

## **ECONOMIC REFORMS IN NEW ZEALAND (3/97)**

### ***HISTORICAL PERSPECTIVE***

1. Interest in New Zealand has been aroused because on the brink of economic catastrophe, it turned itself around, taking a number of radical approaches to public sector management in the process. The remarkable aspect of these changes is that they occurred in a society which for fifty years had resisted economic change. New Zealand is in the South West Pacific and its 3.4 million people comprise descendants of immigrants from the Great Britain and over 600,000 Maori, descendants of the indigenous Polynesian inhabitants. The Treaty of Waitangi, in 1840, between Britain and Maori tribes, authorised European settlement and gave authority to Britain in New Zealand . New Zealand is experiencing a revival of indigenous language and culture and its cultural mix has been augmented from the Pacific Islands and Asia, but since 1840, it has been strongly influenced by British traditions. The British Monarch is Head of State, but New Zealand has had effective autonomy since 1854 and became legally independent in 1947.
2. Uniquely, for a developed economy, agricultural commodity trade has been New Zealand's main source of exports and employment. From 1840 until Britain entered the European Community, (EC), New Zealand benefited from access to the British market for agricultural products and as late as 1960, 60 percent of New Zealand's exports went to Britain. New Zealand's trade links with Britain were stronger than for any other colony and New Zealand's foreign policy stressed trade and security links with Britain. With its infrastructure undamaged by war and demand for food and wool stimulated by conflict in Korea, in the early 1950s New Zealand had one of the highest incomes per capita in the world. The potential military threat from Asia and closer links with the United States experienced during World War II, had an impact on the pattern of its trade, but the post 'oil shock' collapse of commodity prices and its economic crisis of the 1980s finally forced New Zealand to face the Global Economy. The 1981 New Zealand Australia Free Trade Agreement phased in free trade between the two countries. By 1990 Australia, the United States, EC, as a whole, and Japan were each accounting for close to 20 percent of New Zealand's export trade, but the percentage going to Britain had fallen to 7 percent.
3. The globalisation that this pattern of trade represented forced radical changes into many aspects of New Zealand society. Reliance on agriculture had always made its economy vulnerable to swings in prices for commodities and because of its small size there had always been an acceptance of a government role in the economy, where its role could be useful in reducing vulnerability. Hardship during the recession of the 1930s led the New Zealand government to enlarge its already substantial role in cushioning the domestic economy from adverse trends in world markets. An enlarged government role coincided with the peak of New

Zealand's relative prosperity. This led many to draw a causal link and led to continuing demands for government involvement in fresh aspects of the economy. Into the 1980s government was still responsible for:

- ownership of: four banks, two insurance companies, a railway, an airline, a shipping line, a major construction company, and the electricity system,
- government funded and operated health, education and social welfare;
- commercial forests and farming operations, land development and survey;
- price and quantity controls on the financial system;
- high tariffs and quantitative controls on imports;
- centralised wage fixing in the private and public sectors;
- sector specific regulation of most manufacturing and services;
- production, marketing and export controls on major commodities;
- elected agencies running hospitals, schools, airports, harbours etc;
- large energy development projects with extensive government subsidies;
- the Economic Stabilisation Act of 1948, permitting control of anything economic, by executive order, if aimed at "economic stability".

4. By the early 1980s these policies had made New Zealand one of the poorest countries of the OECD and it was facing a major crisis. In the ten years prior to 1984 inflation had averaged 13.3 percent. Despite a wage and price freeze for 2 years, (by regulations under the 1948 stabilisation Act), government expenditure had risen from 28 percent of GDP to 39 percent of GDP, with significant expenditures off balance sheet. Debt servicing had risen from 6.5 percent to 19.5 percent of GDP and unemployment had gone from 5,000 to 132,000 and was rising fast.<sup>1</sup> Most significantly, New Zealand's ability to generate real growth of GDP from its fixed capital formation had been below the average in the OECD and was deteriorating faster than in other OECD countries<sup>2</sup>.

5. Measures designed to cushion New Zealand's economy had badly distorted it. The wage/price freeze created pressures that threatened at any minute to burst into hyperinflation. Forward expenditure commitments and bottled up public sector wage demands threatened to overwhelm the budget. Wage and salary

<sup>1</sup> *The Politics of Successful Structural Reform*, Hon R O Douglas, 20th November 1989, Mt Pelerin Society

<sup>2</sup> *Agriculture in a More Market Economy*, Opening Address, David Butcher M.P., Under-Secretary for Agriculture, December 1985, page 5, Centre for Agricultural Policy Studies Massey University:

Δ Real Growth in GDP/ Δ Fixed Capital Formation	1963-73	1973-83	% Decline
OECD	22.8	11.7	48.6%
New Zealand	18.7	5.8	68.9%

earners paid high marginal tax rates but many avenues of tax avoidance existed for companies and the self-employed; many companies in export activity received tax refunds. Wages and salaries had been frozen, and subject to taxation, whereas welfare beneficiaries received increases related to price movements, tax-free. The wealthy could use tax shelters facilitating tax free conversion of income into capital gains. Bank lending priorities were determined politically rather than on the basis of economic efficiency. Low priority borrowers were required to borrow at high rates from fringe financial institutions. With a freeze on interest rates, these had all but dried up. The wage freeze had also distorted the civil service, the Health Department, was unable to fill 13 of 23 senior medical positions and ten percent of the state workforce were people on unemployment relief programmes.

6. Government policy had focused on the amelioration of inefficiency rather than on its elimination. Even lobby groups had begun to call for more thorough measures to tackle long standing deficiencies. In the early 1980's the farmers' union<sup>3</sup> stopped seeking additional government assistance for its members and launched a manifesto calling for the abolition of agricultural subsidies and the phasing out of assistance to all other sectors of the economy. The government began taking steps to nudge manufacturers and other groups in the direction of less protection. Pressures for adjustment came to a head when an early election in 1984 resulted in a run on the country's currency and change in government. Foreign exchanges were closed the day after the election and the government elect authorised a 20 percent devaluation.
7. 1984 was a watershed. It saw the first government whose members had grown up in the post-war era, were better educated than previous politicians and were more at home in New Zealand's Asia-Pacific neighbourhood. Through a change in government, for much of the next ten years New Zealand saw an unparalleled focus on tackling the causes of inefficiency in the country's economy. "While other OECD countries have pursued similar policies, few, if any, have done so in the context of such a coherent overall framework stressing predictability, transparency and accountability."<sup>4</sup> This period was characterised by movement from government controls to reliance on competition as the primary regulator of economic activity, and a search for better quality government expenditure, ensuring that funds were used as effectively as possible towards the objectives to which they were directed. The overriding aims were greater equity and efficiency, although those affected debate the difference between better targeting of expenditure and cutbacks for their own sake.
8. The reforms in the areas of trade liberalisation, state enterprise and the core civil service have been well documented. This paper will deal with three areas of reform: financial sector reform, taxation reform, including efforts to better integrate transfer payments and the taxation system, and social policy reform,

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<sup>3</sup> *Federated Farmers of New Zealand Incorporated;*

<sup>4</sup> *Report of the New Zealand Economy*, OECD Paris, 1996, Page 41

including health and education. The first two are widely acknowledged that they have been successful. The latter two are less well documented because they are on-going, highly contentious and will be subjected to continuous debate and modification.

## **THE FINANCIAL SECTOR**

9. The OECD have commented that “among the countries which have adopted explicit inflation objectives New Zealand appears to be the only one having done it as part of such a coherent monetary policy framework stressing accountability and transparency. Given that central bank action impacts on inflation only with substantial lags, monetary policy has become increasingly forward-looking , with its stance determined on the basis of inflation forecasts.”<sup>5</sup> This new approach is one of a series during which styles of monetary policies have followed changes in the perception of the role of the New Zealand financial system, from: facilitation of commerce, through a period as a tool of government policy, to the current focus on inflation.
10. Before 1914, New Zealand was linked to the gold standard, with private banks issuing paper money convertible on demand into gold, but subjected to little oversight. In 1914 New Zealand abandoned the gold standard and effectively relied on the banks to manage the exchange rate. This system conflicted with the expansionary fiscal policies of the time and New Zealand sought relief from depressed agricultural prices with a currency devaluation. As another measure to address the depression, a central bank, the Reserve Bank of New Zealand was formed in 1934. Initially it was a private bank, but after it was nationalised in 1936 it became an instrument of government policy.
11. As one way to relieve depressed conditions the government gave itself the power to regulate lending policies. It ran budget deficits (to stimulate employment), softened their impact on financial markets with mandated low interest rates, and managed foreign exchange crises, inflation and other consequences with further controls.<sup>6</sup> These powers were popular with borrowers and became a positive policy option. Supporters described this as “driving at full speed with the brakes on.”<sup>7</sup> Like brakes applied to a car at full speed, too often, for too long, they become increasingly ineffective. By the early 1960s controls included:
  - Reserve Ratio Controls (the proportion of banks’, and other institutions’, reserves that should be held as reserves such as government stock),
  - Selective Advance Controls (determining the priority to be accorded to classes of borrowers, such as exporters, farmers and local industries),

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<sup>5</sup> Op cit. Page 29.

