour Force Survey. Furthermore, over 50,000 have been on an unemployment benefit for more than two years and this number has been increasing. There is also a sizeable number who move into and out of unemployment over a number of years. While any particular spell of unemployment might not be long, the number of episodes can result in substantial total time spent unemployed.

... and the majority are low-skilled.

The low-skilled make up a large share of the long-term unemployed, with around 57% of those registered as unemployed for more than six months having low qualifications, compared with only a third of the total labour force.

Many unemployed move quickly into jobs . . .

Unemployment is temporary for many people, as they are able to find a job or undertake appropriate training reasonably quickly. Over short periods of time, large numbers of people move into and out of jobs, unemployment, education and training, and activities outside the conventionally defined workforce (such as care-giving or retirement).

... but not the long-term unemployed.

In direct contrast, the group of very long-term unemployed have special difficulty in finding employment, and may have many problems in common. This group will need to be a focus of policy, as they have a particularly low potential and opportunity to improve their welfare by their own efforts.

Intergenerational transfer of disadvantage

Although growth helps . . .

As in all countries, some people face multiple problems - such as limited work or social skills, poor health and housing, low income, and poor attitudes to work and acquiring skills. Some may be unemployed; others, such as sole parents, may be on benefits; others may be working, but on low incomes. While better growth will help to some extent because it will then be easier to obtain a job, their problems are likely to limit their ability to share in growth.

... children in disadvantaged situations are of particular concern.

Furthermore, their problems may be passed on from one generation to another, within families or social groups. The problems will be particularly acute for children in such situations. If the problems are not addressed early these children will find it difficult to acquire skills, which will adversely affect their life chances. Long-term child development studies in New Zealand have found links between some early childhood experiences, teenage mental health and behavioural problems, and unemployment.

A better understanding is needed of how this transfer of disadvantage works, in order to help design effective solutions. The longer-term solution is likely to involve preventive measures during schooling or the early childhood years. These could include policies with objectives such as securing better outcomes for poor performers in schools, early identification and treatment of child health and welfare problems, better information and counselling for parents, the development of better parenting skills, and improved choice and opportunities for early childhood education. Finding an effective approach to these problems may require trials of several alternatives.

SKILL ACQUISITION

Problems of low incomes, long-term unemployment and wider disadvantage will not disappear rapidly, for two main reasons: the nature of the labour market, and the time taken for skill levels to adjust.

The labour market is crucial to skill development.

The labour market plays two separate roles in helping people acquire skills:

- Once people enter the workforce the bulk of their experience and training typically takes place within the firm. Thus work experience is a key to developing better skills for most people.

- The difference in pay for different skills and behaviours encourages people to acquire skills with higher rewards.

The labour market does not adjust immediately . . .

These processes, however, are not immediate. For instance, people derive a sense of inclusion and security as well as income from a job, which may lead to a reluctance to change. In addition, when firms recruit staff they have only partial information about a person's skills and abilities. Therefore they may use a record of employment as a key indicator of ability, making it harder for new entrants and the long-term unemployed to find a job.

... and skill development takes time.

It also takes time before new circumstances lead to new skills being acquired. Apart from the time actually taken in training itself, the overall speed of adjustment will depend on the reaction by the trainees, by employers and by educational institutions. These are discussed in turn in the following sections.

Trainees

Higher pay** for **skills encourages training.

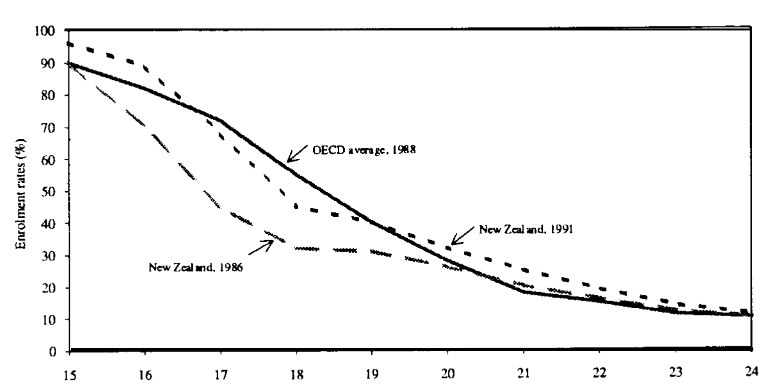
People's willingness or ability to accept work or training directly influences the skills they develop, their productivity and incomes. The current increases in margins between the incomes earned by high-skilled workers and those with fewer skills will tend to increase the willingness of people to take on training. Investment in training will enable those with low skills to move into higher income groups.

