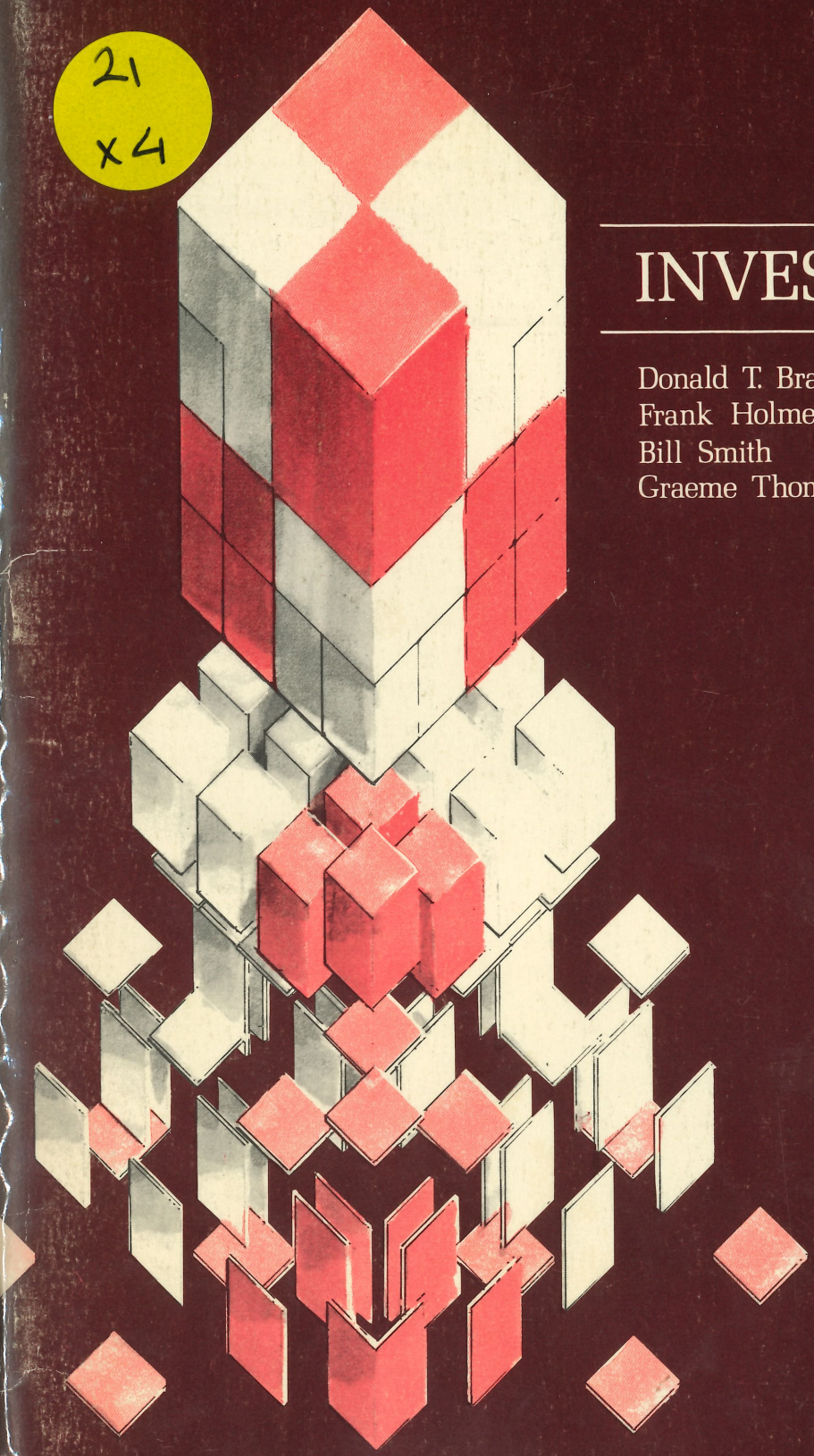


# INVESTMENT ISSUES

Donald T. Brash
Frank Holmes
Bill Smith
Graeme Thompson

New Zealand Planning Council

# INVESTMENT ISSUES

Donald T. Brash
Frank Holmes
Bill Smith
Graeme Thompson

NZPC No. 16

New Zealand Planning Council
P.O. Box 5066
Wellington

June 1980

ISSN 0110-6104
ISBN 0-908601-10-7

## Photo Credits

National Publicity Studios supplied all the photographs used in this report except for the following:
Bank of New Zealand (page 72), *Evening Post* (page 69), Ministry of Works and Development (pages 50, 55, and 59), New Zealand Forest Service (pages 30 and 42), and New Zealand Railways (page 43).

# CONTENTS

## The Authors


| | |
|---|---|
| Donald T. Brash (Convener) | General Manager, Broadbank, Member N.Z. Planning Council |
| Frank Holmes | Chairman, N.Z. Planning Council |
| Bill Smith | Programming Engineer, Ministry of Works and Development |
| Graeme Thompson | Chief Economist, N.Z. Planning Council |


The authors were invited by the Planning Council to analyse investment issues for New Zealand as a contribution to the Council's thinking on development strategy. The report is thus the work of a task force rather than one formally endorsed by the Council as a whole.

# INTRODUCTION

The 1980s can be a decade of great opportunity for New Zealand: we have, if we want it, the opportunity to overcome the difficulties we faced in the 1970s, to increase our living standards, to improve our public services, and to provide jobs for all who want them.

Some of the opportunities were set out in a publication issued recently by the Minister of National Development. It represented the result of investigations by a committee of Ministers in which the Chairman of the Planning Council participated. This work makes it plain that New Zealand is rich in resources—especially resources from the land, the forests, and the sea—and in actual and potential sources of energy. With our favourable climate and the great natural beauty of our environment, we have an exceptional endowment on which to build a good life for all New Zealanders, and to play a constructive part in assisting development in the world around us.

Adequate investment, and effective use of the capital which results from it, are needed if we are to use these opportunities for economic recovery and social advance. Thus this report on investment issues is timely. It was prepared by a task force set up by the Planning Council with Dr Donald Brash as convener.

The focus on investment is only one aspect of a much broader approach being made by the Council towards formulating a comprehensive economic and social development strategy for the 1980s. Our report *The Welfare State?* (June 1979), identifies some of the major social issues for the decade ahead, specifically in health, education, and welfare services; income maintenance; law and order; and the policy implications for Government spending. The more recent report, *He Matapuna—Some Maori Perspectives* (December 1979) is evidence of the Council's interest in and concern with the cultural dimensions of national development. *Planning and the Regions* (April 1980) considers ways in which regional interests and aspirations can be linked with national policies and resource availabilities. Further work on the public sector is in train.

A Council report on more active employment policies is currently under discussion and will soon be published. The Council regards this work towards full employment objectives as central to its thinking on integrated economic and social planning for the 1980s. Its migration survey (June 1980) is a further contribution to the identification of the issues for our society in the years ahead.

Recently, investment has been very low, compared with that prevailing from the mid-1950s to the mid-1970s. There have been several reasons for this: uncertainty arising from inflation, high interest rates, and balance of payment difficulties; slow growth of the domestic market; the effects of falling birth rates and net emigration, for example.

If we are to take advantage of the opportunities for development before us, there will have to be a resurgence of fixed investment for the next few years. It is needed in plant, machinery, and equipment for the development of our energy resources, and to make our farms, factories, and other enterprises more productive and adaptable. There will probably be rather less pressure for additional buildings and public facilities, given population trends and some excess capacity at present.

Most of the energy projects have a high overseas exchange content. Thus the net benefits to the balance of payments, although substantial, will not be felt until the end of the decade. In the short run the effect of the investment will be to widen the balance of payments deficit. If borrowing overseas, and the cost of servicing overseas debt are to be kept within bounds, it is vital that we intensify our efforts to develop other projects as soon as possible.

The Government cannot lay down a detailed blueprint for the level and pattern of investment which should occur in the next decade. It will inevitably be involved in deciding whether a number of large projects should proceed, and may indeed participate directly in financing some of them. It must formulate its own works programme, and influence the programmes of local and ad hoc public authorities: for example, by participating in regional planning. Its contributions to education and training, and research and development, will continue to provide important support to the investment process. However, the Government's main role in an overall strategy for investment is to create the right climate in which private and public enterprises may make investment decisions likely to be of lasting benefit.

The Task Force's report places considerable emphasis on how the right climate for the investment which New Zealand needs can be created. Monetary, fiscal, and income policies which foster stable expansion, curb inflation, and ensure that finance is available for investment on reasonable terms are vital. So too are the exchange rate policies and other incentives to earn and save the overseas exchange which will be needed to make expansion possible. This can be supplemented by judicious overseas borrowing and the attraction of overseas investment. Tax reform that encourages saving and investment, and private expenditure on research and development will also help. Through its employment and training services, and by fostering good industrial relations, the Government can also do much to see that delays and unnecessary escalation of costs on investment projects, due to staffing difficulties, are avoided.

Finding the right balance among development, conservation, and protection of the environment is a major concern of central, regional, and local government. Like the Council in its submissions on the National Development Bill, the Task Force seeks an improvement of present procedures for deciding on such a balance, for both large and small projects. It also addresses the vital question of setting the right prices for the sale of publicly-owned resources for use in investment projects.

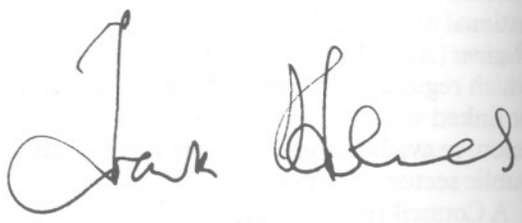
For a number of years now we have been investing quite heavily by the standards of other comparable countries, but obtaining disappointingly low returns on this investment. The Task Force therefore responds to the suggestion made in *Planning Perspectives 1978–83*, the Council's first major report, that "much attention must be paid during this planning period to the efficient use of new and existing capital, so that we obtain more output (and higher living standards) from our investment, in all sectors of the economy". The Task Force sees possibilities of improving the construction process, e.g. by changes in design criteria, and more attention to the stable expansion of demand for construction. They favour the critical review of regulations and controls which they suggest promote the inefficient use of capital. They suggest means of ensuring that capital is used more intensively in several sectors.

The Planning Council has discussed the main investment issues in the course of the preparation of the report. The conclusions and policy recommendations of the Task Force are in line with the Council's general approach to economic strategy. There are some differences within the Council on such issues as policy towards overseas investment and towards the extent to which reliance should be placed on stimulating exports. Nevertheless, we all see the work of the Task Force as proving a useful basis for our future work on a development strategy.

The Council agrees that the emphasis should be on improving the climate for investment, and reducing the negative influence of regulation, licensing, and control—not on fixing targets, trying to force investment into particular channels, or providing still more specific incentives to invest.

Recently there have been important changes of policy in this desirable direction, notably in respect of incentives for exports and in the decisions taken on the textile industry. However, much remains to be done to create an environment in which needed investment will be stimulated, and both new and existing capital, public and private, will be more effectively used. This will reduce recent constraints on our development, and also help ensure that resources released by technological and policy changes are fully employed in the national interest.

A number of departments, agencies, and individuals contributed to the preparation of this report. Particular thanks is owed to the staff of the Development Finance Corporation, the Ministry of Works and Development, the Ministry of Agriculture and Fisheries, the Treasury, and the Department of Statistics; also to Norman Macbeth and J. V. White (consultants), and Chris Livesey and Keith Martin of the Council's secretariat.



FRANK HOLMES, Chairman.

# I OVERVIEW

Recent international developments force a reconsideration of past investment patterns. In future the way we allocate our investment resources, implement large- and small-scale investment projects, and use the capital we have available, will require much closer attention than before if our major economic and social objectives are to be achieved.

During the next 5 years New Zealand will invest vast sums of money in energy development, primarily to become less dependent on imported oil. Large sums will also be invested in agriculture, manufacturing, and other activities in the effort to earn or save more foreign exchange. Although there may be major changes in the way resources are allocated, investments elsewhere in the economy—in housing and other building, transport, and public and private services—must also continue.

Investment is the process by which societies provide for the future, whether the investment is in physical assets (machines, transport facilities, homes or office buildings) or in people (individually through apprenticeships or study courses or collectively through the provision of health, education, or other services).

In its narrower economic sense, and in the sense used in this report, investment is defined as the expenditure by producers on new durable assets. Strictly speaking this is fixed investment. The two main forms of fixed investment are outlays on building and construction (which usually account for about 60 percent) and those on machinery, plant, and equipment, including transport equipment (which account for nearly all the rest). Purchases of existing assets (land, second-hand vehicles, machinery, and so on) are not classified as investment because they are only transfers from one person or firm to another. Changes in stocks held by producers are also a form of investment (or disinvestment) but are not part of fixed investment.

About 20–25 percent of New Zealand's gross domestic product (GDP) is invested in this way. The rest is used in consumption—the current use of goods and services, including those provided by central government and local authorities. Economic growth and change depend on what the country invests in as well as the amount it invests. For more than a decade we have been obtaining disappointingly low returns on our investment. As New Zealand moves into the 1980s, there are new challenges. They arise from recent economic and social change and the application of new technology. Providing enough jobs for a growing labour force, in a period of probably much slower growth in the population, will be a particular challenge. Achieving full employment, and attaining other major economic and social objectives, will depend on easing the very severe shortage of foreign exchange which has limited the room for manoeuvre in recent years.

Much has still to be done before the balance of payments problems are overcome. Specifically, we have still to undertake investment which will earn or save enough foreign exchange to enable us to pay our own way in the world. In the short term, increased investment will mean more imports and will probably also increase the balance of payments deficit. For example, the full benefits of domestic energy development, or new investment in exports, may be realised only after several years. Only as production grows, will the balance of payments improve.

The questions we need to ask about investment can be put quite simply:

- How much do we need to invest?
- What should we invest in?
- Where should the money come from?
- How can we make the investment process more effective?
- What can we do to make better use of the capital we already have?

The answers must be based on an assessment of recent investment patterns and performance, and of the prospects for the economy as a whole.

## Investment Patterns

Investment spending generally accounts for 20–25 percent of GDP, with some variation resulting from the state of, and prospects for, the economy from year to year. Over a long period the average has been between 22 and 23 percent. (See table 1.1.)

## Table 1.1 Investment Ratios 1952–1979 March Years

| Ratio | 1952–56 | 1957–61 | 1962–66 | 1967–71 | 1972–76 | 1977–79 |
|---|---|---|---|---|---|---|
| | (percent) | | | | | |
| Investment/gross domestic product | 22.3 | 22.1 | 22.6 | 22.5 | 23.8 | 22.4 |
| Investment/total domestic expenditure | 22.2 | 22.1 | 22.5 | 22.5 | 22.6 | 22.0 |
| Public sector investment/total investment | 40 | 43 | 39 | 38 | 35 | 39 |

Source: Department of Statistics

## Table 1.2 Investment by Type of Economic Activity

Average for 1972–1978 March Years[1]

| Sector | Private | Public[2] | Total |
|---|---|---|---|
| | (percent) | | |
| Agriculture and fisheries | 7.6 | 0.4 | 8.0 |
| Forestry and logging | 0.4 | 0.3 | 0.7 |
| Mining and quarrying | 1.7 | 1.3 | 3.0 |
| Manufacturing | 13.1 | 0.3 | 13.4 |
| Electricity, gas and water | [3] | 9.2 | 9.2 |
| Construction[4] | 2.3 | 0.7 | 3.0 |
| Trade, restaurants, hotels | 8.0 | 0.3 | 8.3 |
| Transport and storage | 3.8 | 4.6 | 8.4 |
| Communications | [3] | 2.1 | 2.1 |
| Finance plus business and personal services | 5.3 | 3.3 | 8.6 |
| **Total—Excluding home ownership** | 42.2 | 22.5 | 64.7 |
| Home ownership[5] | 20.7 | [3] | 20.7 |
| **Total—Market groups** | 62.9 | 22.5 | 85.4 |
| Central government services | [3] | 9.3 | 9.3 |
| Local government services | [3] | 3.9 | 3.9 |
| Private non-profit services | 1.4 | [3] | 1.4 |
| **Total—Non-market** | 1.4 | 13.2 | 14.6 |
| **Total—Fixed investment** | 64.3 | 35.7 | 100.0 |

Source: Department of Statistics

[1] Statistics for 1977 and 1978 are provisional.
[2] Central and local government; includes all government enterprises.
[3] Not significant as a percentage of total investment.
[4] This is investment in the construction sector itself. Construction activity as a whole accounts for close to 60 percent of investment outlays (see table 1.3).
[5] Private sector only. (See table 1.3 for total investment in residential building.)

The investment/GDP ratio increased slightly in the mid-1970s but this mainly reflected the rise in all types of expenditure in relation to GDP.

Throughout the 1960s and early 1970s public sector investment declined as a proportion of the total. But in the late 1970s it rose to almost 40 percent. About one-third of public investment is in the provision of administrative and social services; another third is in the supply of electricity, gas, water, and communications; and the remainder is in other market sectors.

Public investment is large in transport, forestry, mining and quarrying, and finance and insurance, but very small in other market production sectors, especially agriculture and manufacturing (see table 1.2). Except for investment in electric power generation, most categories of public investment have grown less rapidly than GDP in recent years. In 1961–70, for example, public investment other than in electricity averaged 7.1 percent of GDP; in 1975–79, 5.9 percent. However, investment in electricity increased from 1.6 percent to 2 percent between the two periods.

Between 1971 and 1978 private investment accounted for about 65 percent of all fixed investment. One-third of this was for housing or private non-profit services (churches, clubs, and so on). Much of the rest was for office building, urban development, and other purposes which contributed little to growth in domestic output. *Less than 20 percent of total investment was for private sector machinery, plant and other equipment, or agricultural land development.*

Table 1.3 shows public and private investment by type of capital goods for the period 1971–72 to 1977–78. Tables 1.4 and 1.5 show the share of investment undertaken by central and local government.

A review of recent investment patterns suggests that:

- New Zealand's investment levels have been high in relation to the rates of economic growth obtained.
- The allocation between types of investment may have contributed to relatively low growth: in particular, growth has been constrained by a shortage of overseas exchange; this indicates that not enough investment is being made in activities which earn foreign exchange or provide effective substitutes for imported goods and services.
- Although investment in housing has not on average been higher than in most European countries or North America, the complementary investments in

**Table 1.3 Investment by Type of Capital Good**

Average for 1972–1978 March Years[1]

| Type | Private | Public[2] | Total |
|---|---|---|---|
| | (percent) | | |
| Residential building ... ... | 21.8 | 2.2 | 24.0 |
| Non-residential building ... | 11.3 | 9.6 | 20.9 |
| Other construction ... ... | 2.0 | 11.4 | 13.4 |
| Land improvements ... ... | 1.6 | 0.9 | 2.5 |
| Transport equipment ... ... | 9.8 | 3.4 | 13.2 |
| Plant, machinery, other equipment ... ... ... | 17.8 | 8.2 | 26.0 |
| Total ... ... ... | 64.3 | 35.7 | 100.0 |

Source: Department of Statistics

[1] Statistics for 1977 and 1978 are provisional.
[2] Central and local government—includes all Government enterprises.

**Table 1.4 Public Investment by Type of Economic Activity**

Average for 1972–1978 March Years[1]

| Sector | Central Government | Local Government | Total Public |
|---|---|---|---|
| | (percent) | | |
| Market Groups: | | | |
| Electricity, gas, and water ... | 19.0 | 6.8 | 25.8 |
| Transport and storage ... ... | 8.8 | 4.0 | 12.8 |
| Finance and business services ... | 7.6 | 1.6 | 9.2 |
| Other market groups ... ... | 14.6 | 0.6 | 15.2 |
| Total—Market groups ... | 50.0 | 13.0 | 63.0 |
| Central and local government services[2] ... ... ... | 26.1 | 10.9 | 37.0 |
| Total ... ... ... | 76.1 | 23.9 | 100.0 |

Source: Department of Statistics

[1] Statistics for 1977 and 1978 are provisional
[2] Includes investment in roading, drainage, buildings, and transport for use by non-trading departments, capital expenditure on schools and universities, investment in fire services, etc.

**Table 1.5 Public Investment by Type of Capital Good**

Average for 1972–1978 March Years[1]

| Sector | Central Government | Local Government | Total Public |
|---|---|---|---|
| | (percent) | | |
| Residential building ... ... | 4.9 | 1.2 | 6.1 |
| Non-residential building... ... | 23.9 | 2.9 | 26.8 |
| Other construction ... ... | 18.2 | 13.7 | 31.9 |
| Land improvements ... ... | 1.1 | 1.4 | 2.5 |
| Transport equipment ... ... | 7.9 | 1.8 | 9.7 |
| Plant, machinery, other equipment ... ... ... | 20.1 | 2.9 | 23.0 |
| Total ... ... ... | 76.1 | 23.9 | 100.0 |

Source: Department of Statistics

[1] Statistics for 1977 and 1978 are provisional.

suburban development and associated facilities may have been more costly than in other countries.

- Investment in non-residential building does seem to have been high in relation to other comparable countries, in both private and public sectors; although this could be partly a consequence of faster than average population growth.
- In the construction sector (which accounts for nearly 60 percent of all investment) inefficiencies and delays may

be lowering the returns on investment as a whole.

- Although the proportion of New Zealand investment in new machinery and equipment seems on the surface to be comparable with that of a number of OECD countries, it may be on the low side when the full cost of importing these capital goods is taken into account. It has not been possible to determine whether the combination of freight, duties, taxes, and markups makes new machinery and equipment generally more costly than in other countries. However, the Task Force believes that the problems New Zealand faces are created more by the way in which plant, machinery, and other capital goods are utilised than by how much they cost.

## Recent investment performance

There is obviously room for considerable improvement in New Zealand's investment performance in the 1980s. We have been operating at rates of investment well into the middle ranges for the more developed economies, yet our production and income growth have been disappointingly low. For example, in the decade to 1976 the ratio of investment to GDP averaged nearly 23 percent, and real growth of GDP 3.3 percent. Output per member of the workforce rose by about 1.5 percent a year—the lowest in any OECD country. Since 1975–76 there has been almost no growth in output or employment, and investment has declined.

This is largely the result of the way investment decisions have been made, and the available capital used. The inefficient use of capital is one reason for the poor returns on investment. Many factories, shops, and public facilities are used much less intensively than in other countries because of single shift operation, restricted shopping hours, and other established practices. The investment process itself is often costly because of the generally long gestation caused by delays in obtaining approvals, in construction, or in obtaining and installing capital equipment from abroad. Moreover, public sector investment decisions (which account for up to 40 percent of all New Zealand investment) have often been made without adequate prior analysis, and sometimes on doubtful economic grounds. This may also have been true of many private investment decisions, especially in the more protected areas of private sector activity. Public policy, particularly in its regulatory aspects (both domestically and in relation to imports) distorts the allocation of private sector investment and reduces the returns to investment in the economy as a whole. Thus public policy changes would contribute to improved performance in the future.

## Prospects

Investment is now at a low ebb after a steady decline since 1975. Investment did not decline until well after the end of the 1972–74 boom, and this has led to considerable unutilised capacity. Recent consumption-led growth in demand has stimulated little new investment. The latest New Zealand Institute of Economic Research (NZIER) forecasts suggest limited growth of investment in current prices. It is clear that in real terms the decline has been severe and is not yet arrested. At about 20 percent of GDP, investment is now well below the normal range and is apparently still declining.

Private sector investment is based on confidence in the future: at present this is low. Five factors in particular seem to be inhibiting new investment:

- low domestic demand;
- poor industrial relations;
- concern about the future of the balance of payments, and therefore about a continued foreign-exchange constraint on growth;
- expectations that the profitability of investment could be undermined by inflation;
- the present level and uncertain future of interest rates.

Success in current efforts to boost exports and stabilise the domestic economy would

**Table 1.6 Investment**

1976–1981 March Years

| Sector | 1976 $(m) | % change | 1977 $(m) | % change | 1978[1] $(m) | % change | 1979[1] $(m) | % change | 1980[2] $(m) | % change | 1981[2] $(m) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Private ... | 1904 | 18 | 2244 | −10 | 2017 | 7 | 2168 | 15 | 2490 | 5 | 2615 |
| Public ... | 1224 | −2 | 1204 | 14 | 1376 | −7 | 1473 | 7 | 1580 | 12 | 1770 |
| Total ... | 3128 | 10 | 3448 | −2 | 3393 | −7 | 3641 | 12 | 4070 | 8 | 4385 |
| | | | | | (percent) | | | | | | |
| Investment/GDP | 27 | | 25 | | 23 | | 21 | | 20 | | 19 |

Source: Department of Statistics

[1] Provisional.
[2] NZIER estimate.

help restore investment confidence and stimulate spending on new capital assets. An economic recovery which restored the average New Zealand investment ratio would imply extra investment of at least $500 million in 1979 prices. Some movement in this direction must be expected and provided for.

Several factors, however, will limit the expansion of private investment for the domestic market by large or small enterprises. A shortage of overseas exchange is likely to remain a problem for some time. Accordingly, macro-economic policies must be designed to contain the increase in consumption (and the consequential investment) to a level determined by our capacity to earn foreign exchange. The greater our success, the faster the rate of growth permissible in consumption and the investment required to supply it.

In the short term increases in oil prices will aggravate our balance of payment problems and limit the possibilities for growth in consumption and incomes. More costly oil will affect the prices of non-oil imports, invisibles payments, and possibly export prices as our trading partners adjust to the new situation. Considerably larger balance of payment deficits must now be forecast. Efforts to reduce oil consumption in New Zealand (such as carless days, closing petrol pumps at weekends, and price increases) will also have some impact on domestic economic activity, even if the conservation measures are directed mainly at private motorists. The combined effect will be to extend the already protracted period of very slow growth since the 1975 recession.

In addition, the changed demographic trends could exert a powerful longer-term influence. In the 1970s residential building accounted for nearly one-third of private investment outlays, and over 20 percent of total investment. Housing an expanding population involved much complementary investment in land development, the provision of roads and services, and associated facilities. With population growth static, there has been a rapid decline in new housing development. Although housing investment may be as dependent on the rate of household formation and the availability and cost of finance as on overall population growth, there is unlikely to be a return to the rate of housing construction experienced in the earlier part of the 1970s. In addition, higher transport costs may reduce the demand for new suburban development. This may be reinforced by changes in social attitudes; for example, towards a preference for modification of existing homes and for higher-density accommodation. An increased proportion of housing finance is for existing rather than new houses. Such trends could reduce investment requirements for new housing and increase the capacity to finance new investments in other fields.

Slower population growth may also reduce requirements for more non-residential building, including the

commerical and public office buildings which have absorbed substantial investment funds. Hospital and school building programmes can be reduced without detriment to health or education services. Further economies would be possible if existing non-residential buildings could be more effectively used.

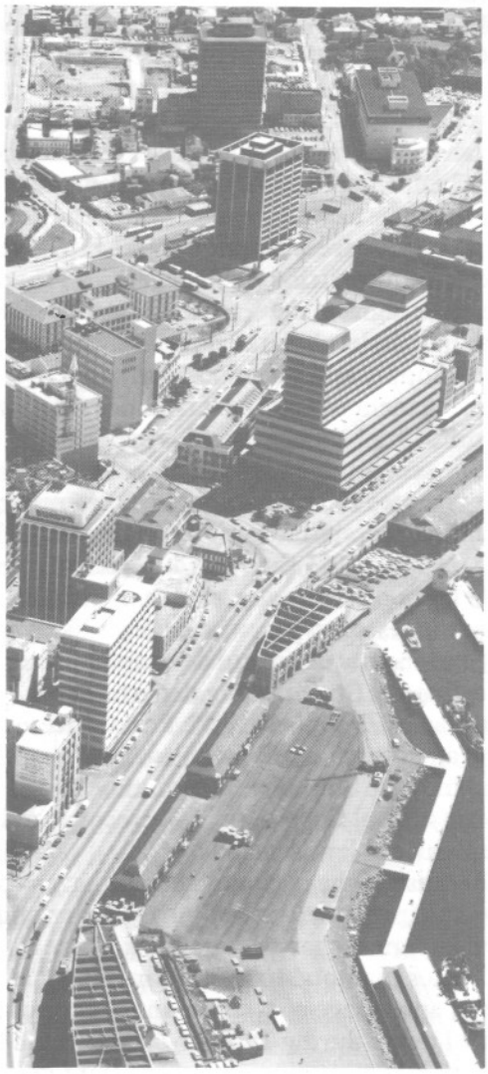
Recent Government initiatives have been designed to encourage more investment in priority activities and to accelerate economic change. These include the introduction of much more flexible monetary policies, measures to encourage agricultural exports including the supplementary minimum prices scheme, the relaxation of price controls, a new system of export incentives for manufacturing and service industries, the introduction of a flexible exchange rate, and the first steps towards modifying the import licensing system. These measures should promote confidence in investment for exports in particular and there is already some evidence, notably from the New Zealand Manufacturers Federation's export research programme, that they are having this effect.

Private sector investment trends as a whole will be determined by the interaction of all the influences noted above.

Investments in primary production, in much of the manufacturing sector, and in activities such as tourism must grow rapidly if the present economic strategy is to succeed. To the extent that it does, investment will recover and grow in other market sectors of the economy. Growth in incomes, and easing financial constraints would also stimulate some new investment in housing (the largest single category of private investment, even if population growth remains low). Because constraints on the growth of domestic demand must continue until the balance of payments improves, only modest expansion in some areas of private investment from present recession levels can be envisaged up to 1985.

Overall we can expect substantial growth in priority areas of investment (especially in the plant, machinery, and other equipment needed to increase foreign exchange earnings) and much more moderate increases in other private investment.

In the public sector, investment (except in energy) has tended to decline as a proportion of total investment and of GDP.



This has occurred partly through the shift of investment into the private sector (for example, reduced State housing activity, and a decline in the importance of railways as a means of transport) and partly because of increased emphasis on labour-intensive services and less on physical facilities in some Government programmes. As noted in the Council's report, *The Welfare State?*, capital expenditures by central government have been relatively restrained and local authority expenditures (excluding those of hospital and education boards) have also declined as a proportion of GDP in recent years.

