

**New Zealand's Experience with Economic Restructuring:
Lessons for Canada's Reform Process**

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Chapter I - Introduction

Since the start of the 1980s Canada has accumulated a proportion of debt to gross domestic product (GDP) that is one of the highest among industrialized countries. The fact that much of the debt was accumulated during a period of strong economic growth from 1983 to 1989 is cause for concern. The response to Canada's persistent deficits has been a shift in economic policy which has gained momentum over the last decade. Although employment and economic growth remain important goals, the immediate focus is on reducing fiscal deficits with a view to reducing the level of debt. The challenge facing policy makers is to restructure government programs and balance total expenditures with revenues over the long term without creating economic stagnation and severe social disruption.

The current period of adjustment has all government institutions and policies under review. Unlike previous *ad hoc* attempts to deal with structural problems, the initiatives taken since the 1993 federal election of the Liberal Party are more comprehensive, involving a review and restructuring of trade, fiscal, monetary and social policies. This is not the first time, however, the Canadian government has stated its intention to reduce its fiscal imbalance. Unlike previous attempts, this is perhaps the best opportunity for policies designed to restore a sustainable fiscal balance to succeed.

Canada is not the first developed country to address its fiscal imbalance. New Zealand has fundamentally restructured its economy since the election of the Labour party in July 1984. Canada and New Zealand have some common features that may provide some insight into how Canada might proceed with its own adjustments. There are also significant differences that provide Canada with some advantages unavailable to New Zealand, such as Canada's proximity to the largest economy in the world and Canada's large endowment of natural resources. However, Canada has to deal with certain regional concerns which are not a significant factor in New Zealand.

Traditionally, both countries placed considerable emphasis on the redistribution of income among its citizens, with Canada having the added concern of the regional distribution of economic activity. The experience of the 1930s depression was the impetus behind the creation of comprehensive social welfare systems in most of today's developed countries, where a minimal level of income was a primary objective of government policy. Throughout the 1970s both New Zealand and Canada broadened their social security systems and New Zealand, along with most other developed countries, began to significantly increase agricultural subsidies. Canada also subsidizes its agricultural sector with the largest increases occurring during the mid-1980s. It is significant that both

economies earn a substantial portion of their export revenues from agriculture. Canada is, however, less dependent on agriculture than New Zealand, although other primary commodities, such as fisheries and minerals, make Canada susceptible to many of the same forces, like global price volatility that affect agricultural products.

Canada and New Zealand also share some common historical features. Both are former British colonies in which the indigenous people were, by and large, displaced by immigrants of European origin. The economic foundations of both countries are anchored in their high proportion of natural endowments relative to population, essentially exploiting these resources to drive economic growth. In the post World War II era both countries experienced significant economic growth with a high proportion fueled by the primary sectors such as agriculture (including livestock), forestry, and mineral and metal products.

The economic performance of Canada and New Zealand began to diverge with New Zealand losing ground in the 1960s. Throughout the 1970s and early 1980s, economic conditions in New Zealand continued to deteriorate. Figure 1.1 shows an index of GDP per person relative to the OECD level which is set at a value of 100. From 1970 to 1985 the relative level of GDP per person in New Zealand increased slightly to 1975 and then declined to a level close to 80 per cent of the OECD level by 1980. There was a slight increase to 1985, however, by 1988 the level declined to near 75 per cent of the OECD level. Canada's performance was much stronger up to 1980 when the GDP per person value was about 30 per cent more than the average for the OECD. By 1988 it had decreased to just 25 per cent more than the OECD average.

Canada was subject to many of the same external forces affecting New Zealand, however, there were important differences which provided Canada with options and opportunities which did not exist for New Zealand. For instance, Canada's natural endowments in hydro-electric and fossil fuels may have dampened the effects of the energy shocks in the 1970s. Another advantage was the greater proportion of trade in manufactured goods. Canadian producers are located beside the world's largest single economy. The need to maintain access to U.S. markets instilled a more outward oriented trade policy and provided opportunities to diversify exports.

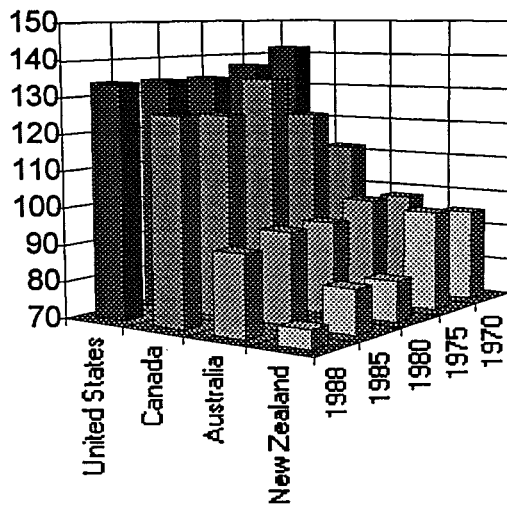
Figure 1.2 shows that in 1990 at least 59 per cent of New Zealand's exports were composed of primary commodities and that 30 per cent of exports were pastoral in origin. By contrast, Figure 1.3 shows that Canada's 1990 export mix was quite different from New Zealand's in that manufactures accounted for 58.8 per cent of exports with automotive products valued at 21.6 per cent of the total. In terms of Canada's primary sectors, agriculture accounted for 17.7 per cent of total exports while mining products

reached 18.6 per cent. Although Canada's exports were comprised of over 40 per cent primary products, the mix of these products was more diversified than in New Zealand.

Canada and New Zealand also share certain economic realities that relate directly to the high proportion of primary products in their export mix. Both countries have acknowledged the need to diversify their economies, however, the approach and outcomes have been different. Various monetary and fiscal policies have been employed over different periods in the two countries with mixed success. Canada is currently in the process of restructuring its economy in a way not seen in previous economic reforms. It was not until 1984, however, that New Zealand embarked on a comprehensive economic and social restructuring program.

This paper identifies what precipitated the rapid reforms in New Zealand, examines how successful these reforms have been, and examines what insights the New Zealand experience provides for Canada's current economic restructuring. Chapter II presents the events leading up to New Zealand's economic restructuring. Chapter III analyzes New Zealand's reforms which began in 1984. Chapter IV examines Canada's past economic performance and its economic reforms over the past few years. Chapter V relates the successes and failures of New Zealand's reforms to Canada's current economic restructuring.

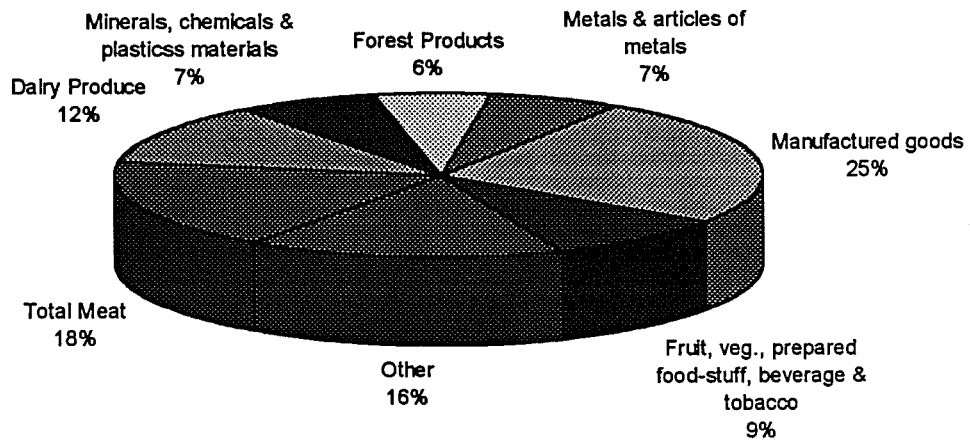
Figure 1.1 - GDP per head*



* current PPP's OECD = 100

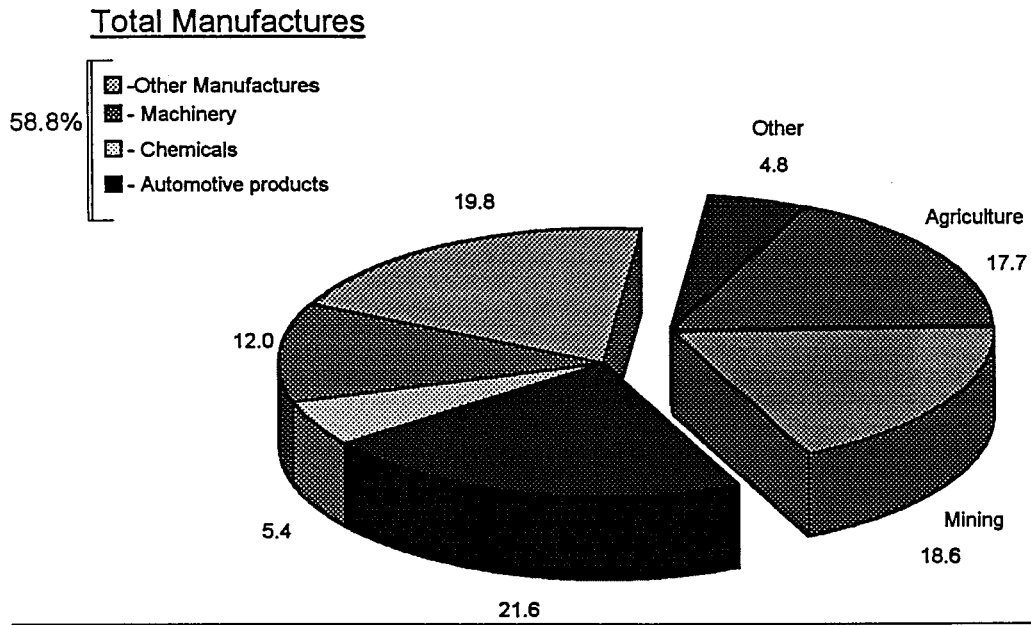
Source: OECD; OECD Economic Survey New Zealand 1990/91; OECD 1991, p. 11

Figure 1.2 - New Zealand Export Composition - 1990



Source: OECD; OECD Economic Surveys, 1995-96, New Zealand; OECD 1996, p. 188

Figure 1.3 - Canada-Merchandise Exports by Broad Product Group-1990
(% share of total)



Source: GATT; Trade Policy Review - Canada - 1995, vol. 1, GATT 1995, p.29

Chapter II- New Zealand to 1984

Low unemployment, a strong rate of economic growth, price stability, a solid balance of payments record, and an equitable income distribution are the goals behind many economic policies. Unfortunately, these objectives are often in conflict. For instance, the objective of price stability may be partly accomplished by controlling domestic demand through instruments such as interest rates or the money supply, yet these policies may negatively affect employment and economic growth. These types of choices, where policy makers must prioritize their objectives, can have significant long-run implications.

Prior to 1984, New Zealand focused more on maintaining low levels of unemployment and tried to foster economic diversity and growth by heavily insulating various sectors of its economy from external competition. In the 1950s, New Zealand enjoyed the third highest standard of living in the world, yet by the early 1980s New Zealand's ranking among OECD members in per capita income had fallen to 18th place (Caygill 1989). There are several contributing factors for the decline of New Zealand's economic performance. Its economy possesses certain characteristics not found in many developed economies. For example, the primary commodities sector employs a high portion of the workforce compared to other industrialized countries and dominates exports. Its small population (just over 3.4 million in 1991) also does not provide adequate domestic demand for many industries to attain economies of scale. New Zealand up until the 1980s relied also on import substitution, financial sector regulation, exchange rate control and, especially in the 1970s, agricultural subsidies to achieve its primary economic objectives of high employment, a diverse manufacturing sector, and economic growth (Kelsey 1995:2, 3).

Trade Policy

Until the 1980s, trade policy in New Zealand was highly interventionist. Import substitution policies such as high tariffs and quantitative controls were widely used. Like most countries of the period, New Zealand's protectionist trade policies originated during the great depression in the 1930s and, except for a brief relaxation of regulations in the mid-1950s, were maintained until the mid 1980s. The long term viability of New Zealand's trade policies was called into question as the 1960s progressed and a different pattern of trade began to emerge among developed countries. The trend was toward freer global trade in manufactures and increased protectionism for the agricultural sectors. New

Zealand's attempt to maintain the status quo in the face of changing global economic forces led to distortions in the exchange rate, and a deteriorating fiscal and balance of payments performance. From 1950 to 1970 the proportion of exports of agricultural origin remained greater than 80 per cent. Although this figure declined to 53.5 per cent by 1991, agricultural products still account for about half the value of New Zealand's exports (OECD 1994c:135).

Figure 2.1 shows that in 1980/81 the proportion of the total production of major agricultural products that were exported ranged from near 74 per cent for all meat, 72 per cent for dairy products, and 76 per cent for wool. Table 2.1 provides a more detailed breakout of the proportion of certain agricultural products destined for export from 1965 to 1970. The heavy dependence on agricultural based products to earn foreign exchange is the basis behind understanding New Zealand's economic policy. New Zealand's comparative advantage in these sectors was exploited beyond the simple production of agricultural products. Import substitution policies were essentially funded by transfers, largely through an over valued exchange rate, from the exporting sectors. Import substitution was intended to diversify the economy, provide employment opportunities requiring manufacturing skills, and to improve the external balance through increasing exports and controlling imports.

By the mid-1970s declines in export performance were having a negative affect on foreign currency earnings which were required to purchase imports. This led to the use of direct export assistance to promote export growth and foreign exchange earnings. The oil shocks of 1973 and 1979, increasing protectionist tendencies in traditional export markets, and a downward trend in prices for agricultural products deteriorated New Zealand's competitive position as its terms of trade worsened. In the period 1974/75 to 1981/82 the current account averaged a deficit of 6.5 per cent of GDP compared with an average of 1 per cent in the preceding eight years. The lagging growth in foreign receipts can be seen in Tables 2.2 and 2.3. It is interesting to note that the net invisibles, which include external debt servicing charges, began to contribute more to the imbalance in payments from 1974/75 onwards. The poor performance of the external account was primarily caused by unfavourable changes in terms of trade, a loss of competitiveness after 1975, and the lack of adjustment in resource allocation as growth in the exporting sector was suppressed by an over-valued exchange rate and import substituting trade policies (OECD 1987:12).

The global trend of reducing barriers to trade did not include most agricultural products. Thus, New Zealand was in the position of being heavily dependent on trade in agricultural products for export earnings while market access became more difficult

and unpredictable. Another characteristic of agricultural products, and many primary commodities in general, is that they have a low income elasticity of demand (OECD 1983) compared to other exportables such as high value added manufactured goods. Simply stated, as a country's real income level increases the proportion of the increased income spent on additional agricultural imports will be less than the proportion spent on high value added imports. Thus, New Zealand recognized the need for export growth if it were to sustain its social and economic policies. However, starting in the mid-1970s, the emerging global economic structure of expanding and more sophisticated international financial markets, higher interest rates, and increased protectionism, combined with declining terms of trade for primary products, limited New Zealand's success and ultimately imposed an even greater strain on its fiscal resources.

Imports

There were essentially two major policy areas employed in New Zealand to support the import competing sectors. First was the use of tariffs which have a direct impact on the price of imports. The second involved various methods of quantitative controls through regulations such as import licensing or foreign exchange controls (Rayner et al 1991:76-7).

High effective protection rates witnessed in the 1970s originated in 1935 when authorities decided to insulate the New Zealand economy from external fluctuations in the export markets. During this period the goals of domestic price stability, income redistribution, and national development were primary. New Zealand was not alone in its isolationist approach as many countries instituted high tariff rates and various other controls on trade and financial movements in an effort to protect their own economic well-being.

Through to the mid-1950s, imports predominating from Britain gave New Zealand a relatively low effective protection rate due to special British Preferential Tariffs established in the Ottawa Agreement of 1934. This agreement set rates between Commonwealth members at around 5 per cent while the Most Favoured Nation (MFN) rates were near 20 per cent (Lattimore 1987:43). The United Kingdom (UK) was also the major market for New Zealand's exports. A significant development of the late 1930s was the implementation of quantitative restrictions on imports and foreign exchange controls. However, during this period and even with the use of quantitative controls, the effective protection rate for New Zealand was comparable to that of other developed countries.

From 1950 to 1955 New Zealand underwent a liberalization of trade policy where many of the quantitative restrictions and foreign exchange controls were reduced or removed. However this trend was reversed in 1957 in response to declining terms of trade and significant balance of payments deficits. Fluctuations in New Zealand's terms of trade continued to factor in policy decisions since volatility in terms of trade made export earnings unreliable. Fiscal uncertainty was also a factor since a decline in terms of trade in agricultural products required greater financial support for producers through, for example, income stabilization policies (Rayner et al 1991:44-8). New Zealand's *ad hoc*, and often reactionary, approach to economic policy was a characteristic which persisted into the 1980s, and proved ineffective in reversing a decline in economic performance starting in the 1960s.

Import substitution was firmly entrenched by 1960 and would remain a cornerstone of economic policy for the next two decades. In the 1960s the volume of global trade in manufactures began to accelerate and New Zealand's sources for imports become more diversified. The implications were that the effective tariff rates on imports rose dramatically in correlation to the rising proportion of imports originating from non-Commonwealth countries which carried the higher MFN rates of duty. By the mid-1960s the combination of tariffs, quantitative restrictions, and foreign exchange controls provided a nominal import protection rate estimated at 54 percent (Lattimore 1987:44). Although tariffs were originally used primarily to generate revenue, the secondary characteristic as a barrier to imports increased as the 1970s approached.

The effective rate of protection was also largely influenced by the import licensing system which was first established in 1938, primarily as a vehicle for conserving foreign exchange and fostering domestic industry. Although it continued to serve this purpose, its role as a method of protecting established import substituting industries grew, and by the 1970s it was clear that this was its primary purpose. Along with the balance of payments concerns, other rationale used to justify this policy ranged from the infant industry argument to the government's view that it was directly responsible for ensuring the availability of employment opportunities requiring a wide variety of skills (Rayner 1991:55).

The industrial sector was comprised of many small and medium sized firms. The very high proportion of exports comprised of agricultural and pastoral products shows that most non-agricultural manufactured products could not compete beyond their protected domestic market. By the 1960s import licensing and tariffs controlled imports of finished goods while those imports deemed necessary as industrial inputs were allowed tariff concessions.

Apart from the advantages of fostering domestic manufacturing and job creation, there are a number of dangers in relying on import substitution policies to create import competing industries. First, domestic demand can only be satiated by domestic production which may lead to domestically generated price inflation. Second, a lack of competition for domestically produced goods could raise prices above world prices as domestic producers may be more willing to pass on any input price increases with little fear of losing market share. Third, there may be less incentive to develop or utilize efficient production techniques in response to higher input prices.

Related to this is the wage inflation effect. Producers may be willing to pay higher prices for scarce labour because, with limited competitive pressure, higher labour costs can be better passed on to the consumer. Figure 2.3 shows that from 1979 to 1981 nominal compensation per employee in the business sector increased annually at a rate much greater than the OECD average and in Canada. In 1982 the nominal wage increases were much closer, and by 1983 and 1984 the increases for New Zealand were the lowest, during the imposition of wage and price freezes. The change in real wages over this period were, however, minimal due to high inflation.

Another undesirable consequence of import substitution, to which New Zealand is particularly vulnerable due to its small manufacturing base, is that over the longer run import substituting industries require inputs of raw materials, parts, or machinery that must be imported. The value of these inputs can be large enough to eliminate any reduction in imports obtained through import substitution. Thus, it may be cheaper to import finished goods than to import components for domestic assembly.

One perceived cause of the persistent trade imbalance toward the end of the 1970s was the dependence on imports in the energy sector. The government started a programme of several "Think Big" projects which were designed to reduce New Zealand's reliance on imports and to increase exports in the energy and steel sectors. The resources required to construct these projects were substantial in terms of financing and labour. The timing of these projects worsened the trade balance as considerable inputs were imported for the construction of the facilities. The viability of the projects relied on the price of oil remaining high into the 1980s, which it did not.

New Zealand's trade policy prior to 1984 was geared to the goal of full employment within the economy. The protection afforded to the manufacturing sectors provided employment opportunities to the extent that New Zealand had one of the lowest levels of unemployment among industrialized nations. Lastly, the export sector was negatively affected by higher input prices as a result of high effective protection rates for imports or from higher costs of domestically produced inputs. Unlike goods

that are sold domestically, the higher input prices must be absorbed by exporting sectors since their products must compete internationally.

Exports

The objective of diversifying New Zealand's export mix had limited success. Figure 2.2 shows that in 1980 over 70 per cent of exports were primary resource based while pastoral products accounted for near 61 per cent of all exports. Since 1950, the agricultural component of exports had decreased only a little more than 20 per cent in terms of total exports. Imports identified as inputs for domestic manufacturers normally received tariff concessions to lower manufacturing costs, however, inputs to the agricultural sector were often excluded from concessionary rates. Also, domestically available agricultural inputs may have been import substitutes and therefore cost more than exporting competitors. Consequently, input costs to the agricultural sector were higher than would have existed without import protection. Table 2.3 shows that the terms of exchange for agriculture (the ratio of output prices to input prices) has declined since the 1950s. These higher costs, however, could not be passed on since most agricultural products were destined for the export market. This effectively forced producers to reduce their profit margins in order to remain internationally competitive.

In the late 1960s a more liberal trade policy was considered as was the removal of import licences because of concern over the high level of import protection. However, a consensus could not be reached on trade liberalization so the high rates of protection were maintained. Nevertheless, New Zealand began to take a more outward approach to trade policy. Without a decrease in protection rates the new emphasis on trade meant that agricultural producers needed some compensation to counter the effects of policies that supported domestic manufacturing. The hope was to make agricultural products more competitive and increase earnings in the sector. The early 1970s saw the broadening and deepening of export support and promotion policies. Supports, however, proved to be inadequate to fully compensate the export sector. Also, due to the volatility of primary commodity prices and worsening terms of trade for such products, they were very costly.

Support for the export sectors was directed toward agriculture, forestry, tourism and international transport industries. The strategies used were a combination of direct tax expenditures, and direct production and export subsidies. The degree of support varied substantially depending on the commodities. Table 2.4 provides a broad

overview of the levels of assistance to pastoral agriculture, and Figure 2.4 shows the relative magnitude of pastoral assistance compared to the total value of output from pastoral agriculture. The increase in assistance from 1970 to 1980 indicates the general decline in terms of trade experienced since 1973. Global prices for New Zealand's exports were more favourable at the end of the 1970s and in 1980, but deteriorated from 1982. This is reflected in the Producer Subsidy Equivalence (PSE) increasing from 12 per cent in 1981 to 34 per cent in 1983 (Table 2.4).

Until 1963, the limited assistance to agriculture took the form of preferred credit rates, and marketing boards designed to stabilize incomes from the export of primary commodities. The initial steps to increase assistance to agriculture occurred in 1963 with the establishment of:

- the State Advances Corporation to implement a specific development loan programme for the pastoral farmers
- subsidies on the transport and price of fertilizer
- the allowance for farmers of a 100 per cent taxation write-off of certain capital expenditure for the development of their farms (Sandrey 1990:65).

Later policies allowing tax deferral provided farmers with an incentive to increase herd sizes. This resulted in increased production, and favourable world prices for primary commodities into the early 1970s increased export earnings. In 1971/72 declining global prices for wool and lamb led to the implementation of stock retention schemes designed to facilitate income stabilization. Stabilization schemes expanded into the 1970s and included meat, wool and dairy products. The State Advances Corporation was replaced by the Rural Banking and Finance Corporation which assumed the rural lending functions. This included providing low interest rates, the possible reduction of loan principles, and tax rebates tied to meeting certain livestock expansion targets. In 1978, a further scheme designed to encourage land development (Land Development Encouragement Loans) provided interest free loans and principal reductions tied to meeting certain land development targets (Sandrey 1991:64-6).