More people are spending longer in education and training.

More people are staying at school longer and taking part in tertiary education and training. The percentage of people entering Form 6 increased from 53% in 1981 to 83% in 1992, while the percentage entering Form 7 increased from 16% to 44% over the same period. The total number of tertiary enrolments in 1992 was estimated to have increased by 22% over enrolments in 1991. At all levels education participation rates now appear to be converging on the OECD average.

Figure 4.1

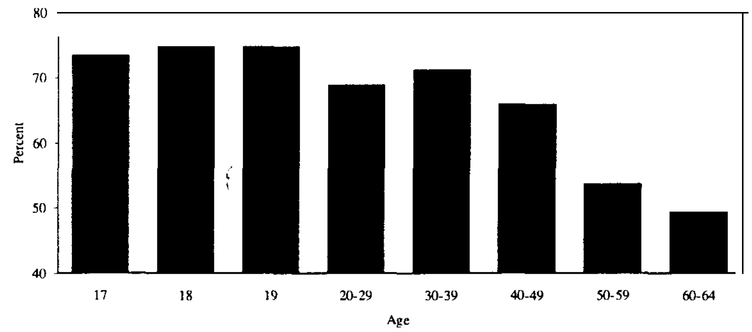
New Zealand now around OECD participation rates



Source: Department of Education, OECD.

Education attainment is increasing, with a greater proportion of young people now having a qualification than is the case for older groups.

Figure 4.2
Younger people now more qualified



Shows percentage of each age group with a qualification
Source: Treasury estimates using Department of Statistics HEIS 1991/92

Policy should focus on raising skills . . .

The focus of policy should be on improving the learning opportunities for those on the lowest incomes. Focusing instead on reducing the dispersion of income could lead to policies that run counter to the real aims.

... rather than redistribution.

For instance, it may seem easier to try to redistribute income through taxation than to lift everybody's living standards through skill improvements. However, any large scale tax-based redistribution programme that significantly raised the income of low-income working families would impose very high costs. The costs include not only the fiscal value of the transfer payments, but also the demotivating effect that high marginal taxes has on efforts to acquire skills or to work long hours.

Rather, the focus should be on improving the opportunities to work and acquire skills, since this will better spread the gains of economic recovery in a pro-growth way.

Welfare systems should encourage work or training ...

The design of the welfare system needs to ensure that people have an incentive to accept work or undertake training, while still providing an adequate level of income. This involves consideration of eligibility criteria, obligations placed on recipients, the levels of assistance and abatement rates, and the duration of assistance.

... through benefit design ...

These issues in turn raise complicated administrative issues, and trade-offs between encouraging desirable behaviour and ensuring adequate living standards.

... and active labour market policies.

While benefit design can be helpful in encouraging desired behaviour it will not be sufficient to ensure that the long-term unemployed re-enter work or training. Active labour-market policies can help get people into jobs to get work experience and to develop skills. Such programmes need to be effectively integrated with the benefit system to reduce the incidence of long-term unemployment.

The Government already undertakes a range of active labour-market interventions: referral services, job clubs, subsidised work, training schemes and work testing. Some of the most consistently effective policies overseas have involved intensified placement and counselling efforts aimed at encouraging effective job search, particularly when targeted at specific categories of unemployed such as the long-term unemployed.

Employers

Employer attitudes are critical to staff development.

The bulk of the future training of people currently in the workforce will take place within the firm. The attitude of employers and the quality of management will be central to successful development of people. The more that skilled staff are seen as critical to the success of an organisation, the more the effort that will be placed on developing training and related strategies.

Recent reforms facilitate a training culture.

This is most likely to happen in a highly competitive environment where success depends on the abilities and responsiveness of managers within the firm and whether they can easily negotiate arrangements with their staff. The economic reforms over the past decade have been positive in both respects.

