OECD GLOBAL FORUM ON GOVERNANCE

"SOCIAL EQUITY, ECONOMIC GROWTH AND GOOD GOVERNANCE"

MODERNISING THE PUBLIC SECTOR: THE EXAMPLE OF NEW ZEALAND

INTRODUCTION

1. I begin with two introductions and a caveat. For those of you who do not know New Zealand, I should say something briefly of my country. I shall also briefly introduce myself and then I need to express a proviso to which everything else is subject.

2. New Zealand is a small country (less than four million people), isolated from the rest of the world. It is three hours flying time from the nearest sizeable land mass, Australia. Its economy is "developed" in the sense that its people enjoy a "western" lifestyle. Most inhabitants are descended from immigrants from Europe, who began to arrive shortly before the country was colonised by Great Britain in 1840.

3. In the 1950s New Zealand enjoyed the third highest standard of living in the world (after Canada and the United States). Now its ranking in terms of gross domestic product per capita is somewhere around twentieth, i.e. below that of Ireland. It has been overtaken by Japan, Singapore and most of western Europe. Its standard of living is now being approached by a number of rapidly developing economies.

4. In part this experience of being overtaken has occurred because the New Zealand economy is still dominated by commodity agricultural exports, the terms of trade for which have declined persistently relative to those of manufactured goods and of services. New Zealand's isolation is also a problematic factor. Arguably it induces self-reliance and a practical strain to "kiwi" culture. But self-confidence lapses easily into complacency, if not lethargy. The lack of close comparators may dull a competitive edge.

5. Whatever the cause, New Zealand's economic performance in the second half of the twentieth century was relatively poor. In the mid 1970s, British entry to the European Community deprived New Zealand of its largest export market, just at the time the oil shocks worsened New Zealand's terms of trade. The policy response to these challenges was poor. By the mid-1980s there was

much need for economic reform. The changes which followed, while largely orthodox, were among the most comprehensive and broadly based of any in the OECD – at least up to the mid 1990s.

6. One last preliminary point is that although New Zealand has long been a member of both the International Monetary Fund and the World Bank, it has never borrowed from either institution. So it has been free to pursue its own remedies at its own pace. Perhaps in retrospect it would have been better had we been obliged to act earlier. As it is, the blame for, as well as the benefits of, our "reforms" lie squarely within New Zealand.

Personal Introduction

7. The writer served as a Member of the New Zealand Parliament for 18 years, including 6 as a Minister in the reforming 1984/1990 Cabinet. I was successively Minister of Trade and Industry, of Health and of Finance – holding the last portfolio in 1989 and 1990. From 1993 to 1996 I served as Deputy Leader of the New Zealand Labour Party (under the present Prime Minister, but before she held that office). My educational background was in law and economics. Now retired from politics I am a partner in a national law firm, specialising in public law. In addition to advising on public policy and public sector reform I hold a number of outside appointments, including as chair of New Zealand's Accident Compensation Corporation (which administers New Zealand's comprehensive, no-fault injury insurance scheme) and as a member of the Representation Commission (which determines New Zealand's electoral boundaries). In 2000 I chaired an inquiry into New Zealand's electricity industry.

Caveat: The New Zealand "Model"

8. Some writers (though perhaps only New Zealanders) have summarised the reforms we undertook as "the New Zealand model". I am uncomfortable with this label. In particular it implies a degree of coherence and foresight which I do not now recollect. We acted as we did for particular reasons, based on the needs as we saw them at the time. I am happy if reading of these changes some years later offers lessons or ideas readers can adapt or use directly. But I do not set out a description of what took place in order to sell a particular solution. I am very conscious that what is possible or desirable in one context may well be inappropriate or impracticable in another.

Summary of New Zealand Public Sector Reform

9. I want to describe how New Zealand dramatically reformed its public sector institutions under four headings. These are:

- Fiscal policy;
- State enterprise reform;
- Reform of public sector controls, including accounting changes;
- Market liberalisation.