In 1978, the Supplementary Minimum Prices program was introduced to guarantee minimal prices for most pastoral products, although it operated differently depending on the product. Depressed prices for wool and dairy products were counteracted by direct payments to make-up the deficiency. This approach had no impact on the domestic price and quantity of product. For beef and sheep meats, the assistance was through export subsidies which raised the domestic price to the global

level plus the added amount of the subsidy. In this manner, consumers directly paid for that proportion of the assistance program.

The substantial export promoting programs introduced during the 1970s depended on the continued buoyancy in global prices for primary commodities. A fall in prices for those products, on which New Zealand was heavily dependent for foreign exchange earnings, occurred in the 1980s. Figure 2.4 shows that the rate of growth in assistance was increasing faster than the rate of growth in the value of production from 1981 to 1983. New Zealand was faced with the dilemma of increasing costs to support the export sector while its balance of payments was deteriorating.

One aspect of New Zealand's response to changing global trade patterns was the Closer Economic Relations (CER) agreement with Australia. In part, the aim of the CER was to secure markets in an economy that was nearly five times its size. This coincided with diversification of New Zealand's export markets and an increase in the proportion of non-agricultural exports such as in metals, textiles, leather and rubber products sector.

Although by the early 1980s there was a gradual shift to liberalizing trade, the policies supporting import substitution combined with a significant increase in agricultural support had a serious and negative impact on New Zealand's fiscal performance beginning in the mid-1970s.

Exchange Rate Policy

Until floating its exchange rate in March, 1985, a variety of exchange rate regimes were used. The New Zealand dollar was pegged to the British Pound until the early 1970s, and then briefly to the U.S. dollar until July 1973. The pegging of the New Zealand dollar to the Pound Sterling did not present any difficulties since the UK was New Zealand's prime export market and main source of imports into the 1970s. In 1973, Britain joined the European Economic Community (EEC) which marked the end of New Zealand's preferential relationship with Britain. The New Zealand dollar's brief alignment to the U.S. dollar signalled the emerging changes in global trade and New Zealand's recognition that its future export markets would emerge elsewhere.

A fixed exchange rate based on a basket of currencies was maintained until July of 1979. During this period, which followed the end of the Bretton Woods system, many other major trading countries allowed their currencies to float. Over this period the first oil crisis, cost and price inflation at levels higher than the OECD average, and declining global prices for New Zealand's exports depressed its terms of trade. These

developments contributed to balance of payments problems and provided the impetus for adjustments to New Zealand's exchange rate. For the most part, devaluations were used to address trade imbalances, however, repeated devaluations during this period increased speculative behaviour in anticipation of further devaluations. Those able to move currency offshore for short terms reinforced the downward pressure on the dollar.

The volatility in trade patterns, exchange rates and declining terms of trade associated with the 1970s made defending a fixed exchange rate difficult. Devaluations were too frequent, making it difficult for business and industry to plan effectively. In an attempt to increase certainty, needed for long-run planning, and to discourage speculative behaviour the government adopted a crawling peg to a basket of currencies until June, 1982. This resulted in a gradual depreciation of the New Zealand dollar corresponding to costs rising more quickly in New Zealand relative to its trading partners.

This system was abandoned because of fears that economic developments were such that the currency could depreciate too rapidly. In 1982 inflation was 17 per cent with considerable indexation built into the economy. The government felt that a downward spiral in the exchange rate, associated with an upward spiral in wages and prices, may develop. Consequently, wage and price freezes were implemented and there was a return to fixing the exchange rate to a basket of currencies until March 1985, at which time the currency was allowed to float.¹

The pre-1980 era of a fixed exchange rate policy co-existed with both foreign exchange and import controls. These policies suggest that the New Zealand dollar was overvalued and that there was an import bias in New Zealand's foreign exchange policy. An overvalued exchange rate acts as an implicit tax on the export sector and lowers the protection for import substituting industries. This situation can lower the sustainable growth rate of an economy and this may provide some explanation for New Zealand's low real growth rate relative to other industrialized economies over the period from 1973 to 1984.

¹ This section draws primarily from Blundell-Wignall, Adrain and Gregory, Robert G.; OECD Department of Economics and Statistics, Working Papers, No. 83 Exchange Rate Policy in Advanced Commodity - Exporting Countries: The Case of Australia and New Zealand, OECD 1990

Price Level

Historically, New Zealand's monetary policy aimed to maintain full employment, ensure continued output growth, and provide an environment where business could flourish. Price stability was secondary to employment in the formulation of policy. Until the mid-1970s, New Zealand had one of the world's lowest official unemployment rates at less than 0.5 per cent. Inflation, however, proceeded to surpass the OECD average. Attempts to devise policies directed at price stability were varied and reactionary. The setting of higher wages by the Arbitration Court in the early 1970s contributed to the presence of high inflation. Gradually the government moved to an income policy culminating in 1982 with the imposition of controls on wages, prices, interest rates and nominal exchange rates (Sandrey 1990:48).

Lending was also controlled in an attempt to curb the credit growth. To compensate for missed wage increases, income tax cuts were introduced. The effects on inflation were significant while the controls remained in place. However, the period saw a rise in the government debt levels and increased government intervention in the economy. Global price increases were a major contributing factor to increases in New Zealand's price level over the period, with deviations above the levels of its major trading partners attributable to changes in net government indirect taxes and charges, the fiscal deficit, and the increase in wage rates in 1971 (Sandrey 1990:44).

New Zealand's approach to price stability was dictated by other policies concerning employment, foreign exchange controls, and financial regulation. A combination of debt monetization and the accommodation of the price and cost inflationary pressures built inflation into the economy. Institutionalized inflation led labour, the private and public sector, and the financial markets to behave in a manner that further entrenched inflationary expectations. Table 2.5 compares wage, price and unemployment between New Zealand and selected OECD countries. Wages and prices in New Zealand increased at a faster rate than the other countries in all years except 1988 when Australia had higher price increases. Clearly wage and prices were rising more quickly in New Zealand. The low unemployment in New Zealand is characteristic of its import substitution policies, however, it began to rise in 1980 and by 1988 it was more in line with the three other countries. This outcome was due to New Zealand's inability, and unwillingness, to subsidize the import substituting sectors at previous levels. The consequence of falling rates of protection was lower employment levels as firms reduced the number of employees in an effort to increase productivity--that is

reduce costs. Also, there were negative employment effects of an anti-inflationary monetary policy which was adopted beginning in the mid-1980s.

The labour force was also highly organized and wage setting very centralized. Government and union institutions set the trend for wage increases throughout the country. There were instances where wage and price controls were used, however, the underlying policies responsible for inflation persisted. Consequently, once price controls were lifted there was a tendency to make up for lost ground and further exacerbate price volatility.

Monetary Policy

Monetary policy is administered through the Reserve Bank of New Zealand which, until 1989, operated under the direction of the Minister of Finance. Unlike the largely autonomous role of the central Bank in Canada, New Zealand's central bank was directly controlled by elected officials and, consequently, monetary policy was heavily influenced by the political forces of the day. The government exercised its monetary policy by controlling monetary aggregates, such as the money supply, through strict regulation of the financial sector.

Control of the financial sector was a fundamental policy instrument used to accomplish economic objectives. In 1936 the Reserve Bank Amendment Act nationalized the Reserve Bank and brought it under control of the Minister of Finance. The Reserve Bank was the government's banker, controlled the note issue, had the power to regulate exchange transactions, and, through varying reserve requirements of the trading banks and its discount rate, controlled the domestic credit system. In 1939, the government passed an amending Act which provided it with the power to finance, through the Reserve Bank, virtually any operation or project it wished (Condliffe 1975:72).

Interest rates were kept low and banks were required to retain increasing amounts of government securities as the 1960s progressed. The tight controls on credit allocation and interest rates, coupled with a rising inflationary trend towards the end of the 1960s led to falling real interest rates. Ultimately, the real interest rate became negative in the early 1970s which depressed the savings rate although capital investment may have been stimulated.

The net effect of such a highly regulated financial sector, and the rising inflation rate, was the growth of non-bank financial institutions. These institutions were able to circumvent many of the regulations imposed on trading banks and thus offered better

terms to clients. This development made monetary policy less effective into the 1970s as the government was about to face unprecedented external shocks and the need to adjust to an increasingly more sophisticated international financial sector. Entry restrictions to the core financial sector and limited competition for the existing trading banks ensured their viability.

The Financial Sector

The trading banks, which were the government's main vehicle for directing monetary policy, focused credit allocation toward the export and import substitution sectors by providing preferential terms on loans. Government was directing the allocation of credit to maintain its overall economic strategy.

There were essentially four reasons for regulation within the financial sector. To provide control of monetary aggregates, as required to influence domestic aggregate demand for the purposes of short term stabilization. To ensure the availability of cheap credit, as required by the government to finance fiscal debt. To allow for the direction of credit to the import substitution and export sectors with the aim of easing any long-run balance of payment constraints and thereby promote growth in these sectors. To ensure the maintenance of a sound and stable financial system (Chapple 1991:3).

In the 1970s the financial sector experienced a proliferation of near banks and other lending institutions in response to the demand for credit and more favourable terms for savings for the non-targeted sectors of the economy. This reduced the market share and profitability of the trading banks and stimulated non-price competition and product tying. In 1976, many financial regulations and controls on interest rates were relaxed. In particular, interest rates on government debt were allowed to rise with the desire of the monetary authorities to use public debt policy as an instrument of monetary policy. Essentially, market level interest rates act as a constraint on government borrowing since, in New Zealand's case, the interest payments on debt would be considerably higher than under the controlled regime. The liberalization in the financial sector was reversed in 1982 as the combination of increasing interest rates and inflation, averaging near 15 per cent between 1975 and 1982, proved too much to bear for the government. At this time New Zealand's terms of trade were declining due to depressed commodity prices. Furthermore, international interest rates had climbed considerably at the end of the 1970s which deepened New Zealand's debt servicing requirements.

The controls imposed on the financial sector succeeded in directing credit to the targeted sectors of the economy and provided the government with a cheap source of deficit financing. However, one cost was poorer economic growth because of inefficient credit allocation, essentially credit rationing. Higher inflation also was likely caused by the government's use of cheap credit to finance deficits. This also had a crowding out effect as the government's need for credit increased. Furthermore, the stability of the financial system was undermined, as was the effectiveness of monetary policy, due to the emergence of firms on the fringes of regulatory control.

Fiscal Policy

A country can choose any trade, monetary, and social policies it wants to obtain its economic and social goals provided it can finance the costs. From 1975 until the Labour election victory in 1984, the government attempted to maintain the traditional policies of direct involvement in virtually every aspect of economic activity.

The performance of New Zealand's economy after 1970 marks the beginning of a period when it experienced unprecedented external pressures while the government continued to expand social programs and pursue interventionist economic policies. Eventually, it was apparent that New Zealand was not adapting to the changing global economy fast enough and that it could no longer shelter itself from severe external shocks. Its core and fundamental sources of economic growth were no longer able to perform as strongly as in the past. Terms of trade for the exportable primary commodities were declining and the manufacturing sector proved too inefficient to compete globally. Furthermore, as international interest rates began to rise and the financing of the accumulating debt required larger proportions of expenditures, it became more difficult to finance deficits through international borrowing and the financial sector and maintain a constant level of expenditures on domestic programs. Table 2.6 shows the growth in external debt (\$NZ) and the servicing requirements. Figure 2.5 represents the proportion of total debt and of external debt to exports and GDP. Starting in 1973, the level of debt, and the proportion held externally, began to climb. By 1982/3 the ratio of total official external debt to exports was near 95 per cent and relative to GDP the external debt was just under 30 per cent.

A growing factor in the fiscal difficulties was the inability to hold unemployment at its historically low levels. From 1970 to 1974 the average rate of unemployment was near 0.25 per cent yet by 1979 the rate had risen to 3.8 per cent. Social support programs established under low unemployment levels provided generous benefits,

however, the fiscal pressures that emerged in the late 1970s constrained spending on employment generating programs. This resulted in a rise in unemployment and an associated increase in expenditures on social assistance programs.

Over the period, government revenues became more dependent on direct corporate and personal income taxes rather than indirect taxation, in direct contrast to many OECD countries. Figure 2.6 shows that in 1975 the proportion of tax revenue derived from personal income tax in New Zealand was close to 55 per cent while the Canadian figure was near 33 per cent and the OECD average was just over 30 per cent. Furthermore, there was a high degree of progressivity in New Zealand's personal tax structure, meaning that those at higher levels of income were taxed at considerably higher rates. When there is high progressivity in a country's personal tax structure, tax avoidance and tax evasion tends to be more prevalent than for less distorted personal tax structures. Also, work effort and initiative may be depressed. The degree of progressivity was recognized and resulted in a reduction of the maximum personal rate in 1970 to 50 per cent from 65 per cent (Rowe 1973). The onset of increasing inflation and wages resulted in the real level of direct personal taxation growing faster than real incomes as more workers' nominal incomes reached the higher tax levels as their nominal wages moved with inflation. The effective rise in personal income taxes left the real disposable income for New Zealanders virtually unchanged in 1979 from what it had been in 1972 (Pope 1984:39).

Summary

In the 1970s, New Zealand began to rapidly accumulate internal and external debt. To continue financing programs in an environment of increasing world interest rates, the government used compulsory financing through the regulated financial sector and monetization of deficits. Contributing to inflation and external balance problems was a strong nominal demand due to a loose monetary policy. Fiscal and monetary policies were often reactionary and short-sighted which created a credibility problem for policy making authorities.

Economic performance in the early 1980s had declined in virtually all areas such as growth, unemployment, inflation, balance of payments, fiscal balance, and debt. Wage and price controls, an overvalued exchange rate, and positive external conditions succeeded in temporarily lowering inflation and improving GDP growth. However, the fundamental structural problems remained. The exporting sector required more support due to the over valued exchange rate, and revenues were depressed due to a

tax cut to counter wage freezes. The short term objective of lowering inflation within the existing structure of the economy served to further entrench government intervention in the labour, product and financial sectors.

It was during the period immediately before the July 1984 elections that the magnitude of New Zealand's debt and the proportion held externally grew substantially. Debt servicing costs as a percentage of net government expenditure increased from 10.8 per cent in 1981/2 to 14.3 per cent in 1983/4, and total outstanding public debt rose from 49 per cent to 63.5 per cent of GDP over the period of March 1982 to March 1984 (OECD 1985:9).

Conditions were such that the election in July of 1984 brought a change in government. Although the campaign referred to the need for reforms, no explicit policies on how to rectify New Zealand's economic problems were announced. However, as Chapter III shows, economic reforms were rapidly introduced. The third chapter will examine and assess the reforms that were implemented in New Zealand, starting in 1984.

Table 2.1 - Exports as a percentage of production for the main farm products^a 1965-70

	1966	1967	1968	1969	1970
Processed milk	75.6	75.4	73.0	87.1	106.7
Cheese	93.6	98.1	83.9	94.3	88.1
Butter	73.2	82.4	80.1	78.5	80.8
Beef	53.3	55.1	60.5	61.7	66.5
Mutton	49.3	57.0	60.9	73.4	56.6
Lamb	92.9	91.7	92.3	91.6	92.6
Apples-Fresh	48.2	40.4	40.7	44.2	44.5
Pears-Fresh	21.5	15.5	17.3	14.1	16.3
Onions	17.0	22.7	34.5	14.0	32.0
Canned Vegetables	7.8	6.0	9.4	8.5	13.5
Quick-frozen vegetables	15.5	14.5	29.6	26.3	36.8
Pulses	67.0	62.8	54.9	48.9	54.5
Honey	5.9	5.8	3.5	5.3	10.2

^a In some cases exports may exceed production for the period, the balance being drawn from stocks in store.
 Source: OECD, Agricultural Policy Reports - Agricultural Policy in New Zealand; OECD 1974, Table 7.

Table 2.2 - Balance of Payments, 1971/72 - 1981/82 (NZ\$ million)

year ending March	1971/2	1972/3	1973/4	1974/5	1975/6	1976/7	1977/8	1978/9	1979/80	1980/1	1981/2
Current Account											
Exports fob	1556	1940	2254	2142	2692	3824	4197	4788	6051	7001	8276
Imports c.i.f.	1512	1720	2260	3403	3486	4248	4467	4644	6409	7283	9195
Balance	44	220	-6	-1261	-794	-424	-207	144	-358	-282	-919
Invisibles receipts	116	160	209	196	215	212	249	246	309	395	518
Invisibles transfers	144	183	202	276	379	490	593	708	747	861	1115
Net Invisibles	-28	-23	7	-80	-164	-278	-344	-462	-438	-466	-597
Current Balance	16	198	2	-1340	-957	-702	-615	-318	-796	-748	-1516

Sources: OECD; National policies and agricultural trade, Country Study New Zealand: OECD 1987

Table 2.3 - Terms of exchange for agriculture at the farm gate

Year ended June	Price indexation of farm outputs	Price indexation of farm inputs	Terms of exchange	
1949/50	100.0	100.0	1000	
1950/1	155.4	108.4	1434	
1951/2	116.4	127.0	916	
1952/3	133.0	132.4	1005	
1953/4	138.7	133.9	1036	
Average 1949/50 - 1953/54				1078
1954/5	140.0	140.2	999	
1955/6	135.5	143.7	943	
1956/7	146.0	145.1	1006	
1957/8	119.3	152.0	785	
1958/9	120.4	152.9	787	
Average 1954/5 - 1958/9				904
1959/60	130.0	154.8	840	
1960/1	123.3	159.0	775	
1961/2	117.5	161.4	728	
1962/3	121.8	163.5	745	
1963/4	139.0	163.8	849	
Average 1959/60 - 1963/4				780
1964/5	141.3	166.0	851	
1965/6	142.2	172.2	826	
1966/7	133.1	177.4	750	
1967/8	128.0	177.9	720	
1968/9	135.6	187.6	723	
Average 1964/5 - 1968/9				774
1969/70	139.5	194.8	716	
1970/1	143.2	204.8	690	
1971/2	158.8	217.5	730	
1972/3	223.9	233.5	959	
1973/4	241.8	265.2	912	
Average 1969/70 - 1973/4				801
1974/5	191.7	294.7	650	
1975/6	249.6	326.2	765	
1976/7	303.8	381.9	795	
1977/8	308.6	461.1	716	
1978/9	376.6	477.2	789	
Average 1974/5 - 1978/9				743
1979/80	444.6	584.1	761	

Source: OECD; National policies and agricultural trade, Country Study New Zealand: OECD 1987, p. 121

Table 2.4 - Assistance to Pastoral Agriculture

(NZ\$ millions)

Year ended March	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Tot. assist. on outputs	-13	141	136	53	457	863	694	630	323	84	42	35	35
Tot. assist. on inputs	9	33	79	72	74	71	73	57	23	19	14	14	18
Tot. assist. to VA ^a factors	27	59	189	216	245	258	326	348	517	416	487	235	153
Total Assistance	23	233	405	341	776	1192	1093	1035	863	519	543	284	206
Total Value Output	722	960	2621	2766	3165	3540	3631	4577	3831	3967	4575	5407	6148
PSE	3	24	16	12	25	34	30	23	23	13	12	5	3
ERA ^b	-8	38	12	3	49	123	98	40	34	19	15	-1	-6

^a Assistance in Value Adding Factors, e.g. advisory services, labour, interest and taxation concessions, climatic relief grants, etc.

^b The cost excess to pastoral agriculture is assumed to be 20% from 1969/70 to 1985/86 and 10% from 1986/7 to 1989/90. The lower rate is to reflect increasing liberalization of non-agricultural activities during this period. A negative ERA indicates the cost excess exceeds total assistance.

Source: Sandrey, Ron and Reynolds, Russell; Farming without Subsidies - New Zealand's Recent Experience, MAF 1990, p. 73

Table 2.5 - Wages, Prices and Unemployment

	Percent Change						Unemployment Rate		
	Wages ¹			Prices ²			Rate		
	1970	1980	1988	1970	1980	1988	1970	1980	1988
New Zealand	12.3	17.8	7.6	5.2	19.1	6.4	0.1	2.7	5.3
Australia	8.4	10.7	7.0	4.9	10.5	6.8	1.6	6.0	7.4
Canada	3.2	9.5	4.0	3.6	10.0	3.4	5.7	7.5	7.8
United States	5.2	9.6	6.0	4.5	10.8	4.2	5.0	7.2	5.5

¹ Total compensation per employee; ² Private consumption deflator

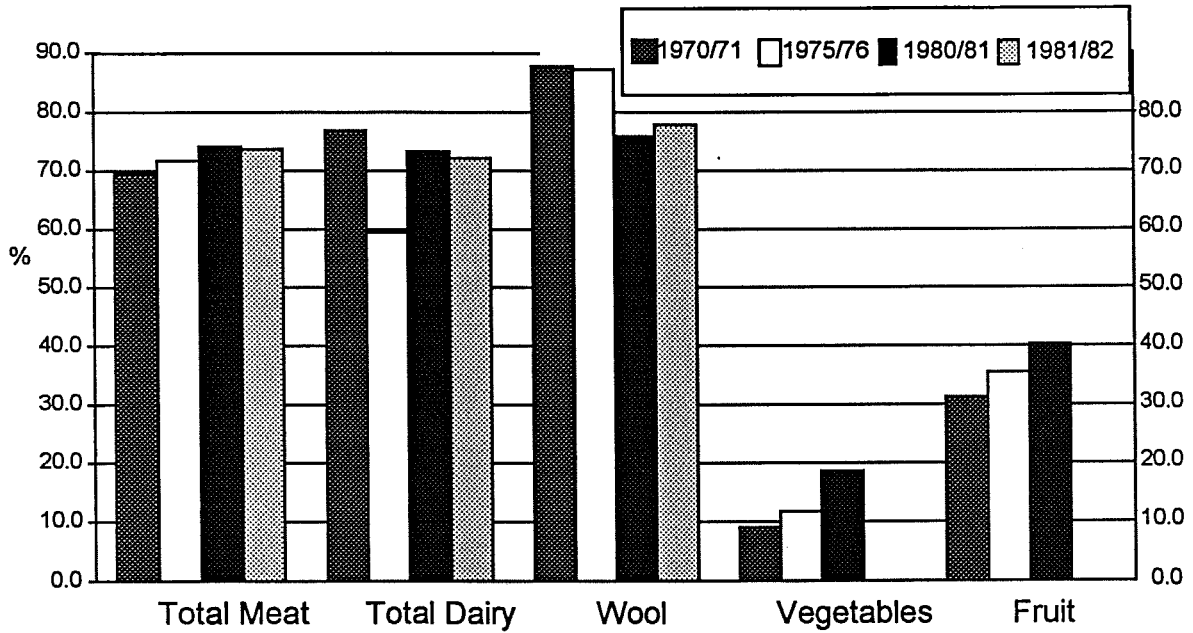
Source: OECD; Economies in Transition - Structural Adjustments in OECD Countries; OECD 1989, p. 30