The diverse skill needs of different firms...

The increased training undertaken by firms is likely to be quite diverse. The mix of skills needed varies significantly across firms. Their training needs may also vary over time. For instance, basic technical training may be of prime importance at times, while at others, the emphasis may be on switching from a domestic to an international focus or from a production to market-led process.

... requires flexibility to be maintained.

This diversity of need means it is important that firms have the opportunity to select and control their own training strategies. This can involve in-house training, cooperative arrangements, or the use of formal education and training institutions. There are two main implications for policy:

- The ability to negotiate employment conditions at the enterprise level is important to permit the development of training which will boost productivity.

- Attempts to direct the provision of training through compulsory approaches is likely to reduce the flexibility that firms and industry need to address their own training needs.

Consistent policy is needed.

Education and training often have long pay-back periods, so policy uncertainty can have powerful effects on investment decisions. Maintaining a consistent focus of policy enables managers to plan and act with more confidence. Inconsistent policy directions would weaken managerial focus on training. All macroeconomic and structural policies which significantly affect the international competitiveness of firms are likely to have an influence on training.

Educational institutions

Public-sector educational** institutions need to **be efficient and responsive.

In order to respond to the demands of "trainees" and employers, it is important that there is an adequate range of learning opportunities offered by education providers. Universities, schools, polytechnics and a plethora of private training institutions are all involved. From a public-policy perspective the dominant issue is the efficiency and responsiveness of the public-sector institutions. If they are to boost their contribution to productivity, and improve their ability to raise the skills of low-skill people, the institutions will need to adjust rapidly to changing labour-market needs. The quality of service they provide will be important.

*Some innovation is **occurring already.***

Current policies have encouraged a degree of innovation at both the school and tertiary levels. For instance, several tertiary institutions, particularly polytechnics, have become much more innovative in developing courses and establishing links with firms. Desirable trends are emerging.

There are ways to reinforce and speed up the trends.

Reinforcing and accelerating these trends may require attention to:

- rationalising funding and charging practices to maintain pressures for innovation and efficiency
- providing better information on performance standards to ensure that quality can be raised over time
- relaxing constraints on managers to allow them to respond efficiently and quickly to new demands
- improving areas of low performance, such as where students are leaving school directly into unemployment.

Some action is under way.

A Ministerial Consultative Group on Funding Growth in Tertiary Education and Training has been set up to look at many of these issues within the tertiary area. A trial of the Teachers Salaries Grant Scheme for schools is under way and being evaluated during 1993 and 1994. Reviews on early childhood funding, school property and the application of a tertiary capital charge are also under way.

Innovation is currently difficult in education.

The experience the "Tomorrow's Schools" reforms demonstrate just how difficult it can be to make substantial changes in the education sector. The practice of centralised collective bargaining and some residual areas of centralised resource controls also tend to reduce local innovation.

The departments involved need to coordinate their activities.

Any policy to assist the education sector to be more adaptable and responsive will require careful coordination and management. At the departmental level there are many players involved, including the Ministry of Education and Department of Labour. When the particular needs of the unemployed or disadvantaged groups are involved, the number of departments expands to include the Department of Social Welfare, Te Puni Kokiri, and the Ministries of Womens Affairs and Pacific Island Affairs. This means that careful coordination of policy development is needed at all levels of government.

Many groups have an active interest.

Looking beyond the Government, there are many groups with an active interest in education issues. These include governing boards, principals and managers of education institutions, staff and their unions, as well as parents and students.

A clear understanding is needed of Government's plans and goals.

It is important that these groups have a clear understanding of the Government's plans and goals, which requires that the Government be clear about its intentions and the rationale for policy changes.

5.
MACROECONOMIC MANAGEMENT

Monetary and fiscal policy are on track to support sustainable growth in the economy. The coming decade offers a rare opportunity to make substantial progress on reducing public debt.

The incoming Government will inherit a steadily improving fiscal position. Fiscal balance is achievable in two to three years. However, there is no room for complacency. Public debt remains very high and a significant number of fiscal risks remain within both the tax and spending areas. Furthermore, after the turn of the century demographic pressures on expenditure will begin to take hold.

