NEW ZEALAND'S

ECONOMIC TRENDS AND POLICIES

May 1982

Report No. 5

ECONOMIC MONITORING GROUP

to the

NEW ZEALAND PLANNING COUNCIL

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Report No. 5
of the
Economic Monitoring Group
to the
New Zealand Planning Council

Wellington, New Zealand
May 1982

MEMBERS OF THE
ECONOMIC MONITORING GROUP

G.J. Schmitt (Chairman)
Professor G.R. Hawke
Sir Alan Low
Professor B.J. Ross

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17 May 1982

Sir Frank Holmes
Chairman
New Zealand Planning Council
P.O. Box 5066
Wellington

Dear Sir Frank,

I present herewith the fifth report of the Economic Monitoring Group, for transmission to the Council.

The report provides the usual review of recent developments and short-term prospects.

On this occasion the Group has paid special attention to employment. The report deals with the interrelationships of the major economic problems facing New Zealand and stresses the need for a broad co-ordinated approach on many fronts to achieve improvement on any field, such as, for example increased employment.

The report presents some policy options which emerged from the Group's analysis of the present position and medium term prospects.

The Group records its thanks to Messrs Brian Easton and Richard Braae of the New Zealand Institute of Economic Research and to Messrs Graeme Thompson and Murray Weatherston of the New Zealand Planning Council Secretariat, for assistance in preparation of this report.

Yours sincerely,

G.J. Schmitt
Chairman

Chapter 1

RECENT DEVELOPMENTS AND OUTLOOK

In respect of the usually-listed objectives of economic policy - growth, price stability, full employment, and external balance - New Zealand's performance in recent years can hardly be called satisfactory. On each count our actual position, and the prospects for the near future, fall well short of the targets we would wish to set ourselves. Inflation, in spite of spasmodic periods of improvement, is still around 15 to 16 per cent; unemployment, in respect of which we were highly self-commendatory in the 1950s and 1960s, has been rising to an historically high level however one chooses to calculate the number of people "out of work"; our propensity to over-spend continues, as shown by our inability to live within our overseas income; and our Gross Domestic Product was barely higher in real terms in 1980/81 than it was five years before.

These are not four distinctly separate aspects of the economy, which can be tackled one by one. They are very much interrelated so that piece-meal remedies put forward to relieve one problem area often have adverse effects elsewhere, and overall no significant progress is made.

We are now well into the 1980s. For some time the Government's economic strategy has been directed towards putting the New Zealand economy into such a position that, by the mid-1980s, it is able to benefit from our energy resources and from potential markets for our products in countries of the Pacific Basin. What was the medium term at the beginning of the decade is fast becoming the near future, and it is important that measures taken now contribute to the achievement of the overall strategy.

Growth

The New Zealand Institute of Economic Research estimates that the growth of real GDP in 1981/82 will have been 4 per cent. Such a result contrasts favourably, both with the absence of significant growth from 1975/76 to 1980/81 and with present growth rates achieved by New Zealand's trading partners. It is not startling, however, relative to rates achieved in the 1960s and early 1970s, nor does it alter the perception that New Zealand's growth record is poor by international standards.

Most sectors have contributed to the increase in production in 1981/82, with the exception of the farm sector for which the Institute believes gross output has fallen by 1 per cent. In manufacturing, building and construction, and the trade sector, a substantial growth in real gross output is evident.

This production growth is reflected by real increases in private consumption, private investment and exports. Investment was led by the construction industry, as is usual in an economy coming out of recession, but the Institute believes it is likely to be sustained across the various sectors of the economy. Much of the evidence, however, is of investment intentions rather than decisions. Any buoyancy of investment could be considered fragile and easily upset by adverse trends in inflation or by Government measures to restrain spending. The growth of consumption in 1981/82 was fed by growth in private disposable income and in personal borrowing; these in turn depended on an expansionary policy stance, notably the February 1981 measures which reduced the effect of fiscal drag on personal taxation and the increasingly accommodating monetary policy implemented during the year. It seems unlikely that a similar policy stance will be maintained during 1982/83. The outlook overseas, especially for OECD countries, is not encouraging, so that the immediate prospects are for a slower growth of exports than that experienced in 1981/82.

There are, therefore, difficulties in the short-term management of the economy if the potential of the mid-1980s is to be realised.

Inflation

During 1981, the rate of increase of the consumers price index was less than in 1980. It fell, however, only to about 15

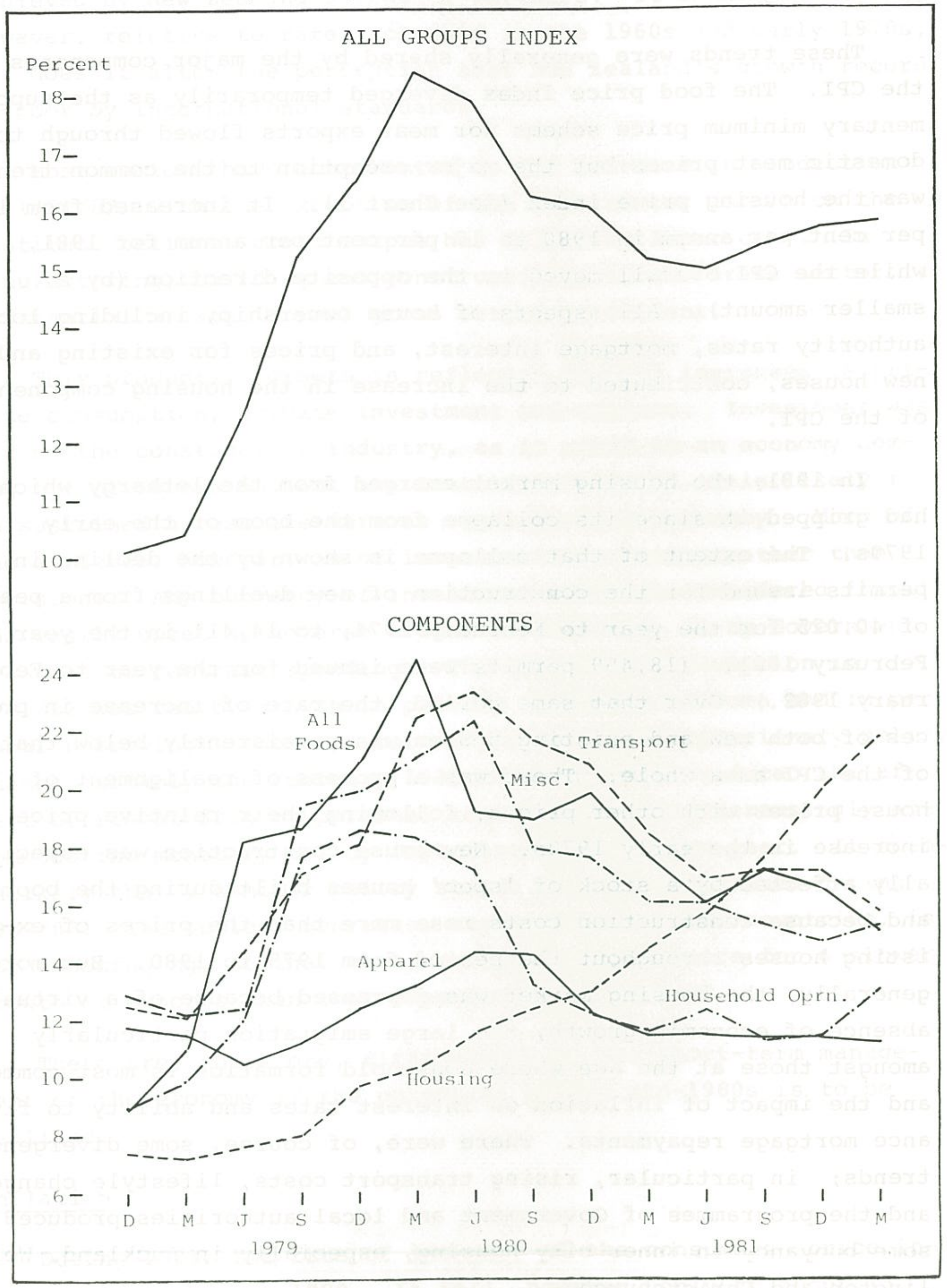
per cent per annum in the middle of 1981 and thereafter tended to increase again.

These trends were generally shared by the major components of the CPI. The food price index diverged temporarily as the supplementary minimum price scheme for meat exports flowed through to domestic meat prices but the major exception to the common trend was the housing price index (see Chart 1). It increased from 12 per cent per annum in 1980 to 17 per cent per annum for 1981, while the CPI overall moved in the opposite direction (by a smaller amount). All aspects of house ownership, including local authority rates, mortgage interest, and prices for existing and new houses, contributed to the increase in the housing component of the CPI.

In 1981, the housing market emerged from the lethargy which had gripped it since its collapse from the boom of the early 1970s. The extent of that collapse is shown by the decline in permits issued for the construction of new dwellings from a peak of 40,025 for the year to February 1974, to 14,411 in the year to February 1981. (18,459 permits were issued for the year to February 1982.) Over that same period, the rate of increase in prices of both new and existing houses was persistently below that of the CPI as a whole. There was a process of realignment of house prices with other prices, following their relative price increase in the early 1970s. New house construction was especially affected by a stock of 'spec' houses built during the boom, and because construction costs rose more than the prices of existing houses throughout the period from 1975 to 1980. But more generally, the housing market was depressed because of a virtual absence of economic growth, the large emigration particularly amongst those at the age where household formation is most common, and the impact of inflation on interest rates and ability to finance mortgage repayments. There were, of course, some divergent trends; in particular, rising transport costs, lifestyle changes, and the programmes of Government and local authorities produced some buoyancy in inner city housing, especially in Auckland, Wellington and Christchurch.

Chart 1 COMPONENTS OF THE CPI

(Annual percentage changes at quarterly intervals)



Source: Department of Statistics, 'MONTHLY ABSTRACT OF STATISTICS' Table 21.02 .

A change was evident in 1981. One identifiable factor was the substantial decline in emigration. Furthermore, there were factors making finance for housing easier to obtain. Both the income limit and the size of the maximum loan of the Housing Corporation were raised, and the 1981 Budget introduced a tax rebate for mortgage interest for first home owners. This measure partly compensated for the increasing interest rates faced by home purchasers. Housing demand also benefited from the general increase in liquidity; trading bank personal lending, for example, grew by approximately 50 per cent in 1981. The housing market became more active over a wide front, although there were still divergences by locality and quality. The prices of existing houses grew more rapidly than those of new houses, compensating in part for the gap which had developed, from 1975 to 1980, between construction costs and existing house prices. Though demographic features will have some effect on housing demand, it appears that monetary policy will continue to be more influential in any future developments of housing prices.

The general pattern of price movements - that is, a deceleration to mid-1981 and a tendency to rise thereafter - is consistent with the analysis of the inflationary process in New Zealand which the Monitoring Group expounded in its last report. Also consistent was the impact of world price movements. The rise in prices of our imports moderated from 18½ per cent per annum in 1980/81 to an estimated 8½ per cent per annum in 1981/82 and is expected to continue at this rate in 1982/83. However, the impact of a continuing decline in the New Zealand dollar of 6 per cent per annum has cancelled the beneficial effect of a lower rate of world inflation on the domestic economy.