<sup>6</sup> *Monetary Policy and the New Zealand Financial System, an Historical Perspective*, Neil C Quigley, in *Monetary Policy and the New Zealand Financial System*, 3rd Edition, 1992, The Reserve Bank of New Zealand, Page 216

<sup>7</sup> *Full Employment*, W. Rosenberg, AH & AW Reed, 1960, Page 44, quoting Professor A J Danks.

- Capital Issues Controls, (until 1962), (governing the rates offered in capital raising activities), and
  - Credit Policy Guidelines, (to curb consumer spending).
12. In 1894 the government became involved in mortgage lending and at about the same time the government formed a general insurance office and a life insurance office. In a small society these institutions were to fill niches in the market that the private sector was not serving adequately. The Bank of New Zealand (BNZ), was nationalised in 1946, with little change to its activities. By 1984 the Government owned four commercial banks: The Rural Bank and the Development Finance Corporation (DFC), were formed as concessional lenders for development, although the latter quickly withdrew from this role. The BNZ and the Post Office Savings Bank had few social functions and offered very poor returns to small savers during high inflation. Once dominant, by the 1980s the market share of these institutions had shrunk as savers sought better avenues of investment.
  13. The Reserve Bank's Act gave it many objectives, such as promoting price stability, fostering development and full employment, and required it to perform other functions, such as government banking, supervising private banks and issuing currency. The Act failed to spell out the priorities attached to each of these and some were potentially in conflict. The legislation did not make it clear who was accountable for performing the functions, whether the "Bank" was the body corporate, its governor or its board. In addition, the Minister of Finance was empowered to issue private instructions to the Bank to give priority to a particular objective.
  14. On three occasions: in the 1960s, early 1970s, and in 1976, most of the interest rate and lending controls were withdrawn. The fiscal position of the government remained loose on each of these occasions and growing balance of payments deficits and increasing inflation led to the controls being quickly reintroduced. Notwithstanding government security ratios, which forced banks and other institutions to buy government debt, the government had increasing difficulty in funding its own expenditure. The only retail debt that found a voluntary market was the inflation proof bonds introduced in 1977. The exchange rate was also subjected to political control with several revaluations and devaluations between 1948 and 1979. In 1979 a "Crawling Peg" of incremental devaluations was introduced and only abandoned following the use of the 1948 Stabilisation Act to introduce draconian wage/price controls in 1982.
  15. The 1982 Wage/Price Freeze measures were introduced because inflation was in excess of 15 percent and had been in double figures for nearly ten years. Policy had lurched from attention to one indicator to another without any lasting success. Leaks quickly appeared in all aspects of the freeze and as schemes were devised to overcome constraints, the web of controls was extended. By 1984, the financial sector was in crisis. The government was commandeering 70

percent of all private savings to fund its deficit. Bank loans to non-favoured borrowers had all but dried up. It was nearly impossible to obtain a housing mortgage. The Freeze momentarily improved the competitiveness of the country's exports, but the New Zealand Dollar was still overvalued relative to underlying inflation and competitiveness. It was widely perceived that a devaluation would be necessary. The day after the 1984 election the foreign exchanges were closed because the banking system had run out of foreign exchange and the official agencies were unable to borrow any more. Controls in place for 50 years had ceased to be effective and were breaking down.

## **POLICY OBJECTIVES**

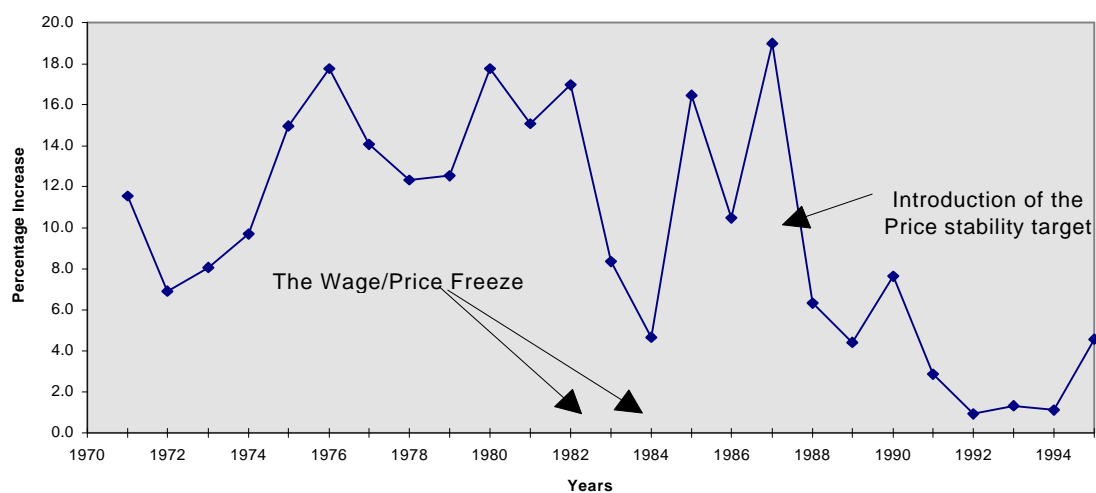
16. Following the 1984 crisis, the objectives of financial sector regulation were narrowed to a focus on greater price stability in a context of deregulated financial markets. There was a growing recognition that competition for clients between banking institutions is an effective control. The losses defending the unrealistic value of the New Zealand Dollar shifted policy towards commercial risks being carried by the individuals and institutions that had the incentives to manage them well. The relationship between the Reserve Bank and the Minister of Finance needed to be made open to public scrutiny and comment. The Reserve Bank had multiple objectives giving it multiple excuses, there was a need to clarify what it was for.
17. From 1987 onwards, the government decided to use the sale of various government-owned businesses to reduce the debt it carried. In addition to four banks, it also owned a Housing Corporation which specialised in housing loans to people on low incomes. In two cases, no social objectives were being pursued by these banks and in two cases operations had been harmful to small savers. Ways were sought to achieve social objectives at lower cost and with greater effectiveness. A policy was agreed which would authorise the sale of government businesses if the benefits from disposal were greater than the benefits from continued ownership.

## **PRINCIPAL MEASURES**

18. Nearly NZ\$ 1 billion was spent defending an unrealistic value for the New Zealand Dollar. The first significant policy change occurred in 1984 with a 20 percent devaluation of the New Zealand dollar. To make the devaluation work it was necessary to regain control of monetary flows. Between December 1984 and October 1987, the government abolished rules prohibiting the payment of interest on short-term deposits, restricting interest rates on accounts, enforcing credit guidelines, controls on exchange rates, overseas borrowing, investment ratios and other remaining controls. The New Zealand Dollar was permitted to float freely from March 1985.

19. With solvency re-established, attention turned to the future shape of the financial system in an open, global economy. Instead of an Act of Parliament authorising the operation of each trading bank and each other kind of financial institution, a registration system was instituted. The Reserve Bank was empowered to authorise institutions to call themselves a bank and carry out banking functions. It also provided for a system of prudential supervision. No limit was placed on the number of banks that could register. Some institutions have entered the market and subsequently scaled back their operations. There are now 17 banks with branch operations in New Zealand and all but one of these are wholly owned overseas or have significant overseas shareholding. Vigorous competition between the various banks has created a strong market for retail financial business. This has transformed the position facing potential borrowers.