In recent years, sounder macroeconomic policies have produced expectations of low inflation and declining deficits. This has contributed to lower interest rates and high business confidence, a major achievement. These gains in credibility have been hard won and it is important that they are not sacrificed in the face of the short-term pressures that will inevitably arise.

Moving into fiscal surplus and reducing debt will support better economic and social outcomes. A stronger fiscal position will contribute to higher national savings and increase the resilience of the economy to external shocks. It will reduce the burden on monetary policy to respond to inflationary pressures. The practical cost of high indebtedness is New Zealand's poor credit rating, which is

reflected in interest rates being higher than they would be otherwise. Lower debt will contribute to reducing the cost and risk of investing in New Zealand.

New Zealand's history and the experience of other countries show that achieving fiscal balance and maintaining surpluses will be difficult. It will require public support and a strong political commitment, reinforced by effective Budget processes and high-quality departmental management.

The improving economic and fiscal position . . .

For the first time in many years, New Zealand is experiencing robust, non-inflationary growth. Current fiscal and monetary settings are supporting that growth. Inflation is under control and fiscal policy is on track to eliminate the deficit.

... means urgent action is not required.

The incoming Government will not need to take urgent economic or fiscal action.

Achieving fiscal balance will not be easy.

Nonetheless, achieving better macroeconomic balance represents a major challenge. It will require another three years of very firm expenditure discipline, ongoing attention to the maintenance of the tax base and careful management of fiscal risks. While low inflation has been attained, the current monetary policy framework has yet to be fully tested in an environment of strong and sustained growth.

Hard-won credibility is easily lost . . .

Despite substantial effort over a number of years, fiscal balance has proved elusive. Expectations of lower deficits have helped underpin declines in interest rates and increases in business confidence. This credibility has been hard won but is still fragile and could be easily lost.

... and public support is important.

To realise the inflation and fiscal outlooks outlined in the Pre-election Update will continue to require broad public acceptance of the objectives of price stability and a stronger fiscal position.

Fiscal improvement will widen choices.

Achieving fiscal balance will begin to open up some important choices about using surpluses to reduce debt more rapidly, reduce taxes or increase spending.

MACROECONOMIC OUTLOOK AND POLICY

The outlook is positive . . .

The immediate prospects for the economy are positive compared with New Zealand's recent history and the present international outlook.

The Pre-election Economic and Fiscal Update projected:

- economic growth continuing at rates close to 3%
- inflation remaining in the range of 0% to 2%
- the balance-of-payments deficit slowly improving towards balance
- the fiscal position moving into broad balance by 1995196
- net public debt falling from 47.9% in 1992/93 to 44.6% in 1995/96.

This outlook assumes a continuation of current approaches to monetary and fiscal policies.

... but there are a number of risks . . .

In practice, though, macroeconomic policy will come under pressure from time to time. Some of these risks are always present:

- pressure for policy changes that increase spending or reduce revenues
- the realisation of contingent liabilities or other known fiscal risks
- variations in the economic growth outlook, interest rates or exchange rates

- erosion of the tax base if new avoidance practices emerge.

Other risks are more likely, given the situation New Zealand is now in:

- Greater uncertainty over policy directions may surround a new government and/or change to the electoral system.

- A strong period of domestic demand could generate the sort of general costs or price pressures discussed more fully in the "Economic and Fiscal Outlook" chapter. A tightening of monetary conditions at some stage will be needed to contain inflationary pressures, if they arise.

- Stronger domestic demand could lead to much higher import demand. If not balanced by stronger growth in exports, concerns about the balance of payments could see financial markets act to lower the exchange rate or raise interest rates.

... which need to be managed.

Such pressures are less likely to occur if the overall policy environment is sound and well managed.

Monetary policy

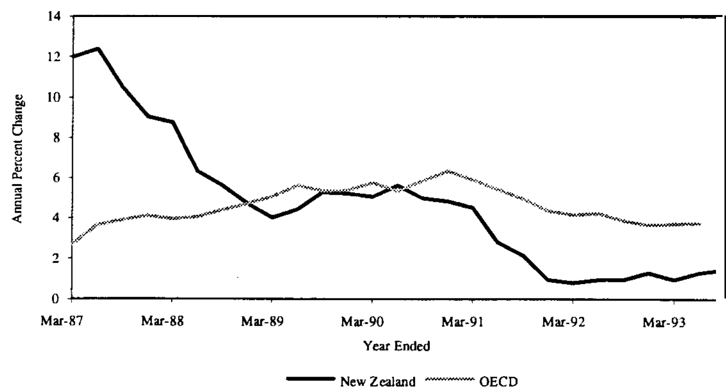
Monetary policy is on a sound footing . . .