The current practice of exchange rate adjustments, which raises the value of export receipts in terms of New Zealand dollars to the extent that local costs rise more than costs in the economies of New Zealand's trading partners, aims to help maintain the profitability of exporting. For farmers, however, for whom (with the exception of dairy farmers) market prices are below the level of the supplementary minimum prices, the exchange rate adjustment is not affecting profitability. For exporters generally, there are at present two elements of the price differential between export and import prices: a lesser increase in our export prices than of prices generally in the world economy, because of depressed markets for agricultural products, and a movement of domestic prices greater than that of world prices, as reflected by imports. The present system of managing the exchange rate compensates for the latter, rather than the former, element of price differential.

During 1981, wages and salaries were increased by a 5 per cent general wage order in June, and a subsequent wage round which averaged about 10 per cent. There was also some wage drift (movement up salary scales or reclassification from one award provision to a higher one), and the increase in average wage and salary rates in 1981/82 is estimated at 18½ per cent. Together with the cuts in personal taxation instituted in February 1981, this led to a considerable rise in real personal disposable income for the 1981/82 year over the 1980/81 year.

There are indications, discussed later in this report, that wage bargaining is being increasingly influenced by the difference between gross and post-tax wages and salaries. This increases the urgency to be attached to decisions on the appropriate incidence of taxes.

Taxation must, however, also be considered in the context of the Government's budget as a whole, in the process of inflation. The latest published estimate of the Institute is that the budget deficit before borrowing for 1982 was $2050 million, approximately 7 per cent of GDP. But recent indications are that a figure around $1900 million is more likely. The expansionary element of Government policy of 1981/82 differed from that of other years, since the thrust came not from consumption, social service transfer expenditures or tax reductions, but instead was concentrated within the Government's capital works programme, principally the special projects associated with energy and liquid fuel developments. The inflationary potential, however, of a large budget deficit remains.

Table 1 CENTRAL GOVERNMENT BUDGET DEFICITS

March Year	Budget Table 2 Deficit[1] ($ million)	Budget Table 2 as Proportion of GDP (%)	Internal Budget Deficit Before Borrowing[2] ($ million)	Real Internal Budget Deficit Before Borrowing[3] ($ million in 1980/81 Prices)	Budget Contribution[4] to the Monetary Base ($ million)	Budget Contribution to the Monetary[3] Base ($ million in 1980/81 Prices)
1970	76	1.5	-28	-96	-57	-194
1971	81	1.4	-25	-81	-58	-187
1972	72	1.1	-48	-141	-80	-236
1973	206	2.6	77	205	-22	-60
1974	242	2.6	-9	-22	-84	-203
1975	390	3.9	201	470	196	458
1976	1,002	8.7	657	1,364	622	1,285
1977	506	3.7	130	223	23	39
1978	694	4.6	249	380	31	47
1979	1,446	8.3	886	1,202	415	563
1980	1,027	4.9	421	483	-53	-61
1981	1,525	6.6	943	943	465	465
1982(est.)	1,900	6.7	1,050	920	300	262

1 Budget Table 2 Deficit before borrowing.
Source: Minister of Finance, Financial Statements (Budgets).

2 The Internal Budget Deficit excludes Government overseas transactions from the Budget Table 2 deficit. This adjusted deficit is therefore a measure of the deficit arising from Government transactions in New Zealand only and is a more appropriate basis from which to assess the impact of a budget deficit on the economy. The Internal Budget Deficit is regularly published in the 'Monetary Conditions' section of Quarterly Predictions, NZ Institute of Economic Research, Wellington.

3 The Internal Budget Deficit Before Borrowing and the Budget Contribution to the Monetary Base are deflated by the implicit gross domestic product price index, derived from the Department of Statistics indices of nominal and real GDP.

4 These figures do not include the Reserve Bank's transactions with the private sector such as the Reserve Bank's role with producer boards, with SMP transactions nor with compensatory deposits. In addition, it does not include private sector foreign exchange transactions.

Even though overseas transactions of Government, such as debt servicing grew during the year, the internal deficit remained high. For much of the year Government policy was concerned with interest rates rather than the growth of monetary aggregates, although Government borrowing became more aggressive in the last quarter of 1981/82, especially in the promotion of inflation-proof bonds.

The monetary impact of Government transactions has been greater than suggested by the budget deficit as advances made by the Reserve Bank under the supplementary minimum price scheme amounting to around $200 million are not included in the budget account for 1981/82.

The Monitoring Group believes the overall effect of the fiscal and monetary policy of 1981/82 was to engender expectations that inflation will continue unabated. Increased prices are frequently described as merely "adjusting" to inflation and plans are made on the basis that no deceleration of inflation can be expected. Indeed there are many people who rely on inflation to reduce the burden of their debt. The cost of not removing the gap which has now persisted for some years between the rate of inflation in New Zealand and in our main trading partners was thus hidden from public view.

It is already obvious that the Government plans in 1982/83 to reduce the extent to which its contribution to the monetary base accommodates inflation. Its review of Government expenditure has already attracted considerable publicity. However, there are some cautions to be borne in mind. Firstly, the internal budget deficit was reduced in 1976/77 and 1979/80 but the reductions were not to the zero level which characterised the 1960s, but were to successively higher levels. It is obviously difficult to keep control of fiscal injections. Secondly, firm control of monetary aggregates is not, in general, consistent with holding interest rates down. Thirdly, different ways of reducing the budget deficit will not contribute in the same way to lowering the inflation rate. In particular, increases in various Government charges, such as occurred in early 1982, seem to feed inflationary pressures by being incorporated into wage-bargains, as happened in 1976 and 1979. As with the more general topic of tax incidence, the implementation of higher charges requires careful scrutiny, in that their inflationary impact should be considered along with the benefits that flow from reducing the deficit before borrowing.

Improvement in the control of inflation has been marginal and temporary. There has not been the reduction of inflation rates in

New Zealand to overseas levels that the Monitoring Group pressed for in its last report, and it is now no easier to achieve this than it was a year ago.

Balance of Payments

Some improvement in the balance of payments has been achieved in recent years, but only by a reduction in growth and an increase in unemployment. The deficit on current account as a ratio of GDP was reduced from 13.4 per cent in 1974/75 to 1.8 per cent in 1978/79, and despite the second oil shock of 1979 it was only 3.6 per cent in 1979/80 and 2.8 per cent in 1980/81. However, the NZ Institute of Economic Research expects it to have risen to 4.9 per cent in 1981/82 and on current trends expects a further rise to 5.2 per cent in 1982/83.

EXPORTS:

A major influence on export receipts is the level of growth in our trading partners. Recent trends have been unfavourable; OECD countries as a whole are now thought to be experiencing nil growth and significant recovery is not expected until late 1982. The recession in the USA is proving to be deeper and more prolonged than had been forecast, and uncertainty in the Middle East has caused marketing problems. The most favourable aspect is that the economies of Japan, Australia and the newly industrialising countries of Asia, to whom approximately 45 per cent of our exports are sold, are expected to perform relatively well.

The prices of traditional exports have already been affected. Wool prices in particular have demonstrated none of the rise that was expected at the start of the 1981/82 season, and the average for the season is now expected to be little above that of 1980/81. Markets for sheepmeat and beef are also depressed; only dairy prices remain buoyant.

Low product prices and rising internal costs have in the past led to reduced output of traditional export commodities. At present, producers are cushioned by the supplementary minimum price scheme, and payments under this scheme are now estimated to be $350 million for the 1981/82 season. There are reasons for doubting whether the scheme will sustain the volume of output indefinitely. The size of payouts and appreciation of the problem they pose for fiscal policy is already raising doubts over whether they will be maintained at current levels relative to farm costs, or indeed whether they will be raised at all above current nominal levels. Furthermore, farmers feel uncomfortable in relying on explicit subsidies, and it is doubtful whether the confidence needed to maintain output volumes can be maintained by any subsidy scheme. Maintenance of traditional export volumes requires control of our own inflation rate and the earning of adequate incomes from the market.

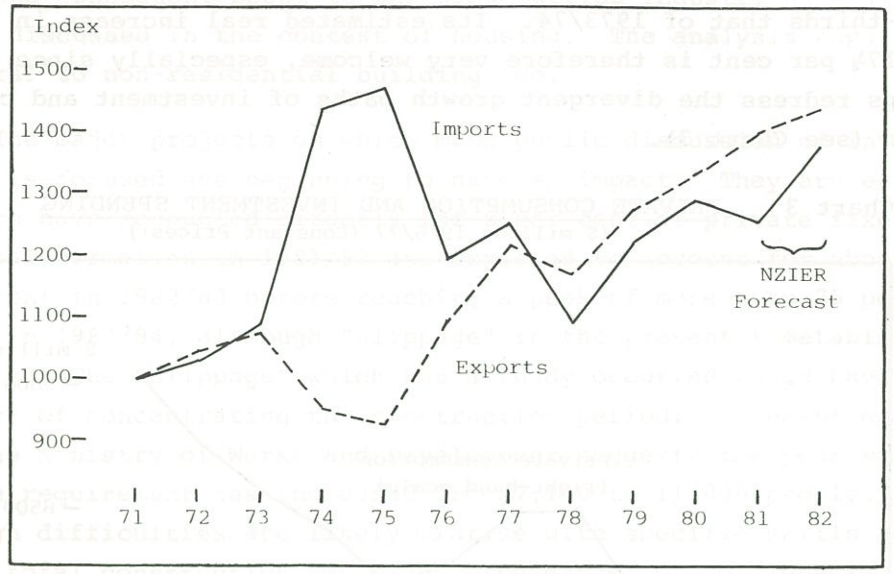
Non-traditional exports, including fishing, forestry and horticulture, now make up over 40 per cent of exported goods receipts. The outlook for receipts from exports of manufactured goods and forestry products is uncertain, because they are affected by trends in the world economy. In particular forestry products are affected by the US economy. For other export receipts stronger growth in Australia and Asian markets may cushion the impact of a weak world economy. For export volumes generally, there appears, for the year to June 1982, to be a slowing down in the growth rate which has prevailed over recent years (see Chart 2).

IMPORTS:

The total of import payments has been volatile in recent years. In 1979/80 a strong demand for imports following the domestic expansion of the preceding year coincided with an oil price rise, and there was a pronounced surge in import payments. Growth in domestic production was curtailed and it took time for stocks of imports to be worked off. Import volumes fell by 9 per cent in 1980/81, although price changes, including the effect of devaluation of the New Zealand dollar, converted this into a 14½ per cent increase in import payments. Another rapid turnaround seems to have occurred in 1981/82, with import volumes estimated to have grown by 10 per cent and import payments by 25 per cent. Even if the import content of the major projects of the growth strategy and some extraordinary

Chart 2 VOLUME OF IMPORTS AND EXPORTS

(Index for June Years
Base Year Ended June 1971 = (1000))



Source: Department of Statistics, 'MONTHLY ABSTRACT OF STATISTICS' Table 11.09 .