Figure 1  
Annual Increase In Consumers' Price Index (Headline), June Years



Source: Department of Statistics

20. In early 1988 the Minister of Finance announced that in future monetary policy would be targeted at price stability. (see Figure 1) This was incorporated in a 1990 amendment to the Reserve Bank Act which provided for a Policy Targets Agreement between the government and the bank governor, with the government determining the price stability targets and the Bank being accountable for their attainment. The Bank takes action in the money market to implement government policy based on its own and other agencies forward forecasts of inflation. From 1985 it was made easier to discount government securities, the definition of primary liquidity was widened, market rates of interest were paid on settlement balances and open market operations were aimed at limiting variations in primary liquidity. Combined with the tendering of Treasury Bills, these measures made market conditions the main determinant of interest rates.
21. From 1987 the government began selling business where the return to the taxpayer would be greater from sale than by continued ownership. By 1992 all government banking assets had been sold, mainly to Australian interest. Another

form of “privatisation” began in January 1989. There was a continuing risk of confusion between the activities of the Reserve Bank as the government’s banker on the one hand and the Bank’s supervisory and monetary policy roles on the other. The government’s banking needs were separated from the Reserve Bank and tendered to the private sector, with the Australian based Westpac Banking Corporation obtaining the contract.

22. As an additional step towards market disciplines becoming the regulator of the banking system, rather than the arbitrary interventions of the central bank, in January 1996 a new three-point system of supervision of banks came into place:
  - a requirement that banks hold capital of not less than 8 percent of their risk weighted exposures, (international practice),
  - a limit on the amount that a bank can lend to a related party, (e.g. a subsidiary company)
  - A requirement that each bank publish a quarterly statement, of complete financial information, signed by its directors and available in its branches.
23. The rationale for this system is that private analysts are better equipped, and have better incentives to monitor the disclosed activities of banks, than do officials. As yet there is little practical experience the operation of this system although the change was welcomed by the banks and the wider community.

## **ASSESSMENT OF ACHIEVEMENTS**

24. From 1984 until the beginning of 1991 the main focus of policy was wringing inflation and inflationary expectations from the economy. Liberalisation of other sectors, which fostered price competition, and the improving fiscal balances of the central government also helped. The cost of success was a significant rise in unemployment to over 10 percent. Monetary policy has since aimed at keeping inflation low, and preventing significant variations from the targets agreed between the Bank and government. The Bank distinguishes between “headline” inflation (See Figure 1) and “underlying inflation” - a more internationally compatible measure with interest rates, government charges and large one off factors removed. The underlying rate has breached the target 0-2 percent, only three times and by less than 1 percent. Driven government charges, the headline annual rate reached 4.5 percent for the June 1995 quarter but has otherwise maintained a close relationship with the underlying rate.<sup>8</sup> Following the first election under proportional representation the banks’ target for price stability was widened to, from 0 to 3 percent.
25. High demand for money and high inflationary expectations have kept short-term interest rates in New Zealand high. From early 1994, 90 day Bank bill rates have been consistently higher than those in the USA, Australia, Japan and the UK.

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<sup>8</sup> *Monetary Policy Statement*, The Reserve Bank of New Zealand, December 1996, Page 4.

Partly, this has been a risk premium attached to a new electoral system with the possibility of a relaxation in the focus on low inflation. Longer-term rates are closer to those in other countries. Despite high short-term interest rates, in the five years of near price stability since mid-1991 the New Zealand economy has grown at an average of a little over 3 percent a year, a very high rate by New Zealand historical standards. In the same period employment has grown by 230,000 bringing unemployment down to a little over 6 percent.<sup>9</sup> Many factors have contributed to this improvement, but vibrant financial institutions and price stability are a good foundation for growth in employment.

26. High interest rates have been a factor driving an appreciation of the New Zealand dollar. Against the United States Dollar the New Zealand Dollar appreciated by nearly 30 percent between early 1993 and mid 1996. Volatility against the US\$ also reflects the depreciation of that currency, while in the same period the New Zealand Dollar depreciated against the Japanese Yen and the German Mark. The New Zealand Dollar has risen sharply against many currencies since mid 1993 reflecting its sharp decline over the previous few years. On a Trade Weighted Index, in 1996, the New Zealand Dollar was still only 5 percent above its level following the 1984 devaluation.<sup>10</sup> While the volatility of the New Zealand Dollar against particular currencies has been high, in many cases this reflects factors over which New Zealand has no control. Since 1970 the exchange rate has moved, over time, to offset inflation differences between New Zealand and its trading partners. Since the reforms of the 1980s, the New Zealand currency has been more stable than many major currencies, such as the US Dollar. Appreciation has also been a symptom of the improving productivity of New Zealand relative to its trading partners.
27. While the overall picture is one of a stronger financial system with ownership linkages stretching bank into some of the most significant banks in the world, criticism has been directed at the speed of deregulation and the role that this played in the severe damage that the world sharemarket crash inflicted on the New Zealand economy in the late 1980s. It took some time to put in place alternatives to the former regulatory instruments. Some of the trading banks, particularly the state owned BNZ, engaged in some questionable lending practices, suffered severe losses and twice the government was forced to inject more capital. The link between the unwise lending by the state-owned bank and the protection from competition that state ownership affords management has seldom been highlighted. Since 1990 the Reserve Bank has undergone major restructuring, and has reduced its costs by nearly 40 percent.

## OUTSTANDING ISSUES

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<sup>9</sup> Op cit. Page 5

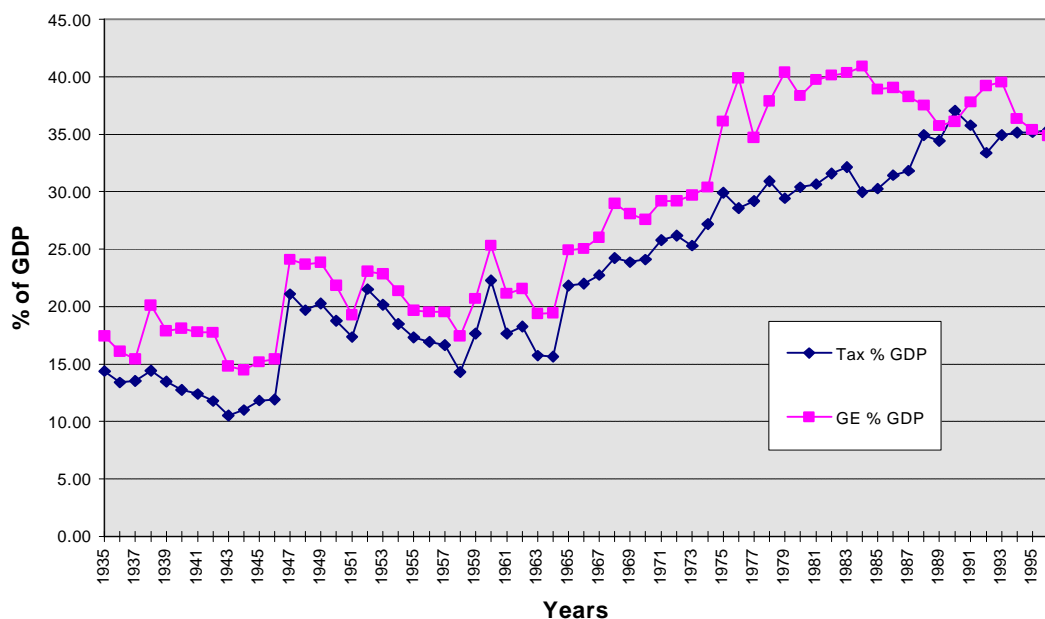
<sup>10</sup> *The Impact of Monetary Policy on Farming*, The Reserve Bank of New Zealand, August 1966.

28. Despite New Zealand's coherent monetary policy framework, monetary policy remains a controversial issue. Attention has focused on the difference between inflation rates (generally below 3 percent) and the retail interest rates, particularly for mortgages, which remain in excess of 9 percent. Other criticism, mainly from organised labour groups, focuses on the perception that the Reserve Bank moves too quickly against future inflation by increasing interest rates just when the economy seems to be moving into a high-growth phase. This criticism rests to some extent on the belief that low interest rates of themselves promote faster development. The Bank retorts that if inflation is allowed to increase, it will cut real wages in the short term but with little lasting benefit to employment and that even at the prevailing interest rates the demand for money is above the levels that are prudent in the light of current household savings levels.
29. With differing emphasis, all major political parties are now committed the 1990 Reserve Bank Act framework, with the government determining policy, and the Reserve Bank administering it. The government is entitled to change its policy targets at any time, and may also issue instructions to the Bank. Under the new arrangements these actions must be transparent, have clear accountability, be reported to Parliament and to the public. This framework was tested by the first post-proportional representation coalition government widening the inflation target. The changes were accepted by the political system and by money markets without any disruption. A small but vocal group now question the need for a central bank at all and point out that the position before 1914 was satisfactory. While there are some economic arguments in favour of this position, they are not widely advanced. The new arrangements remain to be tested in a crisis, and thinking may be refined should this occur.