The Task Force expects these trends to continue and to be reinforced by the change in the demographic patterns. The most striking prospect is a 19–28 percent

reduction in primary school rolls by 1989. Low population growth would ease the pressures for expansion in a number of areas of public sector investment. Greater emphasis on preventative rather than curative social services, as recommended by the Council in *The Welfare State?*, would itself reduce capital requirements. Moreover, there is scope for more effective use of many existing public facilities. There are some signs of deferred development (for example, in local and regional schemes for water supply and waste disposal), and the improvement of transport facilities will command some priority. However, the public sector works programme, which incorporates the bulk of public investment, could on present indications be smaller in real terms in 1985 than it is at present.

Whether there is any growth in public sector investment as a whole seems likely to depend mainly on future developments affecting the State trading departments (such as N.Z. Railways, the Post Office, etc.) and corporations (such as Air New Zealand, the Shipping Corporation, the Tourist Hotel Corporation, Petrocorp, and the Bank of New Zealand).

Because of the encouragement likely to be given to investment in activities to earn and save foreign exchange, The Task Force estimates that total fixed investment could rise at an average of 4–5 percent per annum in real terms during 1980–85 (within a GDP growth rate averaging about 2 percent per annum), and increase from 19 percent to about 21 percent of GDP in that period. Thereafter, it could well increase as constraints on domestic demand are eased and investment activity expands.

These estimates do not provide for the emerging programme of large-scale projects, mainly in energy development, which are discussed later in this report. Gas development projects already authorised, or implicit in current policies, will add at least $1 billion to New Zealand's investment expenditure during 1980–85. Additional proposals to increase the degree of self-sufficiency in liquid fuels, or expand exports, could increase the size of this programme during the 1980s to $3–3.5 billion, on present cost estimates. In addition, other large energy-using projects, such as the expansion of the capacity of N.Z. Steel, could add a further $1 billion to this total. The combined amounts are large enough to add investments equivalent to 2–3 percent of GDP annually (or 10–15 percent of total present investment) to the amounts of investment so far discussed.

This would be an exceptionally large programme by New Zealand standards; large enough on its own to alter the balance of investment in the economy. The big projects will generally have a high foreign exchange content (financed by specific overseas borrowing or direct investment). They will not draw heavily on domestic materials, manpower, or finance except in specialised areas; they need not therefore have a major impact on other investment activity if bunching is avoided. Careful and co-operative planning will nevertheless be needed in relation to specific categories of manpower skills if the energy and other large projects are to be easily accommodated within the framework of national development.

# II INVESTMENT STRATEGY

Patterns of investment determine the prospects for the economy and to a large extent those for our society as well. New Zealand's pattern of investment (described in Part I) has produced very great benefits, particularly plentiful employment; but in recent years it has also produced low and diminishing economic growth and no relief from a persistent balance of payments deficit. Moreover, it has become clear that the situation of full employment maintained over most of the post-World War II period can no longer be so easily achieved.

These problems have intensified partly because our external trading circumstances have changed since the 1950s, but also because our economy has not adjusted sufficiently to the changing conditions. Changing the structure of the economy involves a shift in the directions of investment. That this can be achieved through changes in economic policy is evident from New Zealand's experience in the long post-war period of industrial development through import substitution, and from the 1960s in the growth of manufactured exports. However, we have been reluctant to make substantial changes in a now outmoded investment strategy which was designed to expand production for domestic markets.

The industrial growth strategies of the 1940s and 1950s greatly enlarged and diversified New Zealand's productive base. This could have provided, as in other industrialising countries, the platform for continued economic progress if the policies had been adjusted as the external environment changed, and particularly when the difficulties of access for primary products to traditional markets increased, and the balance of payments pressures intensified. There were considerable efforts in the 1960s to promote growth in alternative exports, but there was limited adjustment within the economy. Domestic development continued behind high walls of protection, which isolated New Zealand from trends in the international economy. It can now be seen that the policy reaction to a changing situation, and therefore the investment response, was not good enough. We are paying a price for this now.

Changes in investment strategy are essential if even modest growth in output, incomes, and employment is to be achieved, and greater internal and external stability attained in the next 5 years. This is now widely, but not universally, recognised and some elements of a new strategy have been put in place. These centre on promoting exports but include steps to improve the functioning of the domestic economy.

These measures include a major revision of the export incentives scheme (which now incorporates export services); a supplementary minimum price scheme for pastoral agriculture; and of more fundamental significance, reforms in the exchange rate regime designed, amongst other things, to maintain the profitability of exports.

Internally, monetary reforms in 1976 have produced a more flexible and competitive financial sector. The relaxation of price control during 1979 should also help reduce distortions in the pricing system and promote more genuine competition. There is the prospect now of significant changes in respect of industrial strategy and import licensing. The first steps have also been taken towards taxation reform, with a modest restructuring of the personal income tax scale.

In the investment area, the controls on overseas investment in New Zealand have been somewhat liberalised and the procedures for domestic as well as foreign investment are to be improved. A major investment programme in energy development, with potentially large benefits for the balance of payments, has begun. Several large energy-intensive export projects are under consideration and in some other sectors investment in activities to earn foreign exchange is under way.

Considerable optimism in the medium-term future for New Zealand has been generated by the policy developments and decisions for exports and energy, and the recognition of existing potential for growth. In contrast, there is widespread concern about the current economic situation, concentrated in the areas in which there has been little change in policy or where the efforts to adjust have had limited effect. These include both elements of macro-economic policy (those concerning the operation of the economy as a whole) and those aspects of policy impinging directly on particular enterprises and individuals. Both affect the use of existing capital as well as the decisions on new investments.

In many of the areas that matter most to investment efficiency, New Zealand is still a

highly regulated and controlled economy. There has been little change yet in the system of import licensing. Within the economy (and in relation to some export products) restrictive licensing also is still widespread, inhibiting efficiency and new investment.

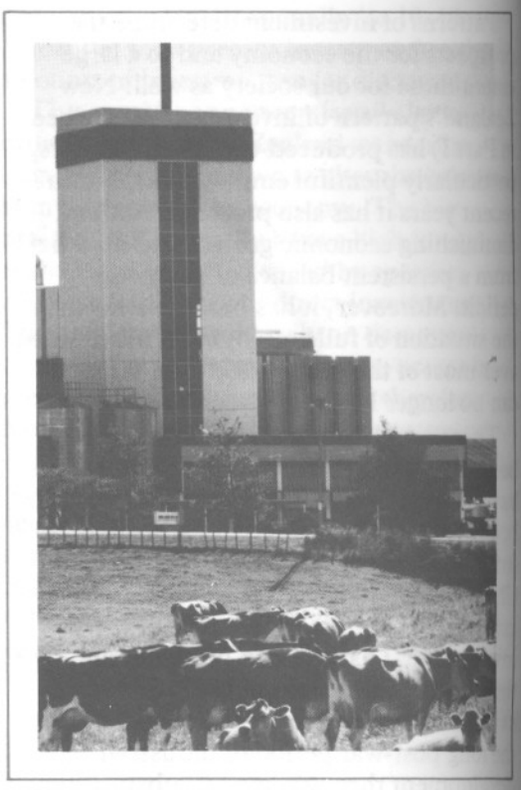
The incentive to invest (even in exports) has been greatly diminished by instability within the economy. Persistent high inflation has affected both the supply of funds for investment and the type of investment activity undertaken. Uncertainty about the future has clouded confidence in investment. We have still not achieved consistency in monetary, fiscal, and incomes policies (as is evident in the very high growth of private sector credit and the concurrent effort to limit wage increases). An incomes policy is complicated by difficult industrial relations and the high present level of unemployment.

None of these problems is unique to New Zealand. A number of OECD economies are experiencing inflation, unemployment, and low growth. What makes New Zealand's position unusually difficult is the dominance of its balance of payments deficit and the very slow increase in its productivity, the causes of which extend back over many years. Yet there are extensive possibilities for new investment and for the more effective use of existing capital, both of which will be needed if the prospects for economic recovery and renewed progress are to be realised.

## Growth Opportunities

The Government's recent publication, *Growth Opportunities,* identifies a wide, but not exhaustive, range of large- and small-scale production and investment possibilities open to New Zealand.

This catalogue of opportunities is based on developing the country's natural resources, the skills of its well-educated and well-trained workforce; and its modern transport, communications, and service industries. It indicates that New Zealand is capable of sustained economic development and employment growth.



Even from existing pastoral land, substantial increases in agricultural production are possible. Horticultural production could be significantly expanded and diversified. Great potential exists in the agricultural and horticultural processing industries, and in tourism, forestry, fishing, and so on. There is the possibility of sizable growth in mining and related activities. The development of the nation's mineral and energy wealth will greatly increase exports, as well as reduce dependence on the uncertain world petroleum market. The manufacturing sector appears capable of markedly increasing output and although techniques for international marketing by New Zealand enterprises are still evolving, manufacturers have already demonstrated an ability to successfully develop, manufacture, and market products internationally. New Zealand enterprises are capable of effectively competing in the international contracting and servicing sector.

Although *Growth Opportunities* canvasses many possibilities, it is acknowledged that not all will necessarily prove economic and that some of the prospects lie more in the longer-term future. Most of the suggestions however appear capable of early development. Significantly, a large number

of the possibilities involving products capable of profitably withstanding world-wide competition are not new. The fact that they remain unexploited is a major cause for concern and a reflection of the limitations of past economic policies.

Similarly, there is no evidence to suggest that many of the newer opportunities (which require even greater effort by way of adoption of new technology or advanced and responsive managerial techniques) will be adopted without substantial changes in policy. As mentioned in Part I, business confidence remains low and investment has continued to decline despite the widespread recognition of the outstanding investment potential (both short and long term) within the economy.

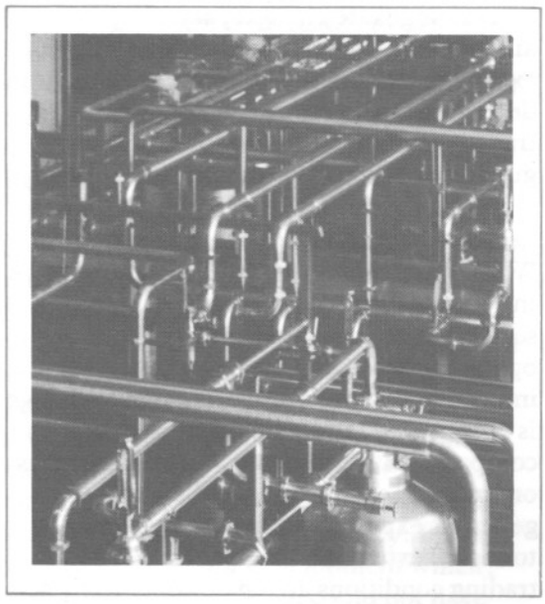
The basic requirements of a successful investment strategy are that a good environment should be created, the appropriate price signals given, and the impediments to investment and the effective use of capital as far as possible removed. The Government has sought to create these conditions for direct investment in exports of goods and services. The National Development Act was passed to try to ensure them for energy and other large-scale projects. The conditions do not exist however for large areas of investment activity, including some related to exports. Consequently, the level of investment is low (both in aggregate and in some important areas of economic activity) and there is widespread inefficiency in the use of capital. This is evident in both public and private sectors.

## Fiscal, Monetary, and Exchange Rate Policies

Instability within the economy has been a major deterrent to investment. It has created an environment of uncertainty about relative prices as well as general price trends (including the prices of labour and capital). This instability strongly reflects developments overseas, and is a problem for most economies. New Zealand cannot fully insulate itself from rising oil prices, or inflation among its major trading partners. The problems have however been compounded by stop-go monetary and fiscal policies. They have included periods of very rapid expansion in money and credit, and in public revenue and expenditure, followed by renewed efforts at control. By most international standards the rate of inflation has been high (16.5 percent in 1979, as measured by the Consumer Price Index) and there is little sign of abatement.

A pre-condition for any general increase in investment activity is a major effort to reduce the rate of inflation and to ensure, through greater consistency and restraint in fiscal and monetary policies, a more stable economic environment. This can be assisted by reducing the rate of growth of Government expenditure, limiting the size of the public account deficit, and keeping down increases in the supply of money and credit.

The problem for policy-makers is to encourage new investment without over-stimulating the economy. The Task Force favours an approach which would maintain some, but comparatively slow, growth in domestic demand through more stable fiscal and monetary policies, and induce progressive change in relative prices through changes in exchange rates, tariffs,



subsidies, and taxes. More frequent but less drastic adjustments in public sector prices would contribute to stability. Past efforts to limit inflation by direct controls on other prices, on wages and on profits, and to restrict demand through direct import and credit controls, have not been successful. Increased reliance on supply and demand mechanisms could well produce better

results. They can do so, however, only if macro-economic policies lead to improved stability.

On its own, greater stability would encourage increased investment but not necessarily the right type. Relative prices, and relative returns on investment, determine the composition of investment. The most important "price" in the economy, in this context, is the exchange rate.

Changes in exchange rates affect the prices of imported and exported goods and services and are an important variable in transmitting inflation from one country to another in a number of ways. For example, higher international meat prices have a direct impact on New Zealand's cost of living and therefore on wage claims, and other domestic prices. Changes in the exchange rate, however, also affect profits and profit shares. They affect the allocation of investment within the country, either towards or away from industries engaged in external trade (although the full impact of exchange rate adjustment is not felt until there is a significant shift in investment patterns). Capital flows are also influenced by exchange rate changes, actual or anticipated. Over a period of time, the exchange rate is a very important element in determining the balance of payments, the trade balance and capital flows, and in guiding the directions of investment.

Success in investment strategy depends heavily on an appropriate exchange rate. When it is overvalued (as it has tended to be in New Zealand), exporting goods and services is generally less profitable than operating in the domestic market, importing and other use of foreign exchange is encouraged, and domestic costs are high compared with those overseas. Restrictions on imports, exchange controls, and generous export incentives may be needed to secure external balance even when trading conditions are favourable. In these circumstances a strategy emphasising growth in exports is unlikely to work well. Devaluation is one remedy, but the occasional large devaluations undertaken by New Zealand, under a fixed exchange rate system, have led to inflation rather than any sustained adjustment of relative prices.

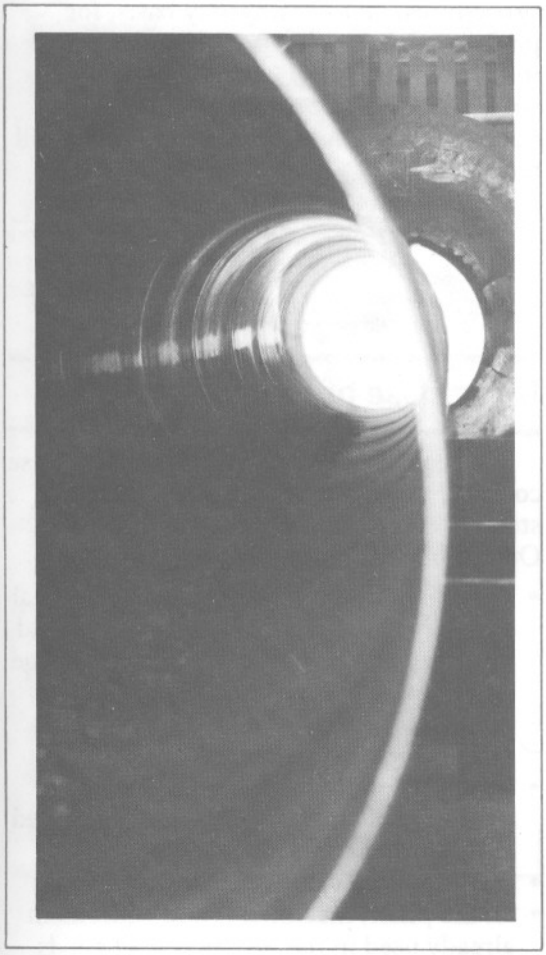
The recent change in the exchange rate regime is therefore potentially of great importance for the economy. The adoption of a system which makes possible frequent small adjustments in the international value of the New Zealand dollar, and the wider provision for forward exchange facilities, makes both for more stability and more appropriate relative prices. One aim in introducing the change was to "halt the erosion of exporters' profitability". There will be other effects on the pattern of investment as the relative price between exported, imported, and domestically traded goods and services adjusts. In this respect, economic management has moved towards greater reliance on supply and demand and less on regulation and control.

## Taxation Reform

There is a need for major changes in the tax structure if investment is to occur in the appropriate amounts and composition. The proportion of tax revenue derived from taxes on income is exceptionally large and that derived from taxes on expenditure correspondingly low. Tax rates on personal income remain steeply progressive in the low-to-middle income range, although the maximum tax rates are exceeded in some other countries. Resistance to increases in specific indirect taxes is strong and rightly so, since these are distortionary in their effects. Attempts to promote a broad-based and non-discriminatory tax on goods and services, or a progressive direct tax on personal expenditure, have made limited progress. There is very little tax on wealth in any form and no capital gains tax. As a result people have the incentive to seek capital gains rather than increases in income which can be highly taxed. This applies also to investment activity, where, for example, the gains from owning land may be greater than those obtained by using it effectively.

More generally, the present tax system tends to penalise effort and reduce incentives while encouraging consumption. This has obvious implications for both savings and investment.

Company tax is still levied on profits calculated on the basis of historical cost accounting. The practice results in distortion of the tax burden among companies, and often the taxation of what are not profits at all. With the persistence of high rates of inflation the viability of some companies has been threatened and the capital base of many others eroded,



damaging their capacity to invest. Tax relief for exporting and for certain other activities has given protection to some, and reduced the proportion of total company tax to nominal company income, but it has increased the distortions of the system as a whole. At present company dividends are taxed twice (with the exception of dividends distributed from capital reserves), once in the hands of the company and once in those of shareholders. This imposes what are often exceptionally high rates of tax on distributed savings and investment in shares of companies which do not export. This puts such companies at a disadvantage relative to other forms of investment, and encourages the search for capital gains.

There is no doubt that more effective use of new and existing capital would be encouraged by the removal of many of these structural defects in the taxation system, quite apart from the other beneficial economic and social effects which would accrue from major tax reform.

## Regulation and Control

Both new investment and the use of existing capital are powerfully influenced by the degree of regulation and control over economic activity. When regulations protect society or the environment they are clearly warranted; even so, they do not need to be complex, numerous, or obscure. When they protect enterprises and individuals from competition, reduce the incentive to keep costs and prices down, inhibit production of goods of acceptable quality, or reduce incentives to provide reasonable standards of service, they require strong justification.

The regulation of imports is discussed in relation to manufacturing in a later section of this report (pages 32–36). Regulation is also extensive in most other sectors of the economy; the transport sector is a prime example. The effect is to reduce competition, protect the inefficient use of capital, prevent the growth of more efficient enterprises, and to keep up the costs of production of many goods and services. Some progress has been made towards the removal of regulations affecting economic activity, notably in the financial sector, and in easing price controls. Much of the economy however remains under extensive regulation and control.

Developments in the financial sector since 1976 provide a case study of the effects of deregulation. Financial institutions now compete actively for funds, over a wide range of activities, offering a better range of services in an increasingly flexible and innovative way, and tapping wider sources of funds. Once notable for its conservatism and slow pace in an environment of controls, the financial sector is now one of the most dynamic in the economy. It has shown a capacity for development which, until controls were eased, could not have been anticipated.

Preserving tight regulation and control elsewhere in the economy implies a lack of confidence in the ability of those involved to respond to the opportunities which a more open and competitive system would provide. There may be areas of activity in which high protection through regulation or restrictive licensing is essential to survival. It would be surprising if extensive protection had not led to some investment

directly dependent on continued support. These areas may be smaller than is generally assumed. In any case, the right to continue to provide high cost, high priced, or poor-quality goods and services must be questioned.

When the cost of producing goods is manifestly excessive, the appropriate policy is to shift resources from these types of production into more efficient activities, unless they can become more competitive. The first steps have already been taken with the adoption by the Government of recommendations for a textile industry development plan. This indicates both the potential for adjustment and the need to consider important questions of timing, methods of implementation, and the appropriate forms of industrial assistance to facilitate change in a period of relatively high unemployment and low domestic demand. The pace of change, however, is not in itself important. The main requirement is to signal clearly the directions of future development so that new investment, as well as efforts to raise productivity and reduce costs, can be confidently pursued.

In relation to the procedures for approving new investment, it has often been stated that the numerous consents and approvals required act as a strong disincentive to invest, especially for overseas investors. An Investment Unit was established last year to assist with such problems. However, its experience so far suggests that these procedures are not the main source of concern to investors. Most developed countries have similar environmental and other requirements. What is of more importance, apparently, is the attitudes of officials to new proposals. The proposals can be dealt with quickly and constructively, or there can be a lack of response and long delays before decisions are made. Large-scale projects with obvious foreign exchange, employment, or other benefits tend to be well received. Smaller investment proposals appear to face more difficulty and delay.

The general point can be made that regulation and control automatically introduce officials into decision-making. The more pervasive the control, the greater the responsibility of the Government and local authorities for the efficiency of the investment process. The National Development Act sets up special procedures, on a contingency basis, for projects of national importance. Measures to encourage positive official response to smaller investment proposals, and in other matters involving the use of capital, are still required.

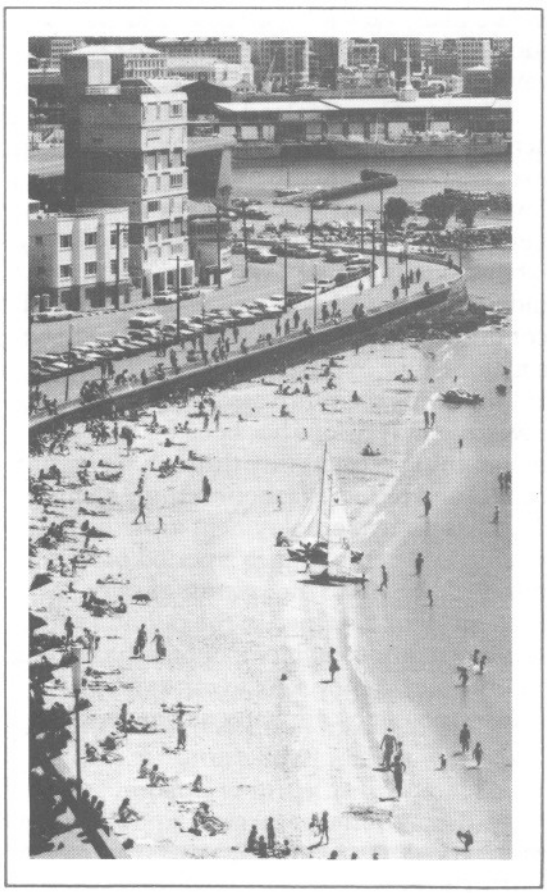
## Better Use of Existing Capital

There is no question that much better use could, if desired, be made of the immense stock of capital built up through the years. Our main existing capital assets are:

- the highly developed economic and social infrastructure (roads, railways, ports and airports; power, gas, water, and sewerage systems; schools and hospitals);
- all the non-residential building in both public, and private ownership;
- about one million houses and other dwellings of an average standard matched by few other countries;
- the improved value of agricultural land;
- all the plant, machinery, and equipment already used in the production of goods and services.

The estimates of capital stock made by the Project on Economic Planning (PEP Internal Paper No. 69, Victoria University of Wellington, March 1979) suggest a total value of $18,750 million in 1976–77, at 1956–66 prices: $15,450 million in buildings and construction, and $3,300 million in plant and equipment. Taking into account inflation since 1965–66 the current value of this capital stock must be 2.5 to 3 times greater. Using this massive accumulation of assets more productively, even a little more productively, would significantly reduce costs, and increase output.

The best way to improve the productivity of capital assets is to make more use of them. Machinery used in continuous processes is more effectively employed than that used on a one-shift basis. Agricultural machinery owned by contractors is often more frequently used than that owned individually by farmers who may need it only once a season. Hospitals, which use their facilities around the clock, are more efficient than schools, which use theirs for less than 1500 hours a year. Warehousing



involving extended hours makes more efficient use of assets than retailing with restricted hours. The 9 to 5 emphasis in economic activity raises the costs of urban transport as buses are underused except at peak travel periods. Fixed holiday periods result in heavy demand on facilities at some times and underutilisation at others.

The extent to which capital is effectively used, and sometimes whether it is used at all, depends on the attitudes, preferences, and beliefs of employees as well as employers. Clearly, improvements cannot be made without consultation with, and the co-operation of, the unions and their members. At present there is a wide gap between the views of many workers and their representatives on the one hand, and those of many owners and managers on the other. The combination of limited growth, high inflation, and uncertainty about the future has obviously had a strong effect on labour as well as business attitudes. The emergence of sizable unemployment is a direct threat to many people. Positive approaches to economic change cannot be expected unless the advantages are clearly perceived.

In production for export the issues should be plain. Increased production at costs and prices acceptable overseas is essential for the economic health of the nation; it benefits both employers and employees, who can negotiate rewards for increased productivity.

In relation to production for the domestic market the issues are more complex. Low domestic demand means less employment growth in some sectors of the economy. Projects which will create new jobs are welcomed; those that involve new technology which could displace labour are likely to be resisted unless there is attractive alternative employment. More effective use of capital is nevertheless desirable because if costs in one area are lowered the scope for increased output and employment in others is increased. High costs and low productivity reduce the demand for goods and services and the number of jobs that can be offered.

In areas of opportunity for better use of capital, and for the introduction of new technology, special efforts are needed in a period of constraint to involve workers and unions in investment decisions which will affect their own futures. The failure to do so in the past has resulted in bitter and costly disputes.

## Employment Considerations

The employment issues for the 1980s are at present being studied by the Planning Council; a separate report on employment will be published later this year. This section deals only with the implications for investment strategy and the use of capital.

With its unique record (for a market economy) of full employment in the post-war years, the task of providing enough jobs for all who want them is clearly a major economic challenge for the 1980s; especially from a starting point of relatively high unemployment and reliance on special Government work programmes.

The prospects identified in the Planning Council's report *The Welfare State?* are for low overall population growth but a comparatively large increase in the potential labour force. During the eighties average annual population growth could be as low as

0.4 percent (compared with an average increase of 1.6 percent a year in the decade to 1976). However, the age distribution will change; the proportions in both the elderly and working-age groups will increase in relation to the young. This will be reflected in an expansion of the labour force which, although moving slowly in the early years of the decade, is expected to grow at 1.5–2 percent a year on average through the eighties.

Growth in the demand for labour, and thus in employment, will depend on increases in aggregate demand for goods and services and on the investment undertaken to provide it. The sources of new demand are growth in the domestic economy, and increased exports. Because demand from within the economy has to be held back until we overcome the balance of payments constraint, in the short run most new jobs will have to result from increased exports of goods and services. The possibilities of import substitution to provide new employment are limited. The easy options were taken many years ago. The main opportunities for import substitution are in the energy sector, and relate especially to Maui gas development. This will be highly capital-intensive, and the direct employment effects will be quite small. In the medium term, growth in foreign exchange earnings and growth in employment will be closely related.

Fortunately, some of the opportunities for growth in foreign exchange earnings have substantial employment possibilities. Tourism could be of special significance—rapid expansion in this sector could provide many jobs in the construction, transport, retail, and other service sectors. Another market sector with high potential is horticulture, in both the investment and production stages. New Zealand's well-developed manufacturing sector also offers many opportunities for employment related to exports, if they are competitive in quality and price with goods available overseas.

Together these activities could generate substantial new employment during a period of slow growth in most domestic sectors of the economy. The extent to which this will contribute to growth in total employment is still not clear. This question is being considered by the Planning Council in the context of its studies on employment. Clearly however, new export activity could create many new jobs, directly and also indirectly, through the stimulus to investment activity.

Whether New Zealand investment in activities designed to earn or save foreign exchange creates many new jobs or only a few, depends partly on what entrepreneurs believe to be the relative advantages of labour versus capital. The direct and indirect cost of labour (i.e., wage levels and conditions attached to employment) will be a major factor in this assessment. The emphasis in recent private sector investment decisions has been on maintaining profitability through increasing capital and reducing labour requirements. This has limited employment growth. In retailing, the emphasis in a period of minimal growth in the volume of sales has been on labour saving. In the public sector, similar trends are evident among the trading enterprises, as they seek to offset increases in labour costs by applying new technology.

## Objectives

New Zealand will make limited economic progress until its balance of payments deficit is reduced. Only then can demand be allowed to expand to provide more jobs, higher real incomes, and a wider range of public and private goods and services.

The Task Force does not believe that this can be achieved solely by further reducing imports, although within a few years New Zealand will be much less dependent on imported oil and there are undoubtedly other opportunities for efficient import substitution. The decline in the volume of imports from 1975 to 1979 was associated with falling production and lower investment, and was a temporary phenomenon. Accelerated growth in exports of goods and services seems essential, and will not be achieved without increased investment.

Growth in export earnings will be sustained only if the goods and services can be provided at competitive prices. This depends partly on the exchange rate, which will have a major influence on the amount and composition of investment.

A successful export drive also requires continued efforts to contain cost increases at home. In terms of economic management, it

implies a rate of inflation no higher, and preferably not as high, as those obtaining in countries with which we trade.

For investment strategy, the message is that efforts to improve efficiency within the economy, through new investment and more effective use of existing capital stock, will also help the balance of payments by reducing the cost and increasing the prospects for export growth. Moreover, better use of capital would reduce import requirements, contributing directly to the balance of payments.

The reduction of regulation, licensing, and control in relation to imports and within the economy would stimulate not only new investment but more effective use of existing capital. Reforms have begun and should continue. The most urgent need is for a clear indication of the direction these reforms will take. If there is evidence of a commitment to reducing costs within the economy as well as promoting exports, a firm base for future development will exist. Further impetus to investment would be given by steps towards taxation reform.

The Government's primary role in the private investment process should be to establish a stable environment and provide the appropriate price signals to prospective investors, whether foreign or domestic, rather than relying on specific provisions to encourage selected types of investment.

In its own large-scale investment activity (whether in providing the economic and social infrastructure, participating in major projects, or supplying market services) the public sector also has the responsibility to ensure that full use is made of available techniques for project and programme evaluation; that capital, once available, is effectively used; and that services are made available at the lowest economic cost.