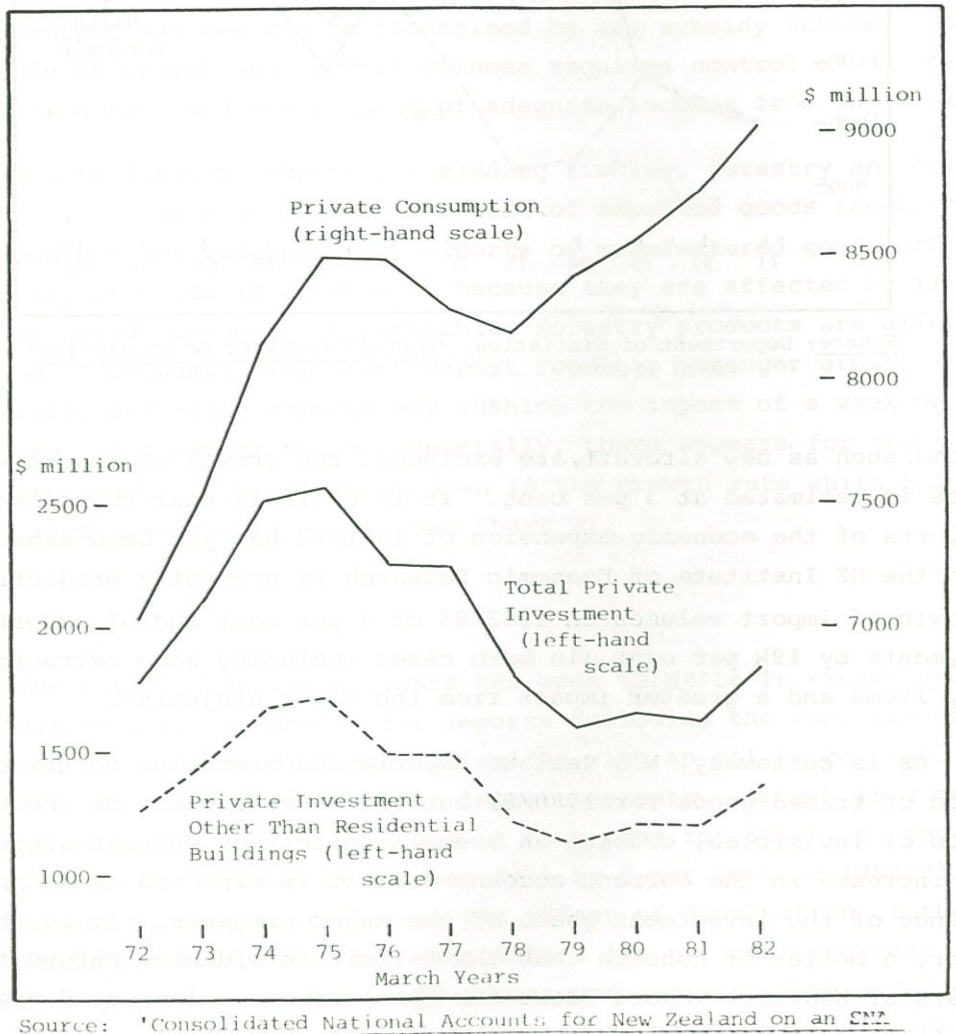
items, such as new aircraft, are excluded, the growth of import volumes is estimated at 3 per cent. It is unlikely that the effect on imports of the economic expansion of 1981/82 has yet been exhausted and the NZ Institute of Economic Research is presently predicting a growth of import volumes in 1982/83 of 4 per cent and of import payments by 19½ per cent (in both cases including some extraordinary items and a greater impact from the major projects).

As is customary, New Zealand experienced a surplus on the balance of traded goods for 1980/81 but a greater deficit on the balance of invisibles, causing an overall deficit on current account. An increase in the current account deficit is expected as a consequence of the investment phase of the major projects. It is, however, a matter of concern that the deficit is widening before the years of heaviest import flows for the projects. Increased overseas borrowing now, means a larger subsequent outflow in interest payments, thus lessening the increase in real income which will result from the major projects, and which is the purpose of the growth strategy.

Investment

The level of real private investment in 1980/81 was less than two-thirds that of 1973/74. Its estimated real increase in 1981/82 of 17½ per cent is therefore very welcome, especially since this helps redress the divergent growth paths of investment and consumption (see Chart 3).

Chart 3 PRIVATE CONSUMPTION AND INVESTMENT SPENDING
($ million 1976/77 (Constant Prices))



Source: 'Consolidated National Accounts for New Zealand on an SNA Basis', D.Grindell (ed.) Reserve Bank of New Zealand, Research Paper No.32, May 1981; and New Zealand Institute of Economic Research.

The revival of the property market, the closing of the gap between prices of existing buildings and the cost of new construction, and the consequent boost to the construction industry have already been discussed in the context of housing. The analysis applies in general to non-residential building too.

The major projects on which much public discussion of investment is focused are beginning to have an impact. They are estimated to have accounted directly for 8 per cent of private fixed capital formation in 1981/82 and expected to account for about 16 per cent in 1982/83 before reaching a peak of more than 25 per cent in 1983/84, although "slippage" in the present timetable is likely. The "slippage" which has already occurred could have the effect of concentrating the construction period: a recent estimate by the Ministry of Works and Development suggests the peak workforce requirement has increased from 7,100 to 11,000 people. Although difficulties are likely to arise with specific skills rather than total construction employees, the danger of bottlenecks has obviously intensified. The danger is not only of physical constraints, but also of escalation of labour costs on the projects themselves and for comparable skills elsewhere in the economy, leading through relativity considerations to labour costs generally. Higher wages are not, of course, undesirable in themselves but higher wage rates not supported by increased production feed the inflationary process.

The increase in investment estimated for 1981/82 and forecast for 1982/83 extends beyond buildings and the major projects and is thought to occur across a broad front of the economy. The anticipated rate of increase is however less than that of buildings or of the major projects. It could be reversed by any decline in the attractiveness of investment, through the effects of increased inflation as discussed in the last report of the Monitoring Group, through restraint on domestic output or, in the case of export industries, through any uncompensated unfavourable changes in the exchange rate regime and export incentives.

Conclusion

The inter-related problems of inadequate economic growth, inflation, insufficient investment, and the balance of payments constraint continue to dominate the short run problems in the path of the Government's medium term economic strategy. There have been minor changes in the year since the Monitoring Group last reported. There has indeed been a modest recovery of economic growth and a slight decline in the level of inflation, but whether they can be more than temporary is doubtful. There has been some revival of investment but it has still to be nurtured. The balance of payments constraint has become more pressing. The immediate outlook does not engender optimism.

Furthermore, there has been no progress with the issue of unemployment. In this report, the Monitoring Group has chosen to give an extended treatment of that subject as it did with inflation last year.

Further Reading

Commentary and forecasts of New Zealand's economic performance are found in:

NZ Institute of Economic Research, Quarterly Predictions;

The Reserve Bank of New Zealand, Bulletin;

OECD Economic Surveys, New Zealand.

Chapter 2
EMPLOYMENT TRENDS

Since the Monitoring Group last reported, some preliminary results of the 1981 census have become available. They are derived from a 10 per cent sample of the census returns and so caution is needed, when comparisons are made with the full results of earlier censuses, but sampling error is unlikely to be serious. They do not include all the information that will eventually be available from the census, especially on sub-divisions of the population. But they do add enormously to our knowledge of employment trends and the Department of Statistics is to be congratulated on making them available less than eight months after the census.

Broad Trends

The broad trends which existed between 1976 and 1981 are shown in Table 2.1. The number of people in employment rose by about 3 per cent, a 10 per cent rise in the number of women in employment outweighing a slight absolute fall in the number of men employed. However, the number of people in the labour force, both men and women, rose much faster than the number of people employed so that unemployment became very much larger.

Table 2.1 MAIN LABOUR FORCE AGGREGATES: 1976/1981

		1976	1981	Percentage Change
Number employed	Males	841,728	839,700	- 0.2
	Females	391,844	430,650	9.9
	Total	1,233,572	1,270,350	3.0
Census unemployed	Males	13,991	35,800	155.9
	Females	11,539	25,060	117.2
	Total	25,530	60,860	138.4
Labour force	Males	855,719	875,500	2.3
	Females	403,383	455,710	13.0
	Total	1,259,102	1,331,210	5.7

Source: Population census (usual residents only).

Unemployment increased, even though the 5.7 per cent increase in the labour force between 1976 and 1981 was the lowest inter-censal increase at least since the Second World War. Its smallness was due almost wholly to emigration. Changes in the age structure of the population had much less effect. Fewer people reached school-leaving age and there was little change in the number of people reaching normal retirement age, but people who were aged over 15 and who were either employed or seeking work remained much the same fraction of the total population.

The concept of labour force used here excludes people working for less than 20 hours per week. Such part-time workers numbered 114,520 in 1981, more, relative to the labour force, than in 1976. But whereas the number of part-time workers grew by about a third between 1976 and 1981, it had grown by about one half between 1971 and 1976, and by about three-quarters between 1966 and 1971. It was not an increased rate of growth of part-time jobs that explains the smallness of the increase in the labour force between 1976 and 1981.

Participation Rates

The overall participation rate, the proportion of the population over 15 who were employed or declared themselves to be unemployed and seeking work, was virtually identical in 1981 and 1976. But there were changes in the participation rates of subdivisions of the population. In particular, the participation rate of males declined while that of females increased.

The decline of the male participation rate was only from 80 per cent to 77½ per cent, and it was almost wholly concentrated in men over 60. The participation rates of men in other age groups changed little. Maori rates were generally lower than those of non-Maoris, but the difference changed little between the two censuses except in the 15-19 age group where the participation rate for Maoris increased while that for non-Maoris was constant. It is with respect to older men that we have to explain the main trend in the male participation rate. This immediately suggests that the introduction of National Superannuation might be involved, but the participation rate of 60-64 year old men merely continued the trend that occurred between 1971 and 1976. (Before 1971 60-64 year olds cannot be segregated from those aged 45-60 but there is little to suggest that the trend was established before the 1970s.) If retirement provision is responsible, it seems likely that it is wider than the specific National Superannuation scheme, but it is even more likely that the trend is due to a decline in the demand for older workers when a slack labour market overall gave employers the option of employing younger men.

The labour force always contained only a small proportion of women aged over 60 and the increase in the female participation rate from 36½ per cent in 1976 to 39 per cent in 1981 was spread among those aged from 20 to 60. Although Maori participation rates generally remained lower than non-Maori ones, both Maori and non-Maori women shared the increase between 1976 and 1981. Nevertheless, the female participation rate in New Zealand remains lower than those prevailing in most West European and North American countries by the mid-to-late 1970s. Indeed, the increase in the participation rates of women of most age-ranges was less than that which would have followed from continuation of the trend between 1971 and 1976; those trends would have produced about 9,000 more women in employment or unemployed and seeking work.

The participation rate of women aged between 15 and 19 declined less than in the preceding ten years; that for Maori women actually increased. Together with the trends in young male participation, these observations make it clear that the difficult labour market conditions of the late 1970s did not hav[e] the effect of forcing young people back into schools or institutions of tertiary education. Full-time students are neither employed nor unemployed and seeking work in the sense used by the census, and any large scale movement towards 'reluctant pupils' would have had the effect of reducing the participation rates of the 15-19 year olds. That did not occur. The Maori/ non-Maori distinction supports (but does not establish) arguments of those who claim to observe a trend for academically-able young Maoris to accept a job for fear of not being able to obtain one later, while the less-academically-able young become unemployed.