10. First however I need to sketch the economic background which gave rise to the pressure for reform. By the mid 1980s New Zealand was suffering from:

- Rising unemployment (from negligible levels as late as 1977);
- Persistent high inflation (which averaged 15% for the years between 1975 and 1984);
- Persistent budget deficits (from 1975, rising to 9% of GDP in fiscal 1983/84);
- High public sector debt (almost 80% of GDP by 1987); and
- Persistent balance of payments deficits (since 1973).

11. In July 1984 New Zealand experienced a foreign exchange crisis at the time of a "snap" (ie unscheduled) election. The country's fixed exchange rates were suspended and the foreign exchange markets temporarily closed. The new government elected that month undertook a comprehensive reform programme over the following decade. Successive governments have continued this programme, though to a lesser extent in recent times.

12. The period on which I will concentrate is that between 1984 and 1992. Within these years a comprehensive programme of economic reform was undertaken. Many of the measures accord with similar changes occurring in many other countries before that time and since. Essentially, all that was unusual about New Zealand's reforms was their breadth and the speed with which they were implemented. Altogether the programme was perhaps one of the most comprehensive outside those undertaken in eastern Europe, following the fall of communism. The significant difference is simply that New Zealand started from a more developed base.

13. Full details of New Zealand's economic reform programme are set out in the appendix to the OECD's 1999 report on New Zealand. A brief summary is as follows:

- *Financial sector reform:* removal of exchange controls and interest rate controls, floating of the New Zealand dollar, and the transfer of the conduct of monetary policy to the independent central bank, whose sole focus became price stability;
- *Fiscal reform:* removal of export subsidies, withdrawal of farm income support, means testing public retirement income payments, abolition of consumer subsidies and price controls;
- *Trade liberalisation:* Abolition of import licensing, reduction of tariffs, removal of export subsidies;
- *Tax reform:* reduction of income tax rates (from 66% to 33%), elimination of tax expenditures, introduction of a comprehensive goods and services tax;
- *Deregulation of product markets:* abolition of numerous individual price controls, repeal of economic stabilisation law and liberalisation of shop trading hours;
- *Public sector reform:* corporatisation and then privatisation of state trading activities, abolition of preferential public sector employment rules, move to accrual accounting, move from input to output budgeting;
- *Reduction in social assistance:* raising qualifying age for public pensions, abolition of universal family allowance, increased fees payable by tertiary students.

14. Those particularly interested in public sector reforms are directed to the OECD's 1996 economic survey of New Zealand, which included an extensive examination of public-sector reform; "Toward Better Governance", a study of public sector reform in New Zealand and its relevance to Canada, published 1995 by the office of the Auditor General of Canada; and "Public Management in New Zealand: Lessons and Challenges" by Graham Scott, a former Secretary of the New Zealand Treasury, published 2001 by the New Zealand Business Roundtable.

FISCAL POLICY

Background to Fiscal Reforms: The Need for Change

15. The government's annual budget was in deficit from 1974 to 1992. Prior to the mid 1970s the government accounts had enjoyed healthy surpluses over a period of what in retrospect seemed long term stability. The first oil shock in 1974, which occurred almost simultaneously with British entry into the European Union, transformed the New Zealand economy. New Zealand's terms of trade collapsed, the price of oil imports soared, and the British export market on which New Zealand had principally relied for so long was suddenly limited.

16. In response, between 1975 and 1984 a series of increasingly desperate but seemingly futile policy measures were employed. For example, export incentives were provided to manufacturers to encourage the growth of industrial exports. At the same time farmers were encouraged to produce more by subsidies to break in marginal land and to lift agricultural output. Minimum farm incomes were guaranteed by the state.

17. At the same time the government continued to aspire to social policies reflecting earlier more prosperous times. In particular, in 1975 the government sought to provide transfer incomes for the elderly based on 80% of the average wage for a married couple, payable at age 60 irrespective of other income. All this, without putting up tax rates. The result was that the government accounts rapidly moved into a position of chronic deficit. By 1983/84 the deficit was the equivalent to 9% of GDP or 1/11th of the country's total income.

18. Not only could such deficits not be sustained, but in order to finance them the government was compelled to control interest rates. In effect it sought to borrow half of all private savings, yet it was not prepared to pay the price in higher interest rates that an uncontrolled market would have demanded. Instead banks were compelled to lend money to the government through reserve asset ratios and investment controls.