The institutional framework under which monetary policy now operates is well placed to manage such pressures without damage to long-term growth or inflation objectives.

... giving a good inflation performance.

It has seen New Zealand achieve one of the best inflation performances in the world. This contrasts sharply to the experience during the 1970s and 1980s.

Figure 5.1
Inflation performance has improved



Source: OECD Main Economic Indicators, Statistics New Zealand

However, the framework is yet to be fully tested over a complete economic cycle.

Fiscal and monetary policies . . .

Should inflation risks emerge, the Reserve Bank will need to allow monetary conditions to tighten. The need for and extent of such tightening can be moderated if the fiscal and debt positions are strengthening.

... can reinforce each other.

The support that fiscal policy should lend to monetary policy is not just a short-term issue. Macroeconomic policy will be most effective when monetary and fiscal policies reinforce each other on a long-term basis.

MACROECONOMIC POLICY= LONG-TERM PERSPECTIVES

A short-term focus produced long-term problems.

Historically, macroeconomic policy has tended to have a short-term focus. Attempts to address individual problems such as balance-of-payments deficits, unemployment, inflation or recession produced a gradual deterioration in performance in all areas over time. Long-term problems accumulated and periodically emerged as short-term crises. The urgent and very difficult action required to make the economy more stable involved periods of costly adjustment.

The big challenges are now fiscal . . .

Given the monetary policy framework now in place and the results produced, the major long-term challenges in macroeconomic policy now lie in the area of fiscal policy. Fiscal policy is vulnerable on a number of fronts and makes the fiscal outlook sensitive to interest and exchange-rate movements.

... with rising debt, . . .

❑ Public debt has built up substantially over the last two decades. At March 1974 net public debt stood at 4.6% of GDP. By 1984 it had risen to 31.6% and by June 1993 the ratio had increased further to 47.9%.

... significant risks . . .

❑ There are still several fairly significant fiscal risks that will need to be managed. Examples are Treaty of Waitangi claims, costs associated with health-sector restructuring, and pressures on the revenue base arising from the increased openness of the New Zealand economy.

... and looming demographic pressures.

❑ Looking ahead to the 21st Century, one of the most significant influences over fiscal policy is going to be the demographic forces associated with an ageing population. These will create growing pressures on expenditure in areas like health and welfare, while also acting to reduce revenues as the tax-paying labour force declines relative to the total population.

These challenges favour lowering debt.

The key to reducing these risks is to lower debt through closing the deficit over the next three years, and then run fiscal surpluses.

REDUCING DEBT

Cutting debt supports growth by . . .

Moving the fiscal position into surplus in the second half of this decade and reducing public debt will support growth in a number of ways, namely by:

... reducing exposure to shocks, . . .

- **Reducing vulnerability to shocks.** High public debt makes the fiscal position vulnerable to adverse movements in interest and exchange rates. For example, a one percentage point increase in interest rates would increase debt servicing costs by around $200 million per year. Higher government savings would contribute to a higher level of national savings and increase the resilience of the economy.

. . . giving more policy flexibility, . . .

- **Creating greater flexibility for fiscal policy options.** Lower debt levels provide the Government with greater room to respond to temporary or cyclical shocks without resorting to unplanned tax increases or expenditure cuts. The Government can be faced with having to reduce expenditure during a period when the economy is already weak (as was the case with the rapid deterioration of the fiscal position in 1990). It is much better to be able to achieve fiscal consolidation when the economy is relatively strong.

... moderating problems associated with monetary tightening, . . .

- **Reducing pressure on monetary policy.** Inevitably, at some future point, inflation pressures will emerge and monetary conditions will need to be tightened. The more sustained the pressure, the more likely higher interest rates will eventuate. Problems associated with any such tightening will be moderated if the fiscal position is continuing to improve.