Unemployment

Table 2.1 shows that the provisional 1981 census total of unemployment was nearly 61,000 compared with a 1976 total of 25,500 and that unemployment of males increased more than that of females.

Even a census cannot measure unemployment with the precision with which one measures physical attributes such as length or weight. The census depends on self-declaration and there may be reluctance to admit to unemployment despite assurances of the confidentiality of the census. The design of a census form is complex and the categories among which respondents are asked to choose are not mutually exclusive in all conceivable circumstances; somebody may be both engaged in household duties and also unemployed and seeking work but must choose to mark only one of the relevant boxes. (Fortunately, the biggest overlap is between 'retired' and 'household duties', neither of which constitutes part of the labour force.) Furthermore, the census concept of unemployment includes the criterion of actively seeking work, while for some purposes, we might be equally interested in those who would seek a job if they thought that there was any chance of success. It is obviously difficult to infer how many such 'discouraged workers' there were in 1981; it is difficult enough in countries which use regular labour force surveys but at least debate in those circumstances centres on the best way of elucidating the measurement rather than on the existence of such potential workers. The provisional census results do contain some strong suggestions of discouraged workers in New Zealand. We have already noted that the trends in female

participation rates indicate that some women may have withdrawn from the search for work; the differences between Maori and non-Maori participation rates have the same implication; the number of married women who declare themselves to be unemployed and seeking work is very much lower than of women of other marital status and although some people still regard home-making as a full-time occupation and many more so regard child-rearing, there are thus grounds for believing that more married women would look for a job if they thought the search worthwhile. It is a mistake to see the census figures of unemployment (even when the full census replaces the 10 per cent sample) as providing a single and conclusive measurement of employment or of unemployment, but they do reduce the extent of our ignorance.

Table 2.2. shows the provisional results of the 1981 census on the incidence of unemployment among different age groups, distinguishing Maori and non-Maori rates. It also shows unemployed rates for married women (who are also included in the total female rates). The table indicates that the incidence of unemployment is highest among young people, that female rates are higher than male rates for most age groups, that unemployment rates are higher among Maori people than non-Maoris of the same sex and age group, and that married women have relatively low unemployment rates.

Table 2.2 PROVISIONAL CENSUS UNEMPLOYMENT RATES: March 1981

	MALES		FEMALES		
Age-Group	Non-Maori	N.Z. Maori	Non-Maori	N.Z. Maori	Married Women
15-19	9.4	30.0	12.8	43.4	4.3
20-24	5.4	15.4	5.6	20.1	2.5
25-29	3.3	10.8	4.1	8.4	1.7
30-39	2.1	7.4	2.3	5.5	1.2
40 and over	1.9	6.1	1.7	3.0	0.9
TOTAL	3.3	13.1	4.5	17.5	1.3

Source: Poot and Brosnan in N.Z. Population Review Vol 8, (April, 1982).

These features were familiar to skilled observers even before the census results became available; they became easier to discern as unemployment numbers grew. But some people were misled into thinking that the differentials were themselves becoming more marked. In general, that is not so; between 1976 and 1981, unemployment became more severe in all the subdivisions of the population distinguished here but in much the same proportion. This is shown dramatically in Table 2.3, and while the ratios do vary when the sexes are treated separately and when Maori and non-Maori are distinguished, the variation remains small relative to the overall expansion of the number of unemployed.

Table 2.3 UNEMPLOYMENT BY AGE, 1976/81

Age Group (Years)	Unemployed 1981 census	Unemployed as a percentage of the labour force 1976	Unemployed as a percentage of the labour force 1981	Ratio of 1981 to 1976
15-19	23,020	6.3	14.2	2.3
20-24	13,740	3.0	6.5	2.2
25-34	11,340	1.5	3.4	2.3
35-44	5,510	0.9	2.1	2.3
45-	7,240	0.8	2.0	2.5

Source: Population Census 1976 and 1981.

It is true that the overall unemployment rate in 1981, 4.6 per cent, was lower than in many overseas societies. The comparable average for the seven major OECD countries was 6.1 per cent, and that for Australia, 5.5 per cent. But in the New Zealand figure in 1976 was 2.1 per cent, while those of the preceding four censuses were all under 1.5 per cent. Moreover, as the figures on Maori unemployment indicate, there are some groups within the population in which unemployment is exceptionally high.

Census and Registered Unemployment

Between censuses, the only regular source of information about unemployment is the total of those registered with the Labour Department. The results of the 1981 census show that the registration data can be very misleading.

The total of registered unemployed grew very much faster than the census measures between 1976 and 1981. This is shown in Table 2.4, but it is perhaps even clearer simply to reflect that, whereas the ratio of registered to census unemployment in 1976 was a little under one-fifth, that of 1981 was nearly four-fifths.

Table 2.4 UNEMPLOYMENT TRENDS, 1976/81

	March 1976	March 1981	Ratio of 1981 to 1976
Unemployed beneficiaries	5,127	35,666	7.0
Registered unemployed	5,021	47,464	9.5
Census unemployed	25,530	60,860	2.4

Source: Easton, B.H. "Unemployment 1976/1981".

It is not surprising that in a period of increasing unemployment, a larger fraction of the total should be covered by the registration statistics. The Department of Labour's employment service is directed towards helping unemployed people find jobs and it sought and received more media attention as unemployment rose. The difference between registering with the service and claiming an unemployment benefit became more widely understood and, as is shown in Table 2.4, more people not eligible for a benefit nevertheless registered with the Department. The employment service took several steps to improve its job-finding performance including an increase in the number of employment centres, while worsening unemployment made other means of searching for a job less likely to be successful. Eligibility for job creation schemes was usually dependent on registration.
It is possible that the registration figures may be wrongly inflated; not all those who do find a job quickly remove their names from the register. In March, 1981, the number of males aged between 25 and 29 who were registered as unemployed slightly exceeded the number who declared themselves in the census to be unemployed and

seeking work. But the margin was small, much lower than the difference found in registration and survey figures in Australia, and the census reveals no group of 'dole-bludgers'.

It is obvious that any belief that the registration data gave a direct measurement of the growth of unemployment between 1976 and 1981 was mistaken. This was apparent to many commentators, but it was the census which revealed the extent of divergence. Furthermore, there are some suggestions that within the period 1976/81 the registration data gave wrong indications of the direction in which unemployment was moving. If we assume that the changes in participation rates of age and sex categories between 1976 and 1981 occurred evenly over the period, then we can construct the time series equivalent to census unemployment figures as in Table 2.5. Whereas the number registered as unemployed, also shown in the table, grew continuously from March, 1977, the synthetic census series shows declines in 1976/79 and 1979/80 as well as in 1976/77. The participation rates may not have changed evenly, but the synthetic trends are plausible in the light of movements in the total output of goods and services. (The same results follow from the simpler but less plausible assumption that the ratio of registered to 'census' unemployment changed evenly between the 1976 and 1981 censuses). We would be in a much better position to evaluate trends in unemployment and productivity if a labour force survey were used to fill in the gaps between the quinquennial censuses.

Table 2.5 REGISTERED UNEMPLOYMENT AS A PROPORTION OF "CENSUS REPORTED" UNEMPLOYMENT

March	Unemployment Registered	Unemployment "Census Reported"	%
1976	5,021	25,530	19.7
1977	4,106	24,161	17.0
1978	19,844	45,313	28.6
1979	23,734	42,932	55.3
1980	28,998	42,842	67.7
1981	47,464	60,860	78.0

Source: NZIER, prepared by R. Braae (preliminary)
"Census reported" means the unemployment that would exist if labour force participation rates in the intercensal years correspond to the interpolated rates between the two censuses.

Changing Work Patterns

Forty to forty-four hours remains the most common length of working week with 46 per cent of the employed so reporting in the 1981 census. But 33 per cent reported longer hours, 11 per cent between 35 and 39 hours and 10 per cent between 20 and 34 hours. According to Labour Department statistics, average weekly hours for the fully employed fell from 39.7 including 2.5 hours overtime in April, 1976 to 38.5 including 2.0 overtime in February, 1981.

We have already noted the relative expansion of part-time labour between 1976 and 1981. In the latter year, those working less than 20 hours per week were equal in number to 8½ per cent of the labour force, although the difference in hours worked means that they probably contributed about 2 per cent of labour input. Male part-time employees totalled 20,060, 46 per cent of them being teenagers and 27 per cent being over 60 years of age. Female part-time employees numbered 94,460, 76 per cent of them being married women.

The census does not give us much indication of whether these work patterns accorded with individual wishes. We might be prepared to conjecture that some part-time workers would have preferred a full-time job, but we do not know how many. Equally, most people are aware of some individuals who prefer to retain a full-time job rather than be unemployed, but who would happily shift to part-time hours and a lower income if that could be arranged. We do not know whether they constitute a sizeable group. Trends in Australia and discussion among our own unions make it apparent that there will be considerable discussion of working hours in the near future. It would be desirable to reduce our ignorance and again a labour force survey is the appropriate mechanism.

The Sectoral Distribution of Employment

The preliminary census results do not permit ready comparison of industry employment levels with those of 1976. Consequently, we still have to use the estimates of the Department of Labour although they will eventually be revised in the light of the census results. Still, the broad trends in relative employment levels are unlikely to be much different from those shown in Table 2.6.

Table 2.6 EMPLOYMENT ESTIMATES BY INDUSTRY (000)

Industrial group	March 1976	February 1981	Change 000	Change %
Agriculture, hunting and fishing	122.2	132.5	10.3	8.4
Forestry and logging	7.8	9.4	1.6	20.5
Mining and quarrying	5.1	4.8	-.3	-5.9
Manufacturing	307.7	303.8	-3.6	-1.3
Electricity, gas, water	15.6	16.9	1.3	8.3
Construction	112.7	87.3	-25.4	-22.5
Wholesale, retail	217.3	230.3	13.0	6.0
Transport and communications	112.4	109.9	-2.5	-2.3
Finance, insurance etc	80.4	99.7	19.3	24.0
Community and personal services	264.8	290.4	25.6	9.7
Estimated total workforce	1,246.0	1,276.0	30.0	2.4

Source: Labour and Employment Gazette, 1981.

The decline in the number employed in construction was undoubtedly the result of the stagnation in the sector referred to in Chapter 1. The overall decline in employment in the manufacturing sector was very much smaller although this was partly because of divergent trends within the sector. The biggest reductions were in textiles, clothing and leather (from 48,700 to 42,900) and machinery and transport equipment 62,700 to 58,300). The biggest increases were in primary products processing (from 69,700 to 73,200) and paper, and paper products, publishing and printing (from 32,000 to 34,500).

The sectors in Table 2.6 which show the biggest absolute increases are agriculture, hunting and fishing and various services. The case of agriculture is especially interesting because the sector's labour force declined through the 1950s and 1960s despite

its growing output. Apparently, the relative expansion of horticulture has had a marked effect on the demand for labour within the sector.