## **TAXATION SYSTEM**

30. In the years between 1935 and 1975 government expenditure in New Zealand was consistently greater than taxation revenue. Government expenditure ranged between 15 percent and 25 percent of GDP. Other sources of revenue resulted in an occasional budget surplus but regular government deficits were accepted as necessary in a young country. The deficit in any year depended on the impact of world agricultural prices on revenue, military expenditure, unemployment benefits and other factors, in particular years. During the Second World War, when New Zealand was fully mobilised and the 1938 Social Security Act, was absorbing additional resources, high prices meant that expenditure seldom exceeded 15 percent of GDP.

Figure 2  
**1936-1996 Tax and Government Expenditure as Percentage GDP**



Source: Department of Statistics

31. Between 1966 and 1974 government expenditure rose from a maximum of 25 percent to 30 percent of GDP. From 1975, after the introduction of National Superannuation and with growth in government assistance to industry, government expenditure absorbed 35-40 percent of GDP. From 1975 concerns arose that the gap between expenditure and revenue was driving inflation and that the tax system, particularly its high marginal rates and many opportunities for avoidance, was not fair and reasonable and needed reform.
  
32. “An Agenda for Tax Reform’ published in 1981 by the New Zealand Planning Council, (a government think tank), noted that taxation in New Zealand, in relation to GDP, was below the average for the countries of the OECD. However, an unusually high proportion, 64 percent, was gained from income taxes, and the rates at the margin became very high at relatively low levels of salary and wage income. If marginal rates are too high people substitute leisure for earning opportunities and there was plenty of evidence that this was happening in New Zealand. The Council was also concerned that privileged groups could obtain relief from these high rates. Dividends on profits of proprietary companies, farming and trusts, were used for evasion, as were tax incentives (also called tax expenditures) introduced to overcome structural weaknesses in the economy, and non-taxable benefits such as access to company cars. The partial wholesale tax affected only 23 percent of total consumption expenditure.<sup>11</sup> The Council suggested a Task Force to review to examine the consequences of high marginal tax rates.

<sup>11</sup> *Radical Tax Reform in New Zealand*, Robert Stephens, Fiscal Studies 1993 Vol. 14, no. 3, page 52

33. The Task Force reported in April 1982. Their report highlighted nine Topics of Major Importance, and seven areas in need of reform:
- reduced of average and marginal income tax rates for the majority of individuals,
  - recognition of the costs of the family unit, through the voluntary splitting of income between partners and children for tax purposes,
  - extension of support to low income families through an extension of the low income family rebate,
  - control over fringe benefits and other forms of tax avoidance to reduce inequities,
  - extension of the wholesale tax system, or the introduction of a value added tax,
  - inflation adjustment of the value of business inventories and depreciable assets to remove the bias in favour of borrowing,
  - ending the double taxing of business dividends through a rebate of 20 percent on all dividends received by individuals
  - the proposed business tax arrangements should be in lieu of a capital gains tax.
  - rigorous assessment of the cost and benefits derived from tax incentives.
34. The Task Force suggested that reform was also needed in the taxation of wealth, life insurance companies and superannuation funds, building societies, co-operatives, trusts and charities. A start was made on ambitious agenda in the 1982 budget with reforms to the tax scale, although incomes above \$24,000 were still taxed at 66 percent. Minor movements were made in the area of sales taxes and additional relief was given to families. Income splitting was partially allowed in 1983. But these reforms fell short of the vision of the Task Force. The measures exacerbated the fiscal deficit by NZ\$ 1 billion, because no steps were taken to address indirect taxes, fringe benefits or tax expenditures.

## **POLICY OBJECTIVES**

35. Following the change in government in 1984 the New Zealand Treasury and Reserve Bank estimated that in the previous financial year assistance to industry cost about NZ\$ 2 billion, tax expenditures cost about NZ\$ 1.5 billion and the narrowness of the tax base prevented a more equitable distribution of the tax burden.<sup>12</sup> Confronting the accumulation of advice and the fiscal position outlined above, a period of systematic reform of the tax and transfer payment system began. The strategic objectives of the reforms were to:

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<sup>12</sup> *Opening the Books*, Key Extracts from the Treasury and Reserve Bank Briefing Documents, Government Printer, Wellington, 1984

- lower marginal tax rates to improve economic incentives, thereby minimising tax driven economic distortions and improve decision making,
  - broaden the tax base by including a larger proportion of the target income and consumption in the tax , and by adopting more rigorous measurement principles,
  - protect low income families from the effects of tax changes, and eliminate tax-created and income-maintenance sourced poverty traps,
  - achieve better administration by new collection mechanisms, approaches to policy development and legislation, changed burdens of proof, tougher disclosure requirements, stronger penalties and improved practices by tax authorities.<sup>13</sup>
36. The new government's aim was more neutral tax treatment of investment options. Despite this intention a number of opportunistic measures were also introduced. These blocked specific loopholes and raised additional revenue. Examples are the fringe benefit tax, paid by employers not the beneficiary and a provisional tax system that brought forward tax payments by the self employed.

## PRINCIPAL MEASURES

37. The 1984 Budget signalled the intention to impose a comprehensive Goods and Services Tax (GST, a Value Added Tax), to replace the partial wholesale tax regime. GST would be across the board and at a single rate<sup>14</sup>, to simplify administration and minimise distortions. Exemptions for food and children's clothing were ruled out on the basis that they were unfocused instruments to assist target groups. Benefits and tax credits were increased instead. The philosophy of neutrality of tax treatment was spelt out using the analogy of a level "playing field between investment options". Tax expenditures delivering assistance to industry had resulted in marginal tax rates ranging from -50 percent in forestry to plus 36 percent on chemicals.<sup>15</sup> The elimination of many deductions and tax expenditures and the removal of many activities from tax-exempt status was foreshadowed. Also announced was a "clawback" on the previously open-ended National Superannuation, and additional support for low-income families.
38. In another strategic move the process of gestation for the implementation of tax reforms was "privatised". Previously, tax legislation had been introduced on budget night and enacted with little opportunity for interested parties to have their opinions heard. The new process involves issuing a discussion document outlining policy principles, soliciting submissions from the general public and interested groups on detailed implementation and reviewing these with an

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<sup>13</sup> *Taxation, Chapter 7*, Ian Dickson, Rogernomics, Reshaping New Zealand's Economy, New Zealand Centre for Independent Studies, Simon Walker, Editor, page 137

<sup>14</sup> Originally at 10 percent this was subsequently increased to 12.5 percent, for revenue reasons.

<sup>15</sup> Stephens, 1994, op cit. page 48

committee of experts. The committee's report is then issued along with the decisions of the government on the submissions and the committee's recommendations. At this point the policy is converted into a draft law, or Bill. This is introduced to Parliament and the legislative process allows for all affected parties to have another opportunity to make submissions, this time to a parliamentary committee. The committee and the government can amend the legislation if they believe that submissions have merit. Consultation focuses on implementation but the thrust of policy is decided by the government. This process survived a change of government and is now accepted as a fair and transparent process of tax review. Numerous areas of taxation were addressed during the ensuing twelve years. These have included<sup>16</sup>:

- public consultation on tax and social security benefit reforms to accompany the introduction of GST, (1984-85),
- taxation of life insurance and superannuation, (1985-89). This moved from an exempt-exempt-taxed regime, to a taxed-taxed-exempt regime to align tax treatment with other savings options,
- primary sector taxation, in particular the ending of the concessional treatment of livestock and investments in forestry, (1985-88). The breeding herd of the pastoral farmer were treated as a capital asset, like plant and machinery, and valued at realistic levels. Forestry lost immediate deductibility of capital costs,
- anti-avoidance rules and a substantial review of business taxation designed to remove the many concessions that had compensating businesses for low profitability, (1986-87). These mainly involved elimination of accelerated depreciation and investment allowances,
- taxation of the petroleum and mining sector, (1987-90). Like the forestry regime these reduced the ability to deduct costs in the year they were incurred,
- accrual rules for the taxation system, (1986-1988). Complex rules designed to end the postponement of tax payments.
- taxation of the international income of New Zealanders through controlled foreign companies (CFCS) and collection of foreign dividend withholding payments, (1987-92). These were designed to crack down on tax avoidance by New Zealand based companies.
- full imputation regime for company dividends, (1988-89). This system allowed a taxpaying shareholder to claim a credit against company tax already paid, to avoid double taxation of dividends,
- domestic interest withholding tax, (1988-89). An avoidance measure with the deduction of tax from interest payments at source,
- tax simplification and the taxation of income from capital, (1989-92). Simplification was implemented but the taxation of capital shelved.