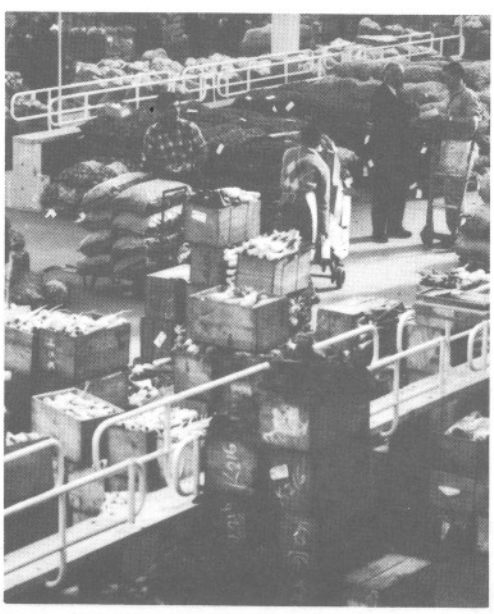
Much of the new investment needed to generate increased exports, increase employment, and improve the operation of the economy has yet to be made. Gestation can take several years; not just for major projects but for some smaller scale agricultural, manufacturing, and services development as well. Efforts to stimulate investment activity and guide it in new directions must be intensified. Equally important are the measures which could be taken to make more productive use of the immense stock of capital already available.

# III SECTORAL ISSUES

In *Planning Perspectives 1978–83* the New Zealand Planning Council defined a strategy for development in which substantial export growth was central to the achievement of economic and social objectives in the medium term. This section discusses the main investment issues for the sectors most directly involved: agriculture (still the primary source of foreign exchange); forestry; manufacturing; tourism; energy development; and the emerging programme of large-scale projects in other export sectors.

Too much emphasis, however, can be placed on foreign exchange objectives. Our future will be determined not just by what we achieve in the way of growth in exports, or savings in imports of liquid fuel through domestic energy development. What determines the performance of an economy is the extent to which *all* the available resources are effectively employed.

For this reason the Task Force has also looked at other major areas of investment—transport, construction, retailing (which is especially important because of the many full-time and part-time jobs it provides for those without technical training), and also central and local government activity, including the operations of State enterprises. In the long run, the quality of investment in these sectors determines our standard of living as much as what happens in manufacturing, agriculture, or energy development.



## AGRICULTURE

Investment in farming consists of any expenditure on productive improvements to a farm. It does not include farm purchase. Productive improvements include land improvement (by way of fertiliser and seeds, fencing, etc.), purchase of machinery and erection of buildings, and the build-up of the livestock herd. It includes permanent tree planting in orchards and the like, shelter belts, and roading. Spending on capital items is to be distinguished from spending on maintenance—fertiliser, repairs, depreciation, and so on. It is useful, furthermore, to distinguish between gross capital expenditure and net capital expenditure—gross investment means total spending on productive improvements, net investment means additional spending on capital assets over and above their maintenance requirements. Expressed in constant prices, economists call the latter real net investment.

Most of gross investment in farming comes from the plough-back of farm revenue. Farmers accept a lower standard of living in the present to raise their income in the future. Other sources of investment capital are the Rural Banking and Finance Corporation, the stock and station firms, the banks, and private lenders. In recent years farmers have spent around 10 percent of gross returns or $300 million on capital expenditure when the value of their total output has been in the region of $3,000 million.

Farmers make their own decisions on capital improvements. There is very little public sector involvement except through the provision of rural finance. The Government played a prominent part in land development for ex-servicemen after the war, but this function has now all but ceased. As individual investors, farmers are very much guided in their investment decisions by their view of the future. Good returns are thus important to farmers, not only to encourage them to invest in the future, but also to provide them with the financial resources to invest.

Over recent years farming has received a considerable amount of Government assistance, mainly in the form of subsidies. This has been additional to *the money* provided for research and advisory services which is traditional in most countries. In

the last 3–4 years, increased Government support for growth has been made available in the form of land development encouragement loans and the livestock incentive scheme. The emphasis has shifted from input subsidies towards assistance directly related to increases in output. A supplementary minimum prices scheme for major pastoral products was introduced in 1978, and extended in 1979, to give farmers more confidence to plan increased production. The encouragement schemes have attracted considerable support, but there will be the usual lag before the investment which they have provoked is reflected in extra production.

Until the mid-1960s a satisfactory rate of growth in the volume of agricultural production was achieved—on average, about 3.5 percent a year. Growth in output

**Table 3.1 Trends in Gross Investment in Agriculture**

| Year Ended 31 March | Land | Buildings | Plant | Total |
|---|---|---|---|---|
| | $(million) at current prices | | | |
| 1946 ... ... | 5.9 | 3.1 | 5.3 | 14.3 |
| 1947 ... ... | 6.7 | 4.6 | 6.9 | 18.3 |
| 1948 ... ... | 8.1 | 6.4 | 8.5 | 23.0 |
| 1949 ... ... | 11.1 | 8.0 | 10.6 | 29.7 |
| 1950 ... ... | 13.8 | 10.0 | 14.5 | 38.4 |
| 1951 ... ... | 15.4 | 11.7 | 17.5 | 44.6 |
| 1952 ... ... | 18.1 | 13.7 | 24.3 | 56.1 |
| 1953 ... ... | 22.3 | 15.1 | 25.7 | 63.1 |
| 1954 ... ... | 23.0 | 16.6 | 24.2 | 63.9 |
| 1955 ... ... | 27.0 | 19.8 | 26.1 | 72.9 |
| 1956 ... ... | 31.2 | 21.7 | 26.1 | 79.0 |
| 1957 ... ... | 27.8 | 22.3 | 21.7 | 71.9 |
| 1958 ... ... | 29.4 | 24.0 | 24.2 | 77.6 |
| 1959 ... ... | 28.7 | 23.6 | 21.7 | 74.0 |
| 1960 ... ... | 29.3 | 23.1 | 18.6 | 71.0 |
| 1961 ... ... | 31.9 | 25.6 | 23.1 | 80.7 |
| 1962 ... ... | 34.7 | 26.8 | 25.6 | 82.2 |
| 1963 ... ... | 32.4 | 29.9 | 24.3 | 86.7 |
| 1964 ... ... | 35.0 | 27.6 | 26.6 | 89.2 |
| 1965 ... ... | 38.9 | 29.5 | 26.5 | 95.0 |
| 1966 ... ... | 40.1 | 35.3 | 35.8 | 111.2 |
| 1967 ... ... | 39.8 | 40.1 | 34.8 | 114.6 |
| 1968 ... ... | 39.8 | 31.8 | 32.0 | 103.7 |
| 1969 ... ... | 39.4 | 29.0 | 31.8 | 100.2 |
| 1970 ... ... | 40.5 | 29.3 | 32.6 | 102.4 |
| 1971 ... ... | 39.8 | 33.9 | 40.6 | 114.3 |
| 1972 ... ... | 34.9 | 32.7 | 64.2 | 131.8 |
| 1973 ... ... | 51.8 | 42.8 | 91.6 | 185.5 |
| 1974 ... ... | 64.9 | 59.8 | 87.2 | 211.3 |
| 1975 ... ... | 54.4 | 72.5 | 74.0 | 202.1 |
| 1976 ... ... | 62.7 | 77.9 | 109.5 | 251.7 |
| 1977 ... ... | 73.5 | 96.1 | 145.1 | 316.3 |
| 1978 ... ... | 64.9 | 152.4 | 141.5 | 358.8 |
| 1979 ... ... | 82.7 | 166.4 | 144.5 | 393.6 |

Sources: Lincoln College Agricultural Economics Research Unit Report No. 65, (1946 to 1969).
Department of Statistics (1970 to 1977).
Agriscope Survey (1978 and 1979).

**Table 3.2 Trends in Real Net Investment at 1949–50 Prices**

| Year Ended 31 March | Land and Buildings | Plant | Livestock | Total |
|---|---|---|---|---|
| | | $(million) | | |
| 1946 | 5.2 | 0.0 | −1.3 | 3.9 |
| 1947 | 6.8 | 2.0 | −4.2 | 4.6 |
| 1948 | 8.5 | 2.8 | 1.5 | 12.8 |
| 1949 | 9.9 | 4.5 | 2.0 | 16.4 |
| 1950 | 12.7 | 8.7 | 11.9 | 33.3 |
| 1951 | 13.4 | 6.5 | 8.0 | 27.9 |
| 1952 | 14.2 | 7.9 | 5.6 | 27.7 |
| 1953 | 15.5 | 8.2 | 13.4 | 37.1 |
| 1954 | 17.5 | 5.0 | 18.2 | 40.7 |
| 1955 | 19.6 | 7.2 | 10.0 | 36.8 |
| 1956 | 20.8 | 5.8 | 9.2 | 35.8 |
| 1957 | 19.7 | 4.0 | 6.7 | 30.4 |
| 1958 | 19.7 | 2.6 | 18.3 | 40.6 |
| 1959 | 19.6 | 1.9 | 7.2 | 28.7 |
| 1960 | 19.7 | 2.1 | 1.7 | 23.5 |
| 1961 | 21.1 | 2.9 | 20.2 | 44.2 |
| 1962 | 22.9 | 4.2 | 17.4 | 34.5 |
| 1963 | 24.4 | 0.8 | 9.3 | 34.5 |
| 1964 | 23.5 | 0.1 | 5.6 | 29.2 |
| 1965 | 24.6 | −0.4 | 15.2 | 39.4 |
| 1966 | 27.4 | 0.4 | 30.1 | 57.9 |
| 1967 | 29.4 | −1.7 | 29.0 | 56.7 |
| 1968 | 25.4 | −0.9 | 17.2 | 41.7 |
| 1969 | 22.5 | −0.7 | 7.7 | 29.5 |
| 1970 | 18.1 | −0.8 | 16.0 | 33.3 |
| 1971 | 17.6 | 1.2 | −14.4 | 4.4 |
| 1972 | 13.4 | 8.7 | 8.3 | 30.4 |
| 1973 | 21.3 | 15.3 | −12.0 | 24.6 |
| 1974 | 26.9 | 11.3 | 5.8 | 44.0 |
| 1975 | 21.3 | 1.2 | 4.2 | 26.7 |
| 1976 | 21.3 | 3.2 | 9.3 | 33.8 |
| 1977 | 21.4 | 4.3 | 4.4 | 30.1 |
| 1978 | 23.7 | 1.2 | −4.2 | 20.7 |
| 1979 | 23.9 | −0.2 | −4.4 | 19.3 |

Source: As for Table 3.1

continued for several more years, but at a slower rate. In the 1970s there was almost no increase in total production.

Tables 3.1 and 3.2 show farm investment from 1945–46 to 1978–79. Fluctuations in farmer confidence are evident in fig. 3.1 which shows real net investment in farming over the last 35 years. Real net investment is the additional net investment in farms by farmers over and above what is required to maintain the asset in constant prices.

Net investment in *land and buildings* built up steadily after the war and reached its peak in the heady days of the mid-1960s. For some years after 1966–67, the cash flow into farmers' hands became more constricted and their confidence diminished until the latest measures of encouragement were introduced. The most marked decline in real investment in land was in 1971–72 and since that date good years have alternated with bad. Real investment in

*plant and machinery* shows a distinctive pattern of its own. There was a build-up of productive capacity in the 1950s to be followed by a long period of maintenance in the 1960s. A large reinvestment was then required in the early 1970s to replenish machinery, but since then little above maintenance has been spent. *Livestock investment* shows the most fluctuations of all. Here climate and other factors are superimposed on farmers' investment decisions, and large increases in livestock numbers permitted by land improvements are sometimes cancelled out in the following year, when the build-up must be started again. When economic conditions are pessimistic, a net disinvestment takes place.

Much of the investment affecting agricultural output and incomes takes place beyond the farm gate, for example in processing pastoral products. Product diversification in the dairy industry continues to require major investment. The Chairman of the New Zealand Dairy Board has referred to the sum of $500 million in new investment by dairy companies over the next 10 years. The meat industry, too, has a major investment programme under way, much of which is attributable to the need to meet the veterinary requirements of our trading partners.

Capital investment within farming is responsive to the changing demand for farm products. Table 3.3 shows trends in gross capital expenditure among the main farm types. Sheep farming is the most important and takes up to 60 percent of the total spent in the 12 years from 1965–66 to 1976–77. Dairy farming has a declining share and has dropped from over 30 percent down to 20 percent in recent years. The cropping farm share is constant at around 9–10 percent. But in market gardening, orcharding, deer farming, and such activities the share has risen rapidly from under 4 percent in 1965–66 right up to 16 percent in 1975–76. The investment in these latter activities will yield dividends in the future.

There are several explanations for the lack of growth of pastoral production, all of which have some validity:

**Diversification.** Diversification of land into deer farming, maize growing, forestry, and horticulture has probably held back traditional agricultural growth. Recent research suggests that this has absorbed the equivalent of 9 million livestock units or about 9 percent of the total. Most of the land diverted in the last 10 years is of good quality, some very good indeed. Much of it is in transition, such as land in kiwi fruit and other types of horticulture where there is a long time before production begins in any quantity. But when it does there should be substantial increases in total agricultural production.

**Table 3.3 Trends in Gross Investment in Agriculture by Main Farm Types, 1966–77 March Years**

| Year ended 31 March | Beef and Sheep | Dairy | Cropping | Market Gardens | Other | Total |
|---|---|---|---|---|---|---|
| | | | ($ million) | | | |
| 1966 ... ... | 84.5 | 37.9 | 9.3 | 0.7 | 4.3 | 136.5 |
| 1967 ... ... | 73.2 | 38.7 | 7.9 | 0.9 | 3.2 | 123.9 |
| 1968 ... ... | 54.2 | 37.6 | 9.6 | 1.1 | 3.0 | 10.5 |
| 1969 ... ... | 54.5 | 30.9 | 10.1 | 1.2 | 3.1 | 99.8 |
| 1970 ... ... | 59.6 | 27.3 | 10.4 | 1.1 | 4.0 | 102.4 |
| 1971 ... ... | 62.2 | 32.3 | 12.1 | 1.6 | 6.1 | 114.3 |
| 1972 ... ... | 66.2 | 42.6 | 7.4[1] | 2.8 | 16.9[1] | 135.9 |
| 1973 ... ... | 108.3 | 50.4 | 9.1 | 3.6 | 20.8 | 192.2 |
| 1974 ... ... | 122.0 | 49.4 | 9.2 | 4.1 | 34.5 | 219.2 |
| 1975 ... ... | 103.8 | 49.7 | 15.6 | 5.7 | 28.1 | 202.9 |
| 1976 ... ... | 135.0 | 55.3 | 20.8 | 7.8 | 32.8 | 251.7 |
| 1977 ... ... | 185.6 | 61.1 | 28.4 | 7.8 | 33.4 | 316.3 |

Source: Department of Statistics

[1] Change in classification from 1971–72.

**Low profitability.** This is undoubtedly the principal factor. Returns in traditional farming have been quite inadequate. Details of farm incomes will be found in the annual financial reviews produced by the N.Z. Meat and Wool Boards' Economic Service and the N.Z. Dairy Board. These and other data are published in the Ministry of Agriculture and Fisheries economic reviews, and the annual report of the Agricultural Review Committee. Table 3.4 shows the changes in net farm income since the peak in 1972–73.

**Farming for capital gain.** A number of institutional and other factors encourage farming for capital gain. Among them are the absence of a capital gains tax, 100 percent depreciation for many capital expenditures, and the related tax-loss possibilities for "Queen Street" farmers. Current prices for pastoral land cannot be justified by the returns on production alone, which are exceptionally low in relation to recent costs of land purchase. The farming community as a whole, however, wants to work the land efficiently and seek increased production. The capital gains some receive are only incidental to this. There is still a strong tendency to pursue profitable activities within the farming sector (such as deer farming and kiwi fruit production) to compensate for low returns in traditional export agriculture. There is also a continuing battle to protect net incomes in the face of continuing cost increases.

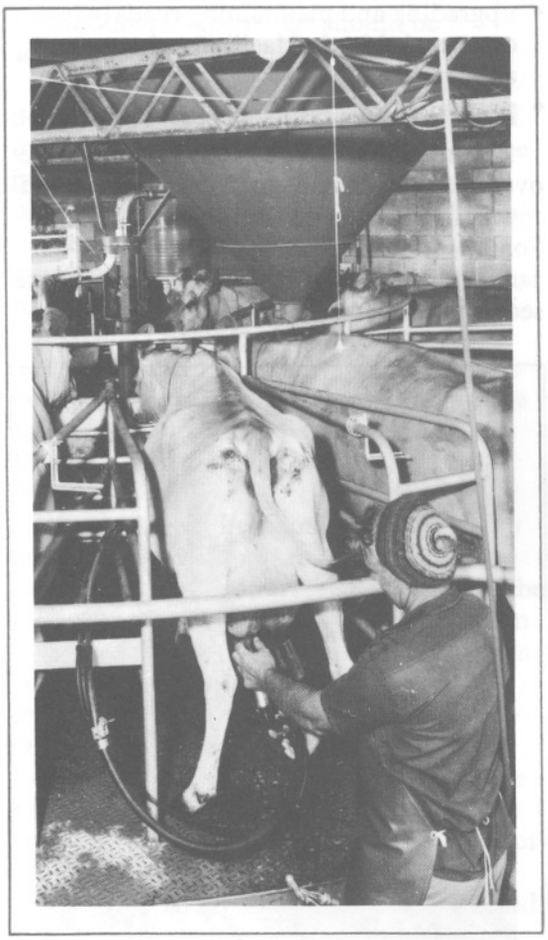
**Market uncertainty.** This has probably been a factor in dairying. Butter marketing problems continue to threaten the industry, but the Dairy Board has been short of every other product. Unless EEC politics produce a highly restrictive import regime for lamb in the Community, markets should be no problem for any meat product (except perhaps mutton occasionally). With a strong demand for wool; the possibilities for lamb in the Middle East, Japan, and North America; and a likely shortage of beef, the main problem will be one of supplying enough to meet the likely demand.

**Table 3.4 Net Farm Incomes in Real Terms**

| Year Ended 30 June | Net Income (All Farms) ($) | Consumers' Price Index (Base: 1973 = 1000) | Net Income: Real Terms ($) | Index |
|---|---|---|---|---|
| **Sheep Farms** | | | | |
| 1973 ... ... | 18 800 | 1 000 | 18 800 | 100 |
| 1974 ... ... | 14 300 | 1 098 | 13 024 | 69 |
| 1975 ... ... | 5 400 | 1 243 | 4 344 | 23 |
| 1976 ... ... | 13 600 | 1 444 | 9 416 | 50 |
| 1977 ... ... | 20 200 | 1 663 | 12 147 | 65 |
| 1978 ... ... | 15 000 | 1 898 | 7 903 | 42 |
| 1979[1] ... ... | 20 500 | 2 107 | 9 729 | 52 |
| 1980[2] ... ... | 22 000 | 2 475 | 8 889 | 47 |
| **Dairy Farms** | | | | |
| 1973 ... ... | 8 400 | 1 000 | 8 400 | 100 |
| 1974 ... ... | 8 200 | 1 098 | 7 513 | 90 |
| 1975 ... ... | 8 600 | 1 243 | 6 955 | 83 |
| 1976 ... ... | 9 600 | 1 444 | 6 645 | 79 |
| 1977 ... ... | 10 500 | 1 663 | 6 310 | 75 |
| 1978 ... ... | 10 200 | 1 898 | 5 350 | 64 |
| 1979[2] ... ... | 13 900 | 2 107 | 6 587 | 79 |
| 1980[2] ... ... | 13 900 | 2 457 | 5 604 | 67 |

Source: Economic Review of New Zealand Agriculture 1979

[1] Provisional.
[2] Ministry of Agriculture and Fisheries estimate.



**Climate.** There has been a high incidence of unfavourable seasons during the last decade, and an unusually large number of drought days. This seriously affected farm production and returns, partly because of a tendency to overstock with cattle during the period of buoyant markets in the early 1970s.

**Psychological factors.** It is impossible to evaluate these, but they are undoubtedly important. Farmers feel bitterly about strikes and other industrial delays. Because of these some farmers have had severe losses; for example during the 1977–78 season when disputes coincided with a drought. Industrial relations problems, especially in the meat processing and transport industries, affect farm incomes, and also farmers' confidence in the future. Domestic inflation has created worse problems for pastoral agriculture than for most other sections of the community. Increased returns may, if sustained, offset some of the effects.

This current season (1979–80) sheep farming should be more profitable According to the Agricultural Review Committee Report, sheep-farm incomes should average $22,000. (Because of the number of partnerships in the industry this is equivalent to about $15,500 per farmer.) However, a return of $22,000 is really very low for an enterprise involving capital of perhaps $400,000, a high level of management skill, and the fairly high risks associated with weather, disease, and marketing difficulties.

What farmers appear to need most is an economic environment more conducive to investment and growth in output. This depends on success in managing the whole economy through improved fiscal, monetary, and exchange-rate policies; and on more stable industrial relations. Direct investment assistance to farming can support, but not substitute for, appropriate macro-economic policies.

The shift in farm support away from input subsidies and towards growth incentives is to be welcomed, as is the supplementary minimum prices scheme. There are encouraging signs of a renewal of confidence in future prospects. It is to be hoped that as the economy becomes more market oriented, direct aids will become less necessary. But this will depend on the extent to which the Government succeeds in keeping the internal cost structure on an even keel, or adjusts the exchange rate.

# FORESTRY

Forest production differs from that in other sectors because it is possible to assess wood resources for many years ahead.

New Zealand's forest industries are based on its exotic pine plantations. Their rapid growth provides the potential to maintain a high-volume wood supply. The indigenous forests do not possess the natural attributes of rapid growth and ease of re-establishment following clear-felling to sustain the supplies of wood needed for modern integrated wood-processing industries. Indigenous milling is gradually being phased down to provide a small sustained yield for special purposes such as handicrafts and quality furniture.

In 1978–79 New Zealand produced 9.15 million cubic metres of exotic logs of which 59 percent was exported (as newsprint, pulp, sawn timber logs, and so on). Productive capacity is expected to remain at about this level throughout most of the next decade. But based on the volumes of wood which will become available from existing forests and planned new plantings, production will progressively increase to 17–20 million cubic metres a year by the turn of the century.

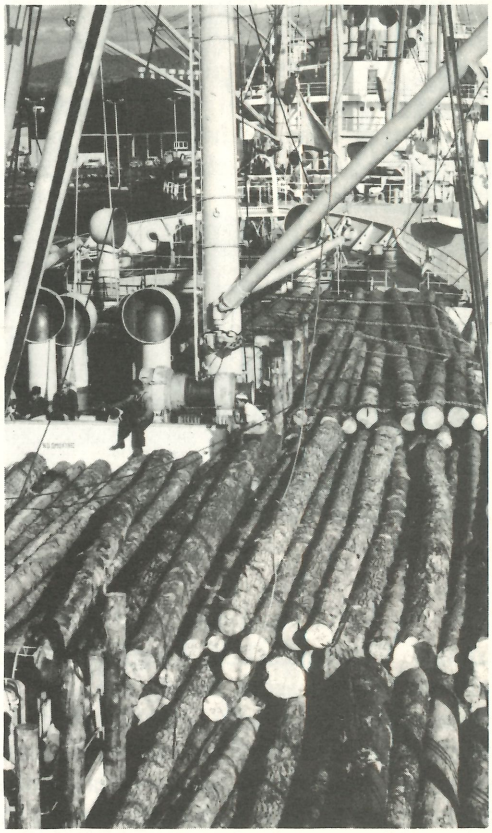
If high planting rates are maintained with planting targets satisfied in each region and the forests milled at the earliest opportunity, the available wood supplies could further increase to about 36 million cubic metres annually in the period 2011–2015. The additional available wood should greatly exceed domestic requirements, even if much is used for energy production.

## Development of the Industry

Even if used in an unprocessed form, the increasing wood supplies will require a larger labour force, an improved roading network, and expanded transport and processing facilities. If the trees are to be exported then certain investments must be made. They will include investments in:

- logging machinery and equipment;
- logging trucks, and other vehicles required for the transport of processed products;
- upgrading and maintaining roads (or rail or coastal shipping facilities where appropriate);
- port facilities.

And the list could be extended to include overseas shipping, and accommodation and township facilities for forestry workers. Some of these capital costs arise in the public sector, while others are direct private sector investments.



In general, however, there seems to be little need for rapid development of the transport infrastructure during the 1980s. Even after 1990, it seems that the existing road, rail, and port facilities could cater for most of the trade, and could be gradually improved or extended as required. So although much greater transport investment will probably be required later, in the period to 2015 the average annual expenditure should remain relatively small. In addition, if the standards of facilities are geared explicitly to requirements, and not over-engineered to satisfy unnecessarily stringent design and construction codes in many central and local authority

regulations, large savings should be achieved.

Other capital costs will depend on the degree of processing and the proportion of total production which is processed. At the potential maximum of 36 million cubic metres per annum there would be sufficient timber to allow the construction of a number of pulp and newsprint mills costing up to $4,000 million at 1978 prices (excluding upwards of another $1,000 million for extra electricity). Although the potential total expenditure is large over the next 35 years (possibly approaching $6,000–$7,000 million inclusive of harvesting and transport investment), the incremental requirements would probably average only 2–2½ percent of total investment in all sectors, though it would be higher in the years of most rapid expansion.

It may well be that the best rate of return will be on exported logs. But there will be pressure for further processing to give more employment and earn more overseas funds. This may not be so important by the 1990s; and even for employment, opportunity costs may favour other types of development and resource use. Much will depend on market demand in the 1990s and beyond and this cannot be seen except in broad terms.

Nevertheless, it will be necessary to progress towards decisions on forest use at least for the more intensive processing options, as a long period is required to construct plants, attract a full complement of skilled workers, and develop sufficiently large markets to realise the full processing potential. Construction of the first plants to process the expanding supplies in the 1990s would have to start in the late 1980s.

## Pricing

The main issues at present confronting the development of forest resources concern the role of the State in the industry. Historically, it has taken the lead in providing new plantings; its dominant position is reflected by its 57 percent ownership of all exotic forests. However, since it disposed of its interests in the Tasman Pulp and Paper Co. the State has only minimal direct investment in the associated milling and processing industries. Consequently, its main interests relate to the price at which the wood should be sold.

Wood-based products such as pulp and paper and sawn timber are traded internationally. More recently international trade in unprocessed logs has developed. With an anticipated increase in world demand for forest-based products, and an expected decline in forest areas in North America and Europe, a buoyant international forest-based commodity market is likely. Moreover, should the longer-term possibilities for the large-scale production of alcohol from wood as a competitive gasoline substitute or extender be realised, international trade in forest derivatives could assume major importance in the world economy.

New Zealand has a rich resource in its abundant and increasing supplies of millable forests. The State, as the major forest owner, should aim to obtain the best international price for its supplies.

To dispose of the wood too cheaply unnecessarily subsidises the users. When international sales of logs, timber, pulp, and so on are made by local firms, the subsidy is conferred upon the New Zealand enterprise. In any international sales of wood direct to foreign interests at less than international rates, the State is merely assigning the subsidy to the foreign interests, with no compensating benefit to New Zealand. Having invested in and maintained the forests, the State (and thus the taxpayer) is entitled to the best return possible.

If New Zealand's producers of wood products are not able to compete on international markets when they pay world market prices for wood bought from the State, it suggests either that they are inefficient and that their labour and other costs are excessive, or that the exchange rate is inappropriate. It is better to attack these fundamental problems than to subsidise producers through underpricing the wood.

# MANUFACTURING

Manufacturing, including the processing of primary products such as livestock and milk, is the largest industrial sector. It accounts for some 23 percent of GDP, and employs about a quarter of the labour force.

In 1975–76 (the most recent year for which statistics are available) there were about 8500 manufacturing establishments, most of them relatively small—48 percent employed fewer than 10 people, and 94 percent fewer than 100. Only 72 establishments (less than 1 percent of the total) employed 500 or more persons. But they accounted for 23 percent of employment in manufacturing, 25 percent of value added, and 21 percent of manufacturing investment.

A numerical predominance of small units is common to most countries, even the industrial giants, but New Zealand does stand out by having a large proportion of enterprises with 10–50 employees. Thus any manufacturing strategy has to cater for both big companies and a very large number of small to medium-sized ones.

There are over 140 types of manufacturing industry. In about 20 of them ownership is highly concentrated with 3 or fewer business units sharing 100 percent of the sales. In six of these there is only one producer. Most others contain a considerable number of business units (up to 400) and operate competitively in the domestic market.

## Protection

Manufacturing developed behind the protection of import duties introduced 90 years ago; but these were largely superseded as the main protective barrier, some 40 years ago, by import licensing (originally for exchange control). The present, well-established structure has afforded high levels of protection for many industries. This policy has resulted in the establishment of a wide range of industries, although it has not been demonstrated that the range is greater than that which would have been achieved with less protection.

The composition, however, is undoubtedly different. A major problem with the policy has been that many industries remain dependent on imports of raw materials and equipment which now constitute over 80 percent of total imports. Until recently, they had to be paid for almost entirely by exports of farm products. Farm exports are still dominant, although there has been very considerable growth of exports of manufactured goods and services.

Exporters of all kinds have a strong interest in ensuring that they can obtain the inputs they require on terms that enable them to be competitive overseas. As more enterprises have entered the export field therefore, there has been more interest in reviewing policies that might impede the export drive.

This interest is leading to a more critical attitude to high protection by import licensing on tariffs, and a search for more positive methods of assisting industries to become more competitive. Major objectives of the licensing system have been to ensure a stable market for industry, to utilise domestic resources to the fullest extent, to maintain full employment, and to encourage investment and greater productivity.

At an earlier stage of industrial development, licensing may have served these purposes, but there is now widespread recognition of a need for modification, though there is disagreement on the speed with which this should occur. The arrangements have been modified to provide import licences to manufacturers who export or undertake to do so. The domestic market remains tightly controlled and well protected.

In this situation the incentives to innovate, improve quality, or keep costs and prices down in the domestic market are at a minimum, although many manufacturers do so. Those who hold the licences have equally little incentive to use them in the best interests of producers or consumers, for example by seeking different and better sources of supply. Manufacturers who export can be assumed to be using resources effectively and to be meeting overseas standards of quality and price (except where they rely heavily on tax incentives or subsidised inputs). For those operating entirely in the domestic markets there are few objective standards of comparison. And because the system is administered confidentially in the commercial interest of those involved, it is not possible to assess the costs and benefits.