The service sectors, wholesale and retail trade, finance insurance etc., and community and personal services added 58,000 jobs in the five year period. They were obviously welcome given the increase in unemployment over the period, and a relative increase in service employment is a common feature of relatively rich societies such as New Zealand. It is likely to continue in the near future[1]. The overall productivity of the economy will therefore be influenced by the course of the service sectors. It is notoriously difficult to measure the output of service industries, and still more difficult to measure improvements in the quality of their output, so that apparent trends must be treated with caution. A much greater emphasis on research into the productivity of service industries would be justified.

A changing sectoral distribution of employment is likely to be a feature of any economy which is growing, or seeking to reallocate its resources so as to promote growth. 'Restructuring' will be painful to many individuals unless the expansion of some activities is sufficient to outweigh the relative declines of others so that the required reallocation can be achieved by voluntary movements, perhaps with the assistance of active employment policy measures.

1 See for example, Eric Haywood, Bryan Philpott and Peter Rankin, National and Sectoral Development: A Framework for Discussion (Wellington: N.Z. Planning Council, Planning Paper No.14, March 1982), p.72

The Employment Outlook

The assessment of the short term outlook discussed in Chapter 1 gives no ground for expecting any marked improvement in employment levels relative to the available labour force. Nor is the medium term outlook reassuring. There is necessarily more uncertainty as one looks further ahead, but the most recent study indicates that present developments cannot be expected to have a major impact on unemployment levels until the second half of the 1980s, and concludes :

> "However the continuation for five more years of unemployment levels well above those experienced in New Zealand since the Depression must be expected to have serious economic as well as social effects. If these lead to significant changes in the behaviour of the economy, then the model's encouraging indications for the second half of the decade are not likely to eventuate".

The standard reply to such observations is that trends which produce unacceptable results will not be allowed to continue. It is not self-evident, however, how they can be changed without unacceptable implications for other aspects of the economy; the interdependencies involved are the topic of the next Chapter. We can observe that, while the study cited did not have available the results of the 1981 census, its central conclusion about the mid-1980s is essentially unaffected, although it now seems likely that rather more potential unemployment will be absorbed by people withdrawing, with more or less reluctance, from the labour force altogether.

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1 Haywood, Philpott and Rankin, National and Sectoral Development, p.38 The discussion on pp.60-64 is also very relevant.

Further Reading:

Most of this chapter is drawn from the preliminary results of the 1981 census published by the Department of Statistics, although the Monitoring Group has relied heavily on processing and analysis by the New Zealand Institute of Economic Research, only a little of which has been published. See Brian Easton, "Unemployment 1976/1981; A Note" NZIER Quarterly Predictions (Dec. 1981), pp.43-6. The Monitoring Group has also benefited from an article, in New Zealand Population Review, Vol.8, (April 1982) "Unemployment and Labour Force Participation: The 1981 Census" by Jacques Poot and Peter Brosnan and from discussions with its authors.

Chapter 3
EMPLOYMENT ISSUES

Unemployment persists because it is interrelated in a complex way with other aspects of the economy. Measures to stimulate employment cannot be considered in isolation but have to be seen in the context of the overall growth of the economy, the balance of payments, and the level of inflation. The Monitoring Group is well aware of the hardship experienced by individuals who are unemployed, and of the variety of ways in which unemployment is manifested in different regions and among different groups. However, it believes that the principal cause of unemployment is to be found in the interdependence of broad economic trends.

From Full Employment to Unemployment

From the Second World War to the late 1960s, New Zealand had an enviable employment record. Most manufacturing industries produced almost entirely for the domestic market, and were protected, where necessary, by import licensing. Licences were issued much more readily for components and materials than for finished goods, and this had the effect of reserving New Zealand markets for local firms. Entrepreneurs could be confident that any interruptions to a growing market would be shortlived, and so attitudes towards investment were generally buoyant. Registered unemployment was usually negligible, but voluntary movements in and out of the labour force, together with variations in productivity and overtime hours, provided the flexibility needed to accommodate short-term variations in the rate of growth of total output.

The period of full employment was not devoid of problems, and critics and policy-makers identified and tackled many issues. In retrospect, the most important was the New Zealand did not participate in the economic growth that flowed from increased

international trade in manufactured goods. New Zealand's exports remained mostly agricultural, and world trade in such goods grew much less than it did in manufactures, especially from the late 1950s. Attention was often focussed on the question of access to the EEC, particularly when Britain's entry into the Community became probable, but that was only the most pressing and visible aspect of a wider issue.

Towards the end of the 1960s, a number of factors combined to make significant changes in our economic position, including the range of goods we exported. The devaluation of the New Zealand dollar in 1967 took it to parity with the Australian dollar and enabled more firms in manufacturing and service activities to be competitive in some overseas markets. The National Development Conference, which first assembled in 1969, focussed attention on the benefits of exporting manufactured goods. Government incentives, although originating earlier in the 1960s, became more prominent.

In the early 1970s, there were hopes that New Zealand was making a painless transition to participation in world trade in manufactures. Hindsight reveals that much of the apparent ease was due to a coincident world boom in the prices of commodities, including wool. But more firms in the non-agricultural sectors of the economy did develop their exports. Those sectors could no longer be regarded primarily as providers of employment; their productivity and continued international competitiveness became much more important than had previously been the case.

The economic pressures on New Zealand were much intensified in the mid-1970s. A rise in the price of oil shifted world income towards oil producers away from New Zealand, both directly and from the countries which provided the main markets for our exports. The gains which had been made through exports of manufactured goods were counteracted and a large deficit in the balance of payments was incurred. The Government elected in 1975 decided that the deficit should be reduced quickly and it took measures to restrain local demand so that the level of imports could be lowered. Although the strategy of continuing to promote exports of manufactures continued, the restraint on demand resulted in the growth of output being insufficient to provide employment for everybody wanting work. Unemployment grew. We have already seen in Chapter 2 that unemployment probably fluctuated in the course of the later 1970s, but the general contrast with earlier years of full employment became very marked.

The Balance of Payments

In recent years, the balance of payments has received less public attention than other aspects of the economy such as unemployment and inflation. The deficit on the current account relative to GDP or to total exports has been much reduced since the mid-1970s, and it is easy to be lulled into a false belief that the problem then experienced has been solved. But reduction of the balance of payments deficit was achieved, in part, because there was little growth of output. This has reduced the demand for imports but has also caused unemployment and made it much more difficult to restrain the rate of inflation.

There was certainly some progress in stimulating exports. The agricultural sector has seen a diversification of production towards areas like horticulture, which were perceived as having more attractive market opportunities than the traditional pastoral products of meat and wool. Dairying, about which many were ready to despair ten years ago, has adapted to new markets and products, and accepted an imaginative role in ensuring that international markets were not disrupted by subsidised stockpiles accumulated in the U.S.A. Exports of manufactured goods have grown. But despite this progress, it has taken a virtual stagnation in total output to keep the deficit in the current account of the balance of payments within sight of the level which the Planning Council recommends as appropriate for medium-term strategy, a level which will allow the import content of the major projects of the 'growth

strategy' to be accommodated.

Expansion of exports is only one answer to a balance of payments constraint. Another is to change the relationship between domestic output and imports so that a faster growth of the former is consistent with any given level of exports. Some changes of this kind occurred in the 1970s, especially in the subsitution of local products for imported oil, but the overall effect was to restrain the ratio of imports to GDP rather than reduce it.

Import substitution is often associated solely with the protection of local finishing processes by import licensing in the 1950s and 1960s. By the end of the 1960s, this was widely judged to have become inappropriate as promoting excessively uneconomic use of resources and being incompatible with New Zealand's participation in world trade in manufactures. It is wrong, however, to infer from that verdict that all the import substitution which had occurred was unwelcome; it did, after all, include local products like pulp and paper and various building boards. Nor was import substitution always the result of Government policies, whether misguided or not. Long before import licensing was introduced in 1938, local firms recognized and utilized opportunities to substitute domestic output for imports. Whenever the sum of the landed cost of imported components and the cost of local processing was less than the landed cost of a comparable final product, there was an opportunity for profitable loca employment and production. With some small assistance from tariffs, this was the basis for industrial growth in New Zealand before 1938.

Further opportunities for desirable import substitution lie in the field of materials, components, equipment and services purchased by business. It is to growth in this aspect of import substitution, rather than to final consumer goods, that policy designed to influence business choices should now be directed.

The use of consulting services or computer software rather than overseas ones, of local electronic equipment rather than imports, or of ceramic rather than plastic materials are typical of the business decisions likely to be most important. The particular cases where savings of imports are desirable cannot be determined centrally but only by the market, that is, by those individuals responsible for decisions in the course of production. It would not have been easy to decide in advance the particular ways in which the market would respond to the opportunities for exporting manufactures in the 1970s and the advantages of decentralized decision-making should be used wherever possible.

Studies within the Victoria University Project on Economic Planning have strongly suggested that increased import substitution of the kind we have described would be a useful component of economic progress. We are therefore directed to enquiring why it is not already occurring. Perhaps disillusionment with the earlier policy has produced an excessive reaction. Perhaps the entrepreneurial talents which in earlier years would have been directed to import substitution have more recently been fully engaged in increasing manufactured exports. These conjectures may have some force.

However, it is likely that the community, and businessmen in particular, have been diverted by the more visible of Government's programmes. These are consistent with an effort to improve the overall foreign exchange position. But they are seen in a more limited frame. For example, the energy programme is generally seen solely as a response to the oil crisis, and export incentives and supplementary minimum prices as exclusively related to the stimulation of exports, and not as part of a comprehensive plan to cure balance of payments problems. This is understandable, as there is no broad programme of Government measures designed to actively encourage replacement of imported goods and services or economy in their use. Furthermore, these policies have been part of the Government operations which have resulted in an

internal deficit accommodating a high level of inflation. Investment is not favoured by such a situation and much import substitution within New Zealand businesses could be implemented only by new investment. And inflation has encouraged a general feeling that increased import prices can readily be passed on, so that there is no need to search for alternatives to increasingly costly purchases from overseas.

Export promotion does have some advantage over import substitution. It induces our businessmen to compete with a wide range of suppliers in other countries, and helps them to keep abreast of technological development. This has been apparent in the case of our whiteware manufacturers, while our wool scouring industry has obtained and kept world leadership in some processes. The extent to which export promotion serves this function, while import substitution does not, is much reduced if our industries are protected by tariffs rather than import licensing, since import substitution industries then have to remain abreast of potential alternative suppliers of the New Zealand market. In any case, it is not argued here that import substitution is preferable to export promotion, but that import substitution over a wider front than the energy sector is a desirable complement to export promotion.

Export incentives and the SMP scheme have caused difficulties with our trading partners, intensified feelings that the incidence of taxation has become unfair, and posed a difficult choice between increased taxation and an internal budget deficit. It is thus clearly impracticable to extend the present incentives from exports to import substitution. But it is desirable to move towards a system in which import substitution is given treatment much closer to equality with export promotion than is presently the case. The total cost of bringing the balance of payments deficit down to acceptable levels will be greater if policies concentrate solely on exports rather than on a balance of export promotion and import substitution.

Inflation

Since the mid-1970s, inflation in New Zealand has exceeded that in our main trading partners. There were earlier periods in which New Zealand had relatively high inflation, but they were short, and explicable mostly in terms of timing differences between New Zealand and other countries. The years since the middle of the 1970s, however, have seen sustained higher levels of inflation in New Zealand and there is no sign of this position ending.