Table 2.6 - Official Debt and Debt Servicing in New Zealand

	1971/2	1972/3	1973/4	1974/5	1975/6	1976/7	1977/8	1978/9	1979/80	1980/1	1981/2	1982/3
1. Total Official external debt	653.5	564.0	465.2	1018.2	1983.5	2563.3	3255.8	3676.4	4296.8	4809.0	6776.5	9251.6
2. Interest payments on 1.	36.3	38.3	34.1	54.5	103.6	159.0	194.6	243.6	303.7	313.4	449.7	614.9
3. Principle payments on 1.	54.1	51.2	112.7	40.2	281.1	474.5	431.0	419.6	549.0	1168.4	1541.3	1776.5
4. Debt Service 2.+3.	90.4	89.5	146.8	90.7	384.7	533.5	625.6	663.2	852.7	1481.8	1991.0	2391.4

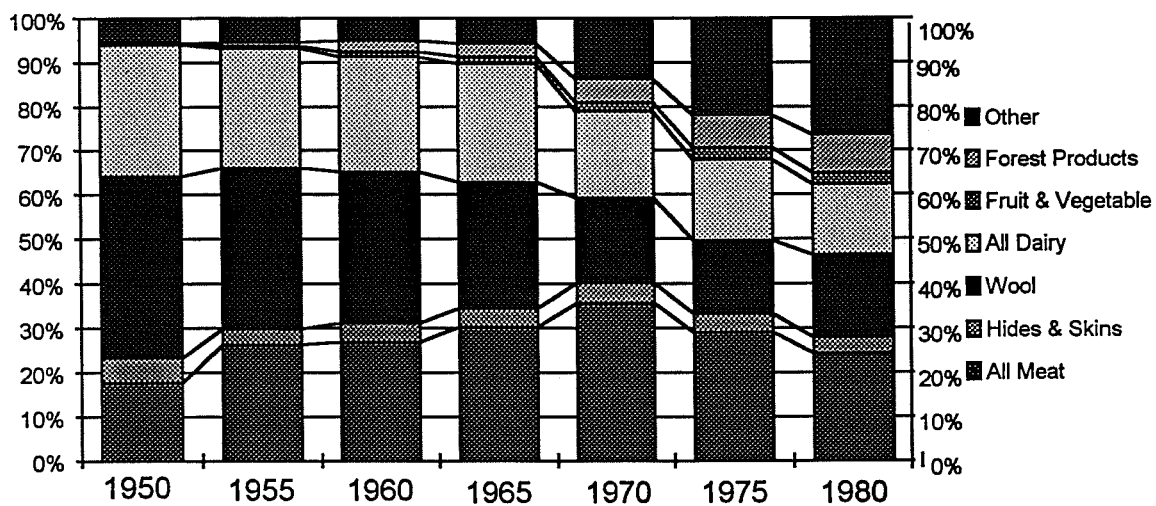
Source: Economic Monitoring Group, Report No. 1; Foreign Exchange Constraints, Export Growth and Overseas Debt; New Zealand Planning Council Monitoring Report, Dec. 1983, p. 34

Figure 2.1- Proportion of main farm products exported, selected years 1970-82,
(% of production)



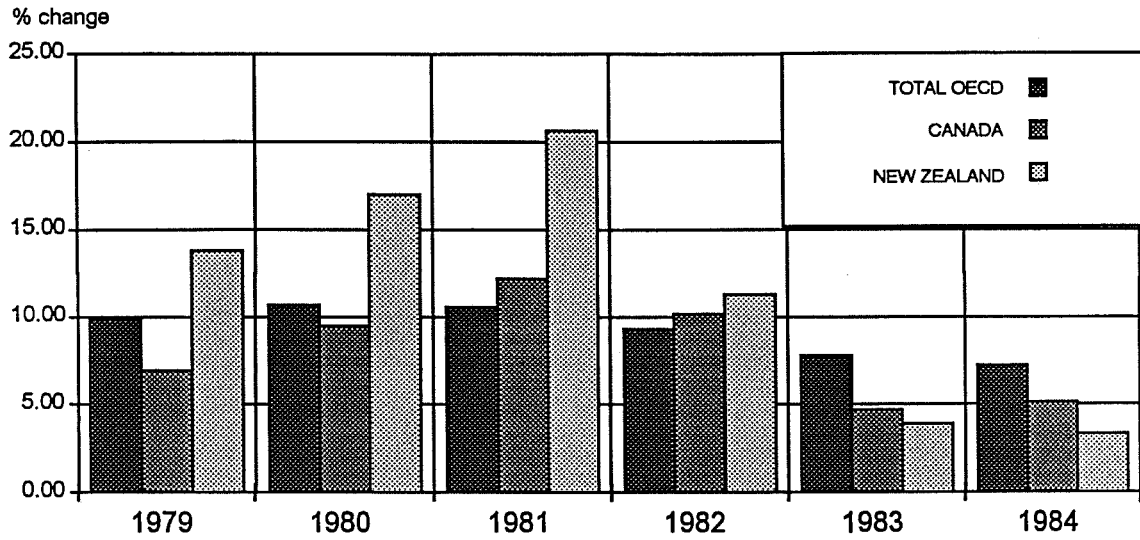
Source: OECD; National policies and agricultural trade - Country Study New Zealand;
OECD 1987, p. 124

Figure 2.2 - Commodity Composition of New Zealand Exports 1950 - 1980
 (% share of total)



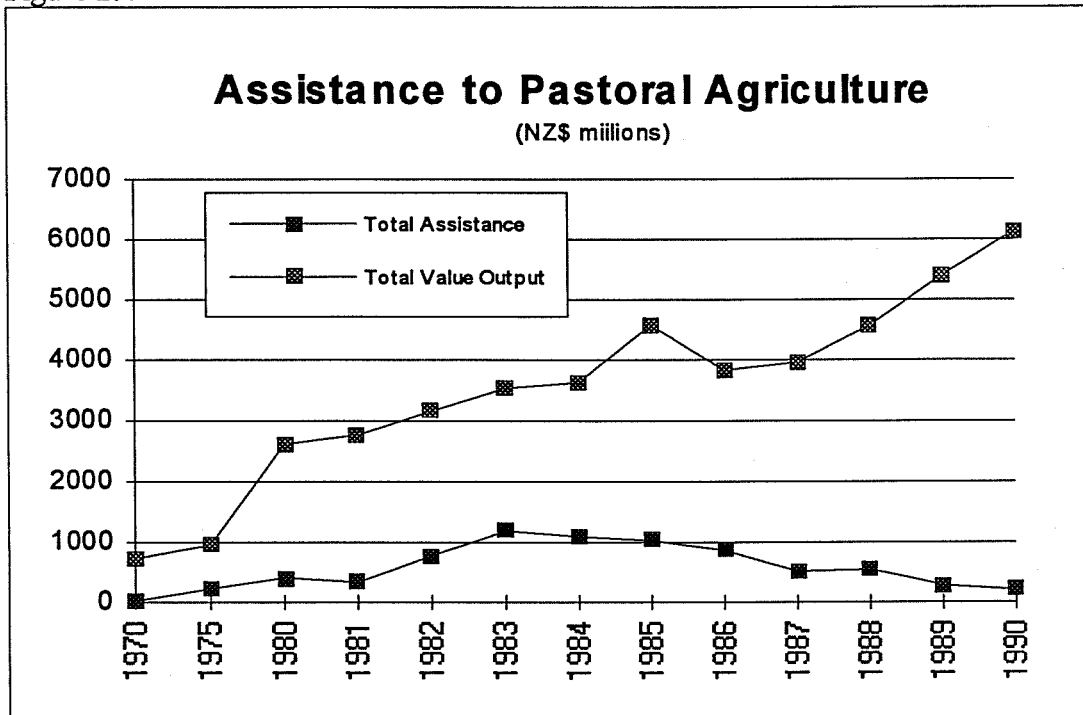
Source: Economic Monitoring Group, Report No. 1; Foreign Exchange Constraints, Export Growth and Overseas Debt; New Zealand Planning Council Monitoring Report, December 1983, p. 56

Figure 2.3 - Compensation per Employee in the Business Sector
(% change over previous period)



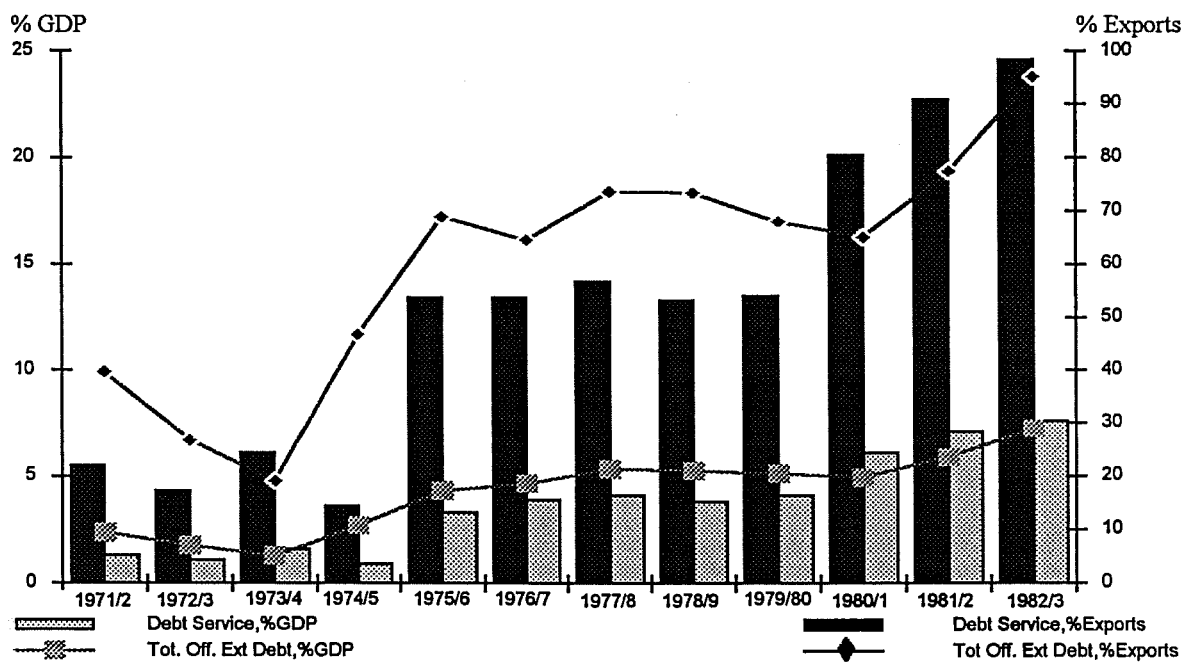
Source: OECD; *OECD Economic Outlook No. 58, December, 1995*; OECD 1995, p. A15-19

Figure 2.4



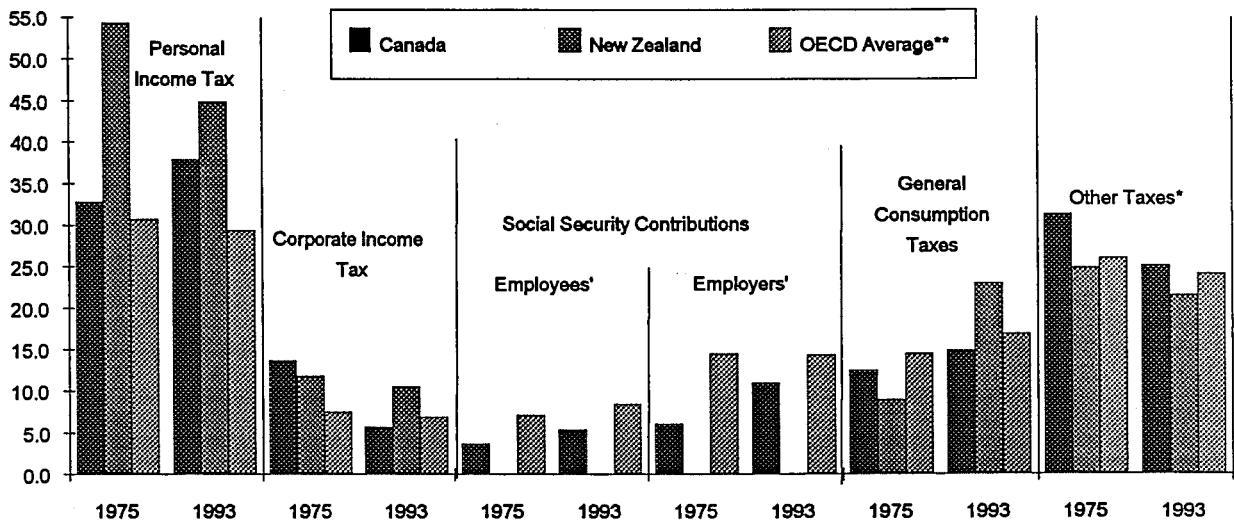
Source: Sandrey, Ron and Reynolds, Russell; Farming Without Subsidies - New Zealand's Recent Experience; MAF 1990, p. 73.

Figure 2.5 - Total & External Debt Servicing as a Proportion of Exports & GDP



Source: Economic Monitoring Group, Report No. 1; Foreign Exchange Constraints, Export Growth and Overseas Debt; New Zealand Planning Council Monitoring Report, Dec. 1983, p. 34

Figure 2.6 - Structure of Taxation
 (% of total tax receipts at all levels of government)



* Includes "taxes on property" and "taxes on payroll and workforce"

** Unweighted average of above data

Source: OECD; *OECD Economies at a Glance, Structural Indicators*; OECD 1995, p.96

Chapter III - New Zealand after 1984

Two major problems that emerged in New Zealand during the 1970's to 1984 were the growing level of debt, of which a larger proportion was held overseas, and poor growth performance relative to its trading partners. In July 1984, the Labour Party won the election after which immediately followed a period of economic and social restructuring which would effect virtually every part of society. Over the next 10 years New Zealand was transformed from one of the highest regulated and protected economies in the OECD to one of the most liberalized and market oriented.

The objectives of the reforms were to reverse the growing level of debt, to provide an economic environment which would allow for the efficient allocation of resources, and provide conditions conducive to economic growth and development. The fundamental shift in policy was based primarily on the belief that a comprehensive change was needed in the nature and attitude of government (OECD 1989:22).

Along with the philosophical and theoretical rationale surrounding economic restructuring there are also the issues of sequencing and pace of reform. In New Zealand's case, these have been the subject of considerable debate as reforms were implemented virtually over night and very rapidly in response to an apparent financial crisis that emerged leading up to the July 1984 election.

Financial Reform and Monetary Policy

In the months immediately preceding the election it was apparent that the exchange rate was over valued and that a devaluation was imminent. The currency crisis was worsened by the public declaration by the Labour Party during the campaign that it would devalue the dollar. Since Labour was poised to win the election and as no devaluation had occurred, speculation of a likely devaluation increased. The result was the flight of capital which all but drained New Zealand's foreign reserves. In response, foreign exchange trading was suspended, and on July 18, the NZ\$ was devalued by 20 per cent relative to a basket of currencies. Furthermore, controls on all lending and deposit rates were eliminated (Sandrey et al 1990:49).

By the end of 1984, the primary financial institutions no longer faced interest rate and credit growth guidelines, the Reserve Bank of New Zealand's (RBNZ) export credit assistance schemes were withdrawn, and the four official money market dealers lost their special status. Also, the Reserve Bank moved to engage in open market operations to fund the fiscal deficit and to achieve the objective of price stability. Further, all limitations

on foreign exchange transactions were lifted. Early in 1985, reserve asset ratios on financial institutions were eliminated and on March 4, 1985, the exchange rate was floated.

The balance of reforms after the initial liberalization stage were to provide a sound legislative foundation for the operation of the new financial system. This involved amending the Reserve Bank Act to give the central bank more power for prudential supervision of the banking industry. An amendment to the Reserve Bank Act in 1995 moved prudential supervision from the RBNZ to the market. Financial institutions were required to publicly disclose their activities thereby enabling lenders and shareholders to monitor activity. All but two registered banks were foreign owned so it was also believed that supervision was provided through the requirements on their foreign owned parent firms.

Entry into the financial sector was allowed provided certain criteria were satisfied and no additional restrictions were placed on foreign banks. The final step in the reform was the passage of a new Reserve Bank Act in 1989 designed to give the central bank more autonomy from political influence. An independent and accountable central bank was considered to be the final key ingredient in the transformation to a market-based financial environment (Chapple 1991:5).

The effects of such rapid reforms were numerous. In 1984, the 20 per cent devaluation of the exchange rate reversed the flight of capital thereby alleviating the immediate pressure on foreign exchange reserves. Further, the devalued exchange rate reduced the bias against exportables by lowering their price on the global markets. On the other hand, it increased the relative value of the external debt.

The abolition of interest rate and credit growth controls along with the lifting of restrictions on foreign exchange transactions led to a rapid adjustment to positive real interest rates which reflected the level of global interest rates and possibly an element of risk associated with the value of New Zealand's debt. As shown in Table 3.1, from March 1985, when the exchange rate was floated, to the end of 1985 the real exchange rate appreciated to a level that eroded the 20 per cent devaluation of July 1984. The appreciation of the exchange rate provided one mechanism for reducing inflation, however, another rationale for adopting a floating system was to allow the currency to adjust to a level which would improve competitiveness and the balance of payments. An apparent contradiction is that adopting a floating exchange rate was an attempt to use one instrument to accomplish two goals. One was the desire to reduce inflation, implying an appreciating exchange rate. The other was to improve competitiveness, implying a

depreciating exchange rate. Both goals could not be accomplished simultaneously through a floating exchange rate .

The focus of monetary policy also shifted to price stability. Annual target ranges were set, and then once the final target was reached (0-2 per cent), keeping inflation within the range became the primary policy objective. High real interest rates combined with a high exchange rate are characteristic of policies intended to accomplish price stability. Table 3.2 shows the short- and long-term nominal interest rates for Canada and New Zealand. A period of higher short-term interest rates for New Zealand began in 1985, when rates went up to 23.3 per cent from 15 per cent a year earlier. It was not until 1989 and 1990 that rates decreased to between 13 and 14 per cent. Monetary policy has a more direct effect on short-term rates as monetary authorities can reduce the growth in the money supply by levying a higher cost for money. The appreciating exchange rate experienced in New Zealand occurred in part because of the flow of capital to take advantage of higher interest rates. Furthermore, in New Zealand's case, there was a high degree of investor confidence in the years immediately following 1984, which also contributed to the strong currency.

One criticism, which is similar to criticism aimed at the Bank of Canada's monetary policy from the mid-1980s, was that inflation targets of 0 to 2 per cent for 1992 were pursued with little consideration given to the consequences on other areas of the economy. The additional time required to lower inflation to less than 2 per cent from 4 per cent likely prolonged the stagnation in economic growth and high unemployment. In Debelle 1996, the impact of increased bank independence on the costs of disinflation in Canada, New Zealand and Australia is examined. The measure used to determine disinflation costs is the sacrifice ratio, defined as the loss in output below trend during the disinflation divided by the reduction in inflation (Debelle 1996:75). The study found that sacrifice ratios for Canada and New Zealand were higher than Australia's, and also higher than previous periods of disinflation. The evidence indicates no reduction in costs from greater central bank independence. Furthermore, there may be higher costs associated with the need to establish credibility when price stability is the primary objective of monetary policy (Debelle 1996:76-7). An assertion has also been made that the prolonged period of stagnation and the rise in unemployment seen from the beginning of the 1980's until the early 1990's resulted in the loss of capital and the loss of skills in the workforce over the long run. An extended period of tight monetary policy induced a fall in economic activity and longer unemployment durations and may have caused persistent and long-run negative effects on the economy (Chapple 1991:12).

Table 3.3 shows that there has been a trend to longer term unemployment. From 1989 to 1993, the proportion of unemployed that were out of work for over 12 months more than doubled from 14.7 per cent to 33.2 per cent. Also, Table 3.4 shows unemployment rates for Canada, New Zealand and an average for the OECD from 1983 to 1993. All three groups experienced higher unemployment rates after 1991 than those over the period 1983 to 1991. In terms of percent change, New Zealand's unemployment rate increased the most, from 5.8 per cent over 1983 to 1991 to 10.3 per cent in 1992.

Exports

The fast pace of liberalization in the financial sector was matched by the removal of many export support schemes by the end of 1986, less than one and a half years after the election. Income support programs and concessionary financing had increased up to the middle of 1984 in an effort to compensate the exporting sector for high effective rates of protection given to the import substituting industries (ISI). The over-valued exchange rate, combined with falling global prices in pastoral exports, were important factors contributing to the growth in rates of assistance prior to mid-1984. The Muldoon administration (1975-1984) had intended to reduce the level of support given to the main exporting sector due to the high cost of the programs and negative overseas reactions to the level of support. The change of government in 1984 brought a quicker pace of reform, and a higher degree of reductions than had been contemplated by the previous government.

There were many factors that, in aggregate, imposed a heavy cost on the export sector during the initial years of reform in the mid-1980s. The benefits of the 20 per cent devaluation did not last long as the new government introduced financial reforms, used tight monetary policy to lower inflation, and endeavoured to reduce expenditures. The impact on the export sector may have been more severe had the world not been entering a period of strong growth in 1984. Also, as shown in Table 3.5, the terms of trade improved by about 20 per cent over the period 1984/85 to 1988/89. The strong global economic growth, combined with slow domestic economic growth, also resulted in a lower current account deficit (Sandrey et al 1990:51).

The Labour Party's budget, four months after the election, eliminated subsidies for fertilizer, irrigation, interest rates, development, research and advisory services, and other programs. The impact of subsidy removals and deregulation in the agricultural sector presented a greater burden than simply the value of lost subsidies (Kelsey 1995:95). One of the original reasons for the introduction of reforms remained---the import substitution

sector was still highly protected and the exchange rate appreciated to near its pre-devaluation level shortly after switching to a floating exchange rate.

The reforms in the financial sector contributed to the additional burdens on the export sector due to higher interest rates at a time when farm land values declined considerably. The level of debt financing in the agricultural industries increased significantly during the years following 1984. Further, the world prices for New Zealand's primary exports were low, which meant lower returns for agricultural products.

Another area subject to review following the initial cuts in assistance expenditures to the exporting sector was international and domestic marketing boards. The domestic marketing boards for eggs (1988), milk (1988) and wheat (1987) were abolished in order to introduce competitive forces within the domestic markets and encourage more efficient use of resources. International marketing boards lost access to Reserve Bank funds (concessionary finance), some had their statutory monopolies removed, and some lost powers to make compulsory levies. By 1995 a number of boards had folded while the position of those remaining had been weakened (Kelsey 1995:96).

Liberalization of trade policy was slower in the import sector. Quantitative controls on imports were gradually phased out and tariff rates were incrementally reduced. The slower pace of deregulation for the import substituting sectors resulted in trade policy imposing significant burdens on the export sector in the years immediately following 1984. The impetus for such a rapid removal of export assistance was simply a cost cutting measure.

Imports

The Muldoon administration had already started the process of phasing out import licences in the late 1970's as part of their *industry plans* approach. The objective was to gradually introduce competition to sectors that were highly uncompetitive by international standards. Requirements for import licences for goods not produced in New Zealand, and for goods that were raw materials required by industry, were mostly removed. In 1981, the government introduced a tendering process for import licences with the aim of phasing out import licences at some point in the future. The value of licences put to tender increased from 1981 to 1985. When the premium attributable to the licensing process decreased to a low level, or if the full value of licences were not tendered, then the requirement of a license could be removed.

Table 3.6 shows that in 1981-82 the nominal weighted average tariff rate was 30 per cent. Table 3.7 shows that from 1981 to 1985 the proportion of import protection

attributable to import licensing decreased in significance compared to tariffs. In 1981 and 1982 the average premium rate was near 20 per cent, while from 1983 to 1985 it ranged from 5 per cent to 8 per cent.