Changes announced in the 1979 Budget in the administration of import licensing, to enhance export competitiveness and encourage cost containment in domestic industries, suggest a reappraisal of some effects of the system. A broader assessment of import licensing, restrictions, tariffs, and emergency protection arrangements is needed. This could build on the Industries Development Commission's textile industry study.

Other signs of change can be discerned in the views of the manufacturers themselves. With the lack of growth in the domestic market and the increased incentives to export, manufacturing has become much more outward-looking. Already, attitudes to protection vary considerably from industry to industry; exporters particularly recognise that costs within New Zealand have to be kept down. Moreover, there is an awareness that export growth implies more access for imports into the domestic market. Because of its growing export orientation the manufacturing sector could well change more rapidly than protected or regulated activities within the confines of the domestic market.

## Technology

Export incentives provide the opportunity for large numbers of manufacturers to get into the export business, but give no assurance of success. Operating either in international markets or in home markets more open to competition than has been the post-war rule, many are facing changed market conditions with regard to price, quality, technology, delivery, and service.

In the area of technology, New Zealand manufacturing does not have a strong base for innovation. Research and development expenditures are on average low within manufacturing and in the support services provided by Government institutions. Moreover, the small size of many firms makes it difficult to reach the minimum threshold level for successful innovation, unless appropriate strategies are formed. In addition, many enterprises do not establish the necessary links between innovation and marketing: most commercially successful innovation comes from developments aimed at satisfying identified market needs. There are clearly limits to what a small enterprise can spend on innovation and market development. Thus smallness itself imposes constraints on manufacturing in New Zealand for markets overseas, or effective competition within New Zealand.

One solution already adopted by some New Zealand firms is to be highly selective in the particular markets and technology on which they concentrate—that is, to specialise. Narrow but highly profitable corners of a world market can be secured, although the company must continue to innovate to survive, possibly selling licences to larger competitors overseas as it develops.

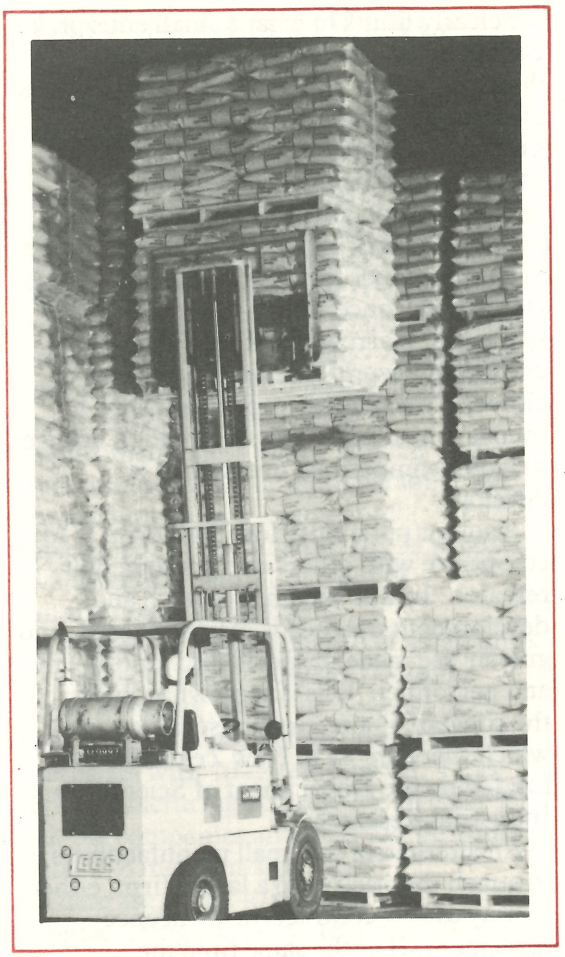
Another possibility for small firms is to co-operate with others in complementary research. In this way the research and development overheads may be shared, and greater use made of specialised equipment and personnel. This is somewhat similar to the concept of a research association, of which there are 12 in New Zealand partly funded by the Department of Scientific and Industrial Research.

An alternative for small manufacturers is to attach themselves to a larger firm, either by way of sub-contracts or by licence agreement. If at the same time the manufacturer works to strengthen his firm's technological base, such contacts will give access to advances in technology beyond those it is capable of generating for itself. The firm must, however, use the contact as a springboard to further development, or else be prepared to accept an inferior position of long-term dependence. These considerations are also relevant to larger firms and enterprises.

## Exports

Over the past decade manufactured exports have increased at a more rapid rate than those of any other sector. This has resulted from a combination of factors: the implementation of the free trade agreement between Australia and New Zealand (NAFTA) export incentives, more favourable exchange rates and, at least for a period, a liberalised Australian import policy.

The export incentive schemes which have operated since the mid-1960s have gone



some way towards offsetting difficulties imposed by protection. It is not possible to quantify their effects but they have undoubtedly been a factor in expanding manufactured exports. There is equally little doubt that a policy of using the exchange rate to maintain profitability of both farm and manufactured exports would have achieved better results than the complex packages of incentives, grants, and subsidies of recent years.

In the 1979 Budget major reforms were introduced, to become effective in April 1980 but to run in parallel with existing schemes until March 1983. Under the new arrangements, export performance incentives will be based on net instead of gross foreign exchange earnings, and apply to all exports rather than to increases over a base period. Two other new provisions, the export market development incentive and export project grants, were also introduced to replace existing schemes. In brief, the new provisions remove anomalies, rationalise the incentive system, and reward manufacturers and exporters of services on the basis of the net contribution to the balance of payments. They are reinforced by the switch to more flexible exchange rate policies designed, amongst other things, to maintain the profitability of exports.

There has been a positive response to these policies. The initial results of the Manufacturers' Export Research Programme indicate confidence among manufacturers engaged in exporting that export volumes can be greatly increased in the next 3–4 years—on the basis of existing corporate plans. From these plans, it has been calculated that by 1984 nearly 16 percent of total manufacturing output might be exported, compared with less than 10 percent, at present. This target would, if achieved, contribute substantially not just to the balance of payments but to investment, output, and employment growth as a whole.

## Policies Affecting the Domestic Market

During the 1970s, domestic manufacturing was subjected to a sequence of price and profit control measures; their history goes back to the Control of Prices Emergency Regulations 1939. The impact on the sector has been severe and cumulative. Low productivity persisting in an over-regulated industrial structure has been a major reason for low growth. The Planning Council recommended last year that "the present detailed control of prices under the Stabilisation of Prices Regulations 1974 should be discontinued", and that "formal control should be confined to a relatively short list of goods and services, notably those sold under conditions of monopoly, subsidised by Government, or specifically brought under control" for stabilisation reasons, with surveillance exercised under the Commerce Act. This stemmed from the recognition that the adverse effects of detailed price control on goods and services have far outweighed their presumed effects on inflation, and that the effective control of inflation is better pursued by other means. Subsequent Government action has removed some of this detailed price control, but it is too soon to determine what the

effects will be on the development of manufacturing. Much will depend on the way in which "surveillance" is exercised, and on the impact of the remaining price controls attached to Category A ("essential") goods.

The Government exerts a powerful influence on the sector not only through its incentive programmes for export promotion and regional development, but also through other measures which influence manufacturing investment and production decisions. These include company taxation provisions which are still administered on the basis of reported rather than real profits. While the average rate of tax paid by companies has declined in recent years, because of the range of incentives and depreciation allowances, wide disparities in the real tax burden of companies have developed. Many are manufacturing enterprises and the effect on their investment and output growth may have been substantial. Distortions in the personal income tax structure create further problems, reducing the capacity to reward skills and enterprise and contributing to shortages of trained personnel. Manufacturers also have to cope with impediments to the use of existing capital, including the effects of an unsettled industrial relations climate. This also is a further deterrent to growth in production and productivity.

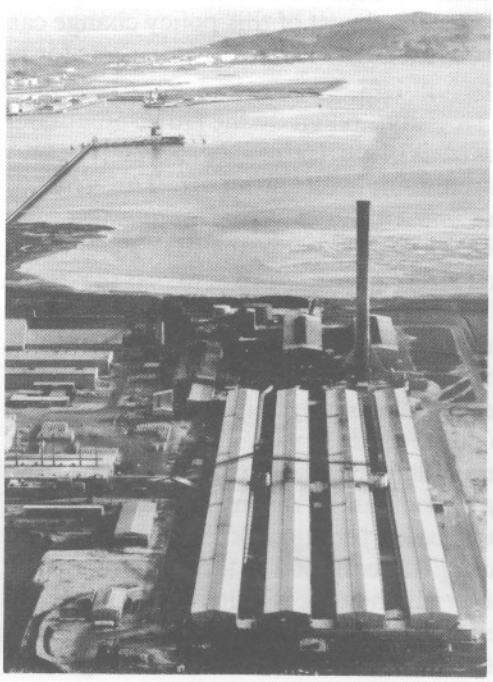
Investment and change in manufacturing will, as in other sectors, depend largely on the general state of the economy and the expectations of those making investment decisions. Success in monetary and incomes policies and a reduced rate of inflation may be the largest contribution the Government could make in stimulating new growth in the manufacturing sector.

## Investment Perspectives

Investment in manufacturing has declined recently as a proportion of total investment, with a sharp fall after 1974–75. In 1971–72 it accounted for 16 percent of all investment; in 1977–78, 11 percent. Almost all manufacturing investment takes place in the private sector. In 1977–78 its share in private investment, excluding that in home ownership, was 27 percent. This is also a reduction from earlier years—in 1971–72 to 1974–75 the average was 33 percent. While investment outlays have risen in current prices, there has been a large reduction in manufacturing investment when inflation is taken into account, particularly the rapid inflation in the prices of imported plant and machinery.

Most investment in manufacturing is in normal replacement, especially of plant, machinery, and transport equipment. In 1976–77 an estimated 60 percent of investment outlays in the sector were for this purpose. New and replacement machinery embodies improvements in technology and is a primary source of productivity growth within the sector and also for the economy as a whole, because of the large size of the manufacturing sector and the opportunities it presents for rapid technological advance. Most manufacturing investment is in plant and equipment. The main components in 1977–78 were:

| | | |
|---|---|---|
| Plant and equipment | ... | 69 percent |
| Transport equipment | ... | 9 percent |
| Factory building | ... | 20 percent |
| Residential building | ... | 1 percent |
| Other construction | ... | 1 percent |
| Total | ... | 100 percent |



Investment levels are currently too low to support the growth in output, and particularly employment, that is being asked of this sector. Substantially increased investment in export production and efficient import substitution based on greatly increased research and development expenditure (both within enterprises and through public and private support systems), more specialisation, and more sophisticated marketing, will be needed if substance is to be given to a changed strategy.

When the elements of a more outward-looking strategy are in place and the directions of manufacturing development are confirmed, increased investment will be encouraged. At present the policies are clear only for exporters. Ninety percent of manufacturing is for the internal market and the proportion will remain high even if present export plans are fully realised. The future for large segments of the industrial sector is thus unclear.

The changes may be gradual but the potential impact on the efficiency of New Zealand industry is great. Where the price effects of high protection have been manifestly excessive, the intention is to use import licensing procedures to shift resources out of such industries (if they cannot become more competitive) thus freeing them for other uses. It is apparently intended that there will be rationalisation in a number of important industries, and some transfer within and between industries. The sooner the thrust of this policy change can be clarified, the better the prospects for new development.

Decisions taken by the Government on the basis of the Industries Development Commission's recent report, *The New Zealand Textile Industry Development Plan 1976–1986*, represent the first major step in this direction. The aim is to halt the decline of the textile industry, reduce protection on clothing (which is said to be costing households around $130 each year or $6,800 per person employed in the industry), and to put the industry on a better base for export-led growth. This will be done mainly by strengthening the major areas of wool-based products (knitwear and apparel) through a reduction in the cost of the materials they use. Positive measures to help the woollen industry and provision for a special fund to assist restructuring and rationalisation are parts of the package.

Eleven other industry groups are under study by the Industries Development Commission or Government departments in co-operation with industry organisations. These include plastics, packaging, wine, radio and television, footwear, rubber products, and motor vehicles. Thus both in its general approach to protection and in relation to specific industries the Government has the opportunity to reduce protection in ways that will provide a firmer foundation for growth in manufacturing output and employment.

The Task Force recognises that measures to reduce levels of protection imply the provision of more adequate arrangements to assist enterprises and individuals to adjust to change by finding means to improve productivity and reduce costs, and to move out of unprofitable or declining activities into more viable ones. Assistance to workers to retrain or resettle, encouragement for investment in activities not requiring high protection, assistance for research and development to encourage and accommodate to technical change, and the further development of business and personal advisory services, should all be elements of a programme for industrial development.

Export promotion in overseas markets is unlikely to succeed beyond a certain point without accompanying steps towards liberalisation of our own import regime. This is one of the lessons to be learnt from the development of Australia-New Zealand relationships under NAFTA. It is increasingly a factor in our growing trade with other Pacific Basin countries, and elsewhere. There is no doubt that New Zealand has wide complementarity in manufactured goods as well as primary products (and a range of services) with ASEAN and Pacific Basin economies, and could take advantage of this. It can do so, in the longer term, only in a less protected and less regulated domestic environment.

# TOURISM

International tourism has grown rapidly in New Zealand in the last decade, in terms of both numbers of visitors and foreign exchange receipts. However, the growth exhibited in the first half of the 1970s has not been sustained.

In November 1978 the Tourism Advisory Council recommended specific annual targets for numbers of visitors and potential travel receipts between 1978–79 and 1987–88. They recommended a planned increase in visitors from 411 000 to 846 000, and in earnings (at 1978–79 prices) from $169 million to $349 million, not including the net overseas earnings of Air New Zealand ($123 million in 1978–79). This would be equivalent to an average growth rate of 8 percent a year.

Tourism growth of this size would offer New Zealand a number of benefits including:

- Increased diversity and scope for employment in skilled, semi-skilled, and unskilled occupations. These opportunities arise in large organisations such as airlines and hotels; in other accommodation, trade, and internal transport activities; and in operations such as organising boating, hunting, and fishing expeditions.
- The potential to increase net foreign currency earnings.
- The contribution tourism can make to regional development by creating employment, and making better use of the existing infrastructure.
- The low impact of the industry on the environment, if carefully planned, in comparison with some other types of development.

There are however a number of constraints—notably internal and external transport costs; the high costs of provision of hotels and the associated low profitability; and the costs of service labour and attitudes to service. Unless New Zealand is internationally competitive in all these respects, the prospects for increasing its share in the international tourist trade will remain remote.

Tourism is a sector which is particularly affected by exchange rates. If New Zealand currency is overvalued, fewer foreigners will come here. Moreover, New Zealanders will be encouraged to travel overseas and consequently make less use of facilities here. According to Reserve Bank statistics, payments for overseas travel in 1979 amounted to $490 million. Higher domestic costs make it difficult for New Zealand enterprises to compete internationally in providing tourism services. Both hotel construction costs and profitability are also affected by exchange rates, so that an adjustment could prove to be of major assistance, particularly if it led to more rapid growth in tourist numbers and rates of increase in occupancy.

**Table 3.5 Overseas Visitors and Travel Receipts**

| Year Ended 31 March | Number of Visitors | | Travel Receipts | |
|---|---|---|---|---|
| | (000) | % Change | $m | % Change |
| 1968 ... ... | 123.2 | ... | 17.4 | ... |
| 1969 ... ... | 131.9 | 7.1 | 20.1 | 15.5 |
| 1970 ... ... | 155.0 | 17.5 | 26.0 | 29.4 |
| 1971 ... ... | 190.9 | 23.2 | 33.6 | 29.2 |
| 1972 ... ... | 227.6 | 19.2 | 45.1 | 34.2 |
| 1973 ... ... | 254.6 | 11.9 | 57.4 | 27.3 |
| 1974 ... ... | 318.2 | 25.0 | 78.5 | 36.8 |
| 1975 ... ... | 361.2 | 13.5 | 107.0 | 36.3 |
| 1976 ... ... | 384.6 | 6.5 | 143.1 | 33.7 |
| 1977 ... ... | 380.2 | −1.1 | 160.8 | 12.4 |
| 1978 ... ... | 390.9 | 2.8 | 160.7 | −0.1 |

Source: Tourism Advisory Council


## Costs

Tourists, like most people, react to large price differentials. Tourist growth from the developed Northern Hemisphere countries, which offer the greatest potential for increasing tourist trade to New Zealand, are no doubt influenced by the comparative cost of travel to, as well as within, New Zealand. Apart however from its relative isolation, there is little reason why New Zealand should be inherently disadvantaged in attracting foreign tourists. Indeed, it offers many unique attractions; promoting these could help offset the disadvantage of higher fares.

Air New Zealand and a number of other airlines servicing the country have taken steps to provide budget fares competitive with those for other destinations. However, it is possible that only further major reductions in air fares will produce the desired increase in tourism.

The Tourism Advisory Council has pointed out that growth in foreign exchange earnings from tourism may come more from high-price or quality conscious segments of the market than from those looking for cheaper fares. The Government considers, however, that low fares would attract some custom from all parts of the market; it accepts that tourist flows are responsive to price levels, although the price of travel includes much more than just the airline ticket. Moreover, there are other factors within the aviation context including access to overseas markets and the flight capacities and frequencies offered.

A recent report, *External Civil Aviation Policy of N. Z.*, says the Government considers that improvements in air services between New Zealand and other countries would probably have more effect on tourism than the introduction of a cheap air policy alone. It notes the problems associated with frequent alteration of trans-Tasman air schedules and the further restrictions imposed by planning for very high load factors on these services. Tourist flows on some South Pacific routes are also impeded by high load factors. According to the report, it is clear that improvements in the range of services, interlining arrangements, and the number of seats available to the public would help to make the South Pacific, including New Zealand, both more attractive and more accessible.

If more tourists do come to New Zealand the Government must decide whether a New Zealand or a foreign carrier should provide the extra services. This is particularly relevant if new equipment has to be purchased because the Government has to assess, on behalf of taxpayers, whether there would be a greater return from investment in aircraft than from investment elsewhere in the economy. The opportunity-cost criterion is, however, only one of the factors to be weighed in a decision on re-equipment.

## Hotels

Internally, the problems centre on the costs of building new hotel accommodation and the prices which may have to be charged for it. A recent study estimated the cost per room for city hotels of the standard assumed to be required for many visitors is

said to be $65,000–$85,000 at 1979 prices; this suggests a room rate of $65–$85 per night for financial viability. Regional hotel costs might be $40–$60 per night. It is important that serious efforts be made to curb the rise of construction costs, in order to help prevent New Zealand becoming too costly a place to visit.

Relatively poor profitability in the hotel industry has not assisted the situation. Despite shortages of accommodation which have occurred in Auckland, and to a lesser extent Christchurch, plans to develop new hotels have proceeded at an exceptionally slow pace.

Hotel profitability might well be assisted by exchange rate adjustments, but the long construction lead times are a costly and inhibiting factor in the growth of the industry. These issues are discussed in the section on the building and construction industry (see page 49). The major impediments to efficient hotel construction are undoubtedly:

- the time-consuming processes in securing approvals, especially if foreign equity is involved;
- the relatively low hours of overtime worked;
- the tendency of the construction industry to close down (like most of New Zealand) during December and January when the advantages of good weather and long daylight hours are close to maximum.

The hotel industy also has difficulties in securing large quantities of some items, such as fittings and furniture, which are manufactured in New Zealand and subject to import protection. The demand for these is often beyond the capacity of local enterprises to supply without long lead times.

## Service Attitudes

Visitors expect friendly and helpful service; failure to provide it is often a cause for complaint. There is ample anecdotal evidence that New Zealand often suffers in comparison with overseas countries; the comparison being all the more odious because of the relatively high cost of service. Moreover, a generally courteous, helpful attitude to service is basic to fostering a successful tourist industry.

Similar considerations apply in respect to other services. In particular, the restrictions on shopping hours are severe by foreign standards; New Zealand is clearly nowhere near maximising the opportunities conferred by attraction of foreign tourists. The questions related to retailing hours are examined in the section on retailing (see pages 46–48).

# TRANSPORT

An efficient transport system can contribute greatly to economic growth, social progress, and energy conservation. Transport is important in determining whether exports can be marketed effectively and profitably. It affects productivity, costs, and prices in other industries and services. Investment in transport equipment and facilities is a significant proportion of total investment. Substantial imports are needed to satisfy our demands for transport.

The transport industry is dependent on imported liquid fuels; the sector consumes about 70 percent of all petroleum. Imports of transport equipment during the decade to 1980 have ranged between 10 and 17 percent of total annual imports. Much of this was for private transport (mainly motor vehicles) and does not count as investment. Even so, the capital outlaid by producers on new transport equipment is a large and important category. Between 1971–72 and 1977–78 it averaged about 13 percent of gross fixed capital investment. Additionally, about 3–4 percent of gross capital formation is devoted to providing transport facilities such as roads, harbours, and airports. This brings the total to 16–17 percent of all investment.

Although New Zealand's total investment in relation to GDP is about the average for OECD countries, the investment in transport equipment seems disproportionately high. Between 1971 and 1977 (the period for which international comparisons are available) New Zealand's investment in transport equipment was about 3.2 percent of GDP compared with an average of 2.5 percent for the 14 OECD countries reporting comparable data.

Expenditure on transport equipment in New Zealand might be expected to exceed that of most OECD nations because of the spread of economic activity, and the topography of the country. However, this should be at least partly offset by the greater life of the assets because of a favourable climate and the smaller distances often covered by inland transport. The higher investment rate may therefore be attributable to a combination of the higher duties and taxes on such equipment and its relatively inefficient use (particularly in road transport).

Duties on goods imported to New Zealand are much higher than for most countries—up to 55 percent for transport goods. This partly explains why transport operators in New Zealand usually pay more for equipment than their overseas counterparts. There are many indications that local operators also use their equipment less intensively. Reasons for this may be found in regulations on the transport industry and the difficult industrial relations affecting some transport operators.

As in any industry, low use of equipment will raise the unit cost. Cost will also be high if a full service is provided when there is only limited demand. This applies to some coastal shipping, suburban transport services, and other transport operations. If the State regulations governing the sector promote uneconomic services and inhibit competition, higher costs are inevitable. More transport imports are needed; these increase the balance of payments deficit and funds are also diverted from more productive investment. High transport charges increase the costs of other goods and services, and will act as a brake on the whole economy. The effects of any inefficiency in the transport industry are similar to, although not as clearly perceived as, those of high international oil prices. The main difference is that the costs of inefficiency are self-inflicted.

Although a continuing flow of new transport equipment will be required, most of the transport sector's investment problems could be solved by achieving better use of equipment and facilities. The stringent, wide-ranging, detailed regulatory and licensing systems which govern the transport industry are inhibiting this.

## Transport Regulations

Although the regulation of transport is not peculiar to New Zealand, the breadth and detail of its regulations are particularly distinctive. The forms of regulation in New Zealand are stringent in contrast, for example, to the systems governing operations in the United Kingdom, Germany, North America, and inter-state transport in Australia. Even in the smaller countries (such as Holland, Belgium, or Sweden) transport regulations are far less

pervasive, and generally permit more competition within and between transport modes.

In New Zealand in recent years, there has been a trend towards deregulation. (For example, distance restrictions on road transport have been eased.) However, the controls, including those on entry, and tariffs and prices, continue in most cases to limit competition within and among the various modes of transport.

In this report it is possible to make only brief comments on the investment issues for transport in general, and for particular types of transport operation. The issues are complex and controversial. On the one hand, there is a strong New Zealand tradition of regulation in the transport industry. The main arguments for this are that it contributes to the orderly development of the industry, ensures the provision of adequate services to all sections of the community, protects the legitimate interests of operators in the public and private sectors, prevents wasteful use of capital (and of foreign exchange), and in the international transport sectors serves the national interest.

On the other hand the consumers of transport services, both organisations and individuals, often complain that these same services are, in particular cases, slow, expensive, unreliable, or unsatisfactory in other respects. Studies in other countries suggest that restrictions on competition and tariff-fixing arrangements hinder investment, protect inefficient operations, impede the expansion of efficient concerns, and distort both investment and prices in other sectors of the economy. It has been estimated that in the United States regulation of the transport sector cost the economy between $8 billion and $16 billion per annum in 1974[1]; that is between 0.6 and 1.2 percent of GDP. No comparable statistics are available for New Zealand. However, the arguments for retaining or extending the regulatory systems have never been satisfactorily substantiated.

In recent years there have been numerous studies of national transport problems, often traversing much the same ground. The pace of reform, however, has been slow—certainly, for example, in comparison with reforms in manufacturing and in the financial sector. It is widely believed that improved transport services, and reductions in costs, are essential if our full production potential, and hence employment possibilities, are to be realised—especially in the agricultural, industrial, and service sectors directly engaged in export activity. The Task Force believes that the aim must be to develop a more flexible and efficient transport sector.

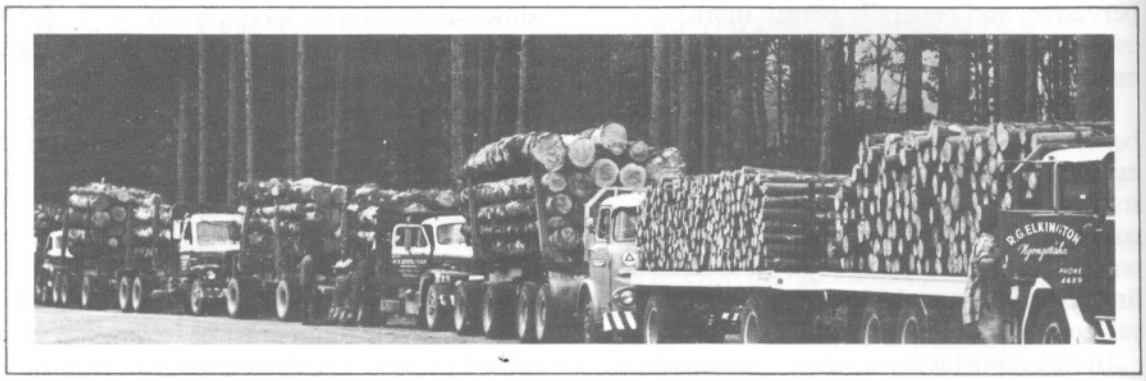
The major issues concern the extent to which, in the interests of transport development and economic growth, there should be reductions in regulation and control; the need for better systems of transport taxation, subsidy, and charges for the use of facilities (roads, harbours, airports, etc.); and the role and performance of the public enterprises (such as New Zealand Railways, Air New Zealand, and the Shipping Corporation of New Zealand) which play such a major part in the provision of transport services.

## Road Transport

The arrangements for road financing in New Zealand, excluding local authority contributions, were reorganised in April 1978 when a system of heavy motor vehicle road-user charges was introduced. These new arrangements are based on user-pays principles, and were introduced with the ultimate aim of charging vehicles according to the cost their use imposes on the roading system. Although certain anomalies appear to exist, the system provides a partial basis for increasing inland transport efficiency. The introduction of the complete provisions of the scheme could provide an economically sound rationale for deregulating the road transport industry—including the elimination of the distance limitations on competition with rail services, and abolition of both the entry limitations and tariff controls on road transport.

With capital investment in roading varying between $80 million and $110 million per annum, including what is done by local authorities, there is a need to ensure that additional investments in roads are soundly justified. At present most road investment decisions are not subject to

[1] Quoted by G. B. Reschenthaler, *Direct Regulation in Canada: Some Policies and Problems*, The Logistics and Transport Review, Vol. 15 No. 1, Vancouver, 1979.




thorough financial scrutiny and little incentive exists to ensure resources are used effectively. It has been found that many roads are constructed without first acquiring the necessary statistical data for pre-project analysis. For example, a recent small roading survey[1] indicated that a disturbing number of projects within the sample provided no direct financial return, with costs exceeding identifiable benefits in certain instances by 200–300 percent. Unless this situation is rectified, many of the benefits which would arise from the complete implementation of the road-user charges scheme will be wasted, with road transport tariffs remaining higher than necessary.

Surveys have shown that most goods service vehicles have payloads of less than 50 percent, and often less than 40 percent. In addition, the road transport industry in New Zealand is characterised by a large proportion of trucks smaller than the maximum legislated limits. Whilst certain specialist vehicles, such as bulk tankers, are generally unable to gain return cargoes because of the nature of the trade, or because restrictions (particularly in urban areas) limit the size of vehicles in certain trade sectors, there is nevertheless substantial excess road transport capacity.

This is partly because over 50 percent of all heavy goods vehicles are operated by enterprises for the purpose of carrying their own goods—for which a licence is generally not required unless competition with rail in excess of the legislated distances is involved. Most of these vehicles however, are prevented by the licensing system from plying for third-party trade and so often make empty return journeys. Because of the restricted trading opportunities, these vehicles possibly tend to be smaller than the maximum allowed.

The licensing system, although supposed to avoid waste, appears to be directly responsible for promoting over-investment. The immediate waste is not limited to creating over-capacity. Freight costs are forced up and fuel is wasted, thus directly increasing the country's import bill for expensive petroleum products.

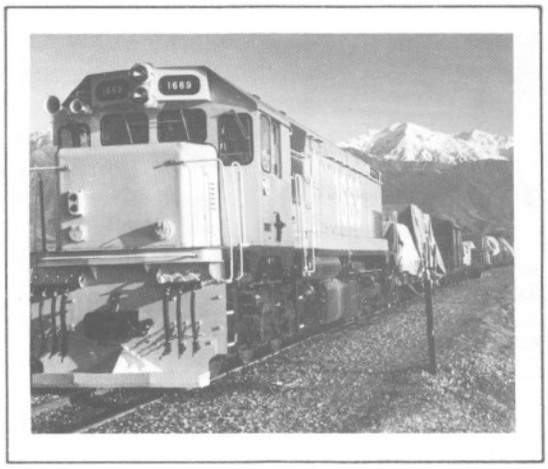
In addition, industrial relations in the road transport industry are a continuing cause for concern. The effects of industrial disruption are similar to those of restrictive licensing. An improvement in industrial relations would provide substantial benefits.

## Rail

The development of road transport long after the railways were constructed has created problems in most countries; particularly as road transport can often provide a more flexible service.

Investment in rail facilities has been largely protected from land-based competition ever since the pre-war introduction of goods transport licensing. Despite some relaxation the licensing system continues to ensure that most inter-regional cargo is transported by the State-owned rail network. Indirectly, this has permitted the short haul and branch-line operations to be subsidised by the protected long-haul routes.