In its report last year, the Monitoring Group set out at some length its view of the causes of inflation in New Zealand. Inflation was traced to the effect of rising prices overseas, transmitted through both export and import prices, and to the response within New Zealand to those price movements. It was argued that it is very easy to mistake one part of the response to rising prices for the cause of rising prices generally; in particular, the efforts of trade unions to maintain real wage rates was a response to rising prices very much like the raising of product prices to recover increased import costs, and both of those responses become part of the explanation of subsequent price increases. "Inflation" is cited by suppliers, and accepted by consumers, as sufficient reason for any price increase, whether or not justified by cost increases in the particular case.

Many prices seem to be determined not in a market but by individual businesses or by Government. But ability to control even such administered prices is constrained; if increased costs are not recovered, losses will become unsupportable. On the other hand, the process is not entirely automatic either, and an important consideration for individual businesses is their judgement about the extent to which total sales can be maintained despite higher prices. In recent years, the internal deficit of the Government has fed the supply of money so that those business judgements have generally been that increased prices would be accommodated. The internal Government deficit was important in the process of inflation even though many prices appear to be administered rather than determined in a market.

The prices for which Government is itself responsible have to be considered in several aspects. They signal to consumers the value of resources used by Government, and inappropriate prices cause inefficient use of resources. While Government is unlike individual businesses, in that it will not go bankrupt if it fails to recover its costs, losses it incurs will feed the budget deficit unless met from taxation. Government charges can be the equivalent of indirect taxation, and finance activities other than the services provided to those who pay them. Increases in Government charges cannot always be avoided, but in recent years they have themselves given a new impetus to the process of inflation.

The Monitoring Group holds to this analysis of inflation. In one respect, with data for an additional year and further research including extension of that drawn on in the last report, it is possible to strengthen one of the Monitoring Group's observations. Since mid-1979, the exchange rate has been depreciated so as to compensate exporters for a faster rise in their costs within New Zealand than in the costs of their overseas competitors. The Monitoring Group supported the intent of this policy, but warned that it required a coincident attack on domestic inflation; it could otherwise become a vicious circle whereby depreciation of the New Zealand dollar fed the inflationary interaction of prices and costs and necessitated further depreciation to sustain the incomes of exporters. There are indications that the warning was well-founded and is still relevant. There has not been the kind of attack on inflation that is required, and the exchange rate adjustment mechanism is having more effect on inflation than on promoting exports. There have been other changes too. In particular, once the world prices of agricultural exports fall below the level of the SMP, the exchange rate adjustments do not affect the gross incomes of farmers, while their costs continue to reflect increased import prices.

The excess of New Zealand's inflation rate over that of our trading partners both helps to cause, and is in part caused by, the lack of growth in our economy and the consequent unemployment. The most important line of causation from slow growth to inflation is that sectional conflict is intensified when there is little additional real income to be shared among all possible claimants; not only trade unions but also many other groups in the community may believe that they are 'missing out', or might 'miss out', if they do not use their influence over wages or prices to ensure that their interests are protected. It is important to realise that the current situation is very different from the 1960s when full employment meant that price increases could be mitigated by restraining aggregate demand. Even in those circumstances there is room for debate over whether the choice between restraining the demand for labour or experiencing inflation was more than a transitory phenomenon. It is, however, quite clear that there is no warrant for transferring the same ideas to the present circumstances, and thinking that inflation can be attacked by further restraining output in general. Even in present circumstances, bottlenecks in the supply of particular resources or skills should be avoided, but the more general situation is that cost levels would be moderated if they could be spread over an increased output. Inflation would be much more easily attacked if the economy were experiencing growth.

The main line of causation from inflation to slow growth flows through investment. Inflation creates more uncertainty about future relative prices and makes it more difficult to assess the likely profitability of an investment venture. Inflation creates incentives to concentrate on short term capital gains available from exploiting temporary movements in asset prices rather than incur the uncertainties of investment such as is needed to create future real income and employment, especially when capital gains are, in general, free of tax. With current institutional arrangements, inflation causes liquidity problems. Inflation creates worries about possible Government action to deflate the economy. And as explained in the last report, inflation increases the transactions costs an

economy has to bear.

Inflation is then intertwined with the balance of payments constraint through the links which we have already explored between slow growth and the balance of payments. In particular, inflation has made it more difficult to recognise and exploit opportunities to replace imports with domestic output, and the exchange rate policy intended to help relieve the balance of payments constraint has become intertwined in the inflationary process.

Taxation

Many of the links between unemployment, inflation and the balance of payments interacted with the tax system. Unemployment increased the demand for Government expenditure, directly through unemployment benefits and the costs of job creation schemes, and indirectly through transfer payments to people entitled to various benefits but who would have supported themselves with a job had they been able to find one. There is also some evidence that unemployment resulted in increased expenditure on health and other social services. At the same time, the Government chose to increase transfer payments to people over 60 through the National Superannuation scheme.

At the same time, the growth in taxation revenue was reduced. Unemployed people had no income on which tax had to be paid, and the Government chose to support exports through the tax system. Export incentives took the form of tax deductions, and where the incentives exceeded tax liability, actual payments which were recorded as deductions from Government revenue rather than as expenditure. (The analogous SMP scheme for farmers will eventually appear as expenditure in the Government's accounts). In effect, the Government substituted a budget problem for a balance of payments one. The tax system was also used to relieve other particular problems posed by inflation, as, for example, in the tax rebate for first home-buyers. Inflation had the opposite effect on personal income tax, because as incomes became higher in monetary terms they moved up a progressive tax scale. Being aware of the inflationary impact of the way in which the budget deficit was financed, the Government felt unable to fully adjust the tax scale in line with inflation, although it did reduce some of the 'fiscal drag' in successive budgets.

The gap between pre- and post-tax incomes consequently widened. Wage and salary earners and other groups within the community increasingly looked on taxes as a simple imposition on their incomes rather than the price to be paid for services provided by Government. There had always been some suggestions that services financed by taxation were unnecessary, but different individuals so regarded different parts of Government expenditure, and there was a general willingness to do no more than grumble about the folly of politicians and bureaucrats. As personal taxation became a larger element of gross incomes, there was more conviction that the Government was not justified in transferring incomes through the tax system, and that the incidence of taxation was unfair. It is absurd to think that real post-tax incomes can be maintained and transfer incomes and the incomes of exporters increased while the total real income of the economy is not growing, but it is human nature to think that one's own real post-tax income should be larger and more of the cost should be borne by somebody else. Wage and salary demands were so pitched as to maintain post-tax incomes relative to consumer prices, professional fees were similarly adjusted, tax shelters were sought and used, and it seems that evasion became more common.

Thus the Government found itself deeply entangled in the issues of inflation while having responsibility for economic management in general. Some actions which it has taken to deal with particular problems such as the support of exporters or

families buying a first home have run counter to what is needed to attack inflation. While small retreats are sometimes desirable preparations for advances, the public has taken the particular measures as indications that the Government tolerates inflation despite its protestations to the contrary. Members of the public have then acted in the expectation of continued rapid inflation. Such expectations become self-fulfilling and intensify the interactive process of inflation.

<u>Wage rates</u>

It is sometimes suggested that explanations of unemployment should focus on wage rates. It is certainly true that salaries and wages are likely to be important in assessing any major economic trend simply because they constitute a large share of private incomes and costs. It is also almost a matter of simple deduction alone that if total demand were held unchanged and wage costs reduced, then more employment would be offered. The 'almost' is required because one should really consider expectations of future wage costs relative to costs of new capital and to product prices, and also the possibility that some managers might prefer a quieter, if less profitable, existence to the difficulties of an expanding labour force, such as recruitment and training costs and potential redundancy payments. But the general expectation that lower wage rates and constant total demand would stimulate employment is the basis of the conclusion in the last report of the Monitoring Group, and elsewhere, that a tax-wage bargain could be expected to promote employment. It should be noted, however, that the reasoning includes maintenance of total demand; it provides no warrant for thinking that a reduction in wage rates alone would reduce unemployment.

Wage costs rose relative to output prices up to 1974, and although there have been variations in more recent years, the ratio which was characteristic of years before 1974 has not been restored. This should not be attributed to union intransigence. First, the conclusion is derived from comparison of series of product prices and of the ratio of wage payments to output, not directly from wage-rates which result from union-employer negotiations. The rise in labour costs can be seen in part as the result of the virtually nil growth in output rather than the cause of that trend and its consequent unemployment. Secondly, not all wages and salaries, even in the private sector of the economy, result directly from bargains between unions and employers. Even if it is true that management salaries are tied to award rates so that the unions can be seen as setting the pace, it is precisely through reconsideration of such relativities that one can hope to see some progress made in countering self-generating inflation. It is nevertheless true that wages and salaries have been, in effect, indexed to the consumers price index, taking no account of the loss of real income to the community as a whole that resulted from unfavourable trends in the terms of trade. Such modification as has occurred within the indexation process has been in the reverse direction, as attempts to recover increased personal taxation have been built into it.

The labour market would probably respond better to economic incentives if the process of wage and salary setting gave more prominence to the relative profitability of different activities and less to relativities between occupations irrespective of the industries in which people with particular qualifications are employed. This is not something which can be achieved quickly. Relative wages are determined by history as much as logic, and they involve deep feelings as well as long chains of precedent. It would be superficial to refer only to trade union conservatism. One can observe in the decisions of the Higher Salaries Commission the principle that people should be paid more than those responsible to them whereas more emphasis on market trends would be likely to produce more than a few exceptional cases in which specialised skills earn more than managers who deploy the results of those special skills. Hierarchical scales are more appropriate in an army than in a market.

Rapid change is not to be expected, but it is necessary to keep in mind the importance of setting average real incomes at a level consistent with output, allowing for the balance of payments, and achieving a distribution which reflects the scarcity of individual skills and the relative value of different products while not conflicting with the community's sense of equity. Attempting to deal mechanically with wage rates is not an appropriate short cut. It is unfortunate that discussions which seemed to make some progress towards realigning wage bargaining on to industry lines came to a dead end. It would be very much easier to make progress in this regard if the economy were experiencing sustained economic growth, but we have to try to proceed simultaneously on both fronts.

Conclusion

There is no conspiracy producing unemployment in New Zealand. Rather, unemployment is one part of a complex of inter-related problems into which we have stumbled, and it is the mixture of problems which makes a solution so elusive. There is unlikely to be any answer to unemployment which does not at the same time reduce inflation, relieve the balance of payments constraint, and foster sustained economic growth. Although 'employment' measures permit the avoidance of particular cases of unemployment and alleviate the experience of some individuals who are rendered unemployed (and are not therefore to be rejected out of hand), the major focus should be on economic management as a whole.

FURTHER READING:

A. Grimes, A Model of the New Zealand Labour Market (Wellington: Reserve Bank Research Paper No. 33, July, 1981).

G.R. Hawke, "Unemployment in New Zealand", in R.J. Harbridge (ed.), Industrial Relations : Insights and Directions (Victoria University of Wellington, Industrial Relations Centre, 1982).