The pace of reducing tariff levels was much slower compared to the speed of reforms in the financial sector and the export support programs. Reductions in tariffs first occurred in July 1986 with a 5 per cent reduction on goods that were in competition with domestic products. An additional 10 per cent reduction occurred a year later. Tariffs were removed for a wide range of goods for which there were no domestic competitors, and tariffs were reduced more quickly for those goods that were used as farm production inputs.

Tariffs were further reduced by 50 per cent between 1988 and 1992 bringing the average tariff level to 14 per cent for most goods. A further reduction was arranged to bring the level to 10 per cent by 1996, however, there were exclusions for textiles, shoes and automobiles. By the turn of the century the objective is to reduce tariffs further, with the rate for the most protected sectors lowered to 15 per cent (Kelsey 1995:99).

The reforms that occurred in the financial and export sectors were unilaterally announced by the government with limited consultation, however, changes to tariffs, tariff concessions, and industry plans were developed with more extensive consultations with industry (Sandrey et al 1990:64).

Fiscal Policy, Privatization and Social Program Reforms

One of the first priorities of the new administration in 1984 was to lower the fiscal deficit which was 9.1 per cent of GDP in 1983-84. Along with cutting expenditure, the tax structure was changed to reduce progressivity in personal taxation, lower administrative costs and evasion for corporate taxation, shift the focus of tax revenue from direct to indirect taxation, and to encourage entrepreneurial activity. The reforms to the tax system included:

- the introduction of a 10 per cent Goods and Services Tax (GST) in October 1986, increased to 12.5 per cent in July 1989,
- the abolition of sales tax,
- the use of rebates or negative taxation to accomplish redistribution objectives previously accomplished through various welfare benefit schemes,

- a reduction from five to three steps for personal income tax at rates, from low to high incomes, of 15 per cent, 30 per cent, and 48 per cent in April 1987, then to two steps of 24 per cent and 33 per cent in October 1988,
- closure of tax loopholes,
- the removal of personal income exemptions (Kelsey 1995:208-9)

Table 3.8 shows the changes in tax structure in New Zealand since 1965 compared to Canada and the unweighted average of the OECD. From the mid-1980s, there has been a definite shift in New Zealand to broad-based indirect taxes on goods and services, such as the GST. Although the personal tax rates are higher than Canada's and the OECD figures this can be explained by the fact that social security contributions are built into the personal tax rates since the national superannuation scheme (renamed Guaranteed Retirement Income in 1989) is funded out of general government revenue. Another notable change in New Zealand is that the proportion of revenue derived from certain indirect taxes on specific goods and services (for example excise, customs and imports duties, profits generated and transferred from fiscal monopolies; taxes on exports, foreign exchange transactions, investment goods and betting stakes, etc.) decreased from 18.5 per cent in 1965 to 9.0 per cent in 1993. Most OECD members saw a significant proportional decrease in this category as tariff rates and export controls decreased or were removed. In New Zealand, the objectives of fiscal reform included a reduction in the number of specific indirect taxes, such as excise taxes on diesel fuel.

New Zealand's tax structure has been criticized for shifting a greater proportion of the tax burden on those with less income. Kelsey (1995) observes that the lower revenues from income taxes (due to the decline in progressivity in personal income taxes) along with the lower personal tax rates in general, has been countered by a switch to highly regressive consumption taxes, such as the GST. Further, other revenue shortfalls have been offset by an increasing application of user fees for government services and cuts in benefits---most of which impact proportionately more on lower income groups.

Another approach to reducing expenditures, and also to lowering financial risk, was the corporatization and privatization of government owned enterprises. Table 3.9 provides a list of privatizations starting in 1988, however, before most privatizations proceeded there was an intermediary phase which was the creation of state-owned-enterprises (SOEs). The SOEs were intended to improve the efficiency of state commercial assets by introducing greater accountability and competition. By 1987, the privatization phase was started with the sale of some enterprises and a review of the rationale for ownership of all SOEs. The basis for privatization was that private

ownership would "increase efficiency, promote dynamic growth and ensure greater responsiveness to consumer needs. The receipts from sale, and relief from much-needed capital injections, would release funds for social spending and repayment of foreign debt." (Kelsey 1995:128).

The state level approach to corporatization and privatization was also applied to commercial activities at the local government level. In 1989, Local Authority Trading Enterprises (LATEs) were established through an amendment to the Local Government Act (1989). As a requirement for receiving state funding, passenger transport and public works operations had to become LATEs by 1991 and prove that they were competitive with the private sector through open tendering. The government initially planned for many activities at the local level to be privatized, however, considerable resistance at the local level compelled the government to leave the decision to sell LATE's at the local level. Local authorities have not been enthusiastic partners in the state's privatization ambitions.

By the end of 1994, receipts from asset sales were NZ\$ 13 billion, however, there was considerable capital injection and debt write-offs prior to the sale of certain enterprises. For example, the government wrote off nearly \$2 billion in debt for New Zealand Steel and \$1.1 billion in debt for the Rural Bank. Further, the pace of privatization may have resulted in the sale of assets at below "market" value prices. Essentially, the capacity of prospective New Zealand-based purchasers was too small to finance buying the large assets slated for privatization. This was accentuated by the share market crash of 1987 when the stock market lost roughly half its value.

Criticism of the privatization ranges from the effects of restructuring on employment, fee structures, and the large profits reaped by investors, to the willingness of the government to allow high foreign ownership of industries that many countries consider strategic, such as air transportation and communications.²

In June 1994 the Fiscal Responsibility Act (FRA) was passed which effectively set certain goals and guidelines of fiscal management in law. The purpose is to provide for more transparency in policy decisions and to provide the public with references for it to measure government policy. The basic principles of the Act are to reduce government debt to prudent levels through operating surpluses, balancing the budget over economic cycles so as to achieve a level of public net worth sufficient to withstand any possible

² Discussions on privatization draws primarily from Bollard, Alan and Mayes, David; Corporatization and Privatization in New Zealand, from "The Political Economy of Privatization", edited by Clarke, Thomas and Pitelis, Christos, 1993 Routledge, p. 331-2; and Kelsey, Jane; Economic Fundamentalism; Jane Kelsey 1995, p. 130.

negative future shocks, prudent management of fiscal risk of the Crown, and to make the future levels and stability of taxes reasonably predictable (OECD 1994d:34).

Social Programs

The six years of Labour government from 1984 to 1990 were characterized by reforms to the financial sector, monetary policy, privatization of public commercial enterprises, the virtual elimination of subsidies, and the start of liberalized trade policies. In 1990 the National Party won the election and embarked on restructuring social programs. New Zealand's traditional approach to social programs was based on universality, however, the National Party proceeded to implement a limited safety net based on the following principles:

- fairness- ensuring those with genuine need have adequate access to assistance;
- self-reliance - policies designed to increase the individual incentive to be responsible;
- efficiency - the maximum value for each dollar spent on programs;
- greater personal choice - encourage new providers of health, education, housing and welfare services;
- realism - provide a sustainable level of social security and services;
- change management - manage changes to services without haste and with sensitivity so the needs of users remains paramount (Kelsey 1995:272).

Health Care

Health sector reforms were designed to separate the health care purchaser from the health services provider. The stated aim was to provide improved health services in a more cost effective manner. Fourteen smaller health boards were replaced by four Regional Health Authorities (RHA) in mid-1993. They were block funded based on the population within their respective jurisdictions, and were mandated to purchase all forms of health care. Public hospitals were converted into Crown Health Enterprises (CHE) which bid against private enterprises to provide health services. There was concern from the public and from within the medical professions that the motivations behind business decisions, essentially profits, conflicted with the ethics and accessibility traditionally associated with health care. Public support to citizens needing health care was based on an income threshold which was determined by whether or not the family was eligible for

family support. Critics noted that most elderly with any private income and most single people earning over \$17,500/year were considered high income. Concern with the quality and accessibility of public funded health care was manifested in the growing proportion of people covered by private insurance. By 1995 the proportion of people with some kind of private health insurance had risen to 55 per cent, up from 40 per cent in 1991 (Kelsey 1995:214-8; and OECD 1994d:47).

Table 3.10 shows health expenditures, as a percent of GDP, for New Zealand, Canada and total OECD for selected years from 1960 to 1993. Over the period, total health expenditures have increased by about 75 per cent for New Zealand, over 90 per cent for Canada, and more than 100 per cent for the total OECD. However, since 1990 the public component for New Zealand has not changed while the non-public component has doubled between 1985 and 1993. Proponents of universal principles in health care have expressed concern that the state will continue to lower its guaranteed core assistance while those who can afford private health care will leave the system.

Education

Education reform was introduced in 1989 despite high satisfaction levels in the early 1980s (Kelsey 1995:219-20). Management and administration of primary and secondary education has been devolved from education boards under the former Department of Education to a board of trustees for each school with its own charter and the option to receive block funding to pay for operational expenses based on their own priorities. Further, the leaving age for students was increased while access to social support benefits for those aged 16 and 17 was removed. The justification was to improve the education and skills of young people, however, it also meant that the secondary schools would have more students without necessarily any increase in funding. Furthermore, the changes were likely to result in lower unemployment figures and lower costs of benefit support (Kelsey 1995:232).

The results of the reforms are unclear, however, as the economy has improved in the last couple of years a shortage of skilled labour has emerged. The devolved system has a less co-ordinated and coherent structure and may have contributed to the shortage. The qualifications of instructors have been lowered and class sizes have increased as the boards are forced to operate within constrained budgets. An outcome of the changes is that some schools fair much better than others due to a favourable location or their ability to obtain additional funding through enrollment fees. The primary motive behind the reforms was identified as a way to improve the use of educational resources. The reforms

also appear to have introduced a type of market dynamic between individual school boards.

Tertiary education has also been reformed to create competition between institutions and to encourage courses that reflect the demands of the job market. Funding to colleges and universities is on a per student basis and the fees for different courses may vary. Furthermore, loans to low-income students have virtually replaced grants and the repayment requirements are demanding. Repayments begin when less than half the average wage is earned with an interest rate set at near market rates. The repayment rate is also high, at 10 per cent of income above the threshold. In Australia repayment begins at near the average wage at one, two or four percent of income above the threshold (Kelsey 1995:224; and The Economist Intelligence Unit 1995:7)

Housing

The Labour administration's housing policy saw a period of improved targeting and enhanced benefits, however, the National Party shifted housing toward an enterprise basis in 1992. The functions performed by the Housing Corporation New Zealand were transferred to several separate agencies. Low income families would receive a cash accommodations supplement, based on an assets test, for rents, mortgages or loans from other lenders. Further, rents were allowed to increase to market values at a yearly rate of \$20 dollars per week. The government has tried to sell its state rental houses to reduce its stock, although the actual number of units sold has been small. The objective of housing reform was the consistent desire of the state to divest itself of involvement in social programs, reduce expenditures, and to introduce market forces (Kelsey 1990:224-7).

Pensions

The superannuation scheme introduced in 1976 proved quite expensive since it was guaranteed to all regardless of income. In 1985, as a cost recovery exercise, a 20 per cent tax was imposed over a minimum income level until all the superannuation was recovered. In 1992, the National Party changed the approach by introducing income tests but no assets test. The Guaranteed Retirement Income (GRI), which replaced the superannuation in 1989, would be fully clawed back at incomes of near \$55,000 for married couples and \$36,000 for single people. Further, the age of eligibility was to increase from 60 to 65 (Kelsey 1990:228, 287-8).

Labour

One of the most important changes since 1984 was the passing of the Employment Contracts Act (ECA) in 1991. The extent to which labour laws were deregulated are substantial. The previous centralized system of awarding wages remained more or less intact between 1984 and 1990. The Labour Party had strong ties with labour organizations and was reluctant to radically change the wage setting structure. The changes implemented by the Labour Party included the removal of compulsory arbitration in 1984 and the passage of the Labour Relations Act (LRA) in 1987 which compelled unions to rationalize. Further, in 1988 the State Sector Act (SSA) provided more flexibility in the staffing of public sector employees (Kelsey 1990:173-5).

The centralized wage setting structure which existed to 1991 was dismantled and provisions for union registration and union recognition were abolished. In 1990, 75 per cent of employees were covered by collective agreements with nearly 50 per cent covered by multi-employer bargaining. After the passage of the ECA, 84 per cent of covered employees are covered under single-employer/enterprise settlements (OECD 1994b:174). Under ECA unions lost their tax exempt status and mandatory union membership was abolished.

Other labour reforms included the tightening of eligibility for unemployment benefits and lowering the replacement ratios. Labour force participation rates declined by 2 per cent from the late 1980s and into the start of the 1990s (Kelsey 1995:265-6). Although some recent increase has occurred, if participation rates in 1993 had been at the same level as the mid-1980s, about 60,000 more people would be in the work force. The effects of the ECA, high unemployment, and the stricter unemployment benefits may have resulted in people leaving the workforce. Also, these factors may account for a rise in education levels seen recently in New Zealand

Sequencing and Pace of Adjustment

The introduction of reforms in New Zealand was at a pace and magnitude not seen before in an industrialized country. From 1984 to 1994 virtually every part of the economy and society had been directly effected. Tables 3.11 and 3.12 provide a list of New Zealand's economic liberalization measures, and a summary of the structural reforms that have been implemented since 1984. Social benefits were targeted, tightened, or merged with other benefits; the tax system was restructured to shifting considerably to indirect taxation rather than direct taxation as a source of revenue. A combination of

interventionist financial and trade policies made New Zealand one of the most regulated and protected developed nations at the start of the 1980s and yet by 1994 subsidies and quantitative restrictions were virtually non-existent, tariffs had declined to near OECD levels, and a shift in focus on markets had highly integrated the New Zealand and Australian economies and had diversified New Zealand export markets towards Asia. Labour had been completely deregulated to a point where wage setting was highly decentralized. This removed rigidities in the system by increasing labour mobility and wage flexibility. The New Zealand government also divested itself from commercial activity and deregulated foreign ownership requirements for virtually all enterprises.

Summary

Since 1984, New Zealand reformed virtually every aspect of its economy. Government has reduced its involvement in the economy through corporatization and privatization. Social programs have been reduced and eligibility for benefits tied to needs tests. Chapter IV examines the recent developments in the Canadian economy and the economic conditions that precipitated the recent focus on fiscal reform.

Table 3.1 - Exchange rates following July 1984, to 1987

End of period	U.S. mid-rate (U.S.\$ / NZ\$)	Exchange rate index ^a (1978=1000)	Real exchange rate ^b (1982=1000)
1984 Jun	0.6339	784	992
Jul	0.4947	627	
Aug	0.4995	627	
Sep	0.4889	627	998
Oct	0.4883	627	
Nov	0.4875	627	
Dec	0.4773	627	951
1985 Jan	0.4707	627	
Feb	0.4487	627	
Mar	0.4623	621	941
Apr	0.4538	625	
May	0.4484	611	
Jun	0.4783	647	964
Jul	0.5245	670	
Aug	0.5387	696	
Sep	0.5455	693	979
Oct	0.5785	730	
Nov	0.5668	709	
Dec	0.4995	627	1007
1986 Jan	0.5363	660	
Feb	0.5193	632	
Mar	0.5340	647	1028
Apr	0.5821	683	
May	0.5665	680	
Jun	0.5480	660	1073
Jul	0.5188	644	
Aug	0.4865	604	
Sep	0.4885	602	1096
Oct	0.5080	629	
Nov	0.5116	629	
Dec	0.5245	634	1111
1987 Jan	0.5413	645	
Feb	0.5594	662	

a exchange rate index is a measure of the value of the New Zealand dollar in relation to a trade-weighted basket of overseas currencies. It was set at 627 before the March 1985 float.

b The real exchange rate series was calculated quarterly as the ratio of the price of nontradeables to the price of tradeables.

Source: Rayner, C. Anthony and Lattimore, Ralph; *Liberalizing Foreign Trade - New Zealand*; from "Liberalizing Foreign Trade - New Zealand, Spain, and Turkey, Volume 6"; Edited by Demetris Papageorgiou, Michael Michaely, and Armeane M. Choksi; IBRD/WB 1991, p.103

Table 3.2 - Short- and long-term nominal interest rates

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995a	1996a
Short-term rates															
Canada	14.4	9.5	11.2	9.6	9.2	8.4	9.6	12.2	13.0	9.0	6.7	5.0	5.4	7.1	5.6
New Zealand	17.0	13.1	15.0	23.3	19.1	21.1	15.4	13.5	13.9	10.0	6.7	6.3	6.7	8.9	8.3
Long-term rates															
Canada	14.4	11.8	12.7	11.1	9.5	9.9	10.2	9.9	10.8	9.8	8.8	7.9	8.6	8.3	7.3
New Zealand	12.9	12.2	12.6	17.6	16.7	15.7	13.1	12.8	12.5	9.9	8.4	6.9	7.7	7.7	7.1

a Estimates and projections

Source: OECD Economic Outlook No. 58, December 1995, Annex p. A39

Table 3.3 - Incidence of long-term unemployment*
(from survey based data in selected OECD countries)

	1983		1989		1990		1991		1992		1993	
	≥ 6 months	≥ 12 months	≥ 6 months	≥ 12 months	≥ 6 months	≥ 12 months	≥ 6 months	≥ 12 months	≥ 6 months	≥ 12 months	≥ 6 months	≥ 12 months
New Zealand	34.5	14.7	38.0	18.7	39.1	21.3	53.2	31.9	52.5	33.2
Canada	28.8	9.9	20.8	6.8	18.9	5.7	23.6	7.2	33.4	13.1	31.4	14.1
U.S.	23.9	13.3	9.9	5.7	10.2	5.6	13.0	6.3	20.6	11.2	20.4	11.7
Australia	52.7	27.5	40.6	23.1	40.9	21.6	49.6	24.9	58.7	34.5	57.1	36.5

* The figures represent the per cent of the already unemployed that were unemployed for 6 months up to 12 months, and for 12 months and over.
Source: OECD, Employment Outlook - July 1994; OECD, 1994, p. 206

Table 3.4 - Unemployment for New Zealand, Canada, OECD Average^a
% of labour force

	1983-91	1992	1993	1994	1995
New Zealand	5.8	10.3	9.2	8.7	8.1
Canada	9.5	11.3	11.2	10.8	10.2
Total OECD	7.4	7.8	8.2	8.5	8.3

a For sources and definitions see *OECD Economic Outlook, No. 55, June 1994*.

Source: OECD, *Employment Outlook - July 1994*; OECD 1994, p. 6

Table 3.5 Terms of trade,
New Zealand

	December quarter 1988=100
1984	83.8
1985	82.3
1986	82.6
1987	91.2
1988	97.9
1989	102.6
1990	100.4
1991	95.1
1992	96.6
1993	99.4

Source: OECD, *OECD Economic Surveys*
- 1993-1994 New Zealand; p. 141

Table 3.6 - Tariff Rates, 1981-82: for goods
outside industrial plans, (NZ\$ million)

Tariff % ¹	Manufacturing output ²
Free	85
1-10	318
11-20	527
21-25	365
26-30	322
31-40	2213
41-50	604
over 50	12
specific tariffs	283

¹ The weighted average of the tariffs is 30%.

² Except industry plans

Source: Rayner, C. Anthony and Lattimore, Ralph; Liberalizing Foreign Trade - New Zealand; from "Liberalizing Foreign Trade - New Zealand, Spain, and Turkey, Volume 6"; Edited by Demetris Papageorgiou, Michael Michaely, and Armeane M. Choksi; IBRD/WB 1991, p. 67.

Table 3.7 - Average import licensing premiums &
license values tendered, 1981-85
(exclusive of tariffs)

	License allocation value	Average premium rate (%)
1981	16.6	17
1982	40.4	23
1983	205.1	6
1984	701.3	5
1985	1331.0	8
Weighted average, 1981-85		7

Source: Rayner, C. Anthony and Lattimore, Ralph; Liberalizing Foreign Trade - New Zealand; from "Liberalizing Foreign Trade - New Zealand, Spain, and Turkey, Volume 6"; Edited by Demetris Papageorgiou, Michael Michaely, and Armeane M. Choksi; IBRD/WB 1991, p. 67.

Table 3.8 - Tax structure, New Zealand, Canada, and OECD, 1965 - 1993

Taxes on personal income as a % of total taxation										
	1965	1970	1975	1980	1985	1989	1990	1991	1992	1993
New Zealand	39.4	42.7	54.3	61.6	59.8	46.7	46.4	45.0	44.5	44.8
Canada	22.6	32.4	32.8	34.1	35.2	38.8	41.0	40.8	39.3	37.9
OECD total ¹	25.9	27.7	30.7	32.0	30.4	29.2	29.8	29.6	29.5	29.2
Taxes on corporate income as a % of total taxation										
New Zealand	20.7	17.8	11.8	7.8	8.3	9.1	6.4	7.0	8.4	10.6
Canada	14.9	11.3	13.6	11.6	8.2	8.5	7.0	5.7	5.1	5.7
OECD total ¹	8.7	8.7	7.5	7.4	7.8	7.8	7.6	7.3	6.8	6.9
Taxes on property as a % of total taxation										
New Zealand	11.5	10.4	9.2	7.9	7.4	6.6	6.5	6.2	6.5	5.9
Canada	14.3	12.8	9.5	9.1	9.3	9.6	10.0	10.5	11.0	11.1
OECD total ¹	7.8	7.0	6.0	5.2	5.1	5.6	5.5	5.4	5.5	5.7
Consumption taxes as a % of total taxation										
New Zealand	26.2	25.2	22.8	21.4	22.0	30.8	31.7	33.4	33.3	32.1
Canada	34.7	27.7	26.0	24.6	26.1	25.6	23.9	23.8	24.2	24.5
OECD total ¹	35.9	33.9	29.6	28.5	29.3	28.9	28.5	28.5	28.7	28.3
Taxes on general consumption as a % of total taxation										
New Zealand	7.7	8.0	9.0	10.2	10.4	20.5	22.5	23.8	23.7	23.0
Canada	17.8	14.4	12.5	11.5	13.2	15.5	14.4	13.6	14.2	14.9
OECD total ¹	11.8	13.4	13.3	13.7	15.5	17.2	17.1	17.0	17.1	16.9
Taxes on specific goods and services as a % of total taxation										
New Zealand	18.5	17.2	13.8	11.2	11.7	10.2	9.2	9.7	9.6	9.0
Canada	16.8	13.3	13.6	13.0	13.0	10.1	9.5	10.2	10.0	9.6
OECD total ¹	24.0	20.4	16.2	14.8	13.7	11.7	11.4	11.5	11.6	11.4

¹ Unweighted average

Source: OECD, *Revenue Statistics of OECD Member Countries, 1964-1994*; 1995 Edition, p.77-87

Table 3.9 - Sale of State-Owned-Enterprises and Assets in New Zealand

Business	Sale Price (NZ\$m)	Settlement Date	Principle Purchaser(s)
NZ Steel	372.2	1988	Equiticorp, NZ investment company (90%)
Petrocorp	801.1	1988	Fletcher Challenge, NZ conglomerate
Health Computing Services	4.3	1988	Paxius Information Services, NZ
Development Finance Corporation	111.3	1988	National Provident Fund, NZ superan. company (80%) Solomon Bros. (20%)
Post Bank	678.5	1989	ANZ, Aust.
Shipping Corporation	33.6	1989/90	ACT (NZ) Ltd., Committee, a UK shipping company
Air New Zealand	660.0	1989	BIL, NZ (65%), Qantas, Aust (19.9%) Japan Airlines (7.5%) American Airlines (7.5%)
Landcorp	77.0	1989/90	Mortgagees
Rural Bank	550.0	1989	Fletcher Challenge
Government Print	35.0	1990	Rank Group, NZ
National Film Unit	2.5	1990	TVNZ, NZ SOE
Communicate NZ	0.1	1989	DAC Group
State Insurance	735.0	1990	Norwich Insurance, UK
Telecom NZ Ltd.	4 250.0	1990	Bell Atlantic & Ameritech, U.S. (90%), Fay Richwhite & Freightways, both NZ (5% each)
NZ Liquid Fuel Investments, Maui Gas & Synfuel stocks	80.2	1990	Fletcher Challenge <i>et al</i>
Export Guarantee Ltd.	15.1	1990	State Insurance (a former SOE)
Tourist Hotel Corporation	73.8	1990	Southern Pacific Hotels, U.S.
Forestry Corporation -cutting rights	1027	1989/90	Not known
Housing Corporation	30	1991	Unavailable
Mortgages			
Bank of New Zealand	850	1988&92	1988, Fay Richwhite (13%), Government (65%), Balance held by smaller share holders 1992, privatized 100%, distribution of ownership not available
Government Supply Brokerage	3	1992	?
NZ Timberlands Ltd.	366	1992	?
Taranaki Petroleum mining licences	118	1992-93	?
NZ Railways Corporation	328	1991&93	Co-op of NZ operators
Fletcher Challenge Shares	418	1993	?
Government Computing Services Ltd.	47	1994	?