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<sup>16</sup> *Major Reforms in Detail*, 1981 to Present, (unpublished list), Inland Revenue Department Wellington, September 1996

- reorganisation of the inland revenue department and the income tax act (1994-96)
  - resolving taxation disputes and binding rulings (1994-95)
  - fiscal responsibility act, designed to bring more transparency to budgeting and independent auditing of fiscal policy (1994)
  - tax reduction and social policy bill, (1996), designed to cut taxes and increase some benefits as a result of buoyant revenues and substantial debt repayments.
39. Power companies, harbours and airports had been constituted as local authorities and thus were tax exempt. These were brought into the tax net forcing them to review their efficiency and profitability. The GST legislation alone brought another 300,000 taxpayers into the tax system. The abolition of a large number of very significant tax privileges was feasible because there were simultaneous reductions in marginal tax rates. These were aimed at another aspect of policy: reducing the penalties attached to re-entering the work force after a period on a social security benefit.

### **Integration with Income Support**

40. Since 1938 New Zealand has offered a flat-rate income-tested, government funded payment for unemployment, sickness and broken families. A Royal Commission in 1972 recommended significant increases in the rates of payment.<sup>17</sup> With the combinations of benefit withdrawal, the cost of going to work, taxation and the phase out of housing subsidies it was quite common for beneficiaries to face effective marginal tax rates (EMTRs) in excess of 100 percent. One effect of the Wage/Price Freeze of 1982 was to exacerbate the high EMTRs confronting a welfare beneficiary. Wages were frozen for two years while benefits continued to increase, albeit more slowly, during the freeze. Major groups of workers, watched their frozen industrial agreement rates fall below the level of the unemployment benefit. An urgent task in 1984 was to address this income disparity between the working and non-working poor and reduce the disincentives to re-entering the work force. A fundamental aim was to ensure that people getting the same income paid the same tax, (horizontal equity), while those on lowest incomes received support from those on the highest (vertical equity). With the end of the freeze it was necessary to cushion both groups against sudden price rises.
41. The reality had to be faced that people who receive financial support of any kind will quickly face a high EMTR, and the higher the taxation on low incomes the higher the EMTR. While there is a strong desire to make as long as possible the income band during which a benefit is abated, this can result in continuously employed low income workers receiving less money than colleagues returning to

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<sup>17</sup> Royal Commission on Social Security, Report 1972

the work force following a period on a benefit. To improve efficiency of any system it also helps to reduce the number of transfers to a particular individual and apply a single abatement regime, but this is difficult where several agencies all abate the assistance they deliver. A Royal Commission on Social Policy which reported in March 1988 could offer little by way of useful advice on how to improve the system.<sup>18</sup>

42. Five major attempts have been made to address this set of problems during the last 12 years, but it has not been possible to meet all fairness and efficiency objectives at the same time. In 1984 a new transfer payment, Family Care, was introduced for low-income working families. This tax credit aligned the working poor with beneficiaries recipient, whose payments increased for each additional child. The introduction of GST on 1st October 1986 was combined with a major restructuring of the tax scale. This provided a three-rate personal tax scale with a maximum rate for individuals and companies of 48 percent, it included a Family Support tax credit, (in place of Family Care) included a Guaranteed Minimum Family Income scheme and provided for the taxation of all income-tested benefits.
43. A further reorganisation took place in 1988 which reduced the top rate of tax for individuals and companies to 33 percent. The thresholds introduced in 1986 for low income tax credits were increased, but no other major changes in structure took place. In 1990, following a sudden collapse of export prices and reductions in government revenues, benefits were cut across the board by an average of 20 percent. These moves were accompanied by a new, lengthy stand-down period before unemployed people could receive benefits following the loss of a job. In 1996 the Tax Reduction and Social Policy legislation included lower income tax rates, more support for families, a new tax credit for independent low and middle-income families, higher qualifying income levels for access to concessional medical care, reduced benefit abatement rates, more job search assistance and a higher claw-back threshold for people receiving the retirement superannuation. Following the 1996 election this later measure is likely to be modified.

## **ASSESSMENT OF ACHIEVEMENTS**

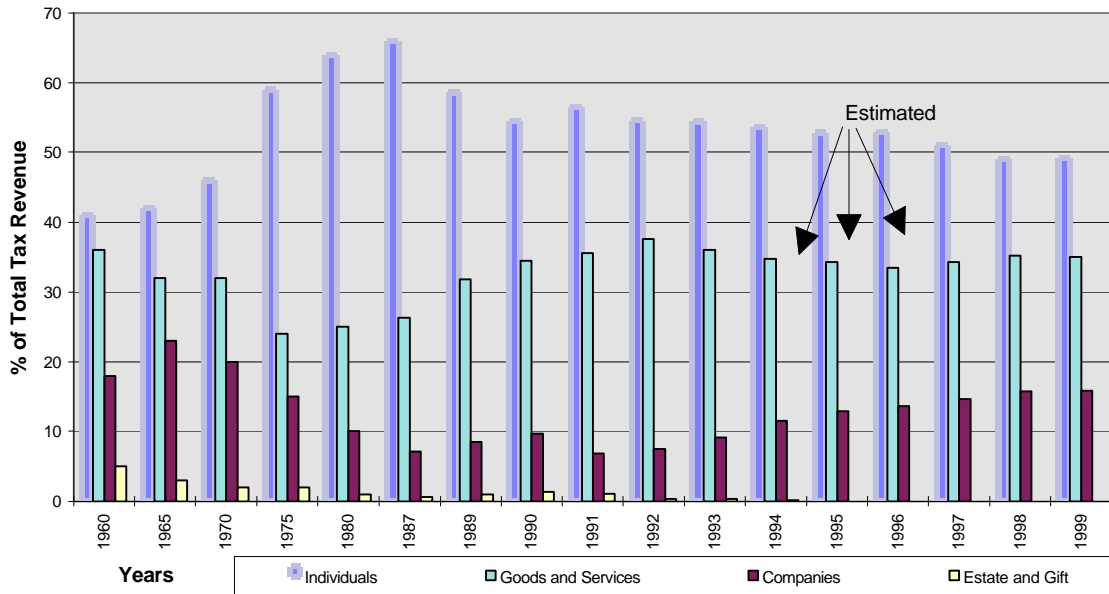
44. The reforms to the taxation system in New Zealand have been comprehensive with almost all of the issues raised in the Task Force Report of 1982 addressed. The system is now significantly more neutral than it was in 1984 and most sectors have benefited from the withdrawal of distorting tax expenditures. The tax load upon individual taxpayers has been lightened significantly and some of the tax burden has been shifted to consumers and companies. (See Figure 3). Inheritance taxes have been eliminated. As a result the government's fiscal position has dramatically improved. The operating balance of the government moved from a deficit to a surplus in 1993/94 and reached a surplus of NZ\$ 3.3 billion, 3.7

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<sup>18</sup> *Income Maintenance & Taxation*, Royal Commission on Social Policy, March 1988

percent of GDP in 1995/96. It was expected to improve from these levels. on an accrual basis, crown net worth became positive in 1995/96 with assets exceeding liabilities, also by NZ\$ 3.3 billion.<sup>19</sup>

Figure 3  
Direct and Indirect Taxation 1960-1996



Source: Planning Council 1981 and Budgets 1991-1996

45. The taxation system now offers substantially reduced opportunities for evasion and avoidance. The simplicity of the overall system and the paper trail created by the GST system facilitate monitoring and enforcement. While compliance costs remain high, compliance requirements have led to much higher standards of record keeping and cash flow management in businesses. The removal of many of the concessions designed to address structural deficiencies in the economy, and the using up of the accumulated tax losses that they created, has led to significant increase in the taxation of large companies. Between 1992 and 1995 additional taxation from companies amounted to more than NZ\$ 2 billion.<sup>20</sup> With the imputation system, and the ending of double taxation of dividends, the overall tax load on shareholders, (which include all the institutions for small savers), has not increased much.
46. Efforts to integrate taxation and welfare systems have not been as successful as the business and commercial tax reforms, in the sense that many people seeking to enter relatively low paid work in the labour force still face high effective marginal tax rates and lengthy stand-downs before they may qualify for assistance if they lose work. Just over 2 percent of married couples without children are paying effective marginal rates over 50 percent, but only 4 percent of single people without children face tax rates of over 80 percent. However, 75 percent

<sup>19</sup> Briefing to the Incoming Government, The Treasury, 12 October, 1996, Page 17-18.