... cutting investment costs and . . .

- **Reducing investment costs.** New Zealand's international credit ratings provide one indication of the economic costs of high indebtedness. The perceived relative risk of investing in New Zealand contributes to our real interest rates being around two percentage points higher than in the major economies. This additional cost impacts very directly on growth because of its effect on the cost of capital and hence on investment.

Long-term Fiscal Pressures: A Window of Opportunity

Demographic trends are an important determinant of long-term revenue and expenditure levels. Population, age and gender are major determinants of the number of tax-payers and beneficiaries, and the demand for health care.

The post-war "baby-boom" generation creates a demographic bulge as it moves through the labour force and then into retirement. As the baby-boomers retire, beginning around 2010, this demographic bulge will place heavy burdens on public expenditure, particularly with respect to New Zealand Superannuation and health care.

Fortunately, the decade from 1993 offers the opportunity to prepare for these pressures. Underlying expenditure pressures will begin to recede. New Zealand Superannuation expenditure will fall as a share of GDP. This reflects a fall in the number of recipients, combined with the phased increase in the retirement age to 65. In addition, debt interest will also fall as a share of GDP, reflecting lower interest rates and a declining ratio of debt to GDP.

These circumstances offer the possibility of moving into budget surplus and/or a reduction in the tax burden. As Figure 5.2 indicates, so long as tight control is maintained on expenditure, the ratio of revenues to GDP required to balance the budget will decline over the coming decade, followed by sharp increases in the following three decades.

... raising business confidence.

- **Improving business and consumer certainty** about future financial and policy pressures. Lower debt allows individuals and firms to make lasting, high-quality decisions with greater confidence.

A window of opportunity

Conditions are right for moving to surplus.

The next decade provides the country with an excellent opportunity to generate fiscal surpluses:

A positive fiscal trend is under way, . . .

- The fiscal outlook is trending in a favourable direction. Over the next three years, on the assumption of continued firm fiscal discipline, the fiscal position is projected to move into broad balance.

. . . the economic outlook is favourable, . . .

- The economic outlook is for steady economic growth, with the international economy becoming more supportive. These circumstances give rise to growing tax revenues, and declining expenditures on unemployment. They offer a more resilient economy in which to make rapid fiscal progress.

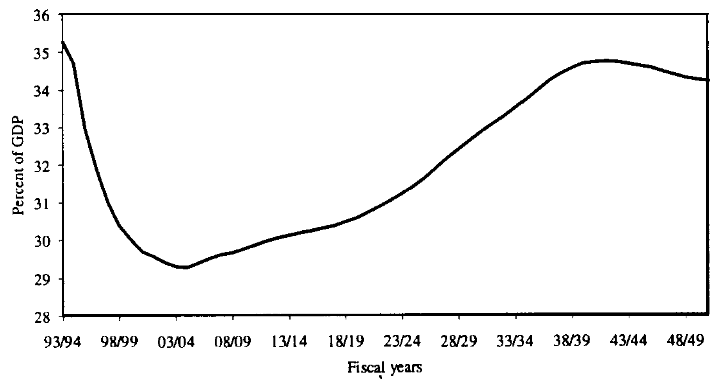
... the necessary tools are available . . .

- The Government now has available management tools that provide the means to maintain effective control of expenditure while also obtaining better value from expenditure.

... and demographics are helpful in the short-term.

- The demographic impact of the post-war “baby boom” generation on Government spending and revenue is still favourable.

Figure 5.2
Tax take needed to balance the Budget



These projections assume current expenditure and revenue policy settings are maintained, demographic projections from Statistics New Zealand.

THE TRANSITION TO FISCAL SURPLUS

Achieving surplus will not be easy.

While the opportunity exists and fiscal projections are promising, achieving surplus will not be easy. Underlying the three-year fiscal projections is the presumption that strong fiscal discipline will be maintained over the next three years. Specifically, the projections assume that:

Projections assume expenditure control, . . .

- **Total expenditure is controlled,** with new policy priorities being funded from savings elsewhere.

... effective tax base maintenance, . . .

- **The tax base is maintained.** In particular, it is assumed that the overseas incomes of New Zealanders are taxed effectively, and that the distinctions between residents and non-residents, between personal and business expenses, and between taxed receipts from capital and untaxed gains are policed in such a way that major avoidance activities do not re-emerge.