Bryan Philpott, Employment Problems and Policies (Victoria University of Wellington, Project on Economic Planning Discussion Paper No. 22, June, 1981.)

The Monitoring Group also benefited from as yet unpublished work by Mr R.A. Buckle in continuation of the research published with its Report No. 4 and from work which is proceeding at the New Zealand Institute of Economic Research and the Project on Economic Planning.

Chapter 4

POLICY

An adequate short-term policy has to attack inflation and the balance of payments constraint, while promoting investment in order to achieve the economic growth and reduced unemployment which will themselves make our economic problems easier to handle. This is partly a matter of tactics and timing in fiscal, monetary and incomes policy, in the context of a medium-term strategy designed for stable growth, a satisfactory balance of payments, and a return to full employment. It also involves the elaboration of the medium-term strategy, the introduction of new elements, and consolidation along lines of development already established.

The short-term requirements are not easily satisfied. High, apparently entrenched inflation and unemployment, a large budget deficit and a worsening balance of payments, limit the room for manoeuvre in 1982 and 1983. At the same time there is a public mood in favour of change, as is evident in the desire for tax reform, recognition of the need for some reductions in public expenditure, and concern about unemployment and inflation. The opportunity exists for measures which clearly constitute an effort to overcome problems which have become more serious in recent years and still have to be solved.

In its discussion of employment issues in this report, the Monitoring Group emphasises the often complex links between unemployment, inflation, growth and the balance of payments. The particular policy issues addressed in this section are those of monetary and fiscal requirements, tax incidence, the balance of payments problem and the implications of a tax-wage bargain. Each is a major area of current concern. Together, they have wider implications for economic management, for inflation and for promotion of investment and employment.

Monetary and Fiscal Policy

The Monitoring Group continues to see the reduction of inflation, at least to the level being experienced by our trading partners, as an essential component of short term policy aims, and it continues to believe that the size of the Government's internal deficit in recent years has contributed to the perpetuation of inflation at unacceptable rates. Consequently, it favours reduction of the internal deficit and its financing by means that do not increase the supply of money. For both political and economic reasons, increased taxation does not in present circumstances offer an acceptable means for achieving this, and, as there are also limits to the extent that Government non-bank borrowing can be expanded, there must be restraint on Government expenditure.

Reducing the rate of growth of Government expenditure is not easy. Groups in society adversely affected by lack of growth in any particular area of spending are vocal in their objections, while those not affected are merely silent. Good cases can be made for more spending in many areas, but the rate of growth of total expenditure cannot be diminished unless the sum of individual components is kept to the required total. Transfer payments and salaries and wages paid by Government are important to many individuals, but since they constitute a large share of Government expenditure they cannot be exempted from the required restraint.

It is obviously wise to reduce the rate of growth of Government expenditure with as little adverse impact as possible on its contribution to economic and social welfare. Across the board cuts of a fixed percentage are a useful administrative device for establishing a range of options, but merely begin the process of evaluation which is needed. Requiring each department to make room for new initiatives by eliminating or reducing current programmes is also a useful mechanism, but it is necessary to compare the value of marginal programmes among departments as well.

Because of the importance which the Monitoring Group attaches to economic growth for countering both unemployment and inflation, it does not wish to see reduction in the rate of growth of Government expenditure achieved through limitations on public investment. One of the features of recent trends in Government spending has been the faster growth of investment than of current expenditure, and to the extent that this promotes economic growth, it should be continued. The important issue with public or private investment is that resources should be used efficiently.

The Monitoring Group is aware that some people see a conflict between its advocacy of investment and its desire to see the Government's internal deficit financed in ways that do not increase the supply of money. It is certainly true that the Monitoring Group favours interest rates on Government securities that are competitive with those offered by the financial system and other private sector borrowers. In the immediate future such rates will be high in nominal terms, but because inflation will cancel much of the apparent interest, real rates will not be high. High nominal rates will nevertheless affect some businesses, especially small and new ones, and also people borrowing to build or buy houses, and local authorities using loan finance. High nominal interest rates frequently cause liquidity problems in the early part of a loan. It is worthwhile pursuing some counter-measures. Loan repayments might be related to prospective trends in monetary incomes instead of spread mechanically over the term of a loan, and indexed securities, as discussed by the Task Force on Tax Reform, should be further investigated. But the problems arise from inflation rather than from high interest rates, and it is reducing inflation which should be the main focus of attention.

Some people see low interest rates as desirable in themselves, as an objective of economic policy and not merely an instrument of economic management. There is force in that view, to the extent that low interest rates imply little discounting of the future, and that implies confidence in continued prosperity and security. But for such an argument, the relevant interest rate is a real one, not the nominal one which is so heavily influenced by inflation. Furthermore, the confidence has to be earned and cannot be created by controls on nominal interest rates.

Taxation

The Monitoring Group was pleased by the appointment during 1981, of a task force on tax reform. Its report contributes substantially to public understanding of tax issues, and offers a guide through complex economic and administrative problems towards a set of taxes that will be widely accepted as equitable.

The Task Force had limited time for its work and concentrated most on accounting and administrative problems, but it did not ignore questions of economic management and policy. Its report therefore provides much information and commentary relevant to the concerns of the Monitoring Group. Three issues are sufficiently central to this report to require specific comment.

First, the Task Force report provides several income tax scales that all have the effect of reducing fiscal drag. One of the hard choices that only the Government can make is the particular scale that best balances the incidence of tax on individuals and households at different income levels against the advantage of reducing the impetus to inflation which results from attempts to recover fiscal drag through higher pre-tax incomes. The degree of fiscal drag is heavily dependent on the first step in any scale. There is not yet adequate understanding of the Task Force's demonstration that the tax rate on low individual incomes is different from the tax burden on low-income households; the existence of second incomes in many families makes invalid the belief that low rates of tax on the initial income range are an efficient means of assisting low income households.

Secondly, the Task Force endorsed and carried forward the argument that business taxation should be based on inflation-adjusted accounts. It suggested that the distinction between accounting for management and for taxation should be carried into inflation accounting and that while specific prices are appropriate for the former, a general price index should be employed in the latter. The Monitoring Group is anxious that the decisions of investors and entrepreneurs should be as well based as possible, and hopes that this recommendation will further the cause of inflation accounting which is so important in this regard.

Thirdly, the Task Force suggested several changes to the base on which taxation is levied. In order to keep rates of tax as low as possible and to promote acceptance of the tax system as equitable, it is important that the incomes of different groups within society and of incomes received in different forms be taxed in an even-handed way, and the guidance of the Task Force report is therefore important for economic management. It is possible that a capital gains tax was dismissed too quickly. Even if it returned little revenue, it would remove an incentive to concentrate on capital gains rather than income growth, and help reduce the sense of inequity in the community. However, the suggestions of the Task Force on the treatment of borrowing gains have some of the same effects as taxes on capital gains and could sensibly be pursued first.

The Task Force demonstrated that if a significant change is to be made to the scale of rates applied to personal incomes while total taxation revenue is more or less unchanged, indirect

taxation must be increased. In this context, it commented,

> "...the Task Force is aware that a shift from direct to indirect taxation is bound to have effects on prices and incomes. These effects could be inflationary, in immediate impact, and perhaps induce continuing effects. Appropriate broad economic policies implemented in an atmosphere of community acceptance of the equity and benefits of the shift are therefore particular requirements for the success of the shift in tax policy recommended later in this report[1]."

The Monitoring Group strongly endorses this comment.

The Task Force recommended that the principal instruments for maintaining Government's revenue should be a rationalised and extended wholesale sales tax and a selective tax on services, keeping in mind the desirability of substituting a value-added tax but recognizing that implementation of such a tax would require at least three years.

However, as part of the contemplated switch towards indirect taxation, the Monitoring Group sees a great deal of merit in imposing taxes on imported goods and services where opportunities exist for efficient import substitution.

Balance of Payments Problems

For many years the main instruments used to reduce the problem of recurring balance of payments deficits were import licensing, tariffs, and exchange controls. The emphasis was thus very much directed towards reducing the expenditure of overseas exchange. The policies chosen, which eventually developed into high levels of protection for finished goods, and little or no protection for raw materials and intermediate goods to be used

1 Report of the Task Force on Tax Reform (Wellington: Government Printer, April, 1982), para. 3.8.

by New Zealand manufacturers, led to the development of a manufacturing industry which is unduly slanted towards the assembly of final goods and which is relatively weak in the production of intermediate goods. The misallocation of resources which has resulted within the manufacturing sector has involved the country in significant real income costs, and is the basis of the Monitoring Group's view that, while import substitution has gone too far in many categories of finished goods, there is considerable potential for efficient import substitution in the immediate goods area.

During the 1960s it became apparent that the traditional form of import replacement of finished goods had been pushed to or beyond the limit. At the same time the performance of the traditional exporting industries began to falter, and accordingly efforts were made to ease the balance of payments problems by stimulating exports of all types. Over the years the various measures aimed at inducing a faster rate of export growth have themselves grown substantially, and are probably now viewed by most of the public as the chief means of limiting our balance of payments deficit. The various protective measures aimed at reducing overseas expenditure probably continue to impose greater costs on the economy than the export promotion measures, but the latter are better known to the public because they are so often quantified - the cost of S.M.Ps, the tax saved by exporting companies, and so on. It is difficult to disentangle the effect of the incentives from other influences on exports, especially traditional exports, but non-traditional exports have certainly grown since the present incentives aimed at them were introduced, and it is stretching credulity to suggest that they have had no effect. Supports to both types of exports have however, reduced the tax base and total tax revenue, and they have been a significant part of the cause of growing doubts over whether the tax system is fair.

Concern over the balance of payments position has led to the

Monitoring Group to examine a number of options relating to policies and programmes in the external sector.

<u>Option 1</u>: - <u>Continue With Existing External Policies Unchanged</u>

As the balance of payments deficit is one of the major constraints on growth in the economy, failure to achieve improvement on this front will lessen chances of getting the growth which would help to reduce inflation and unemployment.

<u>Option 2</u>: - <u>Real Crawling Depreciation</u>

The present gradual changes in our exchange rate are designed to maintain the competitive position of our export industries, and they also have the effect of maintaining the competitive position of our import substitution industries. The rate of depreciation of the exchange rate could be accelerated to improve, rather than merely maintain, the competitive position of these industries over time. It would still be necessary to have better control over internal inflation.

Changing our real exchange rate slowly in this way would probably be more acceptable to our trading partners than a single major devaluation.

Such a creeping real depreciation does not have the same dramatic impact as a single major devaluation towards stimulating some exporters to make efforts to break into new markets where they believe a new exchange rate may have made them competitive.

With many small real changes in the exchange rate it would be difficult to adjust other measures such as export incentives, or levels of protection, in ways which offset the exchange rate changes to any particular desired degree.

Option 3: - Devaluation With Other External Policies Unchanged

A major devaluation with no other changes in external policy would add significantly to the rate of inflation. The benefits of the devaluation to exporters would therefore be quickly lost unless the present system of managing the exchange rate were maintained, and even then other costs of inflation would be intensified.

Real incomes of wage and salary earners would be reduced by the devaluation and attempts to restore real wages would add to inflationary pressures.