<sup>20</sup> Budget figures 1990-1996

of single parent families have incomes below the level where EMTR rise sharply. 140,000 working families receiving the Family Support Tax Credit face EMTR of 50 percent over a wide range of incomes. It is possible for families with two or more children to be simultaneously receiving Family Support and paying the top rate of income tax, at which point they will face an EMTR of 63 percent, (33 percent tax rate and 30 percent abatement rate). While these EMTR are high, they are significantly lower than those in Australia, France, Germany, Ireland and the United Kingdom. The planned future tax cuts will make further progress by further reductions in tax rates and raised thresholds.<sup>21</sup>

47. One effect of the changes has been reduced vertical equity when comparisons are made between taxpayers on given levels of income before and after the changes.<sup>22</sup> Stephens notes that “The nominal degree of progression was reduced substantially, although actual progression may have been maintained due to tax expenditures and tax avoidance being more prevalent among higher incomes levels.”<sup>23</sup> He also notes that due to the targeted nature of family support the reduction in the degree of progressivity for those with dependents, is not quite as marked.<sup>24</sup> These results are predictable given the problems the reforms were addressing. The effect on progressivity of the abolition of nearly NZ\$ 1.5 billion of tax expenditures, which favoured the higher income groups, does not seem to have been investigated. Despite the considerable attention given to EMTR and their effects on work incentives, the only modelling work that has been done demonstrates a very limited labour supply response to the changes.<sup>25</sup>

## OUTSTANDING ISSUES

48. To reduce still further the problem of avoidance and to facilitate the better integration of taxation and welfare, in 1987 the government proposed a flat taxation system. The aim was to roll all the systems of social support into a single benefit system and phase out other forms of assistance. When the full implications of the change that was envisaged were more widely appreciated the proposal did not proceed. Since that time there has been a continuing shift away from the direct provision of goods and services by the government, towards cash assistance to individuals or groups considered to be requiring support, leaving it to them to obtain services from their preferred provider. Whether this trend should continue is the subject of vigorous debate.
49. One of the reasons for not proceeding down the flat marginal tax rate track was a perception that the tax system would cease to be progressive. Combined with

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<sup>21</sup> Report on the New Zealand Economy, OECD Paris, 1996, page 69

<sup>22</sup> *A Study of Economic Reform, the Case of New Zealand*, Silverstone, Bollard and Lattimore, Elsevier, 1996, see the chapters by Stephens and Easton.

<sup>23</sup> Social Services, Stephens, Op cit. page 469.

<sup>24</sup> Social Services, Stephens, Op cit. page 469

<sup>25</sup> *Incentives and Labour Supply: Modelling Taxes and Benefits*, Prebble and Rebstock, Institute of Policy Studies, Wellington.

allowances for low-income taxpayers and a benefit system for the incapacitated or disadvantaged, a flat marginal tax rate would significantly improve incentives to increase incomes but would also maintain progressive average tax rates. It would help overcome some of the problems identified in integrating taxes and welfare provisions. However, it could need to be accompanied by modest property and capital gains taxes for revenue reasons. For this reason while it is unlikely that the issue of moving to a flatter tax scale will die, it will remain highly controversial.

50. Some of the more politically difficult aspects of the reforms have already been watered down. The neutral tax provisions in relation to afforestation and mining were modified in 1991 following election promises. As a result there has been an explosion of tax driven investment in forestry worrying some rural communities about the loss of pastoral land. With the switch to a system of proportional elections it is likely that there will be stronger pressures for political compromises on tax issues. Following the 1996 election, a coalition government agreement proposal to invest a NZ\$ 100 million in subsidies to exporters was stopped by the combined efforts of manufacturers, farmers and chambers of commerce, who were more worried about the effects of increasing expenditure than they were tempted by the spending proposals. This is a hopeful development for the cause of economically sound tax reforms.

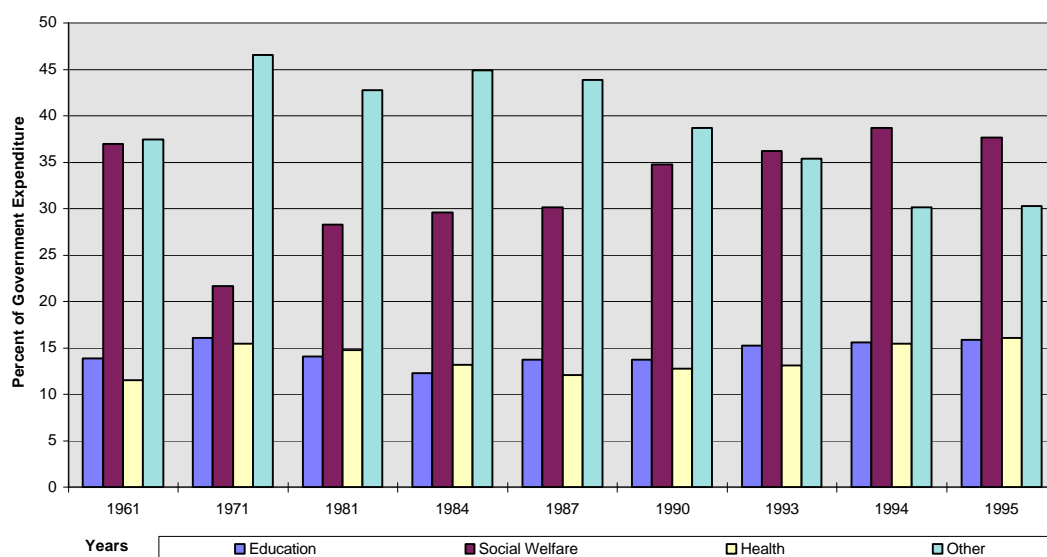
## **SOCIAL POLICY**

51. Compared with New Zealand's other reforms, changes in social policy have been controversial, less thoroughly carried through and bitterly opposed by the employee and professional groups affected. In significant respects they have been reversed. At the heart of the debates have been different perceptions of the relative importance of means and ends, and the fundamental issue of whether private claims on community resources are rights or privileges. Social security in New Zealand was often described as, care from the "cradle to the grave"<sup>26</sup>. By the early 1980s this vision was coming under pressure. Sluggish economic performance, and the cost of debt servicing and assistance to industry, imposed financial constraints. New programmes such as National Superannuation were taking an enormous share of available resources. New Zealand was still not teaching enough of its young people to earn a living at other than manual work and in both education and health services were being cut to put money into infrastructure left over from more prosperous times.

Figure 4  
**Percentages of Government Expenditure on Social Policy and "Other"**

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<sup>26</sup> Description of the Social Security Act by Rt. Hon M J Savage, then Prime Minister, 1938



NZ Official Yearbooks, Department of Statistics

52. Figure 4 demonstrates the pattern of social policy expenditure between 1961 and 1995. Social Welfare expenditure reflects increased expenditure on new policies in the early 1970s. Health expenditure reflects frozen wages in the early 1980s, thirty percent plus wage increases and a real expenditure increase of 18.8 percent between 1985 and 1988.<sup>27</sup> Education spending also shows rising real resources in the late 1980s and into the 1990s. The fall off in “other” in the 1990s reflects falling debt servicing and lower subsidies to industry. All percentages have been affected by the shares of expenditure going on debt servicing and unemployment benefits in the late 1980’s with both falling sharply in the mid 1990s. With costs absorbing real increases in expenditure, social policy reforms, post 1984, had to focus on greater efficiency and accountability. Efficiency meant more people could benefit from the same money. Accountability meant exposing failures, taking remedial action and a role for individual responsibility. When people eat sensibly, smoke less and drive more safely, demands on the health system diminish and resources are freed up. An small element of user pays also put the certainty of more people benefiting from services, over the possibility that financial barriers might prevent access by a few. Reforms, post 1990, were to erect a “safety-net, a modest standard below which people will not be allowed to fall provided they demonstrate they are prepared to help themselves.”<sup>28</sup>

## THE HEALTH SYSTEM

53. Health care in New Zealand suffers from the same problem as in every other country: it will never be possible to provide enough. Technology keeps advancing: 70 percent of health expenditure goes on people under one year old,

<sup>27</sup> Budget figures 1984-85, 1987-88

<sup>28</sup> *Social Assistance: Welfare that Works*, Shipley, Government Printer, Wellington 1991, page 13

or over 65. Medical advances keep increasing people's expectations. Health care is very emotive. Free health care is easy for both patients and providers to abuse, and abuse is difficult to control. Because there is no limit to the care that can be demanded and provided, some form of rationing always takes place.<sup>29</sup>