Taken primarily from:

Bollard, Alan and Mayes, David; Corporatization and Privatization in New Zealand, from "The Political Economy of Privatization", edited by Clarke, Thomas and Pitelis, Christos, 1993 Routledge, p.324;

OECD, Assessing Structural Reforms - Lessons for the Future, OECD 1994, p. 162;

OECD, OECD Economic Surveys 1995-96, New Zealand; OECD 1996, p. 98

Table 3.10 - Health expenditure¹
(% GDP)

	1960	1965	1970	1975	1980	1985	1990	1993
New Zealand								
Total	4.4	..	5.3	7.1	7.5	6.4	7.3	7.8
Public	3.5	3.7	4.3	5.9	6.3	5.5	6.0	6.0
Non Public	0.8	..	1.1	1.1	1.2	0.9	1.3	1.8
Canada								
Total	5.4	5.9	7.0	7.1	7.3	8.5	9.3	10.1
Public	2.3	3.1	4.9	5.4	5.5	6.3	6.8	7.3
Non Public	3.1	2.8	2.1	1.7	1.9	2.1	2.5	2.8
OECD²								
Total	3.9	4.5	5.1	6.4	6.9	7.1	7.6	8.1
Public	2.4	2.9	3.7	4.9	5.3	5.3	5.4	6.0
Non Public	1.4	1.4	1.4	1.5	1.6	1.7	1.9	2.1

¹Extrapolated figures for the non public health expenditure in: Canada 1961-64 and 1966-69; New Zealand 1961-67, 1969 and 71/72; Extrapolated figures for the public health expenditure in: Canada 1961-64 and 1967-69

²Unweighted average

Source: OECD; OECD Economies at a Glance - Structural Indicators; 1995, p. 110-11

Table 3.11 - List of New Zealand Economic Liberalization Measures

Closer economic relations with Australia (CER)	1983+
Deregulation of land freight transport	1983-85
Removal of foreign exchange controls	1984
Deregulation of entry licensing in industry	1984+
Removal of other operating barriers in industry	1984+
Removal of concessions for favoured investment (e.g.: R&D)	1984+
Removal of subsidized agricultural prices	1984
Removal of financial controls (interest rates ceilings, reserve ratio requirements, priorities for various sectors)	1984-86
Removal of most price controls	1984-88
Removal of import licensing	1984-89
Liberalization of foreign direct investment	1985
Floating the exchange rate	1985
Partial deregulation of occupational licensing	1985-90
Significant decrease in import tariffs	1985-92
Deregulation of the milk industry	1986
Deregulation of the financial services sector	1986
Removal of concessional funding for agricultural exports	1986-88
Partial deregulation of energy sector	1986-91
Removal of monopoly rights on state trading	1986-88
Revision of corporate, personal and direct taxation	1986-88
Corporatization of state trading activities	1986-90
Review of competition regulation Commerce Act	1986-91
Abolition of many quangos and quasi-government organizations	1987
Review of role of producer marketing boards	1987+
Reorganization of core government departments	1987+
New entry to air transport	1987-90
Revision of town and country planning	1987-90
Program of sale of state assets	1987-90
Business law reform (Companies Act, Securities legislation)	1988+
Review of education and health provision	1988-90
Deregulation of harbours and wharves	1989
Removal of shop trading hours restrictions	1989
Corporatization of some local authority trading activities	1989
Reform of local government	1989-91

Deregulation of land passenger transport	1989-90
Restructuring of science funding	1989-92
Partial deregulation of shipping	1990
Reform of intellectual property law	1990-92
Resource management law reform	1991
Deregulation of the labour market	1991
Restructuring of guaranteed retirement income	1991
Complete health sector restructuring	1991-93

Source: Bollard, Alan and Mayes, David; Corporatization and Privatization in New Zealand, from, "The Political Economy of Privatization", edited by Clarke, Thomas and Pitelis, Christos, 1993 Routledge, p. 336

Table 3.12 - SUMMARY OF STRUCTURAL REFORMS SINCE 1984

International Trade and Monetary System	
Import protection	
Phasing out of import licensing requirements	1983-89
Reduction of import tariffs on Swiss Formula from average of 38% to 10%	1986-92
Further 1/3 reduction in import tariffs planned	1992-96
Removal of special protection features for eighteen specific "industry plan" sectors and incorporation into general tariff reform programme	1984-92
Slower reduction of tariffs on two remaining "special" industries (motor vehicles/components and textiles/clothing/footwear)	1987-96
International capital controls	
Removal of controls on outward investment/borrowing	1984
Free entry of foreign direct investment (rubber-stamped by Overseas Investment Commission, except for farmland, offshore islands and fishing)	1985-89
Very liberal regime for portfolio investment/repatriation of profits	1985
Exchange rate	
Deregulation of foreign exchange trading	1984
Devaluation in 1984 by 20% against basket of currencies	1984
Free float of currency on foreign exchange markets without direct control	1985
Monetary Policy	
Devotion of monetary policy instruments to deflation, with target of "price stability" (0 to 2 % price increase by 1992/93)	1989
Independence of Reserve Bank from government, formalized through Reserve Bank Act	1989
Industry and Service Sectors	
Finance	
Abolition of credit growth guidelines	1984
Removal of separate requirements for trustee banks, buildings societies, finance houses, stock brokers	1985-87
Removal of quantity restrictions and other entry barriers to banking	1985-86
End of formal financial controls (reserve requirements, sector lending priorities)	1985
Removal of interest rate controls	1984
Abolition of export credit guarantees	1984
Removal of ownership restrictions on financial institutions	1985
Liberalization of stock exchange	1986

Energy

Corporatization of State Coal Mines	1987
Financial restructuring of oil refinery	1988-91
Legislation of oil company ownership of service stations	1988
End of price controls (except gas)	1984-88
Sale of Crown gas exploitation/distribution interests	1988-90
Sale of other Crown energy holdings	1990-92
Corporatization and restructuring of electricity generation, transmission and distribution	1986-91

Transport

removal of restriction on road/rail carriage	1983-86
End of quantity licensing of trucking	1984
Corporatization of state rail, air and bus services	1982-84
Tendering of local authority bus services and liberalization of licensing requirements	1990-91
Deregulation of taxi industry	1990
Opening up of domestic aviation industry	1987
Granting of number of land and on-flying rights to foreign airlines in New Zealand	1989
Corporatization/sale of airports and Airways Corporation	1986-91
Corporatization of ports	1989
deregulation of stevedoring industry	1990
Removal of cabotage on coastal shipping	1991

Agriculture

Termination of Supplementary Minimum Prices on agricultural products	1984
Agricultural tax concessions removed	1985
Termination of concessional financing of primary producer stocks held by producer boards	1986-88
Review of compulsory producer marketing board arrangements	1987
Termination of domestic boards for eggs, milk, and wheat	1984-88

Research and Development

Removal of concessions for research and development to put on equal footing with all investment	1984
Cost-recovery of public R&D work	1985
Establishment of a contestable pool of public funds (Foundation of Research Science and Technology)	1990
Corporatization of government research bodies (Crown Research Institute)	1992

Labour Market

Introduction of voluntary unionism	1983
More market-based bargaining under Industrial Relations Act Amendment: compulsory unionism reinstated	1984
Some contestability in union coverage under Labour Relations Act	1987
Radical reform via Employment Contracts Act (voluntary unionism, contestable unions of any size, any arrangements for employer/employee bargaining at joint or individual level)	1990

Business Law

Establishment of Commerce Act as liberal efficiency-based regime to govern mergers and trade practices	1986
Fair Trading Act governs consumer rights	1986
Review of securities legislation and takeover law (extent of efficiency approach still under discussion)	1988-91
Review of whole intellectual property regime (Patent, copyright, Trademarks and Designs Acts)	1990-91
Review of Town and Country Planning	1987-90
Resource Management Act to govern more liberal planning and environmental legislation	1991
Crown Minerals Act to clarify property rights to mineral resources	1991

Other Deregulation Measures

End of wage/price freeze	1984
Termination of price controls, and replacement by (unused) price surveillance powers under Commerce Act	1984-88
Removal of quantity licensing on almost all industries, and end of quality regulation on most	1986*88
End of all state regulated monopoly rights (except letter post, air traffic control and milk distribution)	1984-89
Removal of some occupational licensing	1985-90
Removal of producer cooperative tax advantages	1989
Termination of restrictions on shop trading hours	1989
Termination of export market development incentive schemes	1984
Phase-out of export performance tax incentives	1984-87

Government Sector

State Trading Operations

Removal of almost all state regulated monopoly rights	1984-89
Corporatization of 24 state-owned enterprises (in transport, finance, tourism, forestry, broadcasting, utilities, and service industries)	1987-88
Restructuring to isolate natural monopoly elements of SOE's	1989-91

Full or partial privatization of Air New Zealand, Bank of New Zealand, Petroleum Corporation, Tourist Hotel Corporation, Shipping Corporation, Rural Bank, Government Life, Forestry Corporation, Post Office Bank, Telecom Corporation and others	1987-91
Further privatization planned via divestment of asset sales, sale of rights, share sales, etc.	1991+
Requirement for local authorities to corporatize Local Authority Trading Enterprises (LATE's) and tender out services	1990-91
Encouragement to local authorities to sell holdings in airports, port companies and local utilities	1991
Sale of other assets, e.g. irrigation schemes, fishing rights	1983-88

Taxation

Broadening tax base through "Goods and Services Tax" (GST) on virtually all final domestic consumption without exception (now 12.5%)	1986
Flattening and lowering of personal income tax rate, with top rate standardized to corporate tax levels, and aimed to minimize poverty traps	1988
standardization and simplification of corporate taxation to minimize evasion and cut administrative costs	1985
Removal of most other indirect taxes	1986-91
Removal of tax concessions for savings, etc. to put on neutral footing	1987
Review of international tax regime	1992

Expenditure Control

Attempts at reduction in government expenditure, especially in areas of administration of industry development	1985+
Assignment of proceeds of sale of SOE's assets to repay public debt	1987+
Public sector management reform through Public Finance Act	1989
Reform of core government departments on corporate lines through State Sector Act 1988 with separation of policy, provision and funding	1986+
User-pays principles for remaining state trading activity	1986+
Redesign of government accounts on more commercial basis, accrual accounting, output-based monitoring systems through Public Finance Act	1988
Abolition of 50 quangos and quasi-government organizations	1987
Renewed attempt at reduction in social spending (education, health, social welfare, superannuation)	1991

Social Services

Reform of compulsory education system, based on elected Boards of Trustees	1988-90
Quasi corporatization and fee-paying for tertiary education institutions	1992
Integration of state housing assistance into private sector rental and mortgage provision	1991
Tightening of requirements and reduction of levels of unemployment benefits and other government social transfers	1990
Tightening of requirements, extensions of age, and reduction of benefits for government funded old age pension scheme	1989-92
Separation of funding from provision of state health services and establishment of Crown health Enterprises	1992
Development of private funding arrangements for health provisions	1992

Source: OECD, OECD Economic Surveys - New Zealand 1993-1994; OECD 1994, Annex I, p. 121-4

Chapter IV - The Canadian Experience

Unlike New Zealand, Canada has not suffered a recent economic crisis in isolation from global cyclical economic patterns. In the early 1980s, expansionary policies were used to counter the recession yet during the subsequent period of strong economic growth, which lasted for the balance of the decade, Canada's deficits persisted and the size of the debt grew relative to the size of the economy.

The New Zealand and Canadian economies share some common features that make them susceptible to certain external pressures. First, both are vulnerable to fluctuations in primary commodity prices because of the importance of exports in primary products. Second, is the system of industrial and agricultural support policies. New Zealand had very high rates of protection into the mid-1980s for its manufacturing sector, and provided substantial assistance to agricultural producers from the 1970s to the mid-1980s. Canada also assists agricultural producers, however, the protection provided to industry has not been as great as New Zealand's and is more industry specific.

One important component of Canadian trade is its large and varied natural resource base. This includes forestry, fisheries, mining, and energy. Programs to assist development and market access for these industries have been extensive. In contrast, the natural resource component of New Zealand's economy is less diverse. Fisheries and forestry are significant, and recently natural gas has been found, however, metal and mineral deposits are not wide spread. New Zealand's pastoral sector dominates all other exports.

Canada's other significant differences to New Zealand are the shared provincial-federal responsibilities for social programs, such as income support, education and health. In Canada these responsibilities are highly decentralized. Further, one of Canada's attractions and attributes is its large geographical size. This also creates some problems with which governments have attempted to remedy since Confederation. Long distances between urban centres makes the movement of goods and people very costly. Also, most of the population live in close proximity to the U.S., consequently, it is often cheaper to conduct commerce from north to south rather than from east to west. This has been the impetus behind policies that support the east-west movement of goods and that help poorer regions of the country. The goals of these policies are not purely economic but are also associated with historic objectives of national identity and unity.

Canada's Economic Outlook

The fiscal position of the Canadian government has worsened considerably over the last 20 years. In 1979 the government net financial liabilities were 13.0 per cent of nominal GDP yet by 1994 the figure had reached 64.4 per cent (OECD 1995a:A38) There are several different explanations for the significant rise in the debt.³ Some suggest that an over aggressive monetary policy fixated on price stability created much of the debt. Others focus on the expenditure side of fiscal policies. In particular, expenditures used to fund various social and industry support programs.⁴

The relationship between the provincial and federal governments, as well as the barriers to trade and commerce between provinces, has also been identified as a contributor to Canada's current structural difficulty. The federal-provincial relationship involves the level and method of transfers to the provinces, the jurisdiction of federal and provincial powers, and the harmonization of social programs and tax administration. At the provincial level, there are significant barriers to interprovincial commerce which may frustrate domestic economic activity. Although provincial policies can influence the success of federal programs and policies, the sections to follow will focus predominately on the federal level.

Leading up to the election of a federal Liberal majority government in October 1993, Canada had experienced two years of negative growth in 1990 and 1991 followed by a weak recovery in 1992. Another characteristic during this period was a rise in the unemployment rate from 7.5 per cent in 1989 to over 11.0 per cent in both 1992 and 1993. At the end of the recession in 1991/92, the inflation rate was below 2.0 per cent and short term interest rates were declining (GATT 1995 vol 1:8-16).

Leading up to the 1993 election, the size of the federal debt, and the larger deficits as a consequence of the recession, were central issues. Figure 4.1 shows the general government net debt interest payments and net financial liabilities for Canada and the OECD. The OECD and Canadian figures are similar from 1979 to 1982, however, starting in 1983 the proportion of interest payments, as a per cent of nominal GDP, became much larger for Canada. Most industrialized countries experienced strong economic growth in

³ See Osberg, Lars, and Fortin, Pierre (eds); Unnecessary Debts; 1996, James Lorimer & Co. Ltd.

⁴ See Brown, David M. , "No Sense of Direction: Public/Private Compensation Differentials" from, Paying Our Way - The Welfare State in Hard Times; C.D. Howe Institute, 1994; Courchene, Thomas J., Redistributing Money and Power - A Guide to the Canada Health and Social Transfer; Observation No. 39, C. D. Howe Institute, 1995; and Harris, Richard G.; Richards, John; Brown, David M.; McCallum, John, Paying Our Way - The Welfare State in Hard Times; The Social Policy Challenge 3, C. D. Howe Institute, 1994.

the mid-1980s. From 1983 to 1988 Canada's rate of economic growth exceeded the OECD average yet the general government net financial liabilities for Canada still increased at a faster rate than the OECD. Only from 1987 to 1988 did Canada experience a decline of 1.3 per cent in the ratio of debt to GDP.

The government has stressed the need to reduce future deficits and debt growth, and to create economic conditions suitable for strong employment growth. As will be shown, the recent program reforms are designed primarily to reduce fiscal deficits and reverse the growth in the debt/GDP ratio by decreasing the level of expenditures.

From 1989/90 to 1992/93 the share that provincial governments contributed to the general government deficit, which is the aggregate of the federal deficit plus the provincial/territorial deficits, increased from 0.7 per cent to 3.6 per cent of GDP (OECD 1995d:43). Over recent years, most provincial governments have taken steps to reduce or eliminate their respective deficits. There has also been a convergence among federal and provincial authorities towards a greater emphasis on fiscal prudence. This is especially important with respect to Ontario and Quebec due to their considerable economic size.

A common economic and political constraint for the various levels of government is that additional revenues through higher rates of taxation is generally not an option to solve the deficit problem, although there has been some broadening of the tax base. Consequently, the emphasis for restructuring is on reducing expenditures, more efficient use of existing revenues, and reducing government exposure to financial risk.

The main components of Canada's fiscal and general economic situation are detailed below.

Government Revenues

The principal sources of revenue can be categorized by personal income taxes, corporate income taxes, unemployment insurance contributions, excise tax and duties, goods and services tax (GST), and other sources. By virtue of the Constitution Act, 1867, the provinces may only impose direct taxation while the Federal government is not restricted in its ability to tax.

Direct taxation, such as income taxes and corporate taxes, has grown in importance over the past 50 years. Higher levels of direct taxation, however, may result in the growth of the informal (underground) economy. Likewise, tax evasion or avoidance behaviour may increase with higher levels of indirect taxation, such as the GST, provincial sales taxes, and excise taxes. The loss in revenue to various tax evasion and avoidance activities is considered quite significant. Tax rates at levels that

motivate such activity may also have other negative economic effects beyond lost revenue. Incentives to work, to save and to invest can be reduced. Further, citizens and businesses may choose to move to lower tax jurisdictions, thereby reducing economic activity in the higher tax jurisdiction.⁵ In the case where substantial social investment is made to develop skills, emigration to another jurisdiction results in the loss of the investment. The potential erosion of the tax base and dampening of economic activity, both attributed to high tax rates, have been identified as a contributing factor to recurrent deficits.

The revenue collecting activities of the two levels of government are harmonized to some degree. All provinces except Quebec have agreements for the federal collection of personal income taxes, and, with the exception of Ontario, Alberta and Quebec, all corporate taxes are also collected at the federal level. Considerable effort has been committed to the harmonization of the collection of the provincial retail sales tax and the GST. Although some progress has recently been made in this regard with the Atlantic provinces, not all provinces are as receptive.

The rationale for harmonization lies in the cost to government of collection and administration of the GST and provincial sales taxes. Costs associated with the GST are high compared to other countries. Harmonization of sales taxes with the GST would serve to reduce the duplication of provincial and federal infrastructures. The compliance costs of the private sector are also considered very high, especially for smaller enterprises. Results from one study estimated these costs at 17 per cent of tax collected for firms with less than \$100,000 in revenues, while firms with over \$1 million had compliance costs near 3 per cent (OECD 1995d:66).

At the federal level, changes to the tax system have been relatively minor compared to changes in expenditures. Many provinces have also put a greater emphasis on expenditure reductions as a strategy to improving their fiscal positions. It is important to note, however, that Ontario has introduced the first part of a 30 per cent reduction in its level of personal income taxes to be phased in over the next three years. A criticism of tax reductions in the early stages of fiscal reforms is that taxes are reduced disproportionately for higher income groups and reductions occur before the magnitude of deficits, or the proportion of debt to GDP, has been sufficiently reduced.

⁵ Grubel, Herbert G., "Constitutional Limits on Government Spending Deficits and Levels in Canada", from Grubel, Purvis and Scarth; Limits to Government-Controlling Deficits and Debt in Canada; C.D. Howe Institute, 1992, p 12-14. The position taken by Grubel stresses heavily the role that excessive taxation has played in Canada's accumulation of debt.

One change in the 1996 Federal Budget Plan is that maximum RRSP contributions are frozen at \$13,500 until 2003. However, the previous seven year limit to carry-forward unused contributions was removed so that unused contributions could accumulate without restriction. Tax changes in the 1995 budget included increases in gasoline and tobacco excise duties, and increases in corporate taxes. Overall, however, the additional revenue generated from the 1995 changes was \$1.4 billion (OECD 1995d:42). Figure 4.2 shows the estimates from the 1996 budget for direct budget savings from 1994-95 through to 1998-99. The source of budget savings illustrates the extent of reliance on expenditure cuts as opposed to expanding revenues to reduce deficits.

Trade Policy and Simplification

The Canadian economy, population and land mass is much larger than New Zealand's, however, both countries share a situation where their closest neighbour has a much larger population and economy. In terms of population, Australia is nearly six times the size of New Zealand and the U.S. is nearly ten times the size of Canada. Access to these markets has become one of the fundamental cornerstones of their respective trade policies, yet, unlike New Zealand's relatively new closer economic ties with Australia, the U.S. has been Canada's major trading partner for considerably longer.

Interprovincial trade is equivalent to nearly a third of GDP yet there are numerous obstructions to the movement of goods, services and labour in the form of non-tariff barriers such as standards, regulations and government procurement practices.

Historically, exporting sectors fueled growth in the Canadian economy and this continues to be true today. Trade policy has become increasingly outward oriented in order to maintain and expand current markets and gain access to new markets. Most notable examples are the Free Trade Agreement (FTA, 1988), and the North American Free Trade Agreement (NAFTA, 1994). Canada is also a signatory to the GATT/WTO and is obliged to implement the agreements reached in the Uruguay round.

Tariffs are no longer relied upon as an instrument for broadly based industry protection or revenue generation. Along with the introduction of tariff rate quotas (TRQs) designed to replace certain quantitative restrictions, as agreed under the Uruguay round of GATT, some labour intensive sectors, like apparel and dairy, continue to receive over twice the 1994 average tariff of 8.6 per cent (GATT 1995:61). The trend towards lower overall tariff protection, due to an increase in

various preferential treatments, has resulted in an increasingly complex tariff structure. This has contributed to higher administrative costs in both the private and public sectors.