To the extent that the market prices in New Zealand currency of those primary product exports now receiving support under the Supplementary Minimum Prices Scheme would be raised closer to, or even above, the guaranteed minimum prices, the cost of S.M.P's to the Government would be reduced or even eliminated.

All exporters would be helped, and all forms of import substitution helped, to the extent that the devaluation could be held, either by cutting inflation and/or by the use of the present exchange rate mechanism.

Option 4: - Foreign Exchange Surcharge

A foreign exchange surcharge would raise revenue which could be used to reduce the Government's internal deficit, or to cut personal income taxes by a compensatory amount. If the revenue were used to reduce taxes, real incomes would be little affected, but there would be a strong incentive to switch purchases away from imports towards locally produced goods. This would have beneficial effects on growth and employment.

Such a surcharge would provide incentives for further import substitution where the price incentive provided by the surcharge

made this worthwhile. The Monitoring Group believes that for physical goods this would mostly be in the form of intermediate goods to be used in production. There would also be a strong incentive to restrict expenditure on invisible items such as travel and consulting services.

If a foreign exchange surcharge were imposed selectively with different levels being imposed on different categories of overseas expenditure, it would be possible to use the introduction of the tax as a step towards greater harmonisation of levels of protection. Such harmonisation has considerable economic benefits.

Coupled with the export incentives, this policy would have the overall effect of a devaluation. If, at a later data, it were decided that conditions were appropriate for a devaluation, it could be accomplished with no inflationary effects as it could be accompanied by a reduction in expenditure on export incentives and the removal of the surcharge.

The Monitoring Group is aware of the difficulties involved with a foreign exchange surcharge. They have been summarised by the Task Force on Tax Reform:

> 11.11 The operation of a foreign exchange surcharge may, moreover, conflict with international agreements entered into by New Zealand. A surcharge of more than 2 per cent is forbidden by the IMF's Articles of Agreement except where special approval is given. Such approval could be given provided certain conditions are met, but only for a temporary measure. A surcharge could also be challenged under several articles of the GATT, which prohibit New Zealand from raising duties or charges of any kind on a wide range of goods. A further agreement to which New Zealand is a party, the OECD Trade Pledge, discourages meausres which impede the free flow of funds for current or capital transactions.

The Monitoring Group endorses the conclusion of the Task Force.

> 11.12 Despite the difficulties recorded above the Task Force does not reject the idea of a foreign exchange surcharge completely. The Task Force did not consider that the surcharge could play a significant role

in long-term tax reform but might be a useful "stop-gap" measure while a new indirect tax was being introduced.

Option 5: - Devaluation Coupled with Substantial Dismantling of Export Incentives, and a Reduction in, and Modification of, Protection

Depending on its size, a devaluation coupled with substantial reductions in export incentives of all kinds would reduce the budget deficit, which would allow for a cut in taxes to help maintain real disposable incomes.

Such tax cuts would offer a basis for moderating the second round of devaluation, those whereby inflation is fuelled by demands for higher pre-tax incomes to offset higher import prices. Thus devaluation could be "held" more easily with consequent benefits for exports, imports and the balance of payments.

If advantage were taken of the opportunity to reduce the highest levels of protection accorded through import controls and tariffs, thus moving towards greater harmonisation of levels of protection, there would be additional gains through the increased efficiency in the allocation of resources.

The Government commitment to continue export incentives at least until 1985 is an impediment to the implementation of such a package deal, but an alternative form of assistance would be provided through the devaluation itself.

Other countries' objections to our export incentives and import restrictions would be eliminated or reduced.

As the Task Force on Tax Reform reminded us: " In recent Budget statements, the Government has indicated its intention to continue a gradual reform of protection policies. This reform has three main features - changing the form of protection from import

licence control to tariffs, introducing more uniformity in the protective structure primarily by reducing the highest levels of assistance, and lowering the average level of protection" [1]. The Monitoring Group strongly supports the Government's aims in this area.

The medium term objective must be to get the exchange rate set at a level which requires minimum supplementation by other measures to assist exporters and protect producers of import-substitute goods. The decision as to how such an objective should be approached is basically a political one. A number of arguments can be advanced against the idea of a substantial devaluation at this time, and the currently depressed state of world trade which has a particularly severe impact on New Zealand's traditional primary exports increases the difficulty of establishing the appropriate exchange rate.

In these circumstances, the Monitoring Group believes that interim policy should include action along the lines of elements of options 2 and/or 4 in conjunction with appropriate internal policies.

A Tax Wage Bargain

A great deal obviously depends on securing an agreed approach to the internal inflationary process. Last year, the Monitoring Group recommended a tax-wage bargain whereby tax reductions were traded for lesser wage increases in the context of a wide-spread agreement that the gains should be reflected in lower prices and of a fiscal and monetary policy reinforcing that agreement. It regrets that it was not possible to utilize the relatively favourable trends in economic growth in 1981/82 to achieve such a bargain, and that difficulties are being experienced in reaching an agreement this year.

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1 Report of the Task Force on Tax Reform, para. 11.4

The attraction of a tax-wage bargain remains as set out in the Monitoring Group's last report although various discussions since it was published have amplified some points. A bargain would require a reduction in the rates at which income tax is levied and a moderation of the extent of wage and salary increases so as to leave after-tax income more or less unchanged. The reduction in income tax could be achieved by raising the income levels at which marginal rates of taxation are increased or by lowering the rates of taxation themselves, but there is no simple mechanism by which all individual wage and salary earners would be affected by exactly the same percentage. Only the average, or a small number of points, could be determined, and the discussions of the past year have brought some progress in public understanding of the 'roughness' with which tax reductions could be substituted for part of the usual interactive adjustment of wages.

There has also been some increased awareness of the points that a tax-wage bargain alone would increase the Government's budget deficit, and that avoiding the accommodation of inflation which this would provide requires a tax-wage bargain to be accompanied by other measures. The research commissioned by the Monitoring Group has been followed up in various ways and generally supports the contention that the combination of bargain and other measures would still be advantageous in stimulating employment. This follows essentially from the way that increases in wage payments by employers are moderated while the after-tax incomes of employees are sustained. There has, however, only very recently been progress towards acceptance of the implication that discussion and agreement has to emcompass aspects of Government policy beyond tax reductions, and even this has been achieved mostly by restrictions on the kind of measures that can accompany a tax-wage bargain.

The Monitoring Group concluded last year that the effect of a tax-wage bargain on inflation was not immediate and self-

evident but depended on the reaction of all price-setters within the economy. (Some subsequent research results have been read as suggesting a more direct impact, but they depend on assumptions that make prices follow costs and do not specify the time period over which this occurs. These results are therefore not incompatible with those on which the Monitoring Group relied.) This has been discussed mainly in the form of what incentives or sanctions there are over self-employed people who would benefit from reductions in income tax without any compensating change in the means by which their pre-tax incomes are determined, and very recently the Government has agreed to enter into consultation with such groups. But more than the professions and self-employed are involved. Wages are not set by agreement between only trade unions and employers' associations, and parties to local negotiations would have to share the general spirit of a bargain. Product prices do not immediately reflect specific wage increases and an agreement would have to be spread through the business community.

Difficulties in reaching agreement on a tax-wage trade off should not be allowed to obscure the need to break the spiral of wages and prices which has become entrenched in the process of inflation. Any form of tax-wage trade off which has the effect of winding down the rate of escalation of nominal incomes is to be welcomed. The magnitude and permanence of the benefits will depend greatly on the extent to which a trade-off is achieved by consent of the parties and is maintained by goodwill and fair dealing.

We do not expect all sectional interests to disappear. But in earlier years in New Zealand, and in other countries more recently, sectional interests have been confined within a framework of belief that competing claimants could be trusted and of willingness to compromise within the available real income. That is what we have to rebuild. It is the kind of understanding that is needed for successful implementation of any tax reform.

Seeking a Desirable Package of Measures

In the light of the analysis of the present economic situation set out in this report, it will be clear that the Economic Monitoring Group is looking for a package of measures which will meet the requirements of attacking inflation, while providing assistance towards alleviating the balance of payments constraint, and promoting the growth needed to counter unemployment. It is the Group's belief that such a package can be devised. Packages are sometimes constructed in an attempt to secure acceptance of an unpleasant measure by coupling it with measures which will have widespread appeal. That is not the Monitoring Group's motivation; it is the interdependence of our economic problems as expounded earlier in this report that leads to the emphasis on the need for a coherent package.

The prospect that a tax-wage trade-off may be effected this year, and that there may be some significant changes within the taxation system, leads to the conclusion that this year may provide the Government with the best opportunity it has had for many years to attack our fundamental economic problems with a package of complementary policies.

A tax-wage trade-off will moderate the rate of increase in employers' costs, and should therefore contribute to a slowing down in the overall rate of inflation. Such a trade-off will also have other effects, however, such as reducing the Government's revenue, thereby adding to the Government's internal deficit. It will therefore be necessary to ensure that the economy is growing so that the Government's deficit does not rise relative to gross domestic product, and to ensure that the increased demand for imports is kept within bounds.

Any further reduction in personal income taxes, which is not associated with a tax wage trade-off, will have to be financed by reductions in Government expenditure or by tapping other sources of revenue. The Task Force on Tax Reform has recommended that the revenue required to offset a cut in income taxes should be obtained by the extension of the wholesale sales tax. The Task Force also suggested that this extension of the wholesale sales tax could be seen as the first step towards the introduction of a VAT system. The Monitoring Group appreciates the arguments presented by the Task Force, but, in the context of the total economic situation, recommends that some of the revenue to be raised from additional indirect taxes should be obtained in ways which encourage import saving and reductions in overseas expenditure generally.

The fact that a tax wage trade-off will have the initial effect of increasing the Government's internal deficit means that efforts must be maintained to reduce Government expenditure. This will put a great premium on efficiency within the Government service and in the expenditure of Government funds, and, in the interests of growth, the idea of promoting efficiency must be extended to all Government policies designed to increase investment and to earn or save foreign exchange. It is for this reason that the Monitoring Group would favour steps towards the harmonisation of levels of protection. The Task Force on Tax Reform drew attention to two further areas which concern tax collection and efficiency. The first was the potential for increasing total tax revenue and reducing inequities which are now felt to be in the system. The second area concerns inflation and its effects on borrowing and hence investment decisions. The Task Force made recommendations concerning current cost accounting, and it is the Monitoring Group's view that very real gains in investment efficiency can be achieved if changes are made both in accounting and taxation practice. These will induce investors to take greater account of the real returns to their investment, disregarding the gains to be made from borrowing in ways which represent very low real costs to those companies which have other taxable income against which interest costs can be offset.

A great deal rests on getting all the complementary parts of a package working together. A Government cannot control all aspects of an economy, and the responses to policy measures are more important than the intentions of their designers. It is important to get the market signals right, as people are more likely to respond to them than to mere rhetoric.

It is obvious that the design of a short term economic policy consistent with our medium term objectives of secure economic growth and full employment is no easy matter. The Government is right to protest that miracles cannot be delivered, but it is possible to improve on our situation.

ISSN 0110 5612

This report is published by the New Zealand Planning Council. It was prepared independently by the Economic Monitoring Group and is presented here in its final form as submitted by the authors.
P.O. Box 5066
Wellington

Printed by BRYCE FRANCIS LTD., Wellington.