From Deficits to Surpluses: 1984-92

19. This approach was dramatically reversed following the change of government in 1984. In its first budget the new government announced the removal of export incentives and the withdrawal of price support for farming. At the same time a means test was imposed on state pensions for the elderly. More was to follow. In 1985 the government introduced a comprehensive tax on goods

and services (of the kind widely employed in Europe). At the same time the government financed its remaining deficit at market interest rates. This policy change reinforced the need to address the deficit, whilst also allowing a rational approach to monetary policy.

20. The decision to place the day to day conduct of monetary policy in the hands of the central bank (The Reserve Bank of New Zealand) was a significant public sector reform in its own right. So too was the decision in May 1985 to float the exchange rate. This latter was a major step forward in exposing the economy to the disciplines of the international market place whilst removing the potential fiscal liability implicit in defending a fixed exchange rate.

Privatisation

33. Whilst not an original objective, by 1987 privatisation began to be seen as potentially yielding a further round of efficiency gains. The first sales of government businesses however were undertaken for the purpose of staunching ongoing losses rather than yielding fiscal benefits directly. In late 1987 the New Zealand Steel Mill, for example, was sold for NZ$300m, having received in the order of NZ$2000m of loan guarantees and capital injections from the government. Different arguments for privatisation influenced different government Ministers. Some, such as the writer, focused on the need to reduce the level of public sector debt. Once a number of off-balance sheet items (such as energy project guarantees) had been acknowledged, gross public debt approached 80% of GDP. Net public debt peaked in 1992 at over 50% of GDP. Without action, debt servicing would soon have absorbed a quarter of the government's budget. Notwithstanding this imperative, for some Ministers the prospect of efficiency improvements under private sector management was at least an equal motivation for privatisation.

34. The government resisted any temptation to treat privatisation proceeds as annual revenue. Even before the adoption of accrual accounting in 1989, the government approached privatisation on the footing that a capital investment was being sold or a liability eliminated. Accordingly, we took the view that all that should appear in government's annual accounts was the difference between the previously anticipated stream of dividends and the interest savings as a result of repaying debt from the proceeds of sale. In each case before sale Ministers carefully assessed whether potential interest savings from reducing debt exceeded anticipated revenues under public ownership. In each case the analysis supported a sale. On that basis, even controversial sales, notably that of the telecommunications network, proceeded.

35. In most cases sales proceeded without restriction as to future owners. In contrast with some countries overseas, the New Zealand government has never sought to foster share ownership as such. Instead, it sold to the highest bidder and looked to obtain a premium for control. A brief experiment with minority private ownership of the Bank of New Zealand left the government convinced that it was better to exit ownership of commercial enterprises altogether than to maintain joint ownership with the private sector. Occasionally, special shareholding requirements were created to protect certain public policy requirements, such as the maintenance of a corporate name

and domestic headquarters (e.g. Air New Zealand) or the requirement of certain pricing policies, as in the case of Telecom New Zealand.

ABOLITION OF PUBLIC SECTOR CONTROLS

State Sector Act 1998

36. I turn now to the reform of the public sector's core administration. Among the most dramatic of the reforms during this period was the passage in 1988 of the State Sector Act. At a stroke this legislation threw out New Zealand's complex public sector manual, which contained hundreds of pages of complex rules governing all aspects of public service employment. In particular, the new Act abolished the hiring preference previously enjoyed by existing civil servants. It also abolished across the board wage adjustments. This revolution also saw "permanent heads" of government departments enjoying permanence no longer. Instead they were placed on individual contracts for a maximum of five years, which have typically been renewed for no more than one term.

37. In place of across the board central controls, each chief executive, as they were now styled, became the legal employer of his or her department's staff. In effect a form of enterprise bargaining was introduced within the state sector at a time when private sector employment was still largely based on national arbitrated "awards".