... growth translating to fiscal gain and . . .

- **Economic growth leads to a steady increase in tax revenues and lower benefit payments.** These, together with the lower benefit payments associated with declines in unemployment, are used to reduce the deficit.

... supportive interest rate levels.

- The **lower world and domestic interest rates** that have taken place over the past year act to reinforce the improving trend associated with the factors above, by also being applied to reduce the deficit.

Any relaxation of those assumptions would reduce the likelihood of further fiscal gains, and put budget balance at risk.

Fiscal gains can be quickly lost.

On several occasions achievement of fiscal balance has been in prospect, only to evaporate in the face of factors such as weaker international and domestic growth, and the realisation of fiscal risks or decisions on new expenditure or tax policies. In both Australia and the United Kingdom surpluses were rapidly turned into large deficits in recent years.

The Government will face spending and revenue pressures . . .

The incoming Government will inevitably face pressures to make policy decisions that could increase overall expenditure or reduce total revenues. It will also inherit the fiscal risks identified in the Pre-election Economic and Fiscal Update. On balance these pressures are more likely to worsen the fiscal outlook.

... and maintaining restraint may be difficult.

As the fiscal position moves closer to balance over the next two years, wider public support for restraint is likely to reduce. It will be important to manage these pressures.

A number of new policies each year can add up to several hundred million dollars, which accumulate to sizeable sums over a few years. With many New Zealand businesses rapidly moving out of tax-loss positions, interest in tax avoidance opportunities can be expected to pick up. Failure to actively maintain the tax base could result in substantial revenue losses.

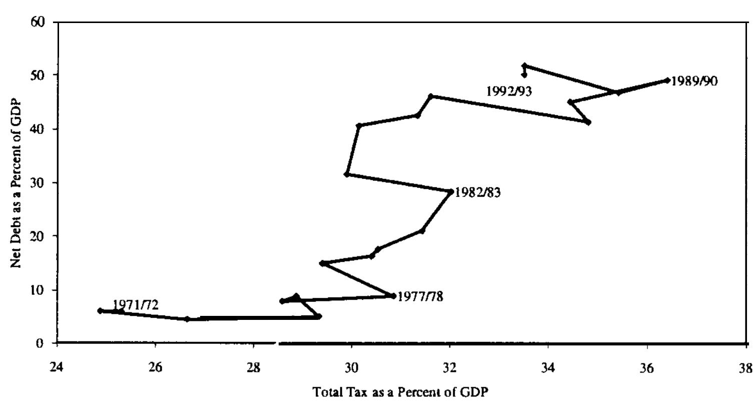
If additional expenditure or revenue leakages of **$200** million to $300 million per year were added to the profiles outlined in the Pre-election Update, the fiscal deficit would be approaching $1,000 million instead of balance by **1995/96**.

Early achievement of balance is desirable.

The Government should aim to achieve fiscal balance at the earliest opportunity. In practice, this means applying the fiscal benefits that flow from a growing economy to reducing deficits and debt. Any unanticipated economies in expenditure or revenue increases should be applied to that end as well. The rate of fiscal consolidation currently projected should be regarded as the minimum.

Figure 5.3

The debt and tax burden has increased over the last 20 years



Source: The Treasury

BEYOND FISCAL BALANCE

There are options for the use of surpluses.

Achieving fiscal balance on an enduring basis will represent a substantial milestone. Assuming mechanisms are in place to enable financial balance to be maintained, it raises questions such as:

- ❑ How long should surpluses be run?
- ❑ What size should they be?
- Cl Should surpluses be applied to debt reduction?

- Should they be used to reduce taxes?

- Should they be used to increase spending in particular areas?

Judgements on risks affect the choices.

There is no simple answer to these questions. They require judgements about the risks that should be accepted and the policies that provide most support for future economic and social development of the country.

Both debt and taxes involve costs.

Expenditure programmes, if well designed, provide benefits. At the same time, financing such expenditure imposes real economic costs in the form of debt, taxes, and higher risks.

Debt can add premia to interest rates.