54. The New Zealand Public Health Act of 1900 was the first acknowledgement of a government role in public health. Innovations in health services resulted, not the least those for the Maori population, which from a fear of extinction in the mid 1890s began a population revival based on public health measures. Health services in New Zealand were always a mixture of public and private systems. Under the social security legislation of 1938 most primary care was delivered by private general practitioners (GPs). The early years of the free health services coincided with the availability of effective drugs, better anaesthesia and more successful operations and these moved the focus of the health service away from prevention and the family doctor and towards public hospitals. At that time New Zealand was rich and there was a large increase in hospital building, in even the smallest communities. These increased the scope of medical services and raised public expectations of the health system.<sup>30</sup> Health services used to mean spreading the use of relatively cheap medicines; today the problem is rationing the use of expensive high technology.
55. From 1950, obstacles to a private hospital sector were removed and in 1961 the first private health insurance company was formed. The government was the funder, local authorities were responsible for public health, elected boards were responsible for the administration of hospitals and independent GPs were the gate keepers to hospital care. Prevention, (important as lifestyle influenced complaints such as heart disease, cancer and road accidents replaced infectious diseases as the main reasons for illness and death), was nobody's responsibility. The 1973 accident compensation scheme divided responsibility further, providing accident victims with a substantially more generous assistance than that for the sick. Waiting lists for admission to hospital were through the 1960s, as was the expenditure on hospitals and pharmaceuticals. Maori and women's groups said health professionals with a vested interest in sickness had captured the system. In 1974 the government proposed to organise service provision around regional, integrated health promotion. Slowed down by vested interests, over the ensuing ten years, Area Health Boards, the institutions to implement this vision were put in place.

## **POLICY OBJECTIVES**

56. Substantial increase in real resources had made no measurable impact on improving health statistics. However urgent the need, further substantial

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<sup>29</sup> This section owes much to Ross Campbell: *Are the Health Reforms Working*, New Zealand Health and Hospital, July/August 1995, page 5

<sup>30</sup> Dr George Salmond, quoted in *The Health Debate*, Frances Ross, the Dominion, 13 January 1997

resources were not available and the emphasis in health shifted to getting better value for the money spent and redirecting resources towards prevention and primary health care. A 1987 review of health administration, “Unshackling the Hospitals<sup>31</sup>”, suggested that managed competition between health providers would encourage efficiency, that savings of NZ\$ 600 million could be achieved in the health service, and that waiting lists could be eliminated at the same time.

57. The government chose instead to focus on getting the best it could from the Area Health Boards. A 1988 policy document “Prescription for Health” sought better management by delegating many hospital board powers to their chief executives. Boards were to take responsibility for their budgets, for capital spending and assume responsibility for primary care. This thrust was emphasised two years later by a system of measurable health goals for each Health Boards. Financial and business experts were appointed to the Boards, to assist in implementation. With the change of government in 1990 the challenge of “Unshackling the Hospitals” was accepted and a full split between policy, funding and providers was introduced.

## **PRINCIPAL MEASURES**

58. In July 1991 reforms were set out in policy documents entitled “Your Health and the Public Health.” These provided for:
- integration of primary and secondary care funding, and integrated sickness and accident provision,
  - separation of the funding and provision of care through the establishment of four regional purchasing bodies, Regional Health Authorities, (RHAs),
  - abolition of the Area Health Boards and replacement with 23 commercially orientated Crown Health Enterprises (CHEs), formed around acute hospitals,
  - alternative health care purchasing agents, for people opted out of RHAs
  - part charges for some services, including the “hotel” element of the costs of keeping a patient in public hospitals,
  - A Community Services Card entitling low-income groups to free or part-charges, where charges had been imposed for services that were formerly free,
  - a Core Health Services Committee to advise on which services should be publicly provided on a continuing basis,
  - a Public Health Commission to advise the Minister,
59. Health Policy advice would be provided by a policy ministry, and the splitting of funding from delivery would create a quasi-contestable market for services. Institutions would be funded in relation to their ability to win contracts

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<sup>31</sup> Government Printer, Wellington, 1988

competitively and their ability to be sensitive to the needs of their clients. The CHEs would be responsible not to the Ministry of Health but to the Minister of Government Enterprises. Setting up the 4 RHAs and 23 CHEs took much longer and were more costly than anticipated. Financial information had to be built up from scratch. Opting out, hotel charges, the Core Health Services Committee and the Public Health Commission were gradually dropped from the scheme as each became a political liability. Following the 1996 election the coalition government decided to drop the requirement for CHEs to act commercially and amalgamate the four RHAs into one purchasing agency.

## **THE EDUCATION SYSTEM**

60. Education in New Zealand began from small private and community initiatives and by the 1870s had developed on regionally distinct lines. Otago, with its Scottish population, had virtually a Presbyterian school system. Maori literacy (in the Maori language) was widespread by 1840 but with land wars in the 1860s went into decline, except in private church schools. Education became a national responsibility in 1876, and in 1894 school attendance was made compulsory. From 1903 students who passed a proficiency examination gained free places in secondary school and by 1928 56 percent of primary school graduates attended. In 1936 proficiency exams were abolished and with the 1944 raising of the school leaving age to 15, there was a doubling of secondary school rolls between 1945 and 1960. A national curriculum, comprising English, Social Studies, General Science, Mathematics, Music and Physical Education, was implemented in 1945. The four earliest universities had been formed as a single body but in 1961 they were split into independent institutions.
  
61. In the 1950s there was a degree of satisfaction that students from humble backgrounds could progress to the highest levels of education and there were examples of people like Ernest Rutherford, born on a New Zealand farm in 1871, who won the Nobel Prize for chemistry in 1908. But evidence of problems was growing. In 1938 only 5 percent of secondary pupils went to university, but the curriculum assumed that the majority would.<sup>32</sup> In 1969 the National Development Conference noted that New Zealand was too dependent on immigrants for skilled workers.<sup>33</sup> By the 1980s there was concern that education programmes had not led to more skilled, more socially responsible citizens. Statistics of family breakdown, family violence and crime were climbing inexorably. Disparities between Maori and Pakeha<sup>34</sup> educational attainment had narrowed little over the years, and by 1984 only 2.2 percent of Maori went to university and 10.4 percent to other tertiary study, compared with 13.9 percent

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<sup>32</sup> I L Kandel, quoted in Book of Events, op cit., page 337

<sup>33</sup> *National Development Conference, Report of the Labour Committee*, Government Printer Wellington, 1969.

<sup>34</sup> Non-Maori, usually European

and 25.2 percent for the rest of the population.<sup>35</sup> New Zealand led the world in reading recovery programmes but this did not explain why they were required.

62. A 1974 Education Development Conference, comprising 4,000 study groups and 60,000 participants, advocated the elimination of barriers between different kinds of education. In 1975 the first regional polytechnic was opened, foreshadowing a rapid growth of non-university continuing education. A 1975 initiative to allow private schools to “integrate” into the state system and receive funding had allowed many church and minority interest schools to survive. Although public sector institutions had been given some autonomy with Boards of Governors, these in fact had little control. Most decisions were taken by the Education Department Officials. It was extremely difficult to remove incompetent or inadequate teachers. The system of education had also become a football between conflicting views of the purpose of education. One group sought the removal of formal examinations, others sought more focus on skill training and measurement of results. Education saw a 26.3 percent<sup>36</sup> real increase in funding between 1984 and 1988, but as with the health service, there was no tangible evidence of improvements. As with health the focus shifted to the efficiency with which current resources were being used.

## **POLICY OBJECTIVES**

63. Between 1987 and 1990 virtually every aspect of the education system underwent major restructuring. Most of the changes were based on a report delivered in 1988 called “Administering for Excellence”. This report concluded that the structure was over-centralised, complex, open to pressure group capture and did not permit staff or pupils to develop to the fullest extent of their abilities. The report proposed a new structure based on choice, the needs of parents and the community, cultural sensitivity and equality. It also called for good management practices, so that those working in the system had detailed and clear objectives, greater control over resources, no overlapping lines of responsibility and an understanding of the need to be accountable for the decisions they make. The policy reaffirmed New Zealand’s tradition of state funded and provided education, but to the greatest extent possible within that introduced choice, competition and accountability.