38. At the same time other controls which had bedevilled the public sector were abolished. Departments were no longer compelled to use the Government Stores Board for the purchase of furniture, stationery and the like. The Government Cleaning Service lost its monopoly on office cleaning. And the Government Accommodation Board was abolished, leaving departments free to make their own decisions as to the premises they would use. Over the next few years a number of agencies relocated to cheaper premises away from the centre of Wellington, the capital city, leaving the core advisory agencies in close proximity to Parliament, but more administrative agencies typically some distance away.

Public Finance Act 1989

39. At the same time as these controls were lifted, a parallel reform was made to the way in which departments accounted for the resources they used. The government switched from input to output budgeting, i.e. from financial reporting based on inputs such as salaries, rent, maintenance, travel and so on to budgeting and performance measurement based on the achievement of

outputs, i.e. programmes relevant to each department, such as policy advice, administration or regulation.

40. The combination of these two changes meant that chief executives were free to switch resources from one activity to another or from one kind of activity to a different kind. So, for example, a chief executive could save on maintenance in order to make a capital investment, or save on salaries in order to purchase more equipment. Public expenditure still required the authority of a Parliamentary appropriation but, within limits, managers acquired the flexibility to manage. Parliamentary approval in turn was focused on outputs, that is the actual services being provided, and not the inputs such as the salaries or equipment which contributed to those services.

41. Although this terminology took some getting used to it has since sunk deep into the New Zealand political culture. Speaking as a former Member of Parliament the writer would assert that far more relevant information was provided to Parliament than had previously been the case. At the same time as a former Minister, it is clear that public agencies acquired far greater capacity to manage, free from previous constraints and inflexibilities.

42. In 1989 the New Zealand government also began to move from cash to accrual accounting, a conversion which was completed in just three years. The New Zealand public sector now has a consolidated balance sheet, which is updated every six months. One consequence has been that many other Crown agencies, that is not just State-owned commercial enterprises and core government departments, have moved from cash to accrual accounting. This has greatly enhanced the public sector's understanding of the capital or resources employed in various activities. Capital intensive departments (such as Defence) have been encouraged to review the need for capital investment in areas such as property or equipment as well as to consider ways of spreading financing costs. An important aspect of the reforms is that the full cost of capital commitments is transparent in the government's accounts, in other words, Ministers and Parliament no longer find that multi-year commitments have been made based on a single year's cash appropriation.

43. Perhaps even more notable has been the attention that has been focused on public sector liabilities, such as the public sector pension arrangements and insurance liabilities. Future pension liabilities of public sector employees are shown, for example, as an actuarially calculated liability on the Crown's balance sheet. In many cases regulatory reform has followed the quantification of

these liabilities. For example, the New Zealand government no longer insures private commercial buildings against earthquake risk, and it did until the early 1990s. Public sector pensions have been moved from a defined benefit to a defined contribution basis, gradually reducing the net liability being carried on the Crown's balance sheet.

44. The State Sector Act and the Public Finance Act excited quite different political responses. The former attracted fervent opposition from public sector unions. Changes to accounting systems on the other hand draw little public interest. When the government changed at the end of 1990, the new government reviewed the State Sector Act. The review's private sector chairman recommended accepting the new decentralised, contractual system and the new government accepted this advice. A decade later a different government again has emphasised the need for across the board co-ordination of public sector activities. There has been some concern that the abolition of public sector controls may have led to a loss of coherence and capacity on the part of competing independent government agencies. All departments are now expected to contribute to the government's key goals and objectives. Nevertheless no-one, from Ministers to commentators to employee representatives, now advocates a return to the dead-hand of centralised controls or life time employment.

MARKET LIBERALISATION

45. The focus of this paper is on reforms to New Zealand's public sector institutions. The most obvious was the corporatisation and then withdrawal from "trading" activities, seen more properly as the private sector's commercial responsibility. Core government departments saw the removal of central controls and a focus on greater flexibility. At the same time improved accounting requirements raised the standards of information and management expected. These changes occurred against a background of sweeping reform in the private sector. The economy was opened to competition from overseas goods and services. And widespread internal sectoral-regulations were swept away.