An interesting item to note is that although tariff rates may be declining, the opposite may be the case for non-tariff barriers (NTB) to trade. Table 4.1 is an index derived from certain NTB measures in Canada, New Zealand, and selected OECD countries. New Zealand certainly has lowered its NTB's quite substantially compared to their starting point of the index in 1981. In contrast, Canada has generally utilized NTB's more heavily than in 1981. The OECD index is mixed with less absolute changes than either Canada or New Zealand. This index only measures the changes of reliance on NTB's within a country. For example, New Zealand's starting point of 1981 was during a period of very high protection for its import substituting industries (ISI). Consequently, its reforms throughout the latter half of the 1980's should have lowered its index considerably.

The largest portion of Canadian exports has traditionally been destined for U.S. markets. Although there is a recognized need to open or expand into non-traditional markets for Canadian exports, the share of exports destined for the U.S. has actually increased over recent years. Canada is fortunate to be adjacent to a large and culturally similar market, however, having such a large neighbour presents some drawbacks. First, the large volume of trade between Canada and the U.S. means that Canada's economic performance depends largely on the American economic performance. Second, there is always the possibility of political events in the U.S. affecting Canadian enterprises. In essence, however, when economic conditions in the U.S. are favourable, Canada's economy benefits directly. Likewise, when the U.S. experiences economic difficulties Canada is likely to experience equal or worse problems.

One area of concern is Canada's relatively high reliance on primary commodities for the generation of export revenues. Similar to New Zealand, Canada is vulnerable to the volatility of global primary commodity prices. Furthermore, industrialized trading partners tend to be highly politicized in the agricultural and primary product based sectors and the U.S. is no exception. Table 4.2 shows that the proportion of total exports attributed to agriculture and mining ranged from 36.3 per cent in 1990 to 38.6 per cent in 1993. Also, it shows that manufactured products comprise a significant portion of exports, however, a large concentration lies in the automobile industry.

As for future developments, implementation of the NAFTA in 1994, shows Canada's commitment to reducing trade restrictions in North America. Also important to

Canada's trade strategy was the conclusion of the Uruguay Round of the GATT and further development of stronger trade links with less traditional markets. For example, Canada recently concluded negotiations with Chile to establish a bilateral agreement parallel to NAFTA, and has already signed the Israel/Canada free trade agreement. Both agreements are expected to be implemented in 1997. Furthermore, Canada's involvement in the Asia-Pacific Economic Co-operation forum (APEC) may grow more important. APEC may eventually develop into a pan-pacific trade area. Essentially, the Canadian strategy is to remain at the forefront of liberalizing trade in both new and established markets.

Trade accounts for about one third of GDP in Canada. After phase in of the Uruguay Round is complete, the Department of Finance expects a 0.4 per cent increase in real national income. Most of this gain is expected from increased demand for Canadian exports in non-traditional markets. Most of the effects from the NAFTA have already occurred (International Monetary Fund (IMF) 1995:131). Therefore, additional growth in real national income from trade will likely come from new trade agreements outside the sphere of the NAFTA.

Other Trade Related Reforms

Revenues from customs duties have decreased in absolute terms. Expressed as a per cent of GDP, from 1989-90 to 1995-96 the revenue from excise taxes and duties decreased from 3.9 to 3.2 per cent (International Monetary Fund (IMF) 1995:45). The structure of the Canadian Customs Tariff is undergoing a process of simplification in an effort to reduce transaction costs for industries involved in international trade, and to enhance transparency regarding customs duties.

Tariff simplification addresses industry concerns about the excessive administrative burden imposed by the existing system. The complexity of current duties relief mechanisms, such as duty drawbacks, remissions, and special concessionary codes for specific goods, are outside of the administrative expertise of many small and medium sized enterprises. The result is higher costs for firms because they are unaware of such programs designed to relieve duties, or they hire customs brokers or consultants to assist in their operations.

Furthermore, simplification to Custom's procedures focuses on how importers report to customs officials. Simply stated, testing is under way to develop a system where importers will have a single account with Revenue Canada which can be credited or debited intermittently. The objective is to develop a system where importers in good

standing need only report over prescribed intervals, at which time their account can be balanced based on the net balance of duties or taxes. This would reduce both restrictions on cash flow and delays in clearing goods as they cross the border.

Export Promotion

The Canadian government continues to support exporters through institutions such as the Export Development Corporation (EDC) and the Business Development Bank of Canada (formerly the Federal Business Development Bank). The former is designed to provide risk sharing and export financing for new and small exporters. The aim is to encourage a more diverse exporting sector as international trade becomes more liberalized with the phasing in of the Uruguay round agreements. The flexibility and lending ability of the latter has been enhanced through a revised mandate and capital injection of \$50 million. The purpose is to assist small and medium-sized business, particularly in strategic growth (new technology) sectors, that cannot obtain sufficient financing from traditional sources (Department of Finance 1996a:77-8).

Monetary Policy

There has been considerable discussion as to whether monetary policy played a role in contributing to Canada's deficits and debt problems (Fortin 1996:770-2). In 1991 the Bank of Canada began to announce inflation rate targets as the primary objective of monetary policy, although it had been quietly pursuing this goal for some years. Monetary authorities felt that credibility of price stability required that it publicly announce its goals and remain resolved to meeting its targets. With price stability as its sole goal, the Bank of Canada instituted a tight monetary approach. This was justified because a low inflation economy would reduce uncertainty and lengthen planning horizons for economic agents. Furthermore, if a country's inflation rate is lower than its trading partners there are competitive gains to be realized.

The beginning of the 1990s saw the onset of an international period of slower economic growth, with the unemployment rate in Canada climbing from 7.5 per cent in 1989 to 11.3 per cent in 1992 (OECD 1995d:154). Employment growth was suppressed by the effect of high interest rates on investment and exports. The decline in employment growth associated with the cyclical slowdown may have been deepened by the restrictive monetary policy during the last half of the 1980s and the early 1990s.

One observation from Table 4.3 is that Canada experienced employment growth above the G7⁶ and OECD average in periods of economic expansion, yet during periods of economic slowdown Canada's performance was markedly worse than OECD and G7 averages. In the years immediately before 1983, Canada's employment growth was strong, and following the recession in the early 1980s, by 1983 employment growth recovered rather quickly. A notable difference leading up to 1991 is that the employment growth rate began to decline in 1989, roughly two years before the recession. There appeared to be a restraint on Canadian employment growth well before the recession actually started. Although the absolute negative growth values for 1991 and 1992 were not as large compared to 1983, the figures indicate that the employment growth performance in Canada was weak over 4 or 5 consecutive years. It has been argued that the focus of monetary authorities on inflationary targets, whether announced or not, may have contributed to the weak employment growth in the years leading up to the recession in the early 1990s.⁷

Second, the price stability policy may have worsened Canada's export performance by appreciating the Canadian dollar. As shown in Table 4.4, Canada's effective exchange rate depreciated from 1983 to 1987 but then appreciated significantly over the next two years. From 1989 to 1991 the rate of appreciation slowed, reaching its highest point in 1991, at which time Canada was in the midst of a recession. The other side of the exchange rate equation is that imports become cheaper in relative terms. This led to a tightening of Canada's trade surplus and a squeeze on profits of import competing domestic industries. This may have contributed to rising unemployment as employers were forced to reduce or rationalize production, or close down completely.

A third criticism leveled on Canada's restrictive monetary policy, is its effect on the growth of the debt. To combat inflation, the Bank of Canada used interest rates as its primary tool. The effects that this may have had on the debt are two fold. First, higher interest rates will cause the debt to increase faster due to compounding interest on both new and roll-over debt. Secondly, the potentially negative effects on economic activity would erode the government revenue base and increase social support expenditures, contributing to higher deficits than if a less aggressive approach were taken by monetary authorities.⁸ Table 4.5 shows the occurrence of large deficits in the unemployment

⁶ The G7 countries are Japan, U.S., Germany, France, U.K., Italy and Canada

⁷ This point is made throughout "Unnecessary Debts"; edited by Osberg, Lars and Fortin, Pierre, 1996

⁸ Comments regarding the effects of tight monetary policy on employment, exchange rates, and the rate of growth in the debt were based in part on views expressed in , McCracken, M.C.;

insurance accounts for 1992 and 1993. The deficits are indicative of a greater general demand for social services.

Recent Interest Rate Developments

The 1996 Budget Plan declared the federal government's commitment to keeping interest rates low in order to facilitate job creation and business investment. The government attributed high real Canadian interest rates over recent years to the level of inflation, and the level of debt. A factor identified by various domestic and international sources in explaining Canada's level of real interest rates is the risk factor associated with political uncertainty concerning the possibility of Quebec separation (OECD 1995d:36). Finally, the anti-inflationary policies of the Bank of Canada have been singled out as the primary reason for high interest rates experienced in Canada starting in 1989.

The inflation rate has remained below three per cent in recent years which is correlated with lower interest rates. Furthermore, the apparent slack in the economy, in particular domestic demand, has left room for a more relaxed monetary policy without immediate concerns of inflationary pressures (The Bank of Canada 1996:3-7). The inflation rate has stayed near the mid-point of the Bank of Canada's target inflation rate band of a range between 1 and 3 per cent.

Overview of Expenditures

The five areas that account for consolidated (local, provincial and federal) government expenditures are economic and regional development, social services, education, health, defence and foreign aid, public debt charges, and other general government spending. Figure 4.3 provides a general overview of government program spending in 1995-96. Figure 4.4 provides a more detailed breakdown of expenditures in the form of transfers to persons and other governments. The four major items are transfers to the elderly, equalization payments to provinces, transfers as part of the Canadian Health and Social Transfer (CHST), and Employment Insurance expenditures.

The most notable increase in proportions of total expenditure in recent years has been in social services and debt servicing. Interest payments on the debt have risen

from just under 3.0 per cent of expenditures in 1960 to near 10.0 per cent in the early 1990s. In the same period, large increases in expenditures on income support, education and health have occurred. There was also a surge in certain industry subsidies and capital assistance in the 1980s. Government expenditures as a share of GDP increased from 28.8 per cent in 1960 to 50.4 per cent in 1991 (OECD 1992:116).

Table 4.6 provides a quick summary of where Canada stands in its financial balance, defined as its fiscal deficit as a per cent of GDP, and gross financial liabilities, defined as the level of debt calculated for all level of government expressed as a per cent of GDP, compared to other G7 countries. In 1995, Canada's financial balance was in the middle of the group while its liabilities, as a percent of nominal GDP, are second from the bottom. Figure 4.5 illustrates Canada's financial balance as the gap between government outlays and receipts as compared to the total OECD performance. During periods of recession, ranging from 1982 to 1985 and 1991 to 1994, Canada experienced relatively large deficits due to counter cyclical fiscal policies. Deficits are common during periods of poor economic performance, however, Figure 4.5 shows that Canada experienced deficits during the period between 1985 and 1991 when economic growth was strong. This may be indicative of a structural factor contributing to the deficits.

Social Services, Health and Education

The increasing portion of expenditures committed to social services, health and education has come under increased scrutiny as policy makers begin to look for ways to bring Canada back on a sustainable fiscal track. First, some problems that have been identified in the social assistance system will be discussed, followed by an examination of some criticisms directed toward health and education policy. Second, some of the reforms introduced to social programs will be described.

Unlike New Zealand, Canada is a federal state. Certain programs are shared between the federal and provincial governments, while other programs are wholly administered by the federal or provincial governments. The federal government is responsible for defence, some social programs, international trade policy. Provinces are responsible for education, health, and many social programs. Funding for provincial

programs has traditionally been provided by provincial revenues and transfers from the federal government.⁹

Canada Assistance Plan

The social assistance responsibilities are shared by the federal, provincial and local governments. The 1970s saw the consolidation of the social assistance system with more generous and comprehensive programs. The Canada Assistance Plan (CAP), which accounted for nearly 22 per cent of total federal transfers to the provinces (1994/95), has been criticized for enabling the provinces to create social assistance programs which were too expensive to sustain. Under CAP, the federal government matched, dollar for dollar, provincial expenditures on assistance to persons in need and on welfare. To qualify for transfers under CAP there must be an existing need of individual recipients and that no minimum residency conditions exist. Although there have been some changes to CAP funding, the open ended funding throughout the 1970s and during much of the 1980s is perceived as one of the reasons for the increase in the generosity of social programs.

The open ended federal-provincial 50-50 approach to funding enabled provinces to establish programs they deemed appropriate for themselves. Increased expenditures on programs eligible for CAP funding occurred because provinces only had to pay half the marginal costs. Likewise, incentives for provinces to reduce spending on CAP funded programs were reduced since savings would be split with the federal government.

Using Ontario as an example, Table 4.7 uses the terms "index of need", defined as the welfare recipients per capita as a percentage of the national average expressed as an index of 100, and an "index of generosity", defined as the expenditure per recipient as a percentage of the national average expressed as an index of 100. The table shows that in 1990 Ontario's "index of need" is below that of the national level while its "index of generosity" is second only to Alberta. The introduction in 1990 of an annual 5.0 per cent limit on the growth of federal CAP transfers (effecting Ontario, Alberta and British Columbia) required any additional expenditure growth above the

⁹ Discussions on social programs and expenditures draw from Boadway, Robin W., and Hobson, Paul A.R.; Intergovernmental Fiscal Relations in Canada - Canadian Tax Papers No. 96; Canadian Tax Foundation 1993;

Treff, Karin and Cook, Ted; 1995 - Finances of the Nation - A review of expenditures and revenues of the federal, provincial and local governments of Canada; 1995, Canadian Tax Foundation, p. 2:5; and Department of Finance; Budget 1995; and Budget 1996.

ceiling in CAP to be financed by Ontario. This has contributed to Ontario's deficits, and hence, Canada's gross deficit.

The original CAP system is seen as a contributor to a social assistance system that has grown beyond many provinces, and hence, Canada's ability to pay. The programs appeared affordable in periods of strong economic growth but are now a major focus of structural reformers.

Established Program Financing

The Established Programs Financing (EPF) system started with the implementation of the 1977 Federal-Provincial Arrangements and Established Programs Act. It combined three major conditional grants for hospital insurance, Medicare, and post secondary school education into a lump sum payment (Boadway et al 1993:45). EPF transfers accounted for nearly 58 per cent of total federal transfers to the provinces (1994/95) and, in part because of its size, is as a candidate for reform. The provinces have had complete control over the allocation of EPF funds in the areas of health care and post-secondary education. The only requirements are that federal health standards be maintained and that funds are directed towards the specified areas.

The Canadian Health and Social Transfer (CHST)

The 1995 Budget contained a major change to the method of transferring funds to provincial governments for social programs. In the 1996 Budget, it explicitly states that, "transfers could not be exempt from restraint", in that, "cash transfers alone account for almost 23 per cent of federal program spending in 1996-97." (p. 57).

Beginning in 1996-97, the method of providing transfer payments will change from the system of separate federal transfers under the EPF and the CAP to block funding under the Canada Health and Social Transfer (CHST). The change gives provincial authorities greater flexibility in the administration of programs. However, the CHST allows the federal government to end the cost sharing structure which existed under the CAP.

An important implication is that the CAP portion of the CHST will no longer be an open ended funding arrangement between federal-provincial governments. Further to strengthening the incentive for more efficient social program spending, the CHST will enable the federal government to set the level of transfers under this system with more certainty. Table 4.8 shows that the transfers under the CHST are projected to decline from the pre-CHST era of just under \$30 billion to \$25.1 billion for fiscal years 1998-99

and 1999-2000. During the three years following 1999-2000, the CHST will increase by the growth rate of the GDP less two, one and a half, and one per cent for each year in succession to 2002-03.

Also, starting in 1995-96, the fiscal stabilization program will be changed. Stabilization payments will begin when a province experiences a year over year five per cent decrease in revenues. Previously, payments began when a province experienced any decline in year over year revenues. The rationale for the five per cent criterion rests in Canada's current low inflation economy, and, given the fiscal changes instituted by some provinces, there are likely to be modest reductions in revenues of some provinces. The intent of the fiscal stabilization program was to compensate provinces when revenues were adversely effected due to severe economic downturns, not because of fiscal restructuring policies. During periods of low inflation even minor variations in economic performance can result in lower revenues. Also, provincial changes in fiscal policy can effect revenues, such as the case of Ontario where expenditure and tax cuts are being simultaneously implemented (Treff et al 1995:(2:5); and Dept. of Finance 1995a:55).

Another reform associated with the change to the CHST involves the transfer allocation method to the provinces. Currently, on a per capita basis, some provinces receive higher levels of transfer payments than others. The government announced in its 1996 Budget Plan (p. 55-6) of its intention to reduce funding disparities among provinces which would better reflect migration and other differences in population growth. By 2002-03 the current level of disparity in per capita allocations between provinces will be reduced by half. The disparities in the CAP system play an equalization role by providing certain provinces with more funds per capita based on regional differences. The new CHST will diminish this aspect of the CAP.

Equalization Payments

The federal government provides equalization payments outside of the CHST arrangement. Equalization payments are transfers to certain provinces to enable the provision of comparable levels of government services at comparable levels of taxation. The objective is to ensure that each province has \$5,000 per resident for funding of public services. Unlike EPF/CAP funding which was essentially reduced under the CHST arrangement, equalization payments will increase over the period 1994-95 to 1998-99. Over this period equalization payments are expected to increase from \$8.5 to \$9.6 billion. The combined provincial and territorial transfers for equalization purposes for 1996-97

will be near \$9.9 billion, about \$8.8 under equalization and \$1.1 billion under Territorial Formula Financing (Dept of Finance 1996a:60-1).

After the federal government announced in its 1995 Budget that the EPF and CAP would be combined into a block payment concerns were raised about maintaining national standards (Battle 1995). It was unclear at that time whether the cash component of the CHST would be maintained in future years. EPF/CAP transfers have both a cash and tax point component. Cash transfers, as opposed to tax points, provide leverage for federal authorities in ensuring that minimal standards for certain programs are maintained by all provinces. For example, if a province adopted any policies that contradicted the Health Act, the federal government could withhold cash transfers until the conditions of the Act were satisfied.

Over time, as the economy grows, the value of tax points will increase at a rate which is faster than the planned growth in the CHST. Depending on the growth rate differentials, the proportion of cash in the CHST would fall to zero if no minimal limit on the cash component of the CHST existed (Courchene 1995; and, Battle 1995). The 1996 Budget Plan (p. 57) addressed the issue of cash transfers by guaranteeing a minimum cash transfer of \$11.0 billion for the current five year arrangement, from 1998-99 to 2002-03.

Elderly Support Programs

Old Age Security (OAS), Guaranteed Income Supplement (GIS), and the Spouse's Allowance (SPA) are subject to the prevailing reforms as well. Future financial resources required by these programs are subject to demographic forces linked to the ageing Canadian population. The 1995 Budget Plan predicts that over the next 15 years the cost of the OAS and GIS will increase 60 per cent from its 1995 level of \$20 billion.

Currently, OAS benefits are subject to an income test based on the previous year's income. Benefits are paid out net of high income recovery amounts. A new program called the Seniors Benefit was announced in the 1996 budget. Its principle objective is to slow growth in the cost of benefits paid to the elderly by reducing payments to high income seniors. The Seniors Benefit is scheduled to be implemented in 2001. However, seniors who qualify for OAS and GIS on or before December 31, 2000, will have a choice between the Seniors Benefit program or the current programs (Department of Finance 1995a:57-8; and, 1996a:65-6).

Unemployment Insurance (UI)

The unemployment insurance (UI) program is a target because of the perception that it is too lenient in its eligibility requirements and is too generous in its benefits. Eligibility for UI varies across the country based on weeks worked and the regional rate of unemployment. The system is criticized because it is perceived as encouraging UI seeking behaviour. For example, in the case of firms that experience periodic reductions in labour requirements, workers may be laid-off for short periods of time. When demand for labour increases workers are re-hired. Labour market behaviour distortions, such as short term labour force attachment and seasonal employment, may be encouraged by the current UI system (Carmicheal 1984:36).

Studies examining the employment effects of UI contributions have reached contradictory conclusions. Some empirical work indicates that contribution rates may have a long-run effect on the unemployment rate in Canada, while others have found that there may only be short-term effects (IMF 1995:68-9).

In a study by Christofides and McKenna (1996), the authors examined whether or not the Variable Entrance Requirements (VER) of 10-14 weeks of insurable employment to qualify for benefits (1986-87) correlated with individuals that remain employed just long enough to qualify for benefits. Also, the study examined whether employers utilize UI to provide a pool of short-term labour by choosing to keep short-term employees long enough to meet the eligibility requirements, thereby lessening separation costs. The authors also looked for repeat users by identifying where spikes in employment separation over longer periods of time corresponded with repeat users.

The authors found that the duration of employment for new jobs shows a correlation with the VER, and they concluded that there is UI seeking behaviour. Furthermore, there was evidence that the occurrence of benefit exhaustion also effects the likelihood of return to employment. They reported that there was a greater incidence of EI beneficiaries returning to work when their benefits ended than in the weeks immediately before and after the week of benefit exhaustion.

Another inference was that moral hazard associated with UI seeking behaviour was also expected to be highest for individuals with an employment duration of less than four months. Essentially, longer periods of employment corresponded with a decreasing occurrence of separation. The authors concluded that more stringent EI eligibility requirements may decrease the moral hazard effects.

Furthermore, UI contributions are shared between employers and employees. The contributions by employers are seen as a payroll tax which can have a prohibitive effect on hiring new employees by raising the cost of labour (OECD 1995d:56-8).

The Employment Insurance (EI) program (formerly the Unemployment Insurance program) has undergone recent reforms designed to address the problems discussed above. First, eligibility requirements have been tightened. For example, the minimum number of weeks worked has been raised, the duration of payments have been reduced, the level of most payments have also been lowered. Also, certain reasons for ending employment may disqualify eligibility. Further, the regional differences in eligibility requirements, based in part on regional levels of unemployment, have been narrowed although they remain significant (OECD 1995d:56-8).

The 1995 Budget Plan states that the EI program would be reduced by 10 per cent by the year 2000, with savings of \$700 million in 1996-97 (p. 56). Recently, revenues from EI contributions surpassed program payments, consequently, there is the perception that lower contribution rates are justified in order to reduce labour costs of employers.¹⁰

In 1993 the EI account had a cumulative deficit of \$5.9 billion, with an annual deficit of \$1.2 billion. However, in 1994 there was an annual surplus of \$2.7 billion and the cumulative deficit had dropped to \$3.2 billion. Based on revenue and expenditure outlooks using current contribution rates (p. 106, 110, 1996 Budget) the EI account is expected to have significant annual surpluses, and a cumulative surplus over the period of 1994-95 to 1996-97 in excess of \$14 billion. The 1995 Budget predicts a surplus in the EI account of over \$5 billion by the end of 1996.

The EI program was reformed over recent years to tighten eligibility requirements and the duration and level of benefits. Further changes to the program are outlined in Bill C-12 (Nakumura 1996). Its objective is to address the matter of repeat users, high income users, and to enhance the fairness of eligibility requirements (Nakumura 1996:7-10).

A major reform under Bill C-12 is referred to as the "intensity rule". This rule will reduce the replacement rate for insured earnings by 1 per cent for every 20 weeks of benefits collected over the previous five years. Another reform under the Bill is to change the unit of account for establishing eligibility of benefits from weeks worked (with a minimum of 15 hours per week) to hours worked. The proposed minimum qualifying hours worked is 420 to 700 hours, depending on regional unemployment rates. There are

¹⁰ The issue of the effects of payroll taxes on the level of employment, or, the level of the natural rate of unemployment are discussed in Department of Finance; Budget 1995 - Budget Plan; February 27, 1995, p. 55; and; International Monetary Fund, IMF Staff Country Report No. 95/46; Canada-Economic Developments and Policies; IMF, Washington, D.C., p. 68

regional redistribution properties built in to the variable eligibility requirements. Using hours rather than weeks as the unit of account, however, will make smaller incremental adjustments to eligibility requirements possible. This would enable the gradual reduction in the regional redistribution characteristic currently built into the EI program.