[1] R. L. Kerr, *Roading Within the New Zealand Economy*, paper presented to N.Z. Roading Symposium, Wellington, August 1979.



In this sense, the rail system has operating advantages on a number of routes; but the failure to implement fully the road-user charges scheme provides an argument for continued protection.

In these circumstances there is less incentive to concentrate on, and take advantage of, the capacity of railways to move large quantities of bulk goods cheaply: that is, to develop a system which must form an integral part of the national transport structure and which offers the best opportunities for profitable operation. The incentives to adapt the size and pattern of the rail network to changing circumstances are also reduced.

The New Zealand Railways sees its function as providing a range of services requested by the Government at the least net cost. It makes substantial losses primarily, if not entirely, because it provides a number of services for social reasons which cannot be justified on commercial grounds. It is important to separate these from the services which can and should be commercially viable, so that questions of efficiency and competitiveness can be properly assessed.

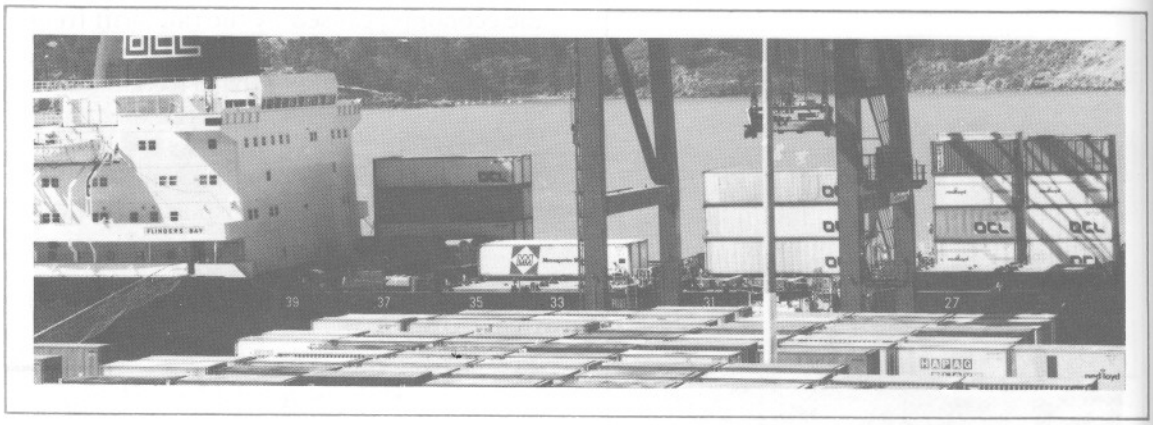
Steps have now been taken to identify and publicise the social component of rail services. This opens the way to a clearer definition of pricing, financial, and related objectives for rail operations. This would facilitate railways investment and development. It could help in tackling problems of productivity, over-manning in some areas and shortages of skilled workers in others, and recurring industrial relations problems. It would make less likely a repetition of the disruption to the railways, to the rest of the transport system, and to the economy, caused by the rail tariff freeze imposed by the Government in the early 1970s, and subsequent sharp freight increases. And it could pave the way for an early relaxation of the protective arrangements still restricting competition between rail and road transport services.

## Port Facilities and Handling

According to harbour board reports, about $400 million is invested in harbour and associated facilities. The relative efficiency with which the assets are used (in addition to general port operating expenses, such as labour costs) has a significant effect on shipping costs. Studies undertaken by the New Zealand Institute for Economic Research on trans-Tasman shipping indicate that in economic terms, port costs in New Zealand and Australia contribute about 55 percent of container shipping rates, 30 percent of roll-on, roll-off rates and 70 percent of conventional rates. Although improvements have occurred since the study was published there still appears to be substantial scope for streamlining and increased efficiency. Increases in port efficiency, including extension to 24-hour operations where safety is not prejudiced, may be expected to provide significant returns. As port costs assume increasing importance the shorter the route involved, improvements in port efficiency in New Zealand offer the prospect of significant returns since more than half of all New Zealand's export trade is shorter-haul to Pacific Basin countries. Port employers, shipping lines, and the unions have a vital role in increasing port efficiency, and improving industrial relations on which this essentially depends.

## Shipping

Because New Zealand is dependent on foreign trade to maintain economic progress, low-cost international transport is essential. But apart from the cost, the characteristics of the services offered




(including frequency, reliability of timetables, transit time, and degree of protection from damage) also contribute to the level of success in meeting competition and maximising returns in foreign markets.

New Zealand relies generally on conference shipping systems, supported by producer and marketing boards with statutory control over particular exports. Despite the many advantages of conference shipping arrangements, the cost of international transport is large in relation to our returns from trade (for example, about 25 percent of the CIF price of lamb exported to the United Kingdom is absorbed by shipping costs). The aim must be to reduce this cost wherever possible while promoting in other ways the growth and diversification of foreign exchange earnings.

In this context it is important from time to time, to explore whether some modifications to conference arrangements are desirable in order to impart a greater element of competition in services and charges.

It was partly to protect New Zealand's interests in international shipping that the Shipping Corporation of New Zealand was established. It has assumed an increasingly important role. It chose to become a member of the New Zealand-United Kindom-Europe conference and is also involved in the Japanese, United States, Caribbean, and other trades. Its prime objective has been to safeguard and promote the interests of New Zealand producers with the least possible capital involvement. The acquisition of new vessels has in fact made for difficulties in generating a profit, although in the longer term the Corporation expects to operate profitably and make a positive contribution to net foreign exchange earnings and savings.

As with other public enterprises in the transport sector, conflicts can arise between the need to operate commercially and profitably and the desire or obligation to serve wider national interests. The Shipping Corporation would benefit from clear statements of Government policy in regard to external shipping arrangements, and of objectives for the Corporation's involvement in existing trade and the development of new services. This would provide a better basis than now exists for planning by the Corporation and also for the evaluation of its present and potential contribution to national economic objectives.

Restrictive industrial maritime practices and a poor industrial relations record have in certain cases severely hindered the development of efficient locally-owned shipping services. In a number of instances, insistence on high manning scales has necessitated expensive vessel additions or modifications and this, together with additional wage costs, has reduced the competitiveness of those coastal and international shipping services affected. A number of key shipping services have been subject to recurrent and highly disruptive industrial disputes and, overall, the industrial relations record of the maritime and allied industries has not been at all satisfactory. Improved industrial relations and removal of costly restrictive practices would result in more efficient use of capital within the industry. This would also help to provide a more satisfactory basis for production planning, stock scheduling and quotation of competitive delivery timetables, in the economy at large.

## Aviation

International civil aviation has traditionally been subject to very extensive Government control and regulation. The regulations extend beyond the requirements of safety into areas including price fixing, regulation of capacity, and the determination of types of service.

In recent years the international conditions for aviation have changed, and one of the major changes has been the growth in demand for lower fares. Whether low cost travel should be best achieved through Government control or market forces has become a major issue. The United States seeks deregulation and open competition in order to eliminate inefficiency, to improve services, and to lower fares. Australia advocates restrictions on competition and strict capacity control as the best way to lower fares while maintaining an acceptable economic return for the airlines. New Zealand's problem is to accommodate to such conflicting views and pressures while preserving our own interests in external aviation in relation to these major partners and others especially in the Pacific Basin.

New Zealand's interests lie in increased earnings from tourism, and through business travel. A main objective of our external aviation policy is to maximise the contribution of all international air transport services to the growth of net foreign exchange earnings. Profitable operation by Air New Zealand, consistent with movement towards this objective, is obviously important. So is the extent and type of regulation of fares, capacity, market access, and frequency of service. A more flexible New Zealand approach is being developed, with less emphasis on stringent controls and more on the freer play of market forces. Even in this area, therefore, the possibilities exist for reductions in the extent and influence of regulation over transport activity.

Domestic aviation services are also heavily licensed and regulated. The dominant role of Air New Zealand means not only that there is little competition in air passenger and freight services but also that the company is expected, if not obliged, to operate a number of uneconomic services. The current review of aviation licensing and the associated domestic air policy review provide a welcome opportunity to assess the economic costs and benefits of the present licensing arrangements, and their effect on competition and the adequacy and costs of service. There appear to be a number of benefits to be derived from a more flexible approach to the provision of domestic air services which would recognise the advantages of increased competition and more effective use of new and existing capital, personnel, and facilities.

## Summary

The transport industry as a whole is characterised by extensive competitive limitations (including restrictive entry regulations), areas of inefficiency, the large role and influence of State enterprises, excess capacity, extensive price and tariff controls in activities which could be opened

to competition, and in some sectors difficult industrial relations.

Many of the arrangements under which the industry operates were instituted during the 1930s, 1940s, and early-1950s. Although these may have served the purposes of the time, some are no longer appropriate. Operating, and hence investment, distortions are apparent in many sections (both intra-modal and inter-modal) of the industry. The industry needs conditions more conducive to better use of its assets; mostly this means greatly reducing the protection afforded the various modes. (This applies also to taxi, bus, and rental car operations.) However, a more competitive environment brought about by reduced intervention in the market is not enough. The benefits will only be achieved with the simultaneous introduction of an equitable basis for charging for the use of roads and other facilities, and clearly stated objectives for the State-owned transport concerns.

# RETAILING

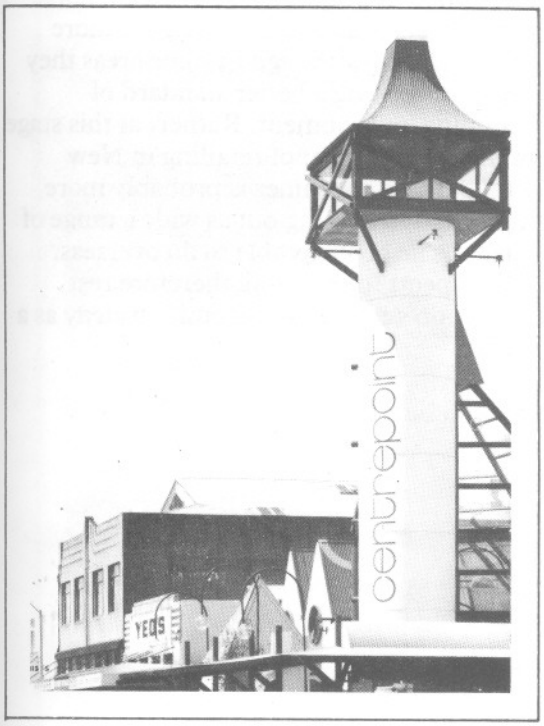
The retail sector is especially important for the size and scope of the employment opportunities it provides. There are over 30 000 retail stores in New Zealand. They embody a huge amount of capital in buildings, fixtures and fittings, and stock. In the year ended 31 March 1979 their retail turnover was about $6,000 million—close to $2,000 per head of population. This trade is shared unevenly across the sector. At the last Census of Distribution (1972–73), 88 percent of the stores accounted for only 40 percent of the sales; a further 8 percent for 20 percent of sales; and 0.6 percent (each with a turnover in excess of $2 million) for 15 percent.

The value of retail sales in constant prices, as well as sales per head, peaked in 1974–75. They declined in the next 3 years then recovered slightly. The depressed trading conditions in the second half of the 1970s have been accompanied by rapid inflation: price and profit control has adversely affected cash flows and caused problems in financing stock.

There is unlikely to be much growth in the retail sector in the near future: population growth is almost static; it is unlikely that real income per head will increase greatly in the near future; and high priority will have to be given to increased investment in other sectors. Clearly, both Government and consumer spending will have to be restrained. A programme of economic restructuring which emphasises exports and energy development provides little opportunity for retail expansion, except perhaps in certain areas; for example, farming districts where the development of small holdings increases the population, or in regions where a large energy plant is under construction. Some forms of retailing may possibly expand even in a generally slow-growth sector.

The retail industry has taken steps to improve efficiency, especially in the use of labour. In fact it has been forced to do so. Increases in labour costs are regarded by retailers as the greatest constraint on business expansion. A recent survey covering a group of firms which together employ 8000 people indicated virtually no change in likely employment opportunities. The new electronic technology will affect retailing in a number of ways by increasing efficiency in some areas and reducing the

demand for labour. This is already evident in the use of more sophisticated point of sale registers. In larger establishments employing a number of clerical staff, automatic processing could cause some job losses and involve rather more capital investment in business equipment. Increasing use of credit cards is another factor which would greatly affect the distribution of trade among retailers.




## Government Intervention

Retail trade has suffered considerably from Government intervention. Development has been affected by price controls; import controls which inhibit the choice and quality of goods; labour laws which define the hours and conditions of employment; and local planning decisions which determine the number and size of shops in an area.

Not all of these restrictions are opposed by retailers. Many do not want extended hours, or what some regard as unnecessary duplication of shopping facilities. Nevertheless, the number and scope of regulations seem excessive. The Task Force believes that in this sector as in others, over-regulation whether at national or local levels reduces the efficiency of investment and frequently results in bad investment decisions.

There are obviously conflicts in land use for retail, hotel, and other commercial development; procedures for resolving them need to be improved. Retail development is a major factor in the urban environment and can add to, or detract from this environment as well as affect land values. Less emphasis on complex zoning restrictions and more on a prompt and effective appeal procedure could provide greater flexibility, in the interests both of retailers and their customers.

Controls on retail margins, after being in force for 7 years, were lifted in 1979 on all except Category A goods. The removal of price control permits greater flexibility, but because of depressed trading a general rise in margins is unlikely. Competition helps ensure that retailers work towards keeping their costs and prices at reasonable levels, and adapt quickly to changes in consumer preferences and attitudes.

The industry supports the Planning Council's recommendations that import controls should be eased. Too much protection restricts consumers' choice, imposes uniformity, and limits competition among retailers. Moreover, the controls can reduce retailers' bargaining power with their domestic suppliers. The freedom to buy more widely overseas would be a stimulus both to the retail sector and to domestic manufacturing.

One of the main issues for the retail industry is whether indirect tax should be levied at the point of sale or on wholesale trade. A tax on wholesale trade seems to be preferred, mainly because of its ease of administration for retailers. But a retail sales tax related to payment at the point of sale would be easier to finance. Presumably a broad-based and low level retail sales tax, as applied for example in the United States, would also be relatively easy to administer—particularly with the improvements in technology already being introduced.

## Efficient Use of Capital

There is widespread concern that existing retail facilities are not being used as efficiently as they might be. There are probably too many of them in total and

some are in the wrong place. In general, increased competition is the best way to sort out both these problems.

The current controversy over extended shopping hours is a test of attitudes over the use of capital. Owners and managers are divided on the issue but the unions oppose it. There are strong indications that many shoppers would prefer more flexibility. The likely needs of an expanding tourist industry must also be considered.

More flexible shopping hours would probably have little immediate effect on the general economy or the better use of capital in retailing. With a static or declining volume of sales, Saturday or more evening trading would mean that some shops would be more fully used but others would have less trade, and there could be some additional transport costs. Many people would find shopping much easier and not have to be given, or to take, time off work. The present system makes shopping difficult for many people, including tourists. It restricts opportunities for part-time and supplementary employment and probably encourages a tendency to use more capital and less labour.

The restrictions are serious in the longer-term development context. New investment will occur only if it is expected to be profitable and, with funds likely to be at a premium, one factor will be the effectiveness with which they can be used. Growth in full- and part-time employment in the sector may well depend on the easing of controls.

A desire to retain the status quo in relation to shopping hours would seem inconsistent with the retail interest in a reduction of other controls affecting the sector. More flexible shopping hours would be a logical extension of the competitive nature of retailing as shown in the diversity in areas such as the range of goods provided, the type of shopping environment, the degree of service, fast food retailing, specialist shops, and so on. There are thus general issues to be raised as well as those which could be solved on a local or area basis.

## Growth

Because of trading opportunities and the financial position of the sector it is unlikely that there will be a general impetus for new capital investment coming from within the sector itself. Much of the support for major new retail investment in the last decade came from property developers with the assistance of institutional financiers, notably insurance companies. Most of this has now dissipated.

It is likely too, that individual retailers will now give even closer scrutiny to new development proposals. It is questionable whether customers are looking for more places to shop although in some areas they could be seeking a better standard of shopping environment. Rather, at this stage in the development of retailing in New Zealand, the consumer is probably more interested in seeking out as wide a range of goods as he or she is able to do overseas.

Prospects for retailing therefore rest largely on success in economic strategy as a whole.

# BUILDING AND CONSTRUCTION

Table 3.6 shows that well over half the total gross fixed capital formation during 1971–72 to 1977–78 was represented by output from the building and construction sector.

Even when residential building (which accounted for 24 percent of total capital formation) is excluded from the statistics in table 3.6, approximately 45 percent of all remaining investment was still in the form of building and construction, as shown in table 3.7.

Apart from its very large share in total investment, the building and construction

**Table 3.6 Investment in Building and Construction by Type of Capital Good**

Average for 1972–1978 March years[1]

| Sector | Private | Public[2] | Total |
|---|---|---|---|
| | (percent) | | |
| Residential building ... ... | 21.8 | 2.2 | 24.0 |
| Non-residential building ... ... | 11.3 | 9.6 | 20.9 |
| Other construction ... ... | 2.0 | 11.4 | 13.4 |
| **Total—Building and construction** ... | 35.1 | 23.2 | 58.3 |
| Other investment ... ... | 29.2 | 12.5 | 41.7 |
| **Total—Investment** ... ... | 64.3 | 35.7 | 100.0 |

Source: Department of Statistics

[1] Statistics for 1977 and 1978 are provisional.
[2] Central and local government—includes all government enterprises.

**Table 3.7 Investment Excluding Residential Building**

Average for 1972–1978 March years[1]

| Sector | Private | Public[2] | Total |
|---|---|---|---|
| | (percent) | | |
| Non-residential building ... | 14.9 | 12.6 | 27.5 |
| Other construction ... ... | 2.6 | 15.0 | 17.6 |
| Sub-total ... ... ... | 17.5 | 27.6 | 45.1 |
| Other investment (excluding residential building) ... ... | 38.4 | 16.5 | 54.9 |
| Total ... ... ... | 55.9 | 44.1 | 100.0 |

Source: Department of Statistics

[1] Statistics for 1977 and 1978 are provisional.
[2] Central and local government—includes all government enterprises.

sector is also notable for its rapid accommodation to changes in the general economic environment; the high costs, and long lead times for construction; poor industrial relations in certain activities; recurring fluctuations from too many to too few workers; and, as shown in table 3.7, the large proportion of State sponsored construction projects (many of which are actually undertaken by the State).

## Instability in the Industry

Instability in the construction industry has been a recurring issue for many years. For example, in the housing sector it has proved extremely difficult to correlate construction with requirements.

In more prosperous times, especially when there were large net migration gains, it was virtually impossible to build fast enough. The industry did expand, then entered the inevitable downturn with excess capacity. Over the past 3–4 years, house building has declined so much that the present output is probably not enough even for replacement purposes.

Similar situations have occurred in industrial construction; periods of high demand have resulted in severe skill shortages, strong competition for locally domiciled staff, and the importation of foreign workers. In contrast, during the past 2–3 years, it appears there has been a large outflow of skilled construction personnel (roughly estimated at 8000–10 000). The country is now ill-equipped to embark on larger-scale construction activity (including the important development of the nation's energy resources) and unless remedial action is taken soon New Zealand must face a renewal of intense competition for at least some categories of skilled labour. In the present circumstances the international competition, even for New Zealanders resident overseas, is likely to be more severe than usual since several countries (including Australia where most expatriate New Zealanders are living) are also embarking on similar large-scale development programmes.

## Housing

The major problems for housing appear to be related to financial issues, and the role of the Housing Corporation of New Zealand. During prosperous periods housing finance has proved relatively easy to obtain with private financial institutions prepared to provide mortgages at "affordable" interest rates. With the economic downturn, long-term funds were inevitably more difficult to obtain and the problems were compounded by the restrictions on interest rates. Although the importance of the Housing Corporation as a source of mortgage finance gradually increased, its resources were not usually sufficient to maintain construction continuity. In the present economic down-turn, inflation has markedly compounded the problem. With uncertainty prevailing over future rates of inflation and the associated effect on the economy, there has been reluctance to engage in longer-term funding of most kinds; and, generally, institutions have sought to minimise the risks, in part, by decreasing loan periods. This added contraction in availability of long term funds has no doubt compounded the recession in housing construction.

Although a downturn in housing output was inevitable with the contraction in general economic activity, and although emigration has contributed to decreased housing demand, a substantial and permanent reduction in the rate of inflation would help increase the demand for new housing and restore some stability in the industry.

Moreover, a more stable financial environment conducive to long-term investment by the private sector would allow a reduction in the proportion of funding undertaken by the Housing Corporation. This would both reduce the call on Government funds and decrease the political involvement of the Government (via the Housing Corporation) in the industry.

## Other Construction

Until recently, hydro-electric projects (coupled from time to time with the construction of large manufacturing or processing plants such as the Bluff aluminium smelter, or the Karioi pulp mill) absorbed substantial quantities of both investment finance and construction labour. The pace of implementing the projects was a major factor in determining the extent of competition for construction resources. Similarly, the way in which construction of the new energy projects is undertaken will determine whether the industry once again embarks on a costly cycle of heavy expansion followed by an enforced depression.

The value of work involved in the new energy projects will be very large, and the degree to which New Zealand's builders and contractors will have the capability and capacity to handle the work is still uncertain. In particular, there could be serious shortages of specific skills: the Planning Council has said that the issues call for special consideration by the Government. Although much progress has been made since the Council's recommendation in *Implications of New Energy Developments*, in view of the importance of the issues a full statement on the relation of the energy development programme to the building and construction sector is given in the Appendix at the end of Part III.

## Design Criteria

There is reason to believe that design standards for much building and construction are more rigorous than is necessary. The Standards Association of New Zealand's (SANZ) model house-building code has been almost universally adopted by local authorities without modification for their individual needs. In addition, high standards of initial construction are often imposed (such as for concrete footpaths) to keep maintenance low, but without thoroughly evaluating the effects on construction costs.

There has also been a tendency for standards to be unduly influenced by technical considerations without sufficient regard to economic factors. This has been recently recognised by SANZ officials, and the increased use of cost benefit analysis of standards (funded if necessary by increased levies within the industry) could provide substantial returns.

## Construction Lead Times

One of the worst features in the construction industry is the delays which occur both in getting started and during construction. Sometimes preliminary negotiations have taken three to four times

as long as the actual job. This of course adds substantially to final costs. Frequently, less than two-thirds of the cost of a larger building is for materials and labour. While it appears that the number of pre-construction approvals required for any project is similar to the number required in other developed countries, in New Zealand delays in obtaining approvals—particularly for smaller projects—are a cause for concern. Although the National Development Act provides a mechanism to streamline the process for large projects of national importance, a system to speed up approvals for smaller ones is urgently required. The efficiency with which small projects are implemented is also important to the economy. They frequently offer the prospects of earlier permanent employment opportunities and more rapid economic returns than larger ones.

There is no doubt that often construction could be speeded up. There is evidence that in the housing sector at least, costly delays can be caused by the inspection procedures of local authorities. For example, it has been estimated that the average Auckland house is subjected to 12 inspections before completion and that these often cause delay.

A number of projects have been delayed by industrial disruption, and this again has added to costs. Probably more important, however, are factors operating when the industry is working normally. For example, there is not a great deal of overtime worked except in certain specialised activities. In general, the industry like many others tends to close down or reduce activity during December and January. These are excellent working months because of good weather and long daylight hours.

## Public Sector Construction

The extent of the public sector's involvement over a reasonably normal 10-year period is shown in tables 3.8 and 3.9. In the years shown, most of the work (and an increasing amount of it) was done by private enterprise—much of it under contract to the Government and local authorities.

As with State involvement in other sectors of the economy, a system is needed which enables the relative efficiencies to be evaluated and, more importantly, which permits the most efficient to undertake the work. At the very least, public sector investigation, design, construction, and maintenance divisions should be managed on a commercial basis and all work charged accordingly. This would ensure that the Government and the public were at least aware of the cost of each activity.

In addition, as much Government work as possible should be placed for tender and Government agencies should compete

**Table 3.8 Sector Shares in Building and Construction**

| Sector | Year Ended 31 March 1964 | 1969 | 1974 |
|---|---|---|---|
| | (percent) | | |
| Private enterprise [1] ... ... ... | 65.1 | 74.8 | 75.9 |
| Government departments (with own employees) ... ... ... | 19.7 | 14.5 | 10.5 |
| Local authorities (with own employees) ... ... ... | 11.8 | 8.8 | 7.4 |
| Owner-builders [1] ... ... ... | 3.4 | 1.9 | 6.2 |
| Total ... ... ... ... | 100.0 | 100.0 | 100.0 |

Source: Census of Building and Construction

[1] Includes work done for Government and local authorities.

**Table 3.9 Share of Building and Construction Activity by Ownerships [1]**

| Owner | Year Ended 31 March 1964 | 1969 | 1974 |
|---|---|---|---|
| | (percent) | | |
| Government (including Government corporations)— | | | |
| Built by own employees ... ... | 17.1 | 12.4 | 8.5 |
| Local authorities (including hospital boards)— | | | |
| Built by own employees ... ... | 10.3 | 7.5 | 6.1 |
| Government and local authorities— | | | |
| Built by private enterprise ... ... | 20.0 | 23.6 | 18.1 |
| Other (including producer boards)— | | | |
| Built by private enterprise ... ... | 49.1 | 54.6 | 61.4 |
| Built by owner builders ... ... | 3.5 | 1.9 | 5.9 |
| Total ... ... ... ... | 100.0 | 100.0 | 100.0 |

Source: Census of Building and Construction

[1] Includes work sub-contracted to private enterprise and owner-builders.

against the private sector for it. This would ensure that the great majority of work in the industry is undertaken by the most efficient concern. Given the range of projects and skills involved, however, this would not necessarily imply that the private sector would gain more work, but merely that the State could profitably compete—to the benefit of the nation—or that the State was demonstrably providing a service not available from the private sector.

planning also has a role to play. It can help avoid the problems which have occurred in the past when numerous large construction projects have been undertaken simultaneously.

Improved phasing of working hours, particularly during summer months, would help reduce construction time and costs. Streamlined planning approvals for the "small-scale" projects would provide even greater returns, and remains a point for priority action.

## Summary

With building and construction responsible for almost 60 percent of total investment, the general efficiency of the industry is clearly of paramount importance. The industry has many long-standing problems. However, creating a more stable economic environment with reduced inflation would alleviate some of the difficulties. Energy

# ENERGY DEVELOPMENT

Investment in the development of New Zealand's energy resources is dominated by the Government's declared objective to reduce dependence on imported liquid fuels.

In October 1979 the Planning Council published a report on the implications of new energy developments based on Maui gas, primarily to assist public discussion about the investment issues involved in this potentially very large programme. Intensive energy planning in 1979 involved the Government and its agencies (such as the Liquid Fuels Trust Board, Petrocorp, the Natural Gas Corporation, the Energy Research and Development Committee) and a number of major companies. As a result, a medium-term gas development strategy for New Zealand has taken shape and the main issues now centre on how to implement the programme economically without delay, and without adverse effects on investment in other sectors.

The Government announced in November 1979, its approval of the Mobil process to make gasoline from methanol produced from Maui gas. The combined cost of the gasoline, methanol, and associated projects was estimated roughly at $1 billion.

At least another billion could be spent on other proposed investment in energy development and related projects announced last year. The total of $2 billion (in 1979 prices) is about equal to total private investment in New Zealand last year. Although it will be spread over several years, it will add substantially to all investment aggregates in the 1980s.

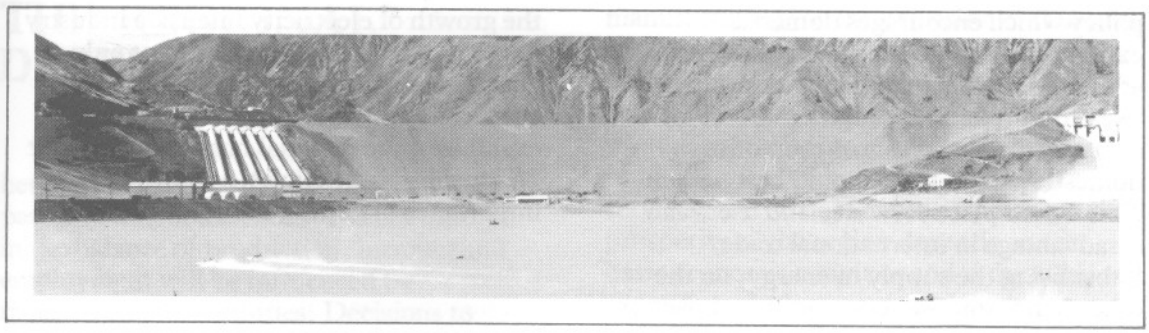
The accelerated development of energy sources in New Zealand is a belated response to the continuing increase in oil prices begun by the Organisation of Petroleum Exporting Countries, (OPEC) in 1973. New Zealand's consumption of oil as a source of primary energy had already been declining since 1973 (see table 3.10).

Dependence on imported oil has been reduced to less than 50 percent of total primary energy use, but imported oil still represents more than 80 percent of the country's consumption of liquid transport fuels. The Government's declared aim is to reduce this to 50 percent by 1987. This would reduce imported oil's share of primary energy consumption to less than 30 percent.

**Table 3.10 Consumption of Primary Energy**

| Type of Energy | Year Ended 31 December | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1964 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 |
| | (petajoules) | | | | | | |
| Coal ... ... ... | 66 | 60 | 62 | 56 | 69 | 56 | 49 |
| Oil— | | | | | | | |
| Imported ... ... | 103 | 201 | 193 | 187 | 184 | 168 | 166 |
| Indigenous ... ... | 0 | 7 | 8 | 8 | 22 | 31 | 26 |
| Natural Gas ... ... | 0 | 13 | 14 | 15 | 40 | 64 | 59 |
| Primary electricity ... | 34 | 55 | 55 | 64 | 60 | 57 | 60 |
| Total ... ... | 203 | 335 | 332 | 331 | 365 | 376 | 360 |
| | (percent) | | | | | | |
| Imported as proportion of total ... ... | 51 | 60 | 58 | 57 | 50 | 45 | 46 |

Source: Department of Statistics



## Development Projects

These are in two main categories, one related primarily to import substitution, the other to exports. In the first category the projects and programmes involve both conversion to alternative fuels. (LPG, CNG, and electric power for public transport) and the production of petrol by the Mobil process. Blending methanol with motor spirit and ethanol production are being considered. Short-term and long-term conservation measures complement this strategy. A mixture of fiscal measures (taxes and subsidies) and administrative controls has been applied, the latter as emergency measures. The export category includes products based on natural gas (urea and methanol) but emphasises other energy forms—coal and hydro electric power—for energy-intensive mineral and forest products.