46. It is not the principal purpose of this paper to describe these private sector changes, except to the extent that they impacted on the public sector. Undoubtedly however there was a significant degree of interaction. Just as tightening fiscal policy influenced attitudes to public sector reform, so too did liberalisation of private sector markets. Widespread change occurred over a limited period of time. And neither sector was ignorant of what was happening to the other. In particular,

liberalisation of the economy had an impact on perceptions as to the role of government in relation to the economy.

47. Between 1982 and 1992 New Zealand moved from arguably the most protected economy in the OECD to one of the least protected. This dramatic shift began with the negotiation of a free-trade agreement between Australia and New Zealand which came into force on 1 January 1983. This agreement required the elimination of all quantitative and tariff restrictions on physical trade between the two countries. Rather than retain high trade barriers against third countries however New Zealand began a gradual process of removing import licence protection across the board. In the first instance remaining licences were allocated by auction in six monthly tender rounds. From 1985 import licence controls were gradually removed until the present time where the entire import licensing system has been dropped and textiles, clothing and footwear are the only industries still protected by tariffs. Even these tariffs are scheduled to disappear in 2010 (as part of New Zealand's commitment to APEC).

48. So far as the internal economy is concerned the high watermark of reform was achieved in 1987 with the repeal of the Economic Stabilisation Act, the post-war measure under which many of the previous regulations had been promulgated. Over succeeding years the role of a number of key government departments changed. Previously the Departments of Trade and Industry and of Customs had been supporters of protection and/or administrators of specific industry plans. These plans had largely been devices for tailoring tariff and licence protection to the requirements of particular domestic producers. Such instruments have now disappeared.

49. In turn the government was no longer seen as a dispenser of aid. Industry was encouraged to look to its own devices in terms of creating wealth. The government's responsibilities were seen as focusing on the broad goals of macro-economic stability and micro-economic efficiency. The latter was to be advanced not by sector-specific controls but by a combination of generic competition legislation and a minimum of discrete, sector-specific regulation. This combination has come to be known in New Zealand as "light-handed" regulation.

50. In turn this approach allowed the removal of sector specific regulation in fields as diverse as the dairy industry, broadcasting, land transport, flour milling, egg production and land ownership.

CONCLUSION

51. New Zealand's programme was a product of New Zealand requirements, of the mistakes we had previously made and of our previous institutional history. Until 1996 New Zealand had no written constitution, a single chamber Parliament, and a first-past-the-post electoral system. That is, there were few constraints on government. But it was also easy for governments to lose office: a relatively small swing in public opinion could produce a marked shift in Parliamentary representation. Three yearly elections also meant a short electoral cycle. The tendency was therefore for governments to act with vigour, especially early in their term of office.

52. Readers might wish to note that New Zealand has since moved to a form of proportional representation known as the Mixed Member Proportional System. This is modelled on that used in Germany. There are now seven parties in Parliament, the current government is a minority coalition. Arguably current governments have less room to move without public approval.

53. I have also said little about the social consequences of the reforms I have described. The most obvious of these was rising unemployment. It is certainly not the case that the government was unconcerned about such consequences of its programme. It helped that New Zealand started with a very low level of unemployment. In 1974 for example the unemployment rate was merely a fraction of 1%. It is also the case that for an initial period, from 1984 to around 1988, the social costs seemed relatively low. Until the share market crash in October 1987, the economy remained buoyant. Unemployment rose by 1988 to around 4% of the labour force, a figure which was both internationally unexceptionable and modest compared to what followed. The most significant point however is simply that the government believed it had little choice in the programme it pursued. Moving more slowly or partially would not in its view have ameliorated the impact of change, but merely postponed the benefits.

54. Until 1991 most social assistance programmes in New Zealand were little altered. In that year however significant reductions were made in income support levels and in the basis of retirement income entitlement. These changes were part of a significant further round of fiscal policy changes at that time. That government too would have said it believed "there was no alternative".

55. The current government (essentially the third since the period of reform began in 1984) is now devoting more of its attention to social assistance programmes. But this is at a time when relative economic performance has improved and macro-economic stability has been restored.

Accordingly, it might be thought that the original aim of the reformers: to lift economic performance in order to achieve social advancement, has, thus far at least, been realised.

David Caygill

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