One of the most tangible indicators of the cost of debt is the risk premium built into New Zealand interest rates. This additional interest-rate cost directly affects the cost of capital for all New Zealand firms. It then impacts on investment and growth.

It is difficult to assess the size of this risk premium. It is likely, however, that if New Zealand had a AAA credit rating on its foreign-currency debt, New Zealand's real interest rates would be significantly lower.

Taxes impose economic, compliance and administrative costs.

Taxes also impose costs. They can discourage someone from working overtime or from earning extra income. They impose compliance and administration costs, and affect decisions to save and invest. Flows of investment are very sensitive to changes in their treatment. The recent decisions to no longer require foreign investors to pay the approved-issuer levy on government securities contributed to the fall in interest rates that followed the 1993 Budget.

Lower tax rates and lower debt would both lend support to stronger economic growth and higher employment.

There are strong arguments for cutting debt . . .

Given New Zealand's history, a strong case can be made for a strategy that aims to reduce public debt rapidly. These arguments centre around the vulnerability to interest rates, the desirability of restoring our credit rating to the highest level, and the benefit of having fiscal room to manoeuvre when large, unexpected international shocks buffet the economy.

... such as supporting savings . . .

More generally, fiscal surpluses will also represent a tangible way in which the Government can contribute to a higher level of savings for the economy as a whole. Higher levels of national savings will increase the attractiveness of New Zealand as an investment destination.

... and making room for future tax cuts.

If lower public debt can be achieved, the risks implicit in our interest rates will reduce. As this happens the trade-off between lower taxes and lower debt, for example, may shift in the direction of lower taxes over time.

FISCAL MANAGEMENT

Much is required to achieve surplus . . .

Achieving financial balance and moving into surplus will require continued political commitment and public support for that objective. It will require effective budget processes and management of the Crown's finances. It will demand high-quality departmental management.

... but tools are available for expenditure control.

Much has been done to improve fiscal management. Mechanisms now exist to provide the Government with assurance that expenditure is being controlled. There are criteria in place that limit the circumstances in which departments can be expected to receive additional funding.

Each department has a three-year budget baseline. Chief Executives are expected to manage within their budgets and to plan on the basis that they will be expected to operate more efficiently in the future. They therefore need to be investing in information and management systems and practices to make this possible.

Maintaining the tax base needs ongoing attention.

On the revenue side, the design and administration of the tax system have been improved, reducing the opportunity for avoidance activity. Maintaining the tax base requires the same sort of careful on-going attention required for effective expenditure control.

A more strategic view offers benefits.

Over the next three years the Government should build on the progress already made. Further improvement requires fiscal management to take a long-term, well-coordinated view of the strategic issues confronting the Government. This is especially important at the beginning of the electoral term.

It is also desirable to conduct annual reviews of strategic priorities to check progress and amend objectives if necessary.

Government priorities should shape departmental action.

These strategic priorities will need to be clearly communicated to departments and other agencies. They should provide the focus for the activities of departments and the Crown over the planning period.

There are two significant ways to achieve this:

- The Government can ensure that its priorities drive the Budget process, and expenditure, revenue, and investment decisions. This will include eliminating low-value outputs and defects in the tax base.

- Better use can be made of departmental performance agreements and monitoring processes, which need to have a multi-year focus. This approach will allow the Government to delegate responsibility for day-to-day operations with greater assurance that objectives are being achieved.

Fiscal management also involves risk management . . .

Fiscal management is as much about asset and liability management as it is about revenue and expenditure flows. The Pre-election Update laid out a number of fiscal risks facing the Government. The more significant risks included:

- Treaty of Waitangi settlements
- Crown Health Enterprises balance-sheet restructuring and debt repayments
- Maui post-facto review
- the cost of new prisons
- additional expenditure for operating costs of the Museum of New Zealand
- implementing "Education in the 21st Century".

Pressure to increase defence spending is also likely following the expiry of the cap on defence expenditure at the end of the 1993/94 financial year.

*... **which can be helped by good quality fiscal reporting.***

Managing these and other risks requires regular reporting and active monitoring of the Crown's balance sheet. The Fiscal Responsibility Bill, if passed, would improve the quality and range of reporting. In doing so it would help broaden public understanding about the nature and extent of these risks and the possible pressures that the Government is managing.