The size and scope of planned energy and energy-intensive development raise important issues. On the one hand, the programme promises to have a major impact on the balance of payments through import substitution as well as exports. On the other, it will impose considerable demands on New Zealand resources; particularly some categories of skilled manpower which are in short supply both here and overseas.

The need to establish priorities and to avoid bunching major projects has been acknowledged. Those recommended by the Liquid Fuels Trust Board are in order of priority: the refinery expansion project; synthetic fuel development; and the methanol project. This is only the beginning, however, of a growing list. Moreover, the specific large-scale projects are only part of the investment programme New Zealand requires to expand its whole range of exports and import substitution. Manpower planning has begun but may need to be developed to a much greater extent than would normally be required, if the demands likely to arise during the next 5 years are to be met. Manpower and construction issues are discussed earlier in the report.

## Pricing policies

The pricing of alternative forms of energy plays an important role in determining the consumption of each form of energy, and hence in shaping national investment in energy resources. The New Zealand economy—basically private enterprise, but subject to considerable State intervention in such fields as the supply of energy—must provide the appropriate signs for decision-makers in both sectors if expensive mistakes in energy investment are to be avoided.

A prime function of the price for any particular form of energy is to balance supply and demand. The price paid by consumers should provide returns to the producers of energy (whether in the public or private sector) as attractive as that which could be obtained by alternative use of the resources employed in supplying the energy. Otherwise, too little will probably be produced. Pricing energy too cheaply encourages wasteful consumption, and inhibits domestic exploration and development. Both these developments occurred in New Zealand and most other countries when oil was cheap.

For products traded internationally, such as oil or coal, world prices are normally the appropriate yardstick. The indications are that energy prices will continue to increase more rapidly then most others; so that from New Zealand's point of view a price and tax

policy which encourages domestic exploration and development and efforts to adopt the most economic patterns of energy use is desirable. Very high prices set for energy, in the interests of promoting domestic production, should be avoided. This would place New Zealand users at a disadvantage in international trade. Subsidising the supply of energy, on the other hand, imposes costs on the whole economy.

With the development of an aluminium industry, hydro-electric power became a form of energy traded internationally. There is now intense interest in the availability of surplus hydro-electric generating capacity for energy-intensive export industries. The price for this supply of energy should be determined according to world prices, with appropriate adjustment for transport costs to different markets. To sell this more cheaply would merely confer an unnecessary subsidy on the users (whether foreign or domestic). New Zealand's advantage lies in its comparatively abundant supplies of energy. In this, as in any other form of exporting, the aim should be to obtain the best international price. Moreover, the surplus generating capacity might well be used up in a few years. Additional capacity, when required will be more costly. The terms and conditions of supply to new projects should take this into account. Short-term concessions, for sound projects, need not be inconsistent with this approach.

The present situation provides an opportunity to re-examine the whole basis of electricity pricing in New Zealand. The earlier principle of a single national tariff was reasonably equitable until the most accessible and economical sources of hydro-electricity had been tapped. Those days ended in the 1960s when, with the construction of the Cook Strait cable for inter-island transmission of power, it was recognised that future large-scale hydro development would be in the South Island.

The Government's decision late in 1979, to call for new industrial developments based on power-consuming industries sited near South Island power schemes, is sound. Power losses in transmission have to be considered. They may be as high as 20 percent of power generated in the Waitaki Basin and transmitted via the Cook Strait cable to industrial users in the Auckland urban area. This has probably encouraged the growth of electricity intensive industry in the north, at the expense of not only South Island development but also the economy generally. It provides a good example of the regional impact of uniform national pricing policies, and the importance of getting the prices right.

# THE REGIONAL DIMENSION

The dispersion of economic activity between the regions has been influenced by past investment decisions. Future changes in the balance of production, income, and employment will be influenced by investment opportunities. Decisions to invest will be influenced both by national and regional development policies. But regional and local futures should be determined primarily by the directions of a national development strategy. Special incentive schemes for regional development are no substitute for a successful national strategy.

For example, policies which lead to a resumption of growth in agricultural output could have more impact in what are now classified as slow-growth regions, than specific provisions to increase investment in those regions. Stagnation in the growth of agricultural production has affected all the regions most dependent on agriculture. If annual increases of 2–3 percent in the volume of agricultural output can be restored, the uneven regional growth which has occurred would be lessened.

In manufacturing, protecting production for domestic markets has led to the concentration of investment in national market centres because that is where most of the sales are made. Emphasising export growth could stimulate growth of production in other regions oriented to world rather than domestic markets. It is already noticeable that production oriented to export markets is geographically dispersed, with much of the production coming from regional centres rather than from the larger cities.

Growth and diversification in activities such as agriculture, forestry, fishing, and manufacturing which result from export incentives, or better still an appropriate exchange rate, should promote a wider dispersion of export-oriented activity than measures designed to prop up enterprises in particular regions.

Many regions depend primarily for progress on their "export base"—their capacity to supply goods and services to the rest of the country and overseas. Natural resources (such as land, minerals, sources of energy, or tourist attractions) often form this base; but it may also involve manufacturing, or the provision of financial and other services. These core economic activities generate other servicing activity—shops, transport operations, and professional services. On this foundation, public services (schools, post offices, fire services, and so on) are built up. The prosperity of the region depends on the basic economic activities and if these fail to expand, or decline, so does the whole region. Sound macro-economic policies which promote agricultural production will also promote regional development. Special assistance is required only if the basic activities are not able to support the region.

One of the major deterrents to growth in some regions which have the capacity to manufacture for domestic as well as overseas markets may be the uniform national pricing policies imposed for some goods and services. Such pricing policies, whether officially established or set by private enterprise, can inhibit regional growth by removing the natural protection given by transport costs. A uniform price for bulk electricity has probably penalised industrial development in the South Island (where electricity is cheaper to produce) and favoured development in the North Island which has the main domestic markets. Uniform pricing for many products tends to centralise production in or close to the largest national markets; this reduces the opportunities for regional specialisation.

There may well be temporary or some special reasons for regional economic assistance. The case exists for the support of "infant industries"—new investments which will in time become economic. There is also an argument for the provision or maintenance of some public services (schools, local hospitals, bus services) where they support activities of national significance (such as export agriculture, fisheries, or mineral development) but would not otherwise be justified. The viability of particular rural areas may depend on what health, education, and other community services are available, and what opportunities secondary to the main economic activities exist for employment and income-earning. If these are inadequate, there may be a loss in both population and production.

Much of what is given by way of regional investment incentives however, might be unnecessary in a less controlled and more competitive national economic

environment, with more rational pricing policies for public and private goods.

The links between regional and national development are explored in two reports issued recently by the Planning Council—*Planning and the Regions* and *Regional Development Objectives and Policies: An Appraisal.*

# PUBLIC SECTOR INVESTMENT

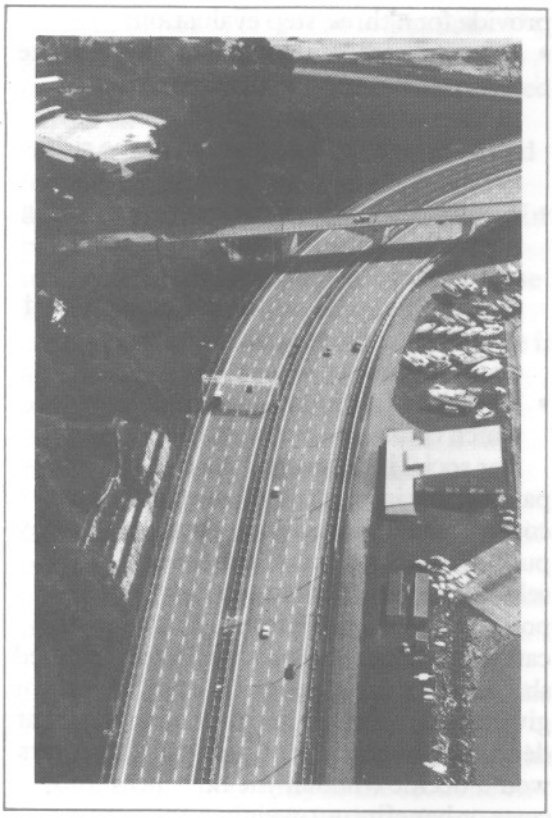
Much of the investment undertaken by the public sector occurs in areas of economic activity already discussed. The sector includes all State enterprises and trading organisations (such as the N.Z. Railways, the Post Office, the Bank of New Zealand, Air New Zealand, the Tourist Hotel Corporation, and Government Life Insurance), as well as all Government departments and regional and local authorities (including hospital and education boards). Together these cover a very large area of economic and social activity and account for one-third of all fixed investment expenditure—an even larger proportion (46 percent on average in 1971–72 to 1977–78) if investment in home ownership is excluded from the total.

Tables 1.2 to 1.5 show the distribution of public sector investment by type of economic activity, by type of capital good, and by central and local authorities. Approximately two-thirds of this investment relates to trading activities (electricity, gas, and water; transport; financial services; and so on), and the remainder to the provision of Government and local authority services (such as schools, hospitals, fire services, and office buildings). About one-quarter of public sector investment is undertaken by local authorities, including hospital boards.

## Existing Capital

Over the years the public sector has built up an immense stock of capital assets—buildings, transport facilities and equipment, water-supply and sewerage systems, and so on. No reliable estimate of the total value of these assets is available. Some Government departments do not have capital accounts, even on an historical cost basis, and thus have little idea of the value of the capital they employ. Yet the efficient use of these assets is clearly in the public interest. Non-trading as well as trading departments should keep capital accounts to give a better appreciation of the use of capital.

The efficient use of capital in central government and local authority services, is



primarily a matter for the Government departments, regional ad hoc boards, and local councils directly concerned; and such monitoring agencies as the State Services Commission, the Treasury, and the Audit Office. They need better and more up-to-date information on all capital assets as a basis for good management.

For Government trading enterprises operating within the market sector it is reasonable to expect a financial return on the assets employed. However, if trading departments and agencies are to use capital effectively, they need to know the current value of the assets they use in the production of goods and services. Unfortunately, the valuation of assets is generally based on historic costs and in some instances has also been substantially written down in value. The first requirement of an approach to more effective use of capital is to make realistic assessments of the value of the capital involved.

Once this adjustment is made, it is possible to consider the performance criteria, with respect to capital, to which Government trading enterprises should be expected to conform.

Problems arise for State trading enterprises from the demands frequently placed on them to provide or maintain clearly unprofitable services for "social" reasons. These services are often desirable, but only sometimes essential. They should be treated as operations separate from the commercial operations of the enterprise, and financed from other sources (preferably general public revenue). Unless these additional costs are specifically provided for, a clear set of financial objectives for public enterprise is hardly feasible.

Otherwise, the objective should be to secure an acceptable rate of return on the assets employed by public enterprise. This approach should be applied to each enterprise and also the different operations carried out by it. There are a number of issues involved, and governments must decide what is acceptable. The maximisation of profits is not an appropriate objective for public enterprises, if only because most operate as monopolies.

But the performance of State enterprises could be measured against the average achieved by the major companies in the private sector and should try to match this as far as possible.

Generally, the aim of public enterprises should be to promote full use of the resources available, and to make assets as productive as possible. This could be achieved by expenditure to reduce costs as well as to provide new services. Investments designed to give increases in productivity may often show higher rates of return than can be achieved on new investment.

Prices should be related to the overall rate of return being sought, and enable it to be achieved. Profitable operation would provide at least part of the resources required to develop new services, and the capacity to service borrowing for investment at normal rates of interest.

The difficulty remains that many public enterprises operate in a protected environment which, in the same way as for highly-protected enterprises in the private sector, gives little incentive to cut costs, keep prices down, and use resources effectively. Where practicable, increased competition with the private sector is one way to improve performance. Closer scrutiny by Parliament and the public is also desirable and this would be helped by increased information on the objectives, plans, and performances of the enterprises concerned.

## New Investment

In the absence of the market considerations which guide and influence most private sector investment (generally undertaken only if it is expected to be profitable) there is an obvious need for careful evaluation of public sector investment proposals. Even in the market sectors of the economy, public enterprises and corporations often have monopoly positions or are otherwise protected from competition. Their investment proposals may require particularly thorough appraisal, because of the effects which wrong decisions can have elsewhere in the economy.

Considerable efforts are already made by the Treasury, Government departments, and State enterprises to evaluate the larger investment projects and programmes. More could be done if there were a larger number of people within central government with training in the techniques involved, and if there were recognised procedures for evaluation which, with appropriate variations, could be used over a wide range of public sector investment activity.

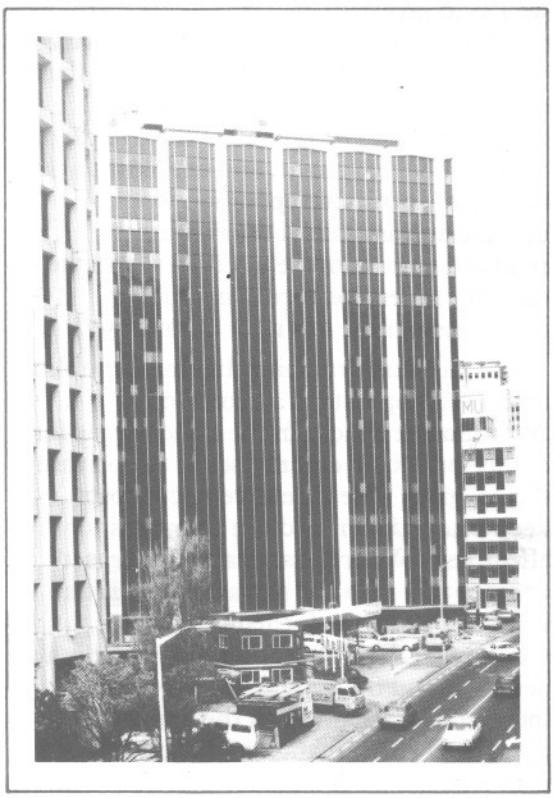
In principle, guidelines for project evaluation in the public sector should provide for a three-step evaluation:

- A formal cost-benefit analysis to calculate an internal rate of return and expected present social value; and, for large projects, a formal evaluation of the risks involved.
- A second-round evaluation incorporating regional, environmental, and other effects which, while not so easily measurable, can and should be estimated to provide a broader basis for decision-making.
- The identification of costs and benefits which cannot be measured.

For social investments the third step is particularly important. Non-quantifiable costs or benefits are a consideration in many public sector projects. Questions of self-sufficiency, national security, trade policy, or social significance come into this category. Whatever methodology is adopted should allow for an assessment of the weight given to such factors in reaching investment decisions. In effect the Cabinet or Ministers would decide whether the non-measurable costs or benefits out-weighed the net quantifiable benefits, positive or negative, of the project proposal.

Such evaluation procedures could be applied, for example, to the consideration of maintaining or discontinuing particular services, or to the industry studies programme or the provision of regional investment incentives. The main concern, however, is that the amount of public investment *not* subject to appraisal be substantially reduced—and preferably eliminated.

These methods may seem formidable but in practice only a brief training in analytical techniques would be required. Training existing staff to perform this type of appraisal could be an investment with very high rates of return. It is important to develop the skills in a large number of departments, agencies, and local authorities rather than only in central locations such as the Treasury: a decentralised evaluation process provides the knowledge and special experience also needed to make good investment decisions. The main need is thorough internal scrutiny of all investment proposals as a matter of routine. For larger and more complex project proposals, outside consultant services (if necessary from overseas) should be used whenever expertise is not available within the public sector.



An important part of the evaluation process, for new or large-scale projects, is provision for consultation among interested parties and for public debate and involvement. Where this has been allowed for, the benefits appear generally to have out-weighed the costs in time and effort. In part this is because the decisions on investments in the public sector, and those involving public policy, are made not by economists but by Ministers, who may be in a better position to judge the merits if a wide body of opinion is tapped. It is also because better advice will be given if the proposal is widely canvassed and thoroughly considered. Freedom of information and the opportunity for public participation are therefore important elements of sound public sector investment planning.

New investment in the public corporations (such as Air New Zealand, the Shipping Corporation, and the Tourist Hotel Corporation) raises other issues which are discussed more fully in the sections on transport (pages 40–45) and tourism (page 37). The main issues centre on the cost at which these corporations can provide services, if they are to be profitable and maintain satisfactory rates of return on the assets they have.

# APPENDIX

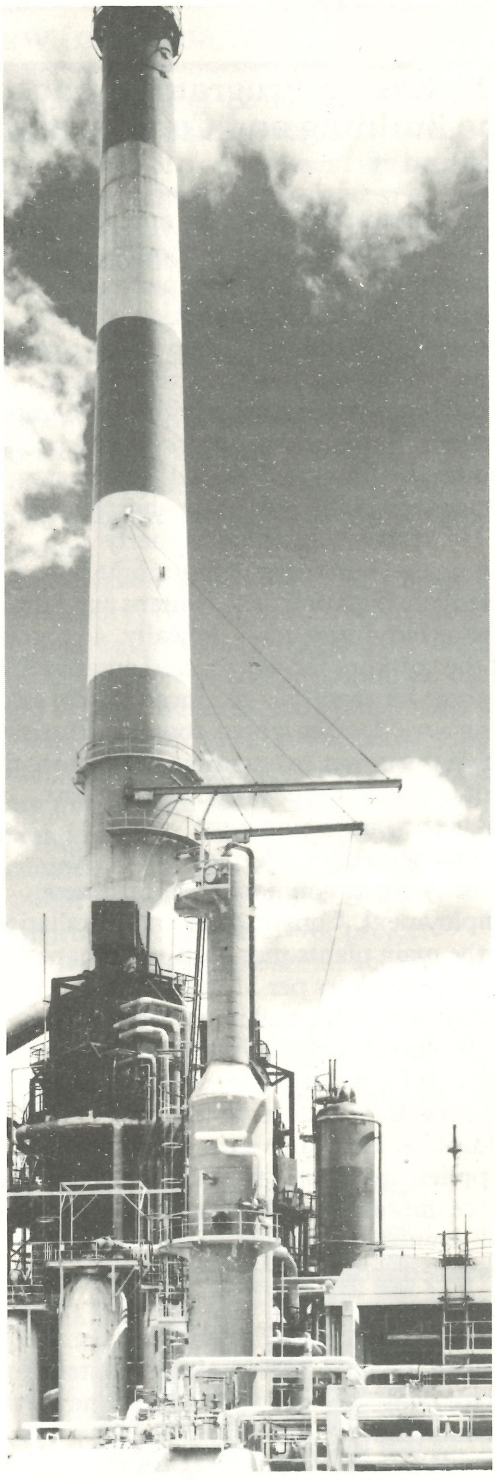
## The Energy Programme and the Building and Construction Industry

In some of its aspects the energy programme will be quite labour-intensive. This applies mainly to the conversion of vehicles to gas, the distribution of fuel supplies, and industrial conversion to gas. Mostly however, it will consist of large capital-intensive projects with a high import content. Relatively few workers will be required, although there will be a heavy demand for skills already in short supply.

Hydro projects which formerly dominated our energy programme have a relatively high domestic content and large labour requirements— typically, 40 percent of the costs are for labour, and another 35 percent for materials produced locally also with considerable labour content. Phasing down the power programme will reduce the requirements for construction workers, engineers, and equipment.

The new energy developments will directly create comparatively little new employment. Construction and installation of the main plants may require perhaps two or three workers per $1 million of investment. The maximum direct labour requirement is about 7000 in any one year and that for a comparatively short time. There will, of course, be indirectly additional jobs, such as in providing supplies, transport, and other services. More important, the energy programme will eventually provide a better basis for sustained economic growth throughout the economy.

Those whom the Task Force have consulted in the New Zealand construction sector do not foresee problems in the New Zealand industry's ability to supply domestic components for the energy development envisaged: the downturn in construction has left many suppliers with under-utilised plant, and management and design teams. However, there are doubts about the availability of construction workers with the required skills. This and the maintenance of good industrial relations are seen as the most important issues to which attention must be paid if large projects are to be effectively carried through. The problem is complicated by the



severity with which the construction sector has been hit by the current recession of activity, and by the consequent loss of skilled people which this has involved. The changing nature of the energy programme will be superimposed on the other structural changes which have been occurring in the sector.

The industry seems able to adjust fairly quickly to a reduced level of activity. This is indicated both by the low rates of registered unemployment among carpenters, electricians, and others with construction skills, and the large net emigration in these categories. Only general labourers are readily available. This shortage of skills makes it difficult for the industry to cope with any rapid increase in demand. Experience of the 1972–74 construction boom suggests that it would be prudent to think in terms of an upper limit to expansion which could soon be reached. The Ministry of Works and Development's development and programming branch considers that this may be about 10 percent per annum; and the indications from their programming model are that this constraint could operate within the next 3–4 years.

Moreover, the shift towards specialised construction will involve other constraints. About 75–85 percent of the work required in residential and non-residential building is done by carpenters, plumbers, bricklayers, painters, electricians, and so on. But they contribute only about 10–15 percent of the work in civil and electrical engineering projects, and probably even less in chemical engineering ones. The pressures will therefore bear heavily on a small segment of the construction industry.

The construction skills involved are largely mechanical and electrical. Because of New Zealand's slower industrial development in recent years there are limited numbers of people skilled in these trades. Past efforts to overcome the shortages by immigration, particularly for boilermakers and riggers, have not always been as beneficial as expected because of difficulties in relationships between management and workers.

Acquiring skilled workers will be made more difficult by the simultaneous upsurge in industrial construction in Australia. In all probability, this will not only help hold the New Zealanders already working in Australia but may attract others. It may also make it difficult to attract Australians here. What is clearly required is a continuing effort through New Zealand's overseas posts, and by other means to secure the additional skilled workers (preferably New Zealanders) who will be essential as the programme gathers momentum. There is also a clear need to accelerate training programmes and to devise new and effective

ways to train more skilled people here. The possible constraints imposed by a lack of skilled workers cannot be ignored. In a situation in which labour shortages are likely to be severe, industrial relations will require particularly sensitive handling. Difficulties could raise costs, extend construction times, lower economic and financial rates of return, and postpone the benefits of increased self-sufficiency in energy.

Apart from specific skills such as those of boilermakers, riggers, and welders there will be increased demand for tradesmen, including electricians, engineers, fitters, and general labourers. Shortages may mainly occur in specific areas, for example in Northland, but some may apply nationally. Off-site work such as prefabrication, assembly, and the use of modular construction methods, could help solve local labour shortages. Fabrication off-shore (i.e. in other countries) is possible, but would increase the already large foreign exchange component of the programme and carry some risk of repercussions on the domestic industrial scene.

Plant erection costs are large enough when construction proceeds smoothly. Project delays resulting from labour problems can have a profound effect on the overall completion schedule and erection costs. Problems deriving from the national industrial climate, as well as job site relations, are important. Part of the construction force has been itinerant in the past, with an interest in getting maximum benefits over limited periods of employment. It probably makes sense to try to get as much work as possible done by long-term employees, preferably resident in the area. Camps on or near construction sites are recognised as a focus of construction problems.

The use of overseas construction teams in special circumstances has not caused major problems in the past; but this approach to overcoming constraints has been used selectively and only occasionally. There does not seem to be any fundamental union objection to the use of highly specialised overseas skills; it is recognised this can provide opportunities to develop them domestically, for use in other projects. However, in the present industrial relations environment, any major attempt to use foreign labour to overcome constraints within New Zealand could be self-defeating: it could arouse widespread resistance and delay rather than accelerate the completion of major projects. In general, the problem of using appropriate foreign skills is possibly best handled by having foreign contractors operate within consortiums alongside resident New Zealand firms. However, the New Zealand tax system may discourage workers with skills in international demand from taking up contracts here.

In the past, we seem on average to have taken longer to complete investment projects than is usual in many other countries. High capital costs put the enterprises concerned at a competitive disadvantage in international trade, and have adverse effects on their domestic customers. A co-operative effort to enhance the construction sector's capacity to implement large projects on schedule, and to become more competitive internationally is essential—not only for the energy programme in the 1980s, but also for profitable domestic and overseas activity in other sectors. A commitment by employers, unions, and the Government to continuing co-operation and regular consultation is needed. Without this, many of the advantages of the energy development programme will not be secured.

# IV INVESTMENT CAPITAL

## THE NEW ZEALAND FINANCIAL SYSTEM AND CAPITAL MARKET

This report is concerned both with the amount of investment taking place in New Zealand and with the efficiency with which that investment is being used. Leaving aside the sharp fall in the ratio of investment to gross domestic product in very recent years, our record in terms of total investment has been reasonable, and certainly up with the average for other developed market economies. Where we have performed poorly is in the use to which we have put our investment capital, with the result that we have been rewarded by a low rate of economic growth for our investment effort.

As already discussed, many of the reasons for our demonstrably inefficient use of capital lie in policies adopted in the sectors where capital is actually used in transport, manufacturing, construction, and so on.

But major problems within the financial sector itself have led to the inefficient use of capital throughout the economy. Because this sector acts as a conduit for capital from those with savings to those wishing to invest, problems here have a significance out of all proportion to the direct contribution of the sector to gross domestic product.

As in other sectors, many of these problems have been caused by governmental controls and regulations. This in itself makes a discussion of the sector important. Of even greater relevance is the fact that the financial sector is perhaps the only major sector where Government policy has moved strongly in the direction of decontrol and deregulation over the last few years, and this makes an examination of the sector of particular significance.

### History of controls

For much of the post-war period the entire financial sector was subject to a multiplicity of Government regulations and controls:

- controls on the maximum average interest rate chargeable by trading banks;
- controls on the interest rates payable by all deposit-taking institutions;
- controls on the amount of Government stock held by all deposit-taking institutions, and by life insurance companies and pension funds;
- controls on new issues of share capital;
- controls on the movement of funds both into and out of the country;
- controls on the foreign exchange market, and the ability to eliminate foreign exchange risk;
- controls on the direction of trading bank lending.

Many of these controls related back to a simplistic view that low interest rates were "a good thing". Interest rates on the Government's own securities were pitched at a very low level because of this article of faith. When few individuals wished to invest in Government securities at rates well below the inflation rate, financial institutions were obliged to subscribe for such securities. Trading bank lending rates were controlled at a low rate, and the Government, having destroyed the market as a method of allocating bank credit, was obliged to allocate credit by directing the banks to lend to "high priority sectors", and not to lend to "low priority sectors". The same controls on trading bank lending encouraged the growth of other financial institutions, and the progressive extension of controls to them also. Cheap money in New Zealand might have tempted foreigners to borrow in New Zealand—or New Zealanders to invest overseas; this was prevented by an elaborate system of foreign exchange control.

The consequences of this regime were partly economic and partly social. All of them were undesirable. First, the very low cost of money in nominal terms (often a negative cost after adjustment for inflation) was almost certainly a major reason for the inefficient use of capital throughout the economy: in both public and private sectors, decision-makers tended to treat capital as almost a free good, and accepted the gross underutilisation of capital that characterises so much of the economy.

Secondly, the controls greatly reduced the ability of the primary financial institutions (the trading banks) to compete for the dollars of savers. When the Reserve Bank began publishing statistics on money

supply and selected liquid assets in 1955, the trading banks' deposits amounted to 39 percent of that total. By 1968 the proportion had fallen to 28 percent. This reduced role of the banks, coupled with the uncompetitive interest rates on the Government's own securities, made it increasingly difficult for the Government to influence the level of total credit creation in the economy and, to the extent that other newer financial institutions sometimes involved a higher degree of risk, placed the funds of some investors seeking a more realistic rate of return in jeopardy.

Thirdly, the low interest rates encouraged savers to use their funds to buy land and other real estate assets, instead of buying the financial instruments which might have facilitated the transfer of funds to productive parts of the economy. This tendency was especially marked in the early- and mid-seventies, when a substantial increase in the money supply coincided with strongly negative real interest rates on most financial instruments. Little wonder that the price of urban land almost doubled in the 3 years from 1972 to 1975.

The interest rate controls had a stultifying effect on competition and innovation in the financial sector. This was particularly true of the trading banks—the institutions most tightly controlled in the area of interest rates. There was no obvious incentive for a bank to take a modest risk by financing a new or struggling venture when the total of all interest earned on overdrafts had to be 6 percent per annum or less. Any above-average rate of interest charged to the slightly risky venture had to be at least offset by a below-average rate to another party. It was simpler just to avoid the risk.

And this was one of the paradoxes of the control regime. Designed in the belief that low interest rates would be socially beneficial and helpful to "the little man", the very reverse tended to be the case. Small companies and private individuals had very limited access to finance at low rates of interest and normally had to depend on much more expensive loans from finance companies. On the other hand, when they had savings to invest they were obliged to deposit them at artificially low interest rates. The larger companies, by contrast, had easy access to cheap loans from trading banks, and were careful to invest in the small number of uncontrolled investment avenues at substantially higher rates of interest (for example commercial bills, which during the early seventies were normally salable in minimum denominations of $20,000). It is obvious that the "social advantages" of the low interest rate policy were more apparent than real.

## Dismantling the Controls

The move away from this controlled regime was initially erratic. The first major breakthrough came in the 1969 Budget, which permitted trading banks to compete freely for large term deposits (over $25,000), and to invest their idle balances in interest-bearing Government securities. Other moves to liberalise the system were introduced in 1970 and 1971. Then in 1972 we reverted to a system of comprehensive controls on the interest rates paid by all deposit-taking institutions.

Over the next 3 years tentative moves to liberalise the system were resumed. In 1974 interest rates on deposits for terms of 5 years or more were decontrolled, and then in 1975 for terms of 3 years or more. Interest rates on Government securities were also increased: the rate on 18-year Government stock moved from 5.5 percent per annum to 6 percent per annum in 1973, and to 6.5 percent per annum in 1975. The commercial bill market, which had never been subject to control and which had expanded markedly during 1973–75, was allowed to reach rates of nearly 15 percent per annum in late 1974 (the only financial instrument which gave investors something close to a positive real rate of return at that time).