The third reform is to enhance the "clawback" provision to counteract frequent use of the program by "well-off" Canadians. The method of clawback would be to raise the degree of experience rating for higher income individuals (Nakamura 1996:9).

Health and Education

Criticisms directed toward health and education has focused on both the level of expenditures and the value or return for expenditures. Universality of health care is at the core of the Canadian health care system. However, some feel the health care system could be made more efficient by introducing service charges, or by setting up a two-tier system based on a minimum level of health care while allowing those with the ability to pay to acquire medical services outside the traditional 'first in first out' system. Supporters feel that a two-tier system would improve the efficiency of health care by preventing unnecessary use of the system, alleviate bottlenecks for services, and discourage emigration of medical professionals to less regulated jurisdictions.

Table 4.9 shows that Canada spends a relatively high amount on education, as a percentage of GDP, with only Denmark and the Netherlands spending more. The return on expenditures has been questioned because the completion rate and quality of graduates is considered to be lower than many other industrialized countries that spend proportionately less (OECD 1992:65-8).

Critics focus on the relatively high proportion of students that fail to complete secondary school and the decline in test scores measuring basic skills such as mathematics, language, vocabulary and reading comprehension. The development of job skills is another area that has been stressed as needing attention, as does a greater focus on vocational training.¹¹

Jurisdiction over education and health care lies predominantly with provincial governments. Alberta has reduced health and education spending in recent years. Ontario is in the process of reducing expenditures on these areas as well. Provincial

¹¹ Based on findings presented by the OECD in; OECD Economic Survey - Canada - 1991/92; OECD 1992.

governments have identified federal cuts in transfer payments as a primary cause for many provincial expenditure cuts.

Restructuring the Role of the Public Sector

Governments are often involved in activities that are also in the private domain. The Canadian government operates many crown corporations, agencies and other organizations. Proponents of smaller government believe that most government activities could be privatized or reorganized to face conditions similar to private sector firms and institutions.

In the late 1980s, the government's philosophy regarding its role in the economy was showing real signs of change. There was a move toward less direct government involvement in commercial enterprise. Two examples are the introduction of private sector management practices for Canada Post, and the sale of Air Canada through stock offerings. The 1995 budget revealed the current government's intention of continuing to find ways of reducing direct government involvement in economic activity. Some methods of accomplishing this objective are reducing or eliminating public ownership of economic enterprises, reducing public provision of services where they can be equally or better provided by the private sector or other agents, or by creating partnerships with these groups when appropriate.

From 1994-95 to 1998-99, federal business subsidies were cut by 61 per cent. The largest single reduction being the termination of the Western Grain Transportation Act and the Feed Freight Assistance transportation subsidy which effectively ends subsidized rail rates for grain transport (Dept. of Finance 1996a:40). The expected savings are near \$0.6 billion annually, however, land owners experiencing a negative effect on property values will be compensated by way of a lump sum payment of \$1.6 billion (OECD 1995d:42). Other cuts include the dairy subsidy, which will be phased out over five years starting in August, 1997, and an 18 per cent reduction in the postal subsidy in 1997-98 and 1998-99 (Dept. of Finance 1996a:41). Finally, there will be a change in farm income security programs to "whole farm" coverage rather than product specific coverage.

Reforms to government operations will also affect its role in regional development. There will be less access to, and reliance on, direct subsidies and other programs as regional agencies are modified to assist small business access to private sector financing. The 1995 budget also indicated the Canadian government would no longer be involved in large mega-projects and that regional development agreements in mining and forestry will end (Dept of Finance 1995b:44, 57)

Another noteworthy item is the current review of the federal government's role in social housing programs. The management of housing resources currently provided by the Canadian Mortgage and Housing Corporation may be transferred to the provincial/territorial authorities. Also, a possible future role for third party administration (presumably private sector) of the social housing stock is being assessed.

Some federal departments will be wholly or partly transformed with the aim of more cost effective delivery of services which are better suited to the changing needs of clients. Some examples are, first, the creation of the Single Food Inspection Agency which is intended to consolidate the food inspection and quarantine services currently provided by three separate departments.

Second, the future creation of an agency to assume tax collection and customs functions currently provided by the Department of National Revenue. The motive is to allow more flexibility by creating an organization able to quickly respond to changing client needs, and to work toward reducing duplication of revenue collection activities at the provincial and federal levels (Dept. of Finance 1996b:46-8).

Third, and perhaps the most striking example of the potential of departmental restructuring so far, are reforms affecting Transport Canada and the National Transportation Agency. They function as the primary federal program delivery and regulatory bodies for the transportation sector. Transport Canada will continue its policy and regulatory development role, however, it has ended its role as a provider of direct services, such as inspections and testing. A fundamental change in transport policy is the elimination of subsidies for grain transport, and removal or reduction in other transport subsidies, such as subsidies to transportation companies under the Atlantic and Maritime Regional Freight Assistance Acts (Dept. of Finance 1995b:62). From 1994-95 to 1996-97 total government expenditures on transport policies and programs will decrease from near \$2.8 billion to less than \$1.6 billion (Dept. of Finance 1995b:61-2).

Finally, the number of people on public payrolls and the amount of compensation which they receive has been the subject of scrutiny. First, reducing public sector employment levels may require shifting some functions to the private sector, restructuring expenditure accountability, creating a more flexible labour-management environment to reduce rigidities in the civil workforce, and privatization of government enterprises where private operation can provide the same service. Currently, the federal government is in the process of reducing the number of employees by at least 45,000, with further reductions likely by the end of the decade (Dept. of Finance 1996a:40).

Table 4.10 shows relative employment growth rates in private and public sectors. In Canada, public sector employment growth surpassed private sector growth in three of five time periods and surpassed the OECD average in all periods. Although crude, this analysis tends to confirm that public sector employment did grow faster than total employment growth. Figure 4.6 shows that most federal departments will experience a cut in operating budgets over the period of 1994-95 to 1997-98. Over this period the departmental reduction in expenditures will be near 21.0 per cent (\$11.1 billion), with nine departments facing reductions higher than 30.0 per cent (Dept. of Finance 1996b:37-9).

Summary

The government's general approach to reforms has focused more on reducing expenditures. Tax measures have been modest. Deficits are expected to decline year over year and the primary surplus is expected to remain on an upward trend. Since the early 1990s inflation has remained low, with any perceived increase in inflation countered-acted with an increase in interest rates. Since the start of the recession, however, unemployment has remained stubbornly high, decreasing only modestly from over 11 per cent in 1993 to its current level of about 10 per cent. With modest economic growth, and fiscal restructuring aimed at generating significant primary surpluses, reducing the unemployment rate may prove difficult.

Chapter V will summarize the lessons that are revealed by New Zealand's restructuring experience and whether the Canadian government should emulate any elements of New Zealand's approach. Also, New Zealand's and Canada's success in meeting the objectives of reforms is discussed. The chapter finishes with some comments on whether there is a need for adjustments to the Canadian government's current reform strategy.

Table 4.1 - Trade coverage ratios¹ of selected non-tariff measures (NTMs)² applied by selected OECD countries from 1981 -1990 (Index numbers 1981=100)

All sectors (SITC 0-9), all selected NTM's											
	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	
Canada	100.0	113.3	114.4	117.1	119.8	194.2	197.3	150.7	135.6	133.6	
New Zealand	100.0	100.0	100.1	100.1	72.0	70.8	64.7	47.9	32.4	25.1	
Total ³	100.0	102.1	103.4	83.5	85.5	88.0	91.7	90.0	95.7	95.1	
Non-fuel trade, core measures											
	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	
Canada	100.0	114.6	114.6	114.6	107.6	107.6	110.1	80.2	68.1	68.1	
New Zealand	100.0	100.0	100.0	100.1	69.2	66.0	39.8	39.8	25.8	19.6	
Total ³	100.0	101.6	101.7	104.1	103.8	103.3	104.7	105.3	104.6	103.0	

¹ Ratios computed using 1988 trade weights

² "all selected NTM's" includes certain para-tariff measures, surcharges, variable levies, anti-dumping and countervailing actions, quantitative restrictions (including prohibitions, quotas, non-automatic licensing, state monopolies, 'voluntary' export restraints and restraints under MFA and similar textile arrangements), import surveillance, automatic licensing and price control measures. The group of "core" NTM's excludes from the group defined above para-tariff measures, anti-dumping and countervailing actions, automatic licensing and import surveillance measures.

³ The U.S., Japan, Canada, Austria, Finland, New Zealand, Norway, Switzerland and the EC (12)
Source: OECD; Progress in Structural Reform - An Overview; OECD 1992, p. 38

Table 4.2 - Merchandise exports by broad product group,
1990 - 93, Canada
(% share of total exports)

Commodity	1990	1991	1992	1993
Agriculture	17.7	17.1	17.9	16.8
- Food	8.7	9.1	9.5	8.2
- Ag Raw Materials	9.1	8.1	8.3	8.6
Mining	18.6	18.7	18.0	16.8
- Ores	4.2	3.6	3.0	2.3
- Non-ferrous metals	4.4	4.3	4.3	3.8
- Fuels	10.0	10.9	10.7	10.7
Manufactures	58.8	59.4	59.7	62.0
- Automotive products	21.6	21.4	22.4	24.5
- Chemicals	5.4	5.4	5.4	5.2
- Machinery	12.0	12.3	11.9	11.9
Other	4.8	4.7	4.5	4.4

Source: GATT; Trade Policy Review - Canada - 1995, vol. 1, GATT, 1995

Table 4.3 - Growth of Employment
(percentage change from previous period)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Canada	1.8	3.5	4.1	3.0	2.7	-3.5	0.5	2.4	2.6	2.8	2.9	3.2	2.0	0.7	-1.8	-0.8	1.3	2.1	2.6
Total G7	1.9	2.3	1.9	0.7	0.3	-0.6	0.7	2.0	1.3	1.4	1.7	1.9	1.8	1.2	0.0	-0.1	0.0	0.7	1.1
Total OECD	1.7	1.8	1.7	0.7	0.3	-0.5	0.5	1.7	1.3	1.5	1.7	1.9	1.9	1.3	0.0	-0.3	-0.3	0.6	1.1

Source: OECD Economic Outlook No. 54, December 1993, p. 142

Table 4.4 - Effective exchange rates
Indices 1991=100, average of daily rates

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995 ^a	1996 ^a
Canada	98.5	95.6	91.8	86.0	87.5	92.9	97.8	98.2	100.0	94.1	88.8	83.4	82.8	85.0
U.S.	116.3	123.9	130.4	113.4	1.5.1	100.0	102.6	100.8	100.0	98.6	100.7	99.9	100.0	103.1
Japan	62.5	65.7	68.1	89.8	97.3	106.2	99.6	91.6	100.0	105.3	126.5	136.1	143.1	129.2
UK	111.3	107.0	107.3	99.5	97.9	103.7	100.5	99.1	100.0	96.4	88.3	88.8	85.2	85.0
Germany	80.7	80.3	81.1	89.8	96.0	95.8	95.1	100.4	100.0	103.5	107.4	108.9	115.6	116.3
France	98.2	94.8	96.3	99.5	99.7	97.9	96.9	101.5	100.0	103.3	106.5	107.9	111.6	113.1
Italy	107.4	103.0	98.1	100.7	100.8	98.0	98.9	101.0	100.0	97.3	82.0	78.9	71.4	72.7
New Zealand	141.2	127.2	116.1	105.4	108.8	112.7	105.7	103.6	100.0	92.3	95.9	101.5	108.0	108.9

^a Estimates and projections

Source: OECD Economic Outlook No. 58, December 1995, Annex p. A41

Table 4.5 - Unemployment insurance expenditures for selected years

	Total Revenue	Payment of benefits ^b	Surplus or deficit (-)
1960	282.8	415.2	-132.4
1970	623.0	542.1	80.9
1975	2 453.8	2 521.0	22.8
1980 ^a	5 143	4 202	941
1985 ^a	10 726	11 702	-976
1990 ^a	13 735	12 773	962
1991 ^a	14 872	15 667	-795
1992 ^a	15 810	19 616	-3 806
1993 ^a	18 012	20 397	-2 385
1994 ^a	18 722	19 356	-634

^a Data unavailable to nearest \$100 000,

^b Includes interest on loans from Minister of Finance, and since June 27, 1971, administrative costs

Source: Treff, Karin and Cook, Ted; 1995 Finances of the Nation - A review of expenditures and revenues of the federal, provincial, and local governments of Canada; 1995 Canadian Tax Foundation, p. 9:4, Table 9.2

Table 4.6 The Fiscal Outlook - G7 Countries
(% of nominal GDP)

	Financial balance ^a			Financial liabilities ^b		
	1993	1995	1997	1993	1995	1997
U.S.	-3.4	-1.6	-1.5	63.9	63.1	62.1
Japan	-1.4	-3.9	-4.1	69.3	83.1	97.3
Germany	.3.5	-3.1	-2.3	52.0	60.0	59.9
France	-6.1	-5.0	-3.0	52.6	57.5	59.8
Italy	-9.6	-7.4	-5.4	118.4	124.4	123.4
UK	-7.8	-5.0	-2.8	56.9	56.8	59.0
Canada	-7.3	-4.4	-2.0	93.8	97.3	95.7
Total of above	-4.2	-3.3	-2.6	67.5	71.6	73.9

^a General government fiscal deficit as a per cent of GDP.;

^b General government gross financial liabilities as a per cent of GDP.

Source: OECD Economic Outlook No. 58 December 1995; OECD 1995, p.21

Table 4.7 CAP Transfers by Province, 1989-90^a

Province	Total ^b (\$million)	\$/capita	Index of need ^c	Index of generosity ^d
Newfoundland	101.0	177.0	104	84
Prince Edward Island	23.9	183.7	86	105
Nova Scotia	157.2	177.4	118	75
New Brunswick	158.9	221.2	130	84
Quebec	1 681.1	251.2	121	103
Ontario	1 906.2	199.0	86	115
Manitoba	194.5	179.3	86	103
Saskatchewan	152.9	151.7	78	96
Alberta	517.0	213.4	84	126
British Columbia	720.0	235.8	107	109

^a Most recent periods available,

^b Inclusive of \$574.7 million value of special abatement to Quebec,

^c Welfare recipient per capita relative to the national average expressed as an index of 100,

^d Expenditure per recipient relative to the national average expressed as and index of 100

Source: Robin W. Boadway and Paul A.R. Hobson; Intergovernmental Fiscal Relations in Canada - Canadian Tax Paper No. 96; Canadian Tax Foundation 1993, p.70. The Table is derived from sources from the Department of Finance and Suzanne Bezanson, "Federal-Provincial Cost Sharing in Social Assistance: Aspects of the Canada Assistance Plan", Unpublished honours thesis, Acadia University, 1992

Table 4.8 - Canada Health and Social Transfer,
1994-95 to 2002-03
(\$ billions)

CHST	
1994-95	29.4
1995-96	29.7
1996-97	26.9
1997-98	25.1
1998-99	25.1
1999-2000	25.1
2000-01	25.7
2001-02	26.5
2002-03	27.4

Source: Dept of Finance; Budget 1995 - 1995
Budget Plan; p. 53 and; Budget 1996 - 1996
Budget Plan; p. 58.

4.9 Total Expenditure on Education¹
1987 figures in local currency and at current prices as a
percentage of GDP

Canada	7.12
Australia ²	5.63
Denmark	7.57
France ²	6.59
Germany	4.41
Japan ²	6.38
Netherlands	7.33
United States ²	6.44

¹ Including transactions relating to loans for Denmark,
Germany, Japan, the Netherlands, and the United
States

² 1986

OECD, OECD Economic Survey 1990-91 - Canada

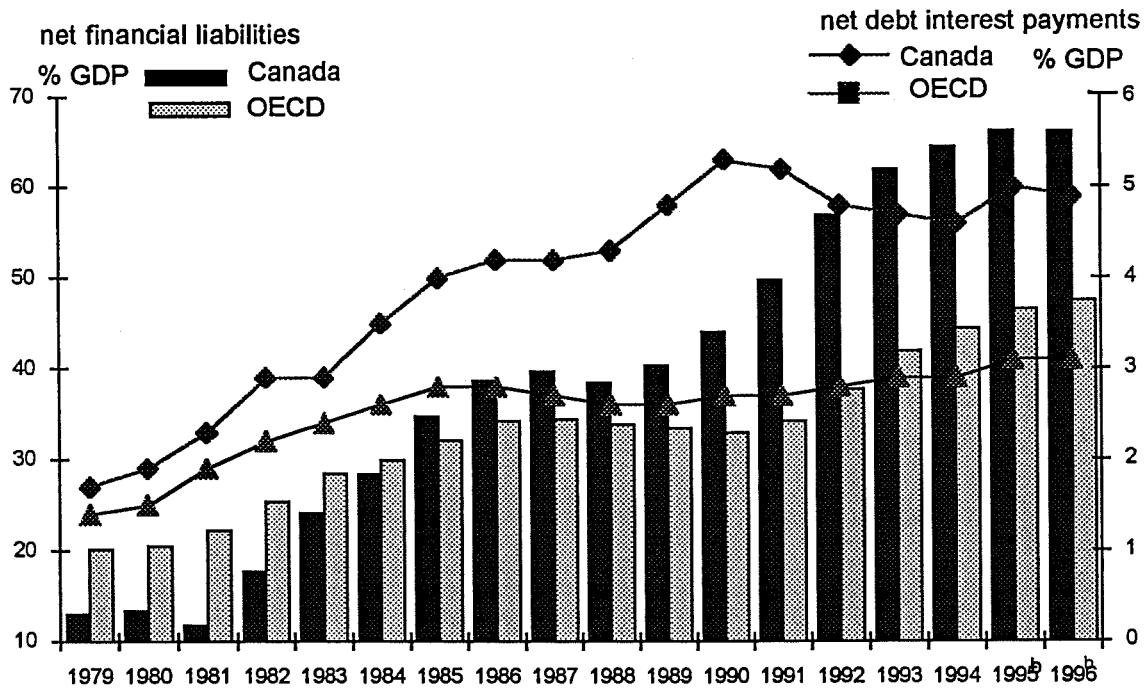
Table 4.10 - Private and public service employment growth -
 selected OECD countries
 Average period growth rate, per cent

	Private service employment					Public service employment				
	1963-73	1974-78	1979-83	1984-89	1990-91	1963-73	1974-78	1979-83	1984-89	1990-92
Canada	3.7	3.5	2.6	3.4	0.4	5.1	3.6	2.0	1.9	2.0
U.S.	2.7	3.5	2.5	3.4	0.5	4.1	2.7	0.3	1.9	1.4
Japan	3.3	2.2	2.4	2.1	2.8	1.7	1.8	1.0	0.1	0.6
Germany	0.7	0.8	1.6	2.1	4.1	3.4	2.2	1.5	0.9	1.0
France	2.8	2.5	1.3	2.1	2.4	2.3	1.9	1.7	1.0	0.5
Italy	0.6	2.7	3.2	3.0	3.0	2.9	2.8	1.4	1.4	0.2
UK	0.6	1.0	1.2	4.9	0.3	2.6	1.5	-0.0	-0.1	-1.0
Australia	4.1	0.6	2.1	5.1	1.7	3.6	8.3	1.7	1.9	0.6
New Zealand	3.5	1.5	2.0	8.5	5.2	2.8	3.7	-0.2	-0.8	-5.0
OECD ^a	2.8	2.4	2.2	3.2	2.4	3.4	2.8	1.1	1.3	0.9

^a Excluding Belgium and Luxembourg

Source: OECD, Assessing Structural Reform - Lessons for the Future; OECD 1994, p. 138

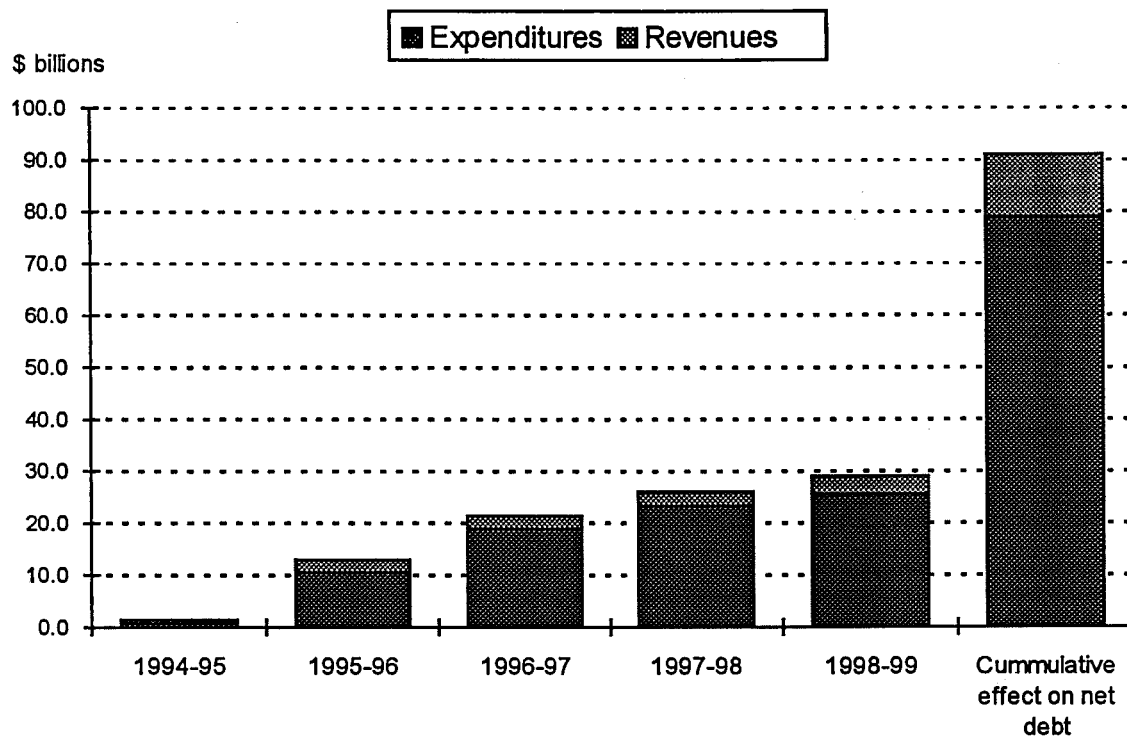
Figure 4.1 - General government net debt interest payments and net financial liabilities - as a % of nominal GDP



^a Includes all financial liabilities less all financial assets, as defined by the System of National Accounts (SNA) and covers the general government sector, which is a consolidation of central government, state and local government and the social security sector. ^b Estimates

Source: OECD; *OECD Economic Outlook No. 58, December 1995*; OECD 1995, p. A 36 & A 38.