## **PRINCIPAL MEASURES**

64. To achieve these objectives, funding of educational institutions was related to their ability to attract students. Early childhood education was reformed to allow more community involvement, new support and development services and centralised bulk funding. Primary and secondary schools are managed by parents

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<sup>35</sup> Stephens, op cit., page 473

<sup>36</sup> Budget tables.

and the community in partnership with the school's teachers through a Board of Trustees. Each school develops its own charter and the Board is accountable for expenditure towards meeting its objectives. Funds come from bulk grants supplied by the government. Many of the administrative tasks previously performed by the ministry are carried out by the school or private businesses. A new institution, the Education Review Office assesses schools regularly and reports to the Minister of Education if remedial action is required. The zoning system that previously limited choice of schools to those in the immediate neighbourhood, was relaxed, then abolished.

65. Post-compulsory education also underwent a major shake up. The main effect was to allow a considerable decentralisation of administration and increased reliance on non-government funding. A common funding system for all post-compulsory education was devised, with the aim of encouraging greatly enhanced participation. In place of the former University Grants Committee, a single National Qualifications Authority was established. This body is empowered to licence suitably qualified institutions to offer courses. Another new agency, the Training and Support Agency, replaced a number of institutions concerned with vocational education. These measures have blurred the distinction between universities and polytechnics. The position is now very similar to that contemplated by the Education Conference of 1974. Universities have to take more note of the needs of their graduates and polytechnics offer undergraduate courses. To compensate for the greater emphasis on course fees student assistance was augmented, with a large component of the assistance related to parental incomes. This scheme was only in place for two years before it was replaced by a generous, soft loan scheme, for students to pay fees and living expenses.
66. These changes complemented an innovative new system of dealing with young offenders, a cause of much stress in the education system but one which had previously not responded to the methods of either the education or justice systems. This system also relies very heavily on the involvement of extended families, called together in Family Group Conferences, to judge and deal with young offenders. Managed by the Children Young Persons and Their Families Service of the Department of Social Welfare this system was set up following extensive consultation between the Maori community and a Parliamentary select committee<sup>37</sup>. It has proven much more effective in dealing with the disruptive students and claims to have reduced reoffending by 70 percent. It offers some hope of influencing the statistics of family breakdown, family violence and crime.

## **ASSESSMENT OF ACHIEVEMENTS**

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<sup>37</sup> This resulted in the Children Young Persons and Their Families Act of 1987

67. New Zealand has a similar demographic profile to the United States and achieves similar health statistics for approximately half the total cost to the community<sup>38</sup>. While the introduction of part charges for tertiary education in New Zealand has been deeply controversial, internationally it is still regarded as laughably cheap. In both health and education there have been some remarkable improvements, but overall the reforms have not achieved the results anticipated. Reforms in health have seen a better integration of primary and medical service planning and have stimulated a wide range of alternative services, particularly for Maori clients. CHEs have economised on their purchases, they have a better idea of their costs and they are disposing of surplus assets that were eating health dollars. Small and inefficient rural hospitals have been closed, but services have improved with more day surgery and access to base hospitals, with access times for rural patients imposed on CHEs by RHAs.
68. Efficiency gains of 15 to 20 percent have been common, but these have been eaten up by 5-8 percent per annum growth in demand, particularly in the Auckland area. Free access for acute services remains of high quality, and although the number of elective operations has increased so have the waiting lists. Efforts to reduce waiting lists have simply reduced the threshold for service. There was insufficient recognition of the differences between a demand driven public hospital and specialised private facilities. Normal commercial incentives are inverted for a public hospital. Confronted with an exhausted budget and people requiring help the hospital has no option but to do extra work. Instead of work producing increased profits it magnifies losses, leading to pressure to cut elective surgery. This means that the government will have to decide on the extent to which it is able to fund free, elective health care. To date governments have sought to postpone this difficult issue by topping-up grants to the RHAs but this approach has undermined systematic allocation of resources. With the return to a single funding agency and some of the commercial drives on CHEs relaxed, the position is not far removed from the situation that existed in 1990.
69. Schools and universities have greatly improved their productivity, by disposing of surplus assets and making better use of their resources, teaching more students with the same resources. But schools that could survive, with the support of the former Department of Education, providing poor service to their pupils, now lose students and run into financial problems. Their Boards of Trustees have been dismissed and replaced with appointed Commissioners. The effect of the reforms has been to highlight the deficiencies in the old system but not necessarily provide adequate remedial measures. In the 1960s prosperity hid the fact that most Maori left school with no formal qualifications. A tighter labour market and more competition have highlighted the fact that the former system was letting down most young Maori. Maori participation rates have increased. They now constitute 8 percent of enrolments at universities and 11 percent in polytechnics,

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<sup>38</sup> *Health Care Financing Reform in New Zealand*, Gordon K MacLeod, Health Affairs, Fall 1994 page 210.

although 37 percent of Maori school leavers still have no qualification, compared with 12 percent of Pakeha<sup>39</sup>. While it has been alleged that Maori and other minority groups would be disadvantaged by the introduction of part charging for fees, this is not reflected in participation rates.

## OUTSTANDING ISSUES

70. In both health and education the reforms have aimed to shift the focus of the institutions towards their clients. Schools and universities are now focusing far more on the need to recruit and retain students and thereby acquire more government funding. But the markets for these services are partial, because essential features are missing:
- Students and patients have an asymmetry of information with providers. They are both in weak negotiating positions, particularly, patients who may be unconscious. To make the policy work consumers of services need to have more control. Funding care through the consumer rather than through the institution is one way to enhance the consumer's power.
  - The government as the owner and the funder of health and education still carries most of the risks. School trustees are elected for three years but can resign at any time, placing additional strain on the school principal. Risks carried by hospital management are smaller than in a market situation.
  - In neither health or education is there a mechanism for an efficient and effective administration to take over an inefficient and ineffective one, except through the uncertain route of the appointment of a commissioner. State ownership of agencies serves to protect bad managers.
  - CHE boards have to provide service demanded by a community but have little ability to exercise control over the demand. This creates the opportunity for political lobbying for additional cash to conceal failure.
  - RHAs have been purchasing services from CHEs at lower rates than they are purchased from the private sector. The RHAs have gained the benefit from increased efficiency at the CHE without any guarantee that these resources will be used for preventative measures in the CHE's district.
71. Few new solutions exist to resolve these problems and provide better incentives to achieve the desired objectives, within the framework of government ownership and funding. If the objective is ensuring that patients have access to treatment and students receive tuition, is the means of delivery a matter of principle or a second order problem? Government funding of health and education has always been regarded as a priority in New Zealand, because of the equality of access that it implies (although has not necessarily delivered).

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<sup>39</sup> Stephens, op cit., page 473

72. It has been suggested as an alternative that all citizens should be required to take out sickness insurance, creating for the first time financially powerful organisations with an incentive to keep people healthy and out of hospital. Where insurance companies do not have the right to turn down potential clients, they have a vested interest in keeping the insured healthy and the cost of treatment low. Similarly, relating all educational funding to the ability to attract students will transfer power from the vested interest to the consumer of the services, but the question is asked, in an insurance driven system who is responsible for public health and how is it paid for? New Zealanders' concerns about the problems experienced by middle income and poor families in voluntary, privately insured regimes, particularly in the United States, has meant very little support for moves in this direction. The bottom line for future reforms is that New Zealanders prefer prevention to cure but when they see an urgent need for medical care they will not accept financial considerations being a reason to deny access.

## **POSTSCRIPT ON REFORM**

73. New Zealand has undergone a series of economic and social reforms more fundamental than any it has experienced over the previous 70 years. Common themes running through them have been the separation of policy advice from the funding and delivery of services, neutrality with respect to investment options and the removal of artificial distinctions and unnecessary rules and regulations. Commercial agencies have been sold to the private sector but there have been few sales in the social policy sector. The state still has a predominance of delivery of services in health and education and state ownership serves primarily to protect management from competition.
74. Reforms have resulted in substantial gains in efficiency and effectiveness of institutions. The community is taking more responsibility for its own health, education, financial and business affairs, and is becoming more self reliant and independent as a result. While in retrospect it may appear that there was a grand design in fact reforms have proceeded very much in accordance with the New Zealand tradition of seeking practical solutions to intractable problems.
75. In the post-1996 environment of proportional representation in the New Zealand Parliament and coalition governments, there has been a retreat from some key economic principles that underpinned reforms. Whether this is a symptom of a high-water mark of reform having been reached, or whether it is simply a pause to digest what has been achieved before another move forward takes place, remains to be seen.