Suddenly, on 2 March 1976, the Government announced the virtual abolition of interest rate controls. The restriction on overdraft interest rates was abolished, as were the controls on almost all deposit interest rates. At the same time the interest rates paid on Government securities were increased quite markedly, although they remained below the level needed to attract significant voluntary investment.

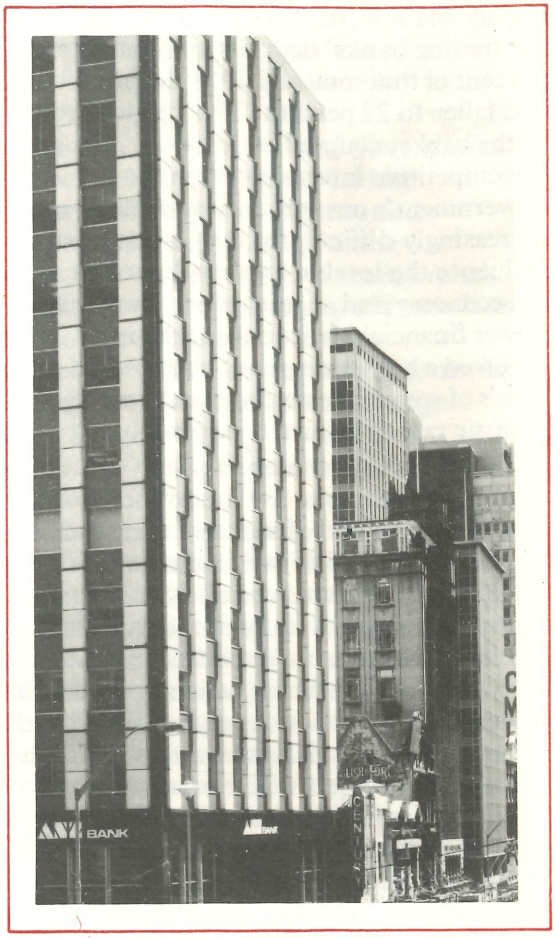
In 1977, 1978, and again in 1979, the interest rates on Government securities were increased further, and in mid-1980 it is possible to get a yield of 13.5 percent on New Zealand Government stock of a 5-year maturity. It is also possible to invest limited

amounts in special inflation-adjusted Government bonds which provide total protection against inflation.

There have been many related changes. One of the most potentially far-reaching was the change announced in the 1979 Budget to the previous system of forward foreign exchange protection. Before June 1979 forward exchange cover had been available through the trading banks (acting as agents for the Reserve Bank) only to those engaged in importing and exporting, within 10 days of the risk being assumed, at a price which bore no relationship to any market factors. In that month, and prompted in part by the rapid growth of the merchant banks' currency "hedging market" (which provided forward cover at rates appreciably better than those available through the trading banks to all comers), the Government announced that the Reserve Bank too would henceforth provide forward cover to any who sought it and, perhaps most significant change of all, at a cost designed to make potential New Zealand borrowers indifferent between borrowing in New Zealand and borrowing overseas. Logically, the abolition of many of the direct controls over overseas borrowing (and investing overseas) should soon follow.

Although direct controls have been removed and reduced, two things should be kept in mind. First, the decontrol process still has some way to go. Most obviously, a great many financial institutions are still subject to a range of direct controls, such as the obligation to hold a proportion of total assets in the form of Government securities, and sometimes local body securities and house or farm mortgages. Pension funds, for example, are obliged to hold 30 percent of their total assets in public sector securities (at least 20 percent in central government securities), and a further 10 percent in house or farm mortgages. In March 1980 trustee savings banks had to hold at least 38 percent of total deposits in Government securities (for private savings banks the ratio was 54 percent), and these institutions are also still subject to interest rate controls on their demand deposits.

Secondly, and more important, abolishing the *direct* controls has not reduced the Government's control over the financial system but has actually enhanced it. Indeed, this was a strong reason for abolishing the direct controls, and one of the most important benefits flowing from it.




Previously, the Government had some (albeit imperfect) control over the *price* of money in the economy but limited control over the *quantity* of money and the rate of credit creation. Now the Government has greatly improved its ability to control the quantity of money and the rate of credit creation, both because of its ability to absorb private sector liquidity directly through the sale of Government securities to private investors and because of the enhanced competitive position of those institutions most directly subject to government influence—the trading banks. (Whether this improved control can be effective, of course, depends also on the stance of the Government's budgetary policy, as discussed below.)

The enhanced position of the trading banks has been the most visible result of the new policy of decontrol: from a low point of 28 percent of the total money supply and selected liquid assets ($M_3$) in 1968, the trading banks reached 42 percent in mid-1979. Together with their subsidiary savings banks, their share had climbed to 52 percent by that time.

One of the principal aims of the liberalisation policy had been an improvement in the quality of housing finance. By 1975–76 only 18 percent of new mortgage registrations related to finance supplied by trading and savings banks, building societies, and insurance companies; a large part of the balance came from sources such as solicitors' nominee companies which were providing finance for short terms (frequently only 2 or 3 years) and at higher rates. By the end of 1978–79 the percentage of new mortgage registrations supplied by the banks, building societies, and insurance companies had risen to 34 percent, and this trend seems likely to continue.

Another objective of the policy had been to improve depositor protection. The short-term effect may well have been the reverse, as it seems likely that the new freedom of the mainstream financial institutions was one of the causes for the collapse in December 1976 of one of the larger fringe institutions. But over the longer term the improved competitive position of the main financial institutions has undoubtedly done much to improve the safety of depositors, by making it unnecessary for them to seek high risk investments as the only way of getting a return commensurate with inflation. It is hoped that the work of the Securities Commission will lead to further improvements in the information made available to lenders, and to greater protection against any dishonesty and sharp practice.

Decontrol of the financial sector has had a dramatic effect on the level of competition in the sector, and with it on innovation and willingness to take prudent risks. It is difficult to quote statistics to support this view. The profitability of most major financial institutions (measured as net profit before tax as a percentage of total average assets) fell markedly in the late seventies compared with the early seventies. This points to a higher level of competition, but could be simply a result of cyclical factors. Only time will tell.

However, nobody involved in the sector, and few involved in dealing with the sector, doubt that competition has intensified markedly in the last few years. Bank personnel now regularly take the initiative in contacting potential investors looking for deposits, even when they are not clients of the bank concerned, and sometimes contact is made to offer additional lending facilities. Such behaviour would be regarded as normal in a competitive banking environment, but has been uncommon in New Zealand until recently. Rates offered on deposits now vary between banks, often markedly, and no corporate treasurer would dream of investing funds for more than a few days without phoning at least two institutions.

Increased competition is also apparent in the foreign exchange market. For many years the trading banks enjoyed a Government-protected monopoly of foreign exchange dealings. This monopoly was maintained because, with low and controlled interest rates in New Zealand, it was imperative to keep a tight control over funds which might flow out of the country seeking greener pastures and over the exchange rate. The trading banks might have competed for foreign exchange business among themselves but despite repeated urgings by the monetary authorities, they failed to do so. As a result, profit margins in foreign exchange dealing in New Zealand were widely regarded as the highest of any developed country in the world, and were identical at all the five trading banks. (To some extent these large foreign exchange profits were necessary to offset the unprofitable lending activities of the banks as the result of controls on interest rates.)

It was only when the Development Finance Corporation (itself a Government-owned institution) and two or three merchant banks found a way around the regulations giving the trading banks a monopoly in foreign exchange dealing that the trading banks began competing in this area also. At present they try to use the strict application of Reserve Bank procedural regulations on foreign exchange dealing to minimise the competitive inroads of the merchant banks, and only the eventual phasing out of those regulations will permit a freely competitive situation.

In other areas, too, there is increased competition. At least two institutions now establish their own letters of credit in international trade, at rates below the standard charge still levied by the five trading banks. Lending institutions are taking a more adventurous attitude to financing new or riskier ventures. Trading banks are moving more aggressively into

personal lending and into leasing, both previously the almost exclusive preserve of the finance companies. The decade has seen the development of the merchant banks and the commercial bills market and with that a range of new financial facilities. A few institutions have experimented with slow-start mortgages. Credit facilities are increasingly written at flexible interest rates, so that borrowers have the assurance that they will not be locked into high rates if the general interest rate structure declines.

One of the important consequences of the deregulation of the sector, and the higher interest rates accompanying it, has been a marked reduction in speculative investment in real estate. For example, the price of urban land, which rose so strongly between 1972 and 1975, remained almost static in the 3 years after March 1976.

There is clearly some way to go in the deregulation of the financial sector but experience so far is very encouraging. Perhaps most encouraging of all is the resilience which most institutions in the sector have displayed in meeting the new challenges. Despite being locked into many long-term assets at low rates of interest, despite the inertia and inflexibility generated by years of controls, despite the erosion of profit margins at least initially involved, most institutions have responded enthusiastically to the changes. There seems little doubt that the capital market has become a more efficient conduit for the nation's savings as a result.

## Major Problems Remain

Unfortunately, many major problems still beset the New Zealand capital market. The higher interest rates which have followed decontrol of the financial sector are having a most adverse effect on the level of investment. There is a growing shortage of longer-term finance which is so crucial for most investment projects. Although there has been some improvement in very recent years, there is a scarcity of risk capital, and equity capital more generally.

All of these problems have led to calls for remedial action—usually by the Government. Some people suggest that controls on interest rates should be reintroduced. Others press for a greatly expanded role for Government financial institutions, especially the Development Finance Corporation. Particular industries, especially those where investment is by its nature very large and very long-term (such as tourist hotels), argue the need for subsidised interest rates or additional taxation incentives to make investment profitable.

But such proposals all attack symptoms and not causes, and like the attempt to remedy the earlier perceived problems in the financial sector, attacking symptoms never works. Closer examination of the New Zealand capital market makes it clear that most of the remaining problems now relate to inflation and, to a lesser extent, the tax system.

## Inflation and the Capital Market

Inflation is having a number of serious effects on the capital market. The most obvious is its effect on interest rates. A high rate of inflation increases interest rates both because it tends to increase the demand for credit, as companies find themselves having to finance a rapidly increasing dollar value of inventories and debtors, and potential borrowers of all kinds see the advantages of borrowing as much as possible to "buy now before prices rise"; and because it reduces the supply of credit, as those who might otherwise save see the futility of doing so, unless interest rates rise to reflect inflation.

High interest rates tend to have an adverse effect on the level of investment. Companies hesitate to invest in a long-term project when they have to pay 15 percent per annum for 8- and 10-year money. Private individuals hesitate to invest in a house when they have to pay 13 percent per annum on mortgage (with the total cost frequently considerably higher when the cost of ancillary life insurance policies, or compulsory savings schemes, is taken into account).

In neither case can such a rate be called inequitable or unfair as is sometimes implied: with inflation in 1980 at rates of above 18 percent it is the borrower who is exploiting the saver (at least in the short term), and not the reverse. The real issue is not one of equity but rather of ability to pay. The effect of trying to compensate

savers for inflation through higher interest rates is not to *increase* the total burden of the debt to the borrower, but rather to *shift* the burden of the debt on to the early years of the loan.

Because this is such an important matter, and one so widely misunderstood, it is worth illustrating the point by quoting an example recently given in the Reserve Bank's "Bulletin" of December 1979. In this example, it is assumed that a borrower has a salary of $8,000 when $25,000 is borrowed for 20 years, on a table mortgage basis with equal annual repayments. It is further assumed that the borrower's salary rises over the term of the loan to match the rate of inflation (which has been broadly valid for most people in New Zealand). It is assumed that with no inflation the interest rate on the mortgage would be 3 percent per annum; with inflation at 10 percent per annum, the interest rate is assumed to be 13 percent per annum. The following table shows the proportion of the borrower's annual income devoted to servicing the mortgage under the two assumptions.

| Year | No inflation; 3% interest | 10% inflation; 13% interest |
|---|---|---|
| 1 | 20.9 | 44.2 |
| 5 | 20.9 | 30.2 |
| 10 | 20.9 | 18.7 |
| 15 | 20.9 | 11.6 |
| 20 | 20.9 | 7.2 |

Clearly, with 10 percent inflation and a commensurately high interest rate, the burden of servicing the mortgage is very heavy in the early years of the loan, but becomes negligible towards the end of the term.

It is this effect of high interest rates on shifting the burden of the debt on to the early years of the loan which is a major reason for the adverse effect of high interest rates on investment: although the potential borrower may well be better off by borrowing to invest even at high interest rates, the short-term problem of servicing the debt from cash-flow is insuperable and the investment is not undertaken. This is undoubtedly an important reason for the present downturn in both housing and industrial investment.

Unfortunately, the increase in interest rates over the last few years has been blamed on the removal of direct interest rate controls. This is quite erroneous. Obviously if the controls had been maintained the interest rates charged by the controlled institutions would be lower than they now are. But less credit would be available from those institutions because savers would have tended to abandon them in search of uncontrolled investment opportunities where the return on their savings was more in line with inflation. The prices of investment assets, such as houses, would have greatly increased for the same reason; people would have been anxious to borrow at low interest rates but to invest their savings in some more tangible form. Potential borrowers would have been no better off.

The real cause of the high interest rates, as suggested above, is inflation itself, and that in turn must be blamed largely on some serious lapses in fiscal policy over the last decade.

The relationship between fiscal policy, monetary policy, inflation, and interest rates is complex, and its analysis is complicated by the impact of extraneous influences from overseas and by the fact that the effects of some moves do not show up for a considerable period after they are taken. But at the risk of gross oversimplification, a deficit in the Government's accounts (the Budget) tends to increase the cash resources of the private sector because, unless the Government is financing the deficit by borrowing from the non-bank private sector, it is injecting more

money into the system through its expenditure than it is siphoning off through taxation. (This may be made possible by the Reserve Bank creating credit for the Government—"printing money"—or by the Government borrowing overseas.) The total availability of money to the private sector may well increase by a multiple of this initial increase in the "monetary base", because banks use the increase in their cash resources to increase their lending. With more money available, the community tends to spend more. The effect depends on how much they spend and how rapidly production can respond. If no additional production is possible, prices tend to rise and inflation is given a further push. The process is helped along by the responses of the whole community— demanding higher wages and salaries, and increasing prices.

Initially, interest rates may well fall, because the supply of credit may rise more quickly than the demand for it. But the situation soon changes when inflation increases, and savers demand a higher return in order to compensate. The demand for credit also rises. Paradoxically, interest rates will rise even more strongly for a period if the Government tries to remedy the situation by reducing its deficit spending because, as a result of inflation, the demand for credit continues for a time after the monetary base starts to contract.

If the Government finances its deficit not by "printing money" or borrowing abroad but by borrowing from the non-bank private sector, the increase in the monetary base arising from the deficit is reduced and the impetus given to money and spending proportionately reduced also. But interest rates still tend to be pushed up, because the Government is obliged to bid for money from the private sector in competition with the private sector itself.

Either way, therefore, directly or indirectly, Government deficits have a tendency to push up interest rates. It is not surprising therefore, that the massive increase in the Government's deficit in 1975–76 produced falling interest rates in 1975 (a trend which continued for some 4 or 5 months beyond the decontrol of interest rates in March 1976) and then rising interest rates for more than a year, as inflation intensified and the Government moved to reduce its deficit sharply. Again, in the last months of 1977–78 and in 1978–79, the strongly increasing deficit produced falling interest rates in 1978, and then rising interest rates well into 1980, with the intensification of inflation and a renewed effort to reduce the deficit. The effect on investment is obviously unfortunate. Inflation creates uncertainty for both borrowers and savers. If inflation were guaranteed to remain steady at 13 percent per annum, investors might be inclined to borrow for a long term at 15 percent per annum to finance their investment knowing that, provided they could service their debt in the short term, their long-term position would be acceptable. The problem is that inflation might fall to 5 percent per annum, and a 15 percent interest rate could become crippling. Alternatively, the general rate of inflation may continue at 13 percent per annum, but the price of the output of a particular firm may rise at only 5 percent per annum. High inflation increases uncertainty—the rate of inflation might change suddenly, governments might induce recession in an attempt to reduce inflation, unions might demand unacceptable wage increases in an attempt to protect their members—and uncertainty is an important enemy of the positive investment decision.

Inflation also increases uncertainty for savers. This may well act to increase people's propensity to save for a rainy day, thereby partly offsetting the tendency inflation has to encourage spending. But whether the net effect is to increase or to reduce savings, uncertainty has a marked effect on the term for which people are prepared to save. With prices rising strongly, and interest rates with them, private individuals tend to be reluctant to commit their savings for more than a few years at a time because of the danger of being "locked in" in a period of increasing interest rates; institutional investment managers (conscious of the devastating effect which being invested long when interest rates are rising can have on their investment performance) have a similar tendency. Little wonder that companies are finding increasing difficulty raising investment funds for a term of more than 5 years. It is inflation which causes the real dearth of long-term investment capital, not any institutional gap in the financial system.

Another effect which inflation has on the capital market is through its effect on the viability of companies caught between rapidly rising prices and systems of

accounting, taxation, and price control geared to historical cost accounting concepts. Some companies have done very well from inflation. These have tended to be those companies investing in fixed assets with a substantial level of low fixed interest borrowing. They have prospered by living on the misfortune of those who lent to them. But many other companies have been adversely affected. Their profit has been calculated on the assumption that the resources used to produce their goods or services can be replaced without an increase in cost. The tax they have paid, the prices they have been allowed to charge (where price control persists), the dividends they have been expected to pay, and even the wages they have been expected to pay have been geared to this fictitious profit.

In 1976 a committee of inquiry into inflation accounting estimated that historical cost accounting resulted in an overstatement of the true profitability of New Zealand public companies reporting in 1975 by about 40 percent on average.[1] This implies that a company tax rate of 45 percent levied on profit determined according to historical cost accounting concepts would have involved companies paying some 63 percent of their true profit to the Department of Inland Revenue and in many cases paying out more than the balance in dividends. (The actual tax rate levied in 1975 was less than 45 percent because of export tax incentives, regional tax incentives, and similar factors.) Little wonder that, despite an increasing tendency for companies to reinvest profits as conventionally measured, retained profits plus depreciation and new capital were both gradually declining sources of funds for companies throughout most of the seventies. Companies came to rely increasingly on borrowed funds from the capital market.

Finally, inflation has affected the capital market through the effect that high inflation and a relatively unchanging progressive personal tax structure have had on the level of personal savings. It is impossible to be precise about this effect because of the various influences at work, but it seems probable that, with high inflation and a progressive tax structure resulting in a large proportion of taxpayers moving into steadily higher tax brackets without any increase in real pre-tax income, personal savings will have suffered as a consequence. This might have been offset had public sector savings or investment been increasing strongly. In fact, rather the reverse has been occurring; public sector investment spending has tended to fall in real terms, and public consumption expenditure, and transfer payments (to those with a typically low tendency to save) have been rising strongly.

It is apparent that inflation has had, and is having, a number of highly deleterious effects on the workings of the capital market, and on its ability to mobilise savings for investment in the eighties.

We have only two alternatives. The first is to adapt the institutional arrangements of the capital market to cope with inflation. This could be done. It might involve the wider introduction of slow-start mortgages. It might involve writing all credit facilities on the basis of a floating interest rate. It might involve the introduction of the "Real", the constant value unit of account proposed in 1979 by Mr R. W. R. White, Governor of the Reserve Bank, speaking in his personal capacity[2]. It might involve the introduction of current cost accounting. It would almost certainly involve indexing the personal tax structure for price changes.

The second, and preferable, alternative is to reduce inflation greatly. Neither alternative is easy but the capital market will not perform its function adequately unless we implement one or the other.

## Taxation and the Capital Market

We have already touched on the effect which taxation levied on company profits determined according to historical cost accounting concepts has on the viability of companies, and the effect which the combination of inflation and a progressive personal income tax has on the ability of individuals to save. But the taxation system is having a number of other influences on the capital market.

[1] *Report of the Committee of Inquiry into Inflation Accounting*, Government Printer, Wellington, 1976, p. 215.

[2] *Money and the New Zealand Economy*, an address to the Economic Society of New Zealand (Wellington) Inc., 30 August 1979.

To begin with, the structure of the personal income tax scale is, in one respect, specifically designed to encourage long-term savings: it permits the deduction from taxable income of amounts paid into approved superannuation funds or as premiums on life insurance policies, up to specified limits. Moreover, the income earned by the assets accumulated by superannuation funds is entirely exempt from taxation and life insurance companies enjoy a specially low rate of tax. These tax advantages have been an important part of the attraction of life insurance policies and superannuation funds for the self-employed: there can be little doubt that the existence of the tax incentives has increased the flow of savings into these avenues, and has possibly increased total savings. Because superannuation funds and life insurance companies are by the nature of the case accumulating funds for probably far-distant contingencies, they tend to invest in long-term assets. It is therefore a reasonable assumption that the tax advantages for contributions to superannuation funds and life insurance premiums have increased the supply of capital available for long-term investments.

Regrettably however, the funds accumulated because of these tax advantages flow to institutions which by their nature tend to be very conservative—a characteristic reinforced by the legislation restricting the types of investment which superannuation funds may hold. The savings specifically encouraged by the tax system are generally not available for supporting new investments, and tend to find their way into public sector securities (as to 30 percent), home or farm mortgages (as to 10 percent), and a cautious selection of debentures and "blue-chip" shares.

A second characteristic of the tax system relevant to the capital market is the absence of a capital gains tax. This may have the effect of encouraging some savings into the share market in search of the tax-free capital gain, but appears to act as an even greater attraction to invest savings in real estate assets, and preferably assets with high capital appreciation and low income return rather than those with low capital appreciation and high income return. Farming is particularly attractive to the private investor, hence the common reference to Featherston Street and Queen Street farmers. It has the enormous tax advantage that many expenses of an essentially capital nature (fencing, roading, pasture improvement, etc.) can be fully written off for tax purposes in the year of expenditure, thus often giving rise to a taxable loss which may be used to offset income from other sources. The benefit of the expenditure will be taxable to the extent that it gives rise to additional farm output, but will be tax-free to the extent that it can be recouped in the form of an enhanced value of the farm when it is sold. This situation not only distorts the pattern of on-farm investment but also diverts a great deal more savings into the purchase of farms (thus pushing up the price of farms) than would otherwise be the case.

The absence of a capital gains tax even distorts the pattern of company investment. When a company earns ordinary taxable income, it incurs tax on that income at the rate of 45 percent. If dividends are paid out of those tax-paid profits, the dividends are taxed again, at a rate up to the highest personal income tax rate of 60 percent. Of the original dollar of pre-tax company income, the amount retained by the shareholder may be as little as 22 cents. But if a company buys a fixed asset and sells it some years later at a capital profit, that profit is not taxable either in the hands of the company or in the hands of the shareholder when it is paid out as a dividend. This means that a capital profit can be worth more than four times as much to a company's shareholders as a profit earned from the production of output.

It is impossible to estimate the effect which this kind of tax structure has on the capital market, or on the direction of investment, but it is hard to see how it could be beneficial.

Another way of looking at the capital-gain phenomenon is to accept that the greater part of many capital gains today arises not from any relative change in the price of one real asset as compared with another, but rather as the result of inflation. In that sense it is not a genuine gain at all, and is therefore defensibly tax-free. The problem here arises from the frequent use of borrowed funds to acquire the asset. If the interest rate is only in small part a reflection of real interest, and in large part compensation to the lender for the erosion of his capital as a result of inflation (as is invariably the case when interest rates are driven up by inflation) it is the deductibility of the full interest payment to the borrower, and the assessment of the full interest payment in the hands of the lender, which is undesirable. The borrower is enabled to deduct payments which are in effect a part of the principal repayment, while these "principal repayments" are assessable in the hands of the lender. In an inflationary environment, this feature of the tax system clearly encourages borrowing to buy real assets, and discourages savings. This may explain in part why there has been so much less complaint about the recent strong rise in interest rates from the commercial community than might have been expected.

The double taxation of distributed company profits has been mentioned above. It is widely accepted in the commercial community that this feature of the tax system makes raising additional equity capital difficult for public companies. In the case of private companies, the double taxation of distributed profits can frequently be avoided. Every lending institution is familiar with private companies which appear to be making virtually no profits at all, but whose owner-manager is paid a salary several times what the managing director of the largest public companies in the country are paid. This may reduce the disincentive to subscribe for additional equity in such private companies otherwise caused by the double taxation of distributed profits, but it often makes it hard for the same companies to attract debt finance.

Perhaps the least defensible tax in New Zealand is the bonus issue tax. This tax is levied at the rate of 17½ percent on any issue of new shares made to shareholders which represents the capitalisation of the company's revenue reserves. Such a bonus gives shareholders not one additional cent of spendable income; nor does it in itself increase the market value of their total shareholding by one cent. (The fact that the value of the total shareholding sometimes rises after a bonus share issue is a reflection of the fact that such a bonus often goes hand in hand with an effective increase in total dividend payments. It is the dividend increase, and not the bonus issue, which increases the value of the shareholding.) And while the tax therefore has no apparent justification from an economic or social justice point of view, it has the disadvantage that it discourages companies from capitalising revenue reserves and to this extent sometimes reduces the willingness of lending institutions to lend to them.

There is no single way to deal with the negative effects of the tax structure on the capital market, though eliminating inflation would go a long way to solving many of the problems enumerated. If inflation is not eliminated, there would be some merit in introducing a capital gains tax as part of a tax package designed to stimulate production by reducing taxes on income, while discouraging hoarding and speculative investments. But since, as acknowledged, so large a part of capital gain in an inflationary situation is illusory in any case, a better way to deal with this problem would be by denominating any debt in Reals (Mr White's constant value unit of account). In this situation, only the "true interest" on the debt would be deductible/assessable, with the compensation to the lender for the effect of inflation on his debt neither deductible by the borrower nor assessable to the lender.

One obvious way to eliminate the bias in favour of conservative institutional investment at present inherent in the personal income tax structure would be to make all savings an allowable deduction from taxable income. At that point New Zealand would have moved from an income tax to an expenditure tax; however, there are many arguments both for and against such a move, and most of the issues involved lie outside the scope of this report. The other alternative to eliminate the bias would be to abolish the deductions for

contributions to pension funds and life insurance premiums.

The double taxation of distributed company profits and the bonus issue tax have no obvious economic or social merit and should be abolished. In the case of the former, there would be logical economic arguments to abolish both the company income tax and the dividend tax, and to attribute the full (untaxed) company income to shareholders to include in their personal income. This would ensure that no company profits, whether distributed or undistributed, were taxed at a rate above the maximum personal income tax rate. It could be handled with administrative simplicity if companies were to pay a kind of withholding tax on behalf of shareholders at the maximum personal income tax rate. Those shareholders paying less than this rate would then be able to claim a refund. One important advantage of this system would be that it would put the shareholders of public companies on essentially the same footing as the shareholders of private companies, and the partners in partnerships. The system might also put pressure on those companies which were earning a poor rate of return to disburse a higher proportion of their profits, thus encouraging the redeployment of savings in more productive areas.

Enough has probably been said to indicate that we believe strongly that the abolition of many direct controls in the financial sector has been to the benefit of the whole economy, and that most of the remaining problems in the capital market can best be solved not by new controls, or more specific subsidies, but rather by getting the macro-economic policy framework right—most importantly by reducing inflation and making some changes in the tax structure.

The changes which have been made to date have improved the efficiency of the capital market and have probably increased total savings by increasing the real return on savings. The recommended improvements in policy, both those directly relevant to the financial sector and those relevant to other sectors, would also improve the efficiency with which capital is used in New Zealand and increase total savings. The more successful we are in implementing these policy improvements the less we will need to rely on the savings of others to achieve any given level of economic growth.

Nevertheless it seems likely that we will still wish to grow at a faster rate than can be sustained from our own savings alone, so that the role of foreign savings must be considered.

# THE ROLE OF FOREIGN CAPITAL

Donald T. Brash

## New Zealand's Use of Foreign Capital

For many decades, New Zealand has drawn on the savings of others to support its investment activity. Table 4.1 below shows that we have been net users of the savings of others in all but 6 of the years since 1950–51 and, in very recent years, this has been a particularly marked characteristic of our economy. In the 5 years to 1978–79, foreign capital was equivalent to 27 percent of gross fixed capital formation.

Of the total foreign capital inflow, only a part has been what is popularly known as "foreign investment" or as the Department of Statistics defines it, "overseas direct investment in New Zealand". Overseas direct investment in New Zealand involves investment in New Zealand by overseas companies or individuals in a form conferring on the overseas investor a significant measure of management control (normally defined as a minimum 25 percent overseas shareholding). In the early part of the period covered by table 4.1, this was the main form of capital inflow into New Zealand, but it has become proportionately much less significant recently as a result of the very heavy public sector borrowings in the last few years.

## The Contribution of Foreign Capital

Uneasiness about using foreign capital in New Zealand dates back to at least the time when Vogel borrowed overseas to finance railway construction in the 1860s and 1870s. At present, there are some indications that the use of foreign capital could become a highly controversial political issue as the debate about the best way to develop and utilise our substantial energy resources proceeds.

The Task Force does not feel a concern about using foreign capital to an appropriate level. It is not difficult to demonstrate that, as long as the use of foreign capital leads to a net increase in investment, and as long as the return on that investment is greater than the amount required to service the foreign capital, the use of foreign capital is prudent, responsible, and economically desirable. Where these conditions are met, it is misleading to talk about "mortgaging the future" by using overseas capital.

It may also be sensible to use overseas capital when these conditions are not met, as for example when an extremely abrupt change in our terms of trade results in a severe deterioration in our balance of payments. Using overseas capital to smooth the transition to a new economic structure avoids the violent social strains which could otherwise be generated, and this has undoubtedly been a major reason for much Government overseas borrowing in recent years.

But using overseas capital for this purpose, or indeed as a means of supporting consumption expenditures in general, does place a burden on future generations and must accordingly be done within strict limits. In addition, a country such as New Zealand, which is subject to violent movements in its terms of trade from time to time, must as a matter of simple prudence preserve some freeboard in its capacity to borrow overseas. It is for these

**Table 4.1 Foreign Capital Inflow into New Zealand, 1951—1979 March Years**

| Year Ended 31 March | Overseas Direct Investment in N.Z. | Other Long-term Private Investment in N.Z. | Long-term Govt. Borrowing (net) | Other[1] | Total Balance on Capital Account |
|---|---|---|---|---|---|
| | | | NZ$(million) | | |
| 1951 ... ... | 11.2 | 7.1 | −17.0 | −57.6 | −56.3 |
| 1952 ... ... | 22.0 | 2.8 | −11.4 | 47.9 | 61.3 |
| 1953 ... ... | 21.2 | 5.7 | 4.8 | −22.5 | 9.2 |
| 1954 ... ... | 6.4 | −2.2 | 21.0 | −97.1 | −71.9 |
| 1955 ... ... | 22.2 | 0.3 | 14.8 | 34.3 | 71.6 |
| 1956 ... ... | 31.5 | 6.2 | −6.4 | 28.3 | 59.6 |
| 1957 ... ... | 20.2 | −0.1 | 20.0 | −11.7 | 28.4 |
| 1958 ... ... | 19.2 | 4.1 | −4.2 | 71.0 | 90.1 |
| 1959 ... ... | 27.7 | 6.3 | 74.0 | −68.8 | 39.2 |
| 1960 ... ... | 6.5 | 14.8 | −30.0 | −71.9 | −80.6 |
| 1961 ... ... | 34.2 | 18.8 | −22.2 | 78.3 | 109.1 |
| 1962 ... ... | 36.2 | 18.1 | 24.2 | 34.0 | 112.5 |
| 1963 ... ... | 55.3 | 7.5 | 20.3 | −37.0 | 46.1 |
| 1964 ... ... | 38.1 | 7.4 | 17.2 | −32.3 | 30.4 |
| 1965 ... ... | 43.5 | 21.1 | 2.0 | −29.6 | 37.0 |
| 1966 ... ... | 62.8 | 14.0 | 29.8 | 72.6 | 179.2 |
| 1967 ... ... | 28.9 | 14.8 | 58.9 | 57.6 | 160.2 |
| 1968 ... ... | 28.1 | 42.3 | 65.2 | −52.2 | 83.4 |
| 1969 ... ... | 38.9 | 17.6 | 24.6 | −129.7 | −48.6 |
| 1970 ... ... | 76.2 | 3.6 | −30.7 | −78.7 | −29.6 |
| 1971 ... ... | 130.0 | 8.4 | 5.4 | 54.4 | 198.2 |
| 1972 ... ... | 97.5 | 92.7 | 59.9 | −237.2 | 12.9 |
| 1973 ... ... | 106.4 | 89.7 | −50.2 | −307.3 | −161.4 |
| 1974 ... ... | 152.7 | 51.1 | 30.7 | −135.3 | 99.2 |
| 1975 ... ... | 179.8 | 209.3 | 30.0 | 945.3 | 1 364.4 |
| 1976 ... ... | 114.7 | 159.4 | 176.8 | 564.7 | 1 015.6 |
| 1977 ... ... | 278.9 | 51.5 | 139.5 | 361.6 | 831.5 |
| 1978 ... ... | 159.2 | 109.8 | −32.8 | 479.6 | 715.8 |
| 1979 ... ... | n.a. | n.a. | n.a. | n.a. | 453.0 |

Source: Department of Statistics

[1] Includes the net total of overseas investment by N.Z. companies, borrowings by monetary institutions (including the trading banks and the Reserve Bank) short-term Government borrowing, and errors and omissions. Negative figures in this column tend to reflect increases in overseas reserves; positive figures the run-down of reserves and short-term borrowings by the Government, the Reserve Bank, and others.

reasons that the Planning Council has repeatedly taken the view that we should be aiming to reduce our balance of payments deficit, and thus our dependence on overseas capital, in relation to gross domestic product.

On the other hand, where it can be shown that overseas capital is being used to increase the level of investment undertaken, above what it would otherwise have been, and that the total return on that investment exceeds the cost of using the foreign capital, it would be responsible for New Zealand to use a higher level of foreign capital than that suggested by the general recommendation.

This is obviously not a point of mere academic relevance. We clearly have a number of very major investment projects ahead of us, especially in the energy and related industries. Realistically, most of

them cannot be financed locally. Should we use overseas capital to finance them, and if so, on what basis? The answer depends very largely on whether the total return from those investments (the value added at international prices, taking into account indirect effects of both an economic and social nature) exceeds the cost of overseas capital. If it does, it would be prudent for New Zealand to make more extensive use of foreign capital than the Planning Council envisaged in *Planning Perspectives*.

It is important to note in passing that it is often misleading to measure the "burden" of using foreign capital by comparing the ratio of profits and interest accruing to overseas residents with, say, our export earnings. As an example, consider an economy with export earnings of $4,000 million, and profits and interest due overseas of $600 million, for a "debt service ratio" of 15 percent. Now suppose $500 million is borrowed at an interest rate of 10 percent per annum to build a major plant to reduce imports by $200 million a year. The direct effect of this is to increase the debt service ratio from 15 percent to 16.25 percent, but the country is better off by a net $150 million than without the plant.


## Debt or Equity Capital?

So far we have made no distinction between *borrowing* overseas and using foreign direct *investment*. If New Zealand is acting responsibly in using overseas capital, why not borrow it at a fixed rate of interest rather than give overseas residents an equity interest in our industry? On the face of it, borrowing overseas is clearly a preferable way of getting access to overseas capital: the rate of interest payable is likely to be lower than the rate of profit, and borrowing involves ceding little if any domestic control over the economy.

But the two ways of getting access to overseas capital are fundamentally different, and cannot be compared in this simplistic way. Foreign investment almost never gives access to capital alone: usually foreign investment brings with it access to technical and managerial know-how, and often access to markets also. Indeed, where foreign investment provides none of these extra benefits, the rate of profit earned on it rarely exceeds the rate of interest. It is the additional elements which make foreign borrowing and foreign investment fundamentally different, and make any simple comparison of the rate of interest paid on borrowing, with the rate of profit earned on investment, inappropriate.

It is also relevant that although increased foreign investment does not guarantee that overall investment will increase, there is at least some presumption that this will happen. And there is a strong presumption that the total output generated by the investment will exceed the profit earned by the foreign investor.

An additional factor to consider is that the amount which New Zealand can borrow in world capital markets is not unlimited. We have an excellent reputation in those markets, and rightly so, but it would be unrealistic to expect them to provide all the capital we can use productively. This emphasises the point that the issue is not equity investment *or* borrowing, but equity investment *and* borrowing.

## Problems, Real and Imagined, with Foreign Investment

But given the acknowledged benefits of foreign investment, does it not have disadvantages which warrant a substantial degree of Government control over its operations?

One widely held view is that foreign direct investment tends to make the balance of payments worse because, over time, the foreign exchange which goes out of the country exceeds the capital which comes in. If the project is successful this is inevitably true, as it is for even the lowest-cost borrowing. It is a groundless concern based on the erroneous belief that the effect of foreign investment on the balance of payments can be measured in terms of profit remittances and capital inflow, ignoring the effects of the operation of the foreign-financed capacity on the rates of growth of imports and exports.

A variant of this concern for the balance of payments would have all foreign investment limited to sectors where it can directly generate the foreign exchange required to service it, by producing exports or import-substitutes. But so long as the economy has some capacity to move resources from one sector to another, it is largely irrelevant where the foreign investment takes place: the sale of its output will generate more goods for export, will replace imports, or will free resources in home-trade sectors for employment in international-trade sectors.

Some concern has been expressed that the subsidiaries of overseas companies may be prevented by their parent companies from exporting. It is beyond doubt that many foreign-owned companies are prevented from exporting in this way. But this should be kept in perspective: some foreign-controlled companies are among the country's most successful exporters, while others were established as high cost producers to serve a local market only because of New Zealand import controls. It would be unrealistic to expect the latter to export. In some industries it is probably the foreign-owned companies which are in the most advantageous position to develop a vigorous export activity because of their network of overseas affiliates.

Another widely held view is that foreign investors should be compelled, or at least strongly encouraged, to share the ownership of their ventures with local investors. This is suggested partly for balance of payments reasons because a jointly-owned venture would reduce the future cost of remitting profits in foreign exchange. This is perfectly true of course, but what is almost invariably ignored by proponents of this view is that, if the local equity is purchased at a fair market price—a price which in other words reflects the market's expectations of the future earnings of the company—the immediate cost of purchasing the local interest in terms of capital outflow (or capital inflow forgone) is merely a reflection of the discounted present value of the future profit outflow averted. Only if the market's expectations of the profitability of the foreign-affiliated company prove to have been unduly pessimistic will New Zealand's balance of payments benefit from a policy of pressuring foreign-affiliated companies to share ownership. To judge from past experience, the New Zealand sharemarket tends to overestimate the profitability of foreign-affiliated companies, and it seems likely that in these circumstances New Zealand's balance of payments has been harmed as a result.

Joint ownership is also preferred for reasons associated with control. There appears to be a widespread belief that a

company in which local shareholders have an equity interest will be more amenable to the national interest than will a wholly foreign company. In theory (and very often in practice), however, a minority local equity merely extends *foreign* control over *local* resources, and not vice versa. Indeed, even where the local equity is in a majority, foreign control will be substantially unimpaired if the local shareholding is widely dispersed or if the company is heavily dependent on the foreign affiliate for markets or technology.

Sometimes a local shareholding does result in greater weight being given to local interests in the company's decision-making process. But there is no consistent evidence either in New Zealand or overseas suggesting that companies with a local equity participation export a larger

decisions affecting the level and direction of bank credit are ultimately determined by the Government acting through the Reserve Bank. Only in sectors requiring very large levels of investment by New Zealand standards, or in sectors of unusual technical complexity (where Government may be hampered in its policy formation by a lack of knowledge), may foreign-owned companies be at a major negotiating advantage. In these circumstances there may well be a case for safeguarding the national interest by a direct involvement by the Government in one form or another.

There are in fact, two theoretically respectable justifications for seeking to control or direct the flow of foreign investment, though one is not particularly strong in the New Zealand context and the other is valid for only a limited period. The


percentage of their output, for example, or in other ways behave more closely in line with national aspirations.

The whole area of control is one where there is a great deal of misunderstanding. It is often suggested, for example, that the fact that perhaps 30 percent of New Zealand's manufacturing sector, 60 percent of our banking sector, and a high percentage of our oil refining and distribution industry is owned overseas means that New Zealand's sovereignty is somehow threatened. This is misleading. Whatever the ownership and nominal control, effective control normally rests with the Government, through its control of taxes, tariffs, monetary policy, and the rest. Nowhere is this better seen than in the banking sector, where four out of five trading banks are owned abroad—but where, notwithstanding recent moves to deregulate the financial sector, the key

first is the so-called "infant firm" argument. This view holds that, while foreign investment is beneficial to domestic residents in the short term, it actually harms the host country in the longer run because of the stultifying effect which competition from foreign-owned companies has on the development of local enterprise. The argument is often extended to take into account the probability of declining costs as companies get established (through learning effects as well as external economies). The problem with this view is partly that it is impossible to prove or refute empirically: one can point to economies like the Japanese, where a restrictive policy towards foreign investment is associated with a very dynamic domestic industrial and commercial sector; but one can also point to other economies, such as Canada, Australia, and New Zealand itself, where a more open

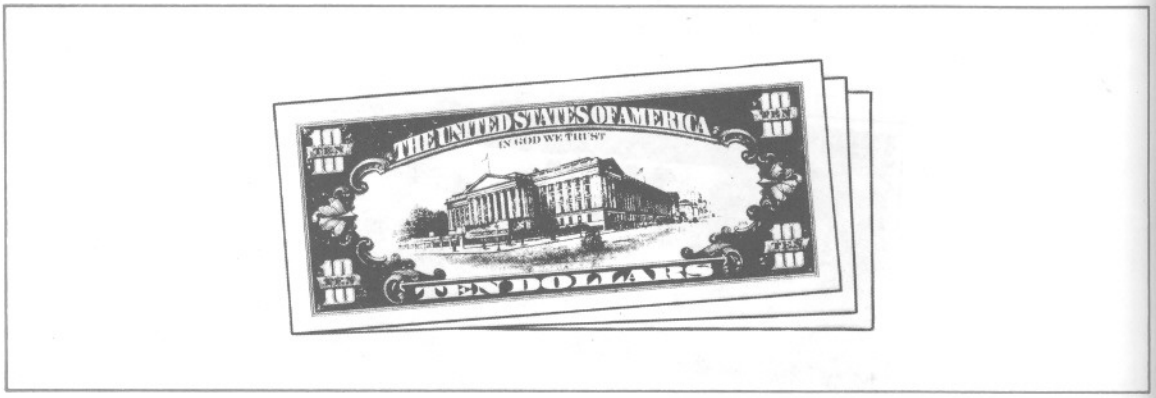
door policy towards foreign investment has not prevented the development of a large number of strong, locally-owned enterprises.

Perhaps an even more important objection to the infant firm argument is that foreign investment is likely to benefit domestic incomes now, whereas the growth of domestic companies which might occur in its absence is likely to produce equivalent benefit only after a lag. Because of this lag, it will often be found that the economic "benefits" of restricting the inflow of foreign investment, when appropriately discounted, are in fact non-existent or negative. Indeed, this will almost inevitably be true when it is recalled that what is being compared is, on the one hand, the discounted present social value of an investment when it is made by local citizens; with, on the other hand, the discounted present social value of that investment when made by foreigners, *plus* the discounted present social value of the investment of the local capital thereby released in the next most profitable avenue. In short, it is hard to see this argument having much validity in New Zealand, except where it can be convincingly demonstrated that the Government and foreign investors have a very much clearer view of the future than do domestic private investors.

It is important to note that, while this exception will presumably form a justification for the Government's blocking foreign investment in very few situations, those few situations could well be of crucial importance to New Zealand at this moment. The most obvious possibilities relate to the various uses of our natural gas resources. It is probable that the complexities involved in assessing the alternative uses for these resources, the amounts of capital involved, and the widespread failure to appreciate how valuable the natural gas resource could shortly become (as the price of alternative fuels rise) have created a situation where the Government must, in the national interest, take a leading role in determining the use of this resource, at least for a time.

The other "respectable" justification for controlling the inflow of foreign investment is that arising from the existence of inappropriate policies in other areas. The structure of industrial protection in New Zealand at the present time is the most obvious example. Protection can be justified on economic grounds only where it can be shown that the subsidy provided by the community to the protected industry will eventually be fully repaid (with appropriate adjustment for time differences), through lower prices, external economies, and other means. Where these subsidies are not repaid, the community is worse off than if no protection had been given; and if the subsidies are paid not to domestic residents but to foreigners, then the loss to the community as a whole is presumably greater still. There seems little doubt that much protection given to New Zealand industry today is excessive, and represents a subsidy which will never be adequately repaid to the community. It also seems beyond doubt that foreign-owned companies have been the beneficiaries of these subsidies in many cases, and that as a consequence foreign investment in these sectors has not only not benefited New Zealand but has been to our positive detriment.

The culprit, of course, is not foreign investment as such, but the form and pattern of industrial protection. It is industrial protection which should be changed. But this inevitably takes time, and in the interim there would be good reason to restrict the flow of foreign investment into



sectors which require a substantial level of protection.

Returning therefore to one of the general themes of this report: it is primarily the weakness of macro-economic policies which creates the need for interventionist regulations, controls, and subsidies. At the present time, virtually all new foreign investment projects are screened by the Overseas Investment Commission to ensure that they make a contribution to the economy commensurate with their cost to the economy in terms of profits, and this is desirable. Such screening would be largely unnecessary, however, with the right macro-economic policies: no foreign investment, indeed no investment of any ownership, will long make a profit significantly above the rate of interest unless it contributes some new and useful dimension (be it technology, market, or management skill), or unless it is able to exploit some monopolistic condition in the market. The long-term solution therefore is not to screen new foreign investments, and spend weeks appraising their "real contribution", but to adopt policies designed to ensure that companies are forced to operate in an open, competitive environment, where high profits tend to be a very temporary phenomenon unless new developments are constantly made.

## Attracting More Foreign Investment

The conclusion must be that New Zealand derives benefit from foreign investment and that New Zealanders would benefit from a strong inflow of such investment. How can it best be encouraged?

Various suggestions have been made to provide free land, tax holidays, and other incentives to encourage foreign investment to come to New Zealand. But on balance it is not certain that these are warranted. Evidence from overseas suggests that such incentives are rarely of determining importance in the investment decision, and in this situation they almost certainly represent a very costly way of enticing the small amount of investment which would not have come here without such incentives.

Of greater significance in encouraging overseas investment would be a reduction in the bureaucratic controls which currently inhibit investment in New Zealand, be it foreign or domestic. These controls, and the long delays they engender, discourage investment by local companies, as discussed, and positively deter it by foreign companies. The Task Force welcomes the establishment of an Investment Unit within the Department of Trade and Industry, late in 1979, to assist potential investors through the procedures required by Government departments and agencies. As soon as the macro-economic policy framework can be improved, and in particular in this context; as soon as the distortions created by excessive protection in some parts of the manufacturing sector can be eliminated—many of the detailed controls and regulations on foreign investment should themselves be eliminated.

Almost certainly the most important part of any programme to encourage foreign investment is the creation of the right environment. In part this is a matter of ensuring a wide public understanding of the benefits of foreign investment: the demonstrations against the German investment mission early in 1979 suggest that there is still a very considerable ignorance of the true effects of foreign investment, and this can only serve to discourage foreign investment.

Even more important, once again, is the creation of the right macro-economic policy framework—so that foreign investors can see that the value of their investment is not jeopardised by the effects of an irresponsible fiscal policy on the value of the New Zealand dollar; so that they can see that policies designed to eliminate inflation are widely understood and implemented; so that they can see that the viability of their investment will not be undermined by the sudden provision of a monopoly to a supplier, through import licensing. Fortunately, these are also the kinds of policies required to ensure that foreign investment confers the maximum benefit on New Zealanders; and the same policies required by New Zealanders whether we attract foreign investment or not.

# V POLICIES

The broad objectives of the Government's investment policy should be:

- to create a positive environment for investment;
- to provide clear guidance to those who want to invest, about the directions in which investment can confidently be undertaken;
- to remove as far as possible barriers to the effective use of new and existing capital.

Reliance on special incentives to promote investment has been a prominent feature of past investment policy. The Task Force believes they were needed mainly because the above objectives of investment policy were not being met.

Private investment will be undertaken only if it is expected to be profitable. Companies and individuals will be guided in their choice of investment by the Government's policies; but the level and the direction of investment spending will be determined principally by the scope provided for the effective use of capital.

The Task Force believes that at present the amount of investment is clearly too low to generate the increases in output, employment, and incomes needed to secure agreed social and economic objectives. The recent decline in real terms of private sector investment is of particular concern.

## Stimulating Private Investment

Uncertainty about the future is perhaps the strongest deterrent to private investment. If uncertainty can be reduced by Government policies, the climate for investment will improve. The belief that returns on investment could be undermined by inflation, and the associated concern over the present level and future uncertainty of interest rates, are major impediments to investment. Uncertainty also leads to a preference for short-term investments. This results in a shortage of funds for longer-term investment projects. Increased stability secured through more consistency in fiscal, monetary, and incomes policies, leading to lower rates of inflation and interest rates, would contribute to confidence in the future—an essential element in private sector investment decisions.

Some of our inflation and economic instability is externally generated. We cannot rely on a return to the benevolent international conditions which obtained for most of the 1950s and 1960s. Policies that will modify these external influences and assist enterprises, and the community generally, to cope with unavoidable inflation are needed.

## Taxation Reform

The company tax structure, at present based on historical cost accounting, is in urgent need of comprehensive reform so that it recognises the effects of inflation on company profits and financing. In addition, other reforms in the tax structure are needed to re-establish an environment conducive to increased investment. The economic effects of prolonged inflation on a tax system heavily reliant on personal income tax (now over 75 percent of all tax revenue) have been damaging to many people, not least in the influences on attitudes to work and initiative and to tax avoidance and direct evasion. With one major exception, maximum tax rates are not unduly high compared with other countries. (The exception is company dividends: they are taxed twice—once as company profits, and again in the hands of the shareholders. This results in exceptionally high combined rates of taxation.) Personal tax rates rise steeply through the low-to-middle income range; thus the majority of taxpayers are affected. This compounds the problems for incomes policy (and industrial relations) by stimulating wages and other income claims which must exceed the rate of inflation if people are to maintain their real after-tax incomes. Our present tax structure, despite some adjustments last year, is conducive to inflation. More fundamentally, the heavy reliance on personal income tax and the absence of a capital gains tax combine to penalise effort and initiative, and reward unnecessarily those in a position to make capital gains.

The distortions in the system are such that *indexing* the structure to adjust for the further effects of inflation would be inadequate on its own. Tax reform is needed also to establish a sensible basis for indexation. The reforms should be directed towards increasing taxation on expenditure, and correspondingly reducing taxes on earned income. Major reforms in indirect

taxation will be needed if this form of taxation is to become more acceptable. The present structure is in many respects arbitrary, discriminatory, and costly, and it adds to liquidity problems especially in a period of high inflation. The Task Force is in favour of a broad-based but low retail sales tax on goods and services to replace most of the existing provisions.

Reforms would have to take into account the need to maintain progression in the tax system as a whole. For those on higher incomes (or in receipt of capital gains) the Task Force recommends further investigation of proposals for a personal expenditure tax (as distinct from a tax on goods and services) which might, for example, apply to those with consumption spending over $12,000 or $15,000 a year.

## Wages and Salaries, Industrial Relations, and Employment

The effect of the income tax structure on stimulating wage demands has been mentioned. The Task Force believes it is possible that the high growth in pre-tax wages and salaries has been one important factor in creating unemployment in recent years.

This possibility arises for three distinct reasons. First, to the extent that high wage and salary demands have contributed to inflation, which has a negative effect on investment (through its effect on interest rates and uncertainty), these demands have reduced investment and new job opportunities. Secondly, there is some evidence, albeit not conclusive, that the real pre-tax cost of labour has risen quite markedly over the last decade, at the expense of the real profitability of investment. If true, this would have had a negative effect on new investment and employment. Thirdly, any increase in the cost of labour relative to capital will have led employers to invest in labour-saving plant and equipment wherever possible.

The state of, and prospects for, industrial relations also exert a powerful influence on both the amount and direction of investment expenditure. Directly or indirectly, industrial disruption from whatever cause reduces the opportunities for profitable investment and reduces the number of jobs. Owners, managers, and employees have an interest in making capital work effectively to generate satisfactory incomes and purchasing power. In most New Zealand industries this shared interest is recognised and, in spite of difficult economic conditions, good industrial relations are the rule. When open disputes occur they are usually settled quickly. In a relatively few activities in the manufacturing and processing, transport, and construction sectors there are deep-seated industrial problems which both undermine their own growth and deter investment elsewhere in the economy. The alternatives are to live with these situations and the consequences for investment and employment growth, or to make fresh and determined efforts to get to the root of what are highly complex problems of management and union organisation in each of the major trouble areas. Investment in better industrial relations is obviously the better course and warrants high Government priority.

## Regulation and Control

For the reasons stated in both the general and sectoral sections of this report, the Task Force recommends a firm commitment by the Government to progressively reduce the degree of regulation and restrictive licensing on economic activity as rapidly as conditions allow. This applies both to import licensing and regulation within the economy.

There is enough evidence now in the export sectors, and in other areas where there are growth opportunities, that a great deal of individual and corporate enterprise exists among New Zealanders, that the capacity for growth and change is large, and that efforts to increase investment, incomes, and employment will be made wherever the openings exist. Recent developments in the financial sector, following the removal of restrictions, provide an example of what can be achieved even in difficult domestic circumstances. In the banking industry deregulation did not produce unemployment or collapse—on the contrary, the sector has become more flexible, efficient, and diversified. In other sectors subject to continued regulation and

control, similar initiatives have been stifled and little change has occurred.

There is no question that a degree of regulation and control is necessary in any system, to maintain safety standards and quality of service, protect community interests, prevent environmental or other damage, and so on. Regulation becomes self-defeating where it serves individual rather than social interests and limits freedom to compete, innovate, or adapt to changed situations.

In our view the pace of adaptation to changing economic and social circumstances will continue to be slow while the degree of control remains as extensive as it is in New Zealand now. In some situations the problem is not so much the regulations themselves but the way in which they are administered. At both local and national levels the process of obtaining planning decisions is sometimes inordinately slow. While hasty decisions are often bad ones, there is clearly ample scope to improve present procedures so that delays and frustrations are reduced, and disputes are resolved more effectively and openly. Regulations which are no longer appropriate to changed circumstances should be reviewed, amended, or abolished.

For the manufacturing sector the problems are created mainly by import licensing. The Task Force supports the efforts being made to reduce the damaging effects of this system. We recommend a more rapid transition towards reliance on tariffs, rather than licensing. We recognise the need for adjustment assistance, both through more active employment policies and provision for specific industrial activities. But we do not believe that New Zealand's economic or indeed social objectives can be secured without major changes in what has become a costly and unproductive system of protection. There are limits to what can be achieved in exporting or in the domestic provision of tradable goods when costs are high and competition low in a number of manufacturing activities.

In relation to exports, the Task Force sees restrictive licensing in some areas, for example dairy and meat products, as impeding diversification and growth. Many of the best export prospects are in agriculture-based products. Much has been done to develop new markets for traditional and new primary products, but there is room for greater flexibility in production (through delicensing meat-works and encouraging further processing), in simplifying export procedures, and in providing more scope for enterprise in marketing overseas.

Licensing and control procedures are also prevalent in the transport sector, where competition remains limited within and between many transport modes. Capital appears to be often poorly used and costs are a frequent cause for complaint. Industrial relations problems compound the effects of an over-regulated transport system still operating under a regime introduced at a much earlier stage of development. The Task Force commends the present efforts to investigate the problems and recommends further reforms including, for example, easing restrictions on road/rail competition and introducing the complete provisions of the road-user charges scheme. However, change has been exceptionally slow. Much higher priority should be given to a wide-ranging programme for a major reduction in the licensing and control of transport.

Investigation into the effects on construction activity of inflexible design standards, where these exist, is a matter for urgent attention. With construction accounting for about 60 percent of all investment activity, the community has a strong interest in any measures to update design rules and regulations and make them as flexible and economical as safety requirements allow.

## Pricing Policies

Among the main signals guiding investment are the prices fixed by the Government for the goods and services it provides, and the prices of private sector goods and services which it controls. The Task Force welcomes the relaxation of price controls which occurred last year and considers that further progress in this direction would be desirable.

It is particularly important that appropriate prices be set for public sector goods and services, especially in energy and transport, but also generally among the State enterprises whether they monopolise particular areas of activity or compete with the private sector.

The pricing issues for energy and forestry are discussed in appropriate sections of the report. Generally, the recommendation is for prices related to international parities where goods which can enter international trade are concerned, and prices reflecting the real costs of production involved where the goods and services are solely for domestic markets.

More consideration should be given to appropriate regional differentials in the supply price of some public goods, including bulk electricity and natural gas products. The impact on transport and transmission costs could be significant, and encouragement would be given to investing in the most suitable locations. This would contribute to, rather than discourage, increased regional specialisation in the use of resources in the interests of the regions concerned and of the country as a whole.

Where subsidies or the provision of free services are considered desirable in the national or regional interest, these should be explicitly provided for in Government or local authority budgets. State trading enterprises should otherwise be expected to earn reasonable rates of return on the very large amounts of capital they employ. Generally, the aim should be to promote the fullest and most productive use of the resources available to the public sector. This will be encouraged by the increasingly careful evaluation of public sector investment proposals.

## Exchange Rates

The most important price set by the Government is the exchange rate. The more flexible exchange rate regime introduced last year provides for adjustments in response to relative price changes between New Zealand and its trading partners (as when domestic costs move faster than international prices), and also for changes to reflect structural adjustments in our international trading relationships. For agriculture, manufacturing, and tourism the maintenance of an appropriate exchange rate is of particular significance in determining the balance between production for domestic and overseas markets, the sourcing of finance as between domestic and overseas capital, and the potential for growth. The exchange rate may also have a material bearing on employment levels: to the extent that it affects the prices of capital goods, it affects the incentive to invest in plant and equipment to replace labour, with an over-valued exchange rate encouraging the displacement of labour.

Many of the regulations, controls, subsidies, and incentives in these sectors have been necessary because of deficiencies in past exchange rate policy. There now exists the possibility of increased reliance on active management of the exchange rate in the interests of balanced growth. One benefit would be a reduction in the need for Government expenditure to administer detailed regulations and licensing systems. There would be less need also for the subsidies and generous tax incentives still required to promote export activity. Increased reliance on the exchange rate as a means of adjusting relative prices is strongly recommended, now that the mechanism for frequent and discretionary adjustment has been installed.

## Investment Finance

The conclusion of the Task Force is that the abolition of many direct controls in the domestic financial sector has benefited the whole economy. Most of the remaining problems in the capital market can best be solved not by new controls or more specific subsidies, but rather by getting the macro-economic policy framework right—most importantly by reducing inflation and making some necessary changes in the tax structure.

Creating a stable, open environment is also desirable for foreign investment if the kinds of investment which will most benefit New Zealand are to be attracted. The main arguments for controlling the inflow of such investment arise from distortions within the economy, such as those occurring where there is excessive protection, where the incentives for foreign investment are over-generous, or where the specific national interest requires intervention by the Government in one form or another. The solutions generally lie not in restricting investment opportunities to domestic residents but in reducing unduly high levels

of protection, avoiding unnecessary incentives, and getting the policies right. These are the kinds of policies required to ensure that foreign investment confers the maximum benefit on New Zealanders; and the same policies are required by New Zealanders whether we attract foreign investment or not.

## Conclusion

In summary, the Task Force's view of investment policy is that the emphasis should be on improving the climate for investment, giving better signals, and reducing the negative influence of regulation, licensing, and control—not on fixing targets, trying to force investment into particular channels, or providing still more specific incentives to invest. The immediate need is not for abrupt change but for clearer indications of the direction of change towards a more flexible, competitive economy in which new and existing capital, in both private and public sectors, will be more effectively used.

P. D. HASSELBERG, GOVERNMENT PRINTER, WELLINGTON, NEW ZEALAND—1980

45428B—80PT