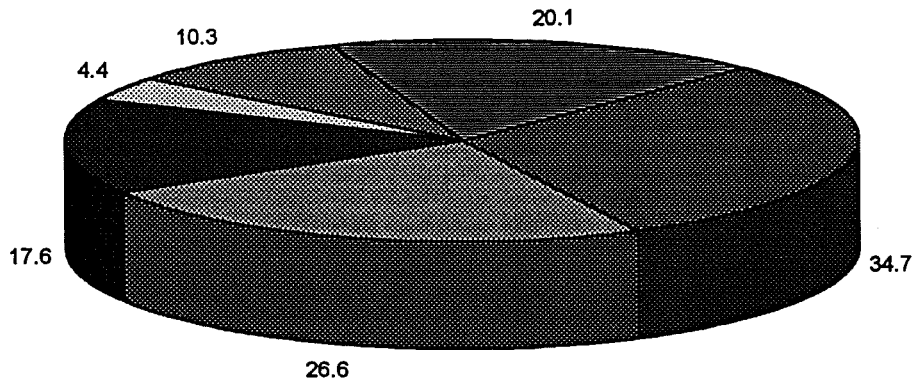
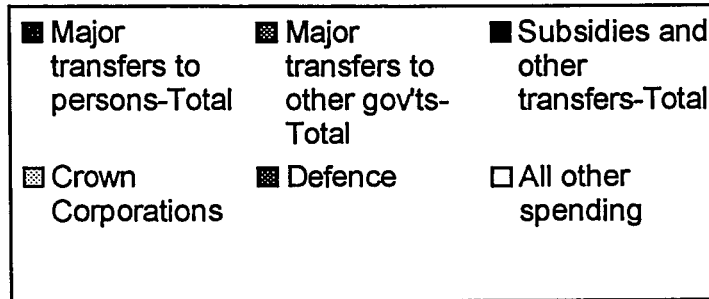
Figure 4.2 - Direct Budget Savings
(\$ billions)



¹Savings for 1996-97 included in the 1995 Budget

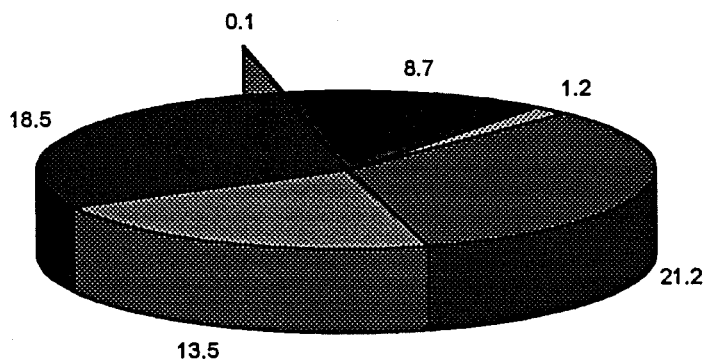
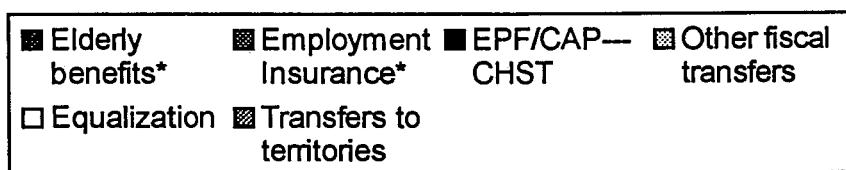
Source: Department of Finance; Budget Plan - 1996; March 6, 1996, p. 14

Figure 4.3 - Federal Government Program Expenditures
(billions)



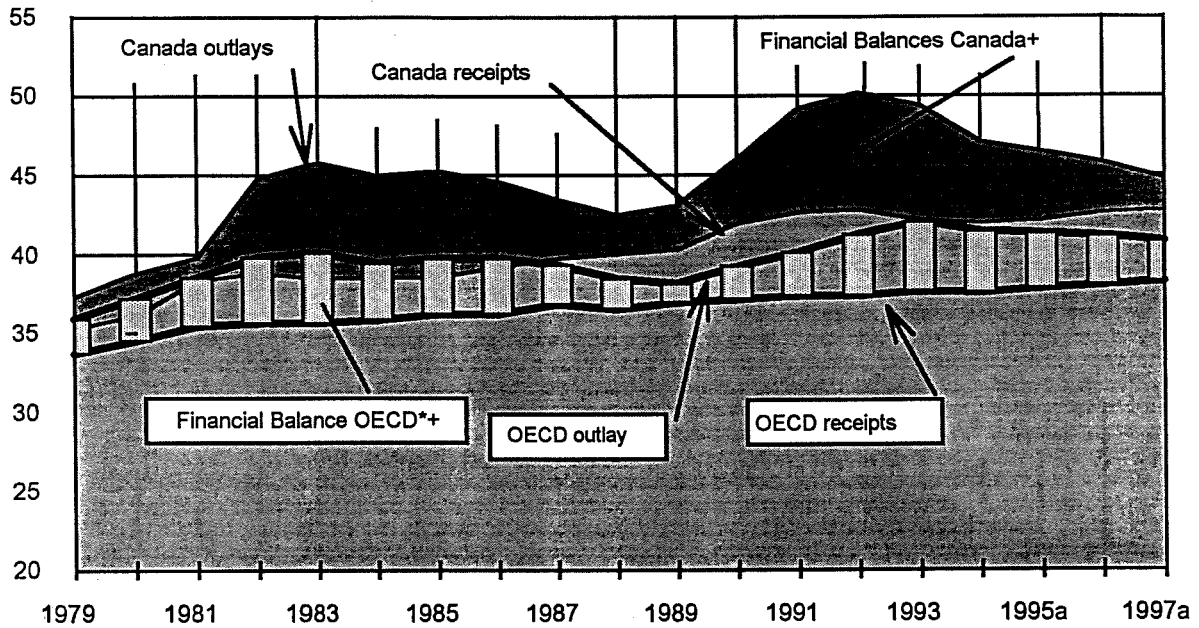
Department of Finance; Budget Plan - 1996; p. 110

Figure 4.4 - Major transfers to persons* and Other governments 1995/96 (billions)



Department of Finance; Budget Plan - 1996; p. 110

**Figure 4.5 - General Government Total Outlays and Current Receipts
(as a percent of nominal GDP)**



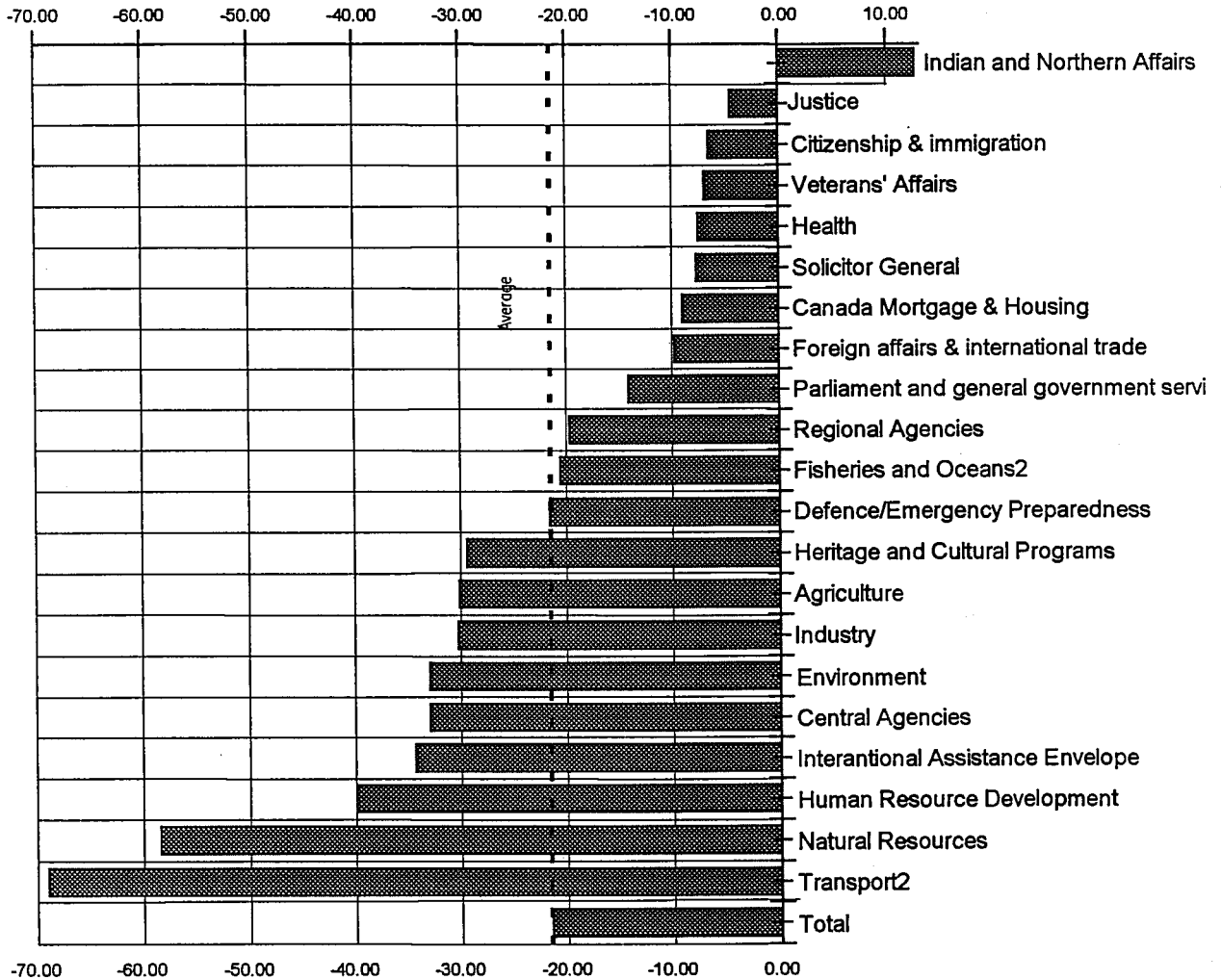
^a Estimates and projections;

* The following countries not included in OECD Total: New Zealand, Switzerland, Turkey, Iceland, Luxembourg, Mexico;

+ Financial balance equals outlays less receipts. The shaded areas showing OECD and Canada's financial balance represent negative values

Source: OECD Economic Outlook, No. 58, December 1995, Annex p. A31-33

Figure 4.6 - Departmental Spending¹, 1998-99 relative to 1994-95
(per cent change)



¹ These estimates include spending on new initiatives.

² The Canadian Coast Guard (CCG) was part to Transport in 1994-95, and is now part of Fisheries and Oceans. For consistent year over year comparisons, CCG is included in Fisheries and Oceans for both 1994-95 and 1998-99

Sources: Department of Finance; Budget 1996 - Budget Plan; March 6, 1996, p. 36

Chapter V - Lessons from New Zealand's Experience and Canada's Options for Reforms

The Canadian and New Zealand approaches to economic restructuring share some similarities, however, there are numerous and significant differences. First, other than initial attempts to remove quantitative restrictions on certain importations before 1984, New Zealand essentially started its reform process on an economy that was highly insulated from external economic pressures. Second, conditions which initiated reforms were building for some time prior to 1984, by which time it was apparent that there was no choice but to restructure the economy in some manner. Figure 5.1 compares the relative rates of increase in GDP per capita for New Zealand and Canada. It is evident that New Zealand gradually lost ground up to near 1970. From 1970 onward, growth in New Zealand's GDP per capita was considerably less than Canada, and it is important to note that even after 1984, until about 1992, growth remained flat.

In contrast to New Zealand's restructuring experience, the Canadian economy has gradually been deregulated and liberalized without reforms being precipitated by a crisis. The financial sector has been lightly regulated by international standards. Since the mid-1970s a managed floating exchange rate regime has existed, and, although New Zealand and Canada depended heavily on trade, the Canadian export mix is considerably more diversified.

Canadian manufacturers have been less protected from foreign competition than their New Zealand counterparts. Furthermore, trade liberalization has been implemented in Canada over a greater period of time. Although Canada uses various trade protection techniques, including some quantitative restrictions, New Zealand used high tariffs and broad quantitative restrictions to protect a very diverse but small manufacturing sector. Import substitution was the predominate industrial and trade policy in New Zealand with respect to manufactured goods of non-agricultural origin. New Zealand was able to maintain its import substitution policies because of its comparative advantage in the pastoral sector---its primary foreign exchange earner. Import substitution industries employed large numbers of people, thereby contributing to a very low unemployment rate up to the early 1980s. Ultimately, the trend of declining terms of trade for primary products, and the grandiose policies of the 1975-1984 government, made some form of economic restructuring inevitable.

Considerations for Restructuring

Over the last ten years, the governments have restructured the Canadian economy by focusing on three distinct objectives. First, trade was liberalized through the implementation of the Free Trade Agreement (FTA), and more recently the North American Free Trade Agreement (NAFTA). Second, tight monetary policy was used to achieve a reduction in inflation to less than 3 per cent. This occurred simultaneously with the implementation of the FTA and the NAFTA. Third, since the 1990s there has been a focus on deficit reduction by reducing government expenditures.

New Zealand's approach to restructuring was more ambitious than Canada's, transforming New Zealand from one of the most, to one of the least protected and regulated economies in the OECD (Hazledine 1996). In contrast to the Canadian approach, from 1984, the New Zealand government set broad objectives which encompassed every sector of the New Zealand economy. Objectives, such as enhancing market forces and contestability, were often difficult to measure since they could be applied to any element of the economy. Also, policies were sometimes introduced that conflicted with each other. For example, the objectives of price stability and exchange rate stability are often incompatible.

Certain characteristics of a particular government's restructuring program can affect its success. New Zealand's restructuring experience provides the following lessons for other countries considering economic reforms. First, restructuring requires definable objectives which can be observed and analyzed. A country must be able to measure the effectiveness of its reforms in a reasonable time frame, and in as an objective manner as possible. Second, government's need to recognize that restructuring involves trade-offs. The objectives of restructuring policies must be weighed against any negative effects. Certainly, reforms will have negative and, hopefully, positive impacts. Governments must take these affects into consideration in order to offset any disproportionate cost imposed on certain sectors of the economy. Third, the degree of openness of an economy reduces the likelihood of economic mismanagement. This is a fundamental lesson from pre-1984 New Zealand. The government had constructed an elaborate system of checks and balances to counteract external pressures which ultimately became unsustainable. Fourth, there is no general approach to economic reforms that will be successful for all countries. The objectives of reforms, the economic conditions, and the structure of government are some of the factors which need to be considered when formulating the appropriate reform programs. The economies and problems of present day Canada compared to pre-1984 New Zealand are indeed very different. Reform policies should reflect the specific

characteristics of the country concerned, taking into consideration its economic, cultural and social structure. Below, each lesson is examined in greater detail.

The Need for Definable and Observable Objectives

The objectives of reforms in New Zealand were to reverse the growing level of debt, provide an economic environment which would enable the efficient allocation of resources, and provide conditions conducive to economic growth and development. In 1984, the New Zealand government's broad objectives of reforms were without bounds. The simultaneous introduction of reforms to different sectors of the economy combined with the absence of tying many specific objectives to measurable indicators made the impact of reforms difficult to assess. In areas that could be measured, such as balance of payments and levels of debt, the continuation of poor performance in these areas after the initial introduction of reform programs was used to justify further reforms rather than considering the possibility that the initial reforms may have contributed to the problems. Furthermore, many reforms were based on the ideological or theoretical principles of individual enterprise mediated by contestable markets (Kelsey 1995:18-9, 348-52; and, Hazledine 1996). The immediate impact of such reforms was considered to be transitory and therefore were often ignored.

The Trade-offs of Restructuring

Over the past several years, the monetary policy objective of price stability in New Zealand and Canada affected employment, capital investment, the current account, domestic demand, and the level of debt. Governments need to be aware of the trade-offs involved in restructuring, and should endeavour to reduce negative effects. In New Zealand's case, the Reserve Bank Act (1989) does not mention employment or economic growth as part of its primary goal (Debelle 1996:56, 61). The failure of the Bank of Canada and government officials to either recognize or consider the impact of implementing very tight monetary policy to reduce inflation in 1988 from 4 per cent is identified as having serious negative consequences on the Canadian economy (Osberg et al 1996:160-4).

In New Zealand's case, any negative effects of restructuring were often attributed to other rigidities or weaknesses in the New Zealand economy, or they were ignored (Kelsey 1995:349). Likewise, the New Zealand government's privatization and corporatization strategy was intended to reduce government involvement in enterprise,

increase efficiency by introducing market forces, and generate revenues to pay down debt. However, this also contributed to rising unemployment (Dubelle 1996:68).

New Zealand embarked on a restructuring process of such magnitude that the costs and benefits were virtually impossible to ascertain. Furthermore, the primary goal of restructuring was to introduce an entirely new economic and social structure in New Zealand. Negative effects of restructuring were considered transitory, with the long-term gains expected to exceed any short-term costs. One of the justifications for restructuring was that New Zealand's pre-1984 economy grew at a rate below the OECD level. However, even if the long-run growth rate of the New Zealand economy were to resume at the OECD growth rate the losses from 1986 to 1993 would not be recovered. The economy would grow at a level 12 per cent below the prevailing rate in 1984 (Kelsey 1995:244-5).

The Canadian government needs to ensure that the costs of reforms are considered and weighed against any expected benefits. The costs associated with the objective of price stability may have been under estimated by the Canadian authorities (Fortin 1996:775-7). However, once true costs are apparent governments may need to adjust their policies.

Economic Openness and Sound Economic Management

Before 1984, New Zealand's economy was highly regulated and protected. The global economy had changed considerably in the twenty years leading up to 1984. Growth in international trade of high value consumer goods increased and financial markets became more sophisticated. Traditional barriers to trade gradually decreased for high value consumer goods, yet remained high, and even increased, for many agricultural products. New Zealand responded by imposing additional regulations and economic intervention policies in an attempt to insulate the economy from external forces. By 1982 the government had resorted to price, wage, rent, and interest rate freezes (Kelsey 1995:24).

The lack of openness in the New Zealand economy also led to some questionable decisions with respect to government investment in major projects. In the late 1970s and early 1980s, the government's desire to expand and diversify exports led to significant investment in major projects in steel, industrial chemicals and petroleum refining. The traditional approach of import substitution was carried to its extreme in these industry specific major projects, which acted as a drain on foreign reserves and resources well into the 1980's.

The severity of the adjustment process in New Zealand is directly attributed to the government's failure to move in step with international economic developments. Once comprehensive reforms were introduced in 1984, their scale combined with the sheltered economy, made the costs of adjustment higher.

The Canadian economy has gradually been exposed to more external competition, thereby spreading adjustments over a longer period. Compared to New Zealand's situation prior to 1984, Canada's current economy is considerably more open.

Choosing a Restructuring Program

Considerable attention has been given to the New Zealand experience to determine whether or not their restructuring process is applicable to Canada. When considering the economic conditions that prevailed in New Zealand up to 1984, and the economic conditions that exist in Canada today, there are striking differences. Canada's trade policy is very open, inflation is very low, real interest rates have declined over the last year, and there are clear and measurable objectives for current reforms.

In 1984, a myriad number of economic problems existed in New Zealand. The restructuring choices made by the New Zealand government were based on complicated problems specific to their economy, and an ideological shift in government itself.

Recent Developments, and Considerations of Future Reforms

The shortcomings of New Zealand's restructuring process can be tied directly to the four lessons outlined above. The Canadian government can eliminate unnecessary economic and social costs during restructuring programs by avoiding the mistakes of New Zealand's reform process. Below is a brief discussion regarding some possible considerations for future reforms.

Objectives of Reforms

Eliminating the deficit and reducing the level of debt is the Canadian government's primary economic objective. However, the 1996 Federal Budget stresses that "the government's focus on debt reduction and debt control is not an end in itself, but rather an integral part of the government's job and growth strategy." (p. 30). It is evident that authorities at the Department of Finance believe that to achieve and maintain robust

growth in employment, it is essential to fundamentally change some core elements of Canada's economy.

Compared to the implementation of reforms in New Zealand, the objectives and types of reforms utilized by the government of Canada are clear. The objectives of many of New Zealand's reforms implemented over the last ten years are difficult to ascertain. The scope of reforms, along with their pace and simultaneous implementation, are indicative of a process that seemed to take on a life of its own.

Kelsey presents the following as the Labour Party's "foundations for economic recovery" during the election in 1984:

- consensus on the programme of economic and social reconstruction;
- a fair prices and incomes policy;
- an investment strategy to help restore full employment and reduce the external deficit;
- reform of industry assistance;
- a fair tax system;
- monetary policy that underpins a balanced growth strategy;
- fiscal policy that tackles problems caused by the internal deficit;
- the re-targeting of public resources to ensure more effective delivery of services to those in greater need (Kelsey 1995:31).

In 1984 the Labour Party considered everything as a target for reforms. The Canadian government also indicated that nothing is exempt from consideration for reforms. However, clearer objectives, along with a relatively decentralized government structure, act to confine the scope, magnitude, and pace of reforms. Also, there is certainly a difference between considering whether or not reforms are required for all sectors of the economy and actually setting out to reform all sectors of the economy. In New Zealand, the pace and timing of reforms, not to mention the scope and magnitude, was not widely discussed. In 1984, however, the New Zealand government's approach to reform became apparent. Virtually from Labour's first day in office the fundamental elements to their reform agenda emerged, which essentially amounted to deregulating, liberalizing, or "downsizing" as much and as fast as possible.

The following are five fundamental elements to New Zealand's reform process. First, deregulation of the labour market. Second, liberalization of all aspects of industry including trade, finance, and foreign ownership. Third, narrowing the focus of monetary policy to price stability. Fourth, reducing the size and scope of the state as much as

possible. Finally, implementing fiscal restraint through expenditure reductions and broadening the tax base (Kelsey 1995:85)

There are some intangible factors that were predominately overlooked, or ignore, by New Zealand's reforming governments. Essentially, when industry and citizens are placed in a situation where most of the rules or traditions of society are changing simultaneously there are bound to be unforeseen costs. Economic agents must expend energy, time, and resources to adapt and function within a new structure. The following sections will look at some options for reforms in Canada. Also, some other considerations which are often understated by governments, such as the social costs of reforms, will be discussed.

Tax Reforms

Recent reports predict a lower 1995-96 Canadian deficit than expected, consequently, there is pressure on government regarding how to use the savings (Dept. of Finance 1996b:40). One option is to apply all the savings to reducing the deficit, a second involves some form of tax cut, and a third would be to use the savings to ease the effects created by certain cuts in program spending. Finally, a combination of the above could be implemented.

The benefits of lower tax rates are widely discussed in economic literature. Briefly stated, tax cuts may reduce distortionary or substitution effects in work effort, production, consumption and investment (Barro 1987:34). Likewise, the effects of government debt and deficits are also widely discussed in economic literature. Considering the effects of deficits, the conventional view is that high deficits have upward effects on interest rates. A study by P.L. Siklos (1988), presents evidence contradicting the conventional view that there is a significant positive link between long-term interest rates and deficits.

Another study by Douglas McMillin and Faik Koray (1989), examines the role of government debt in explaining movements in price, output, and interest rates. The traditional view is that funding government debt through bonds, rather than with higher taxes, is perceived as a gain in wealth and therefore has consequential effects on prices, output and interest rates. In contrast, the Ricardian Equivalence Theorem reasons that government debt is not wealth and that, regardless of whether government debt is financed with bonds or higher taxes, there should be no effect on prices, output and interest rates. The authors findings do not support the traditional view that government debt is wealth and that it raises aggregate demand (McMillin et al 1989:113-24). Essentially, the Ricardian Equivalence Theorem envisions that economic agents recognize the higher

deficits and debt is a postponement of future taxation, and therefore, they adjust their current consumption in anticipation of higher taxes at in the future

The merits of lower taxes today at the expense of a higher deficit, and consequently, a higher debt in the future are questionable. In addition to the possibility that lowering taxes early in the reform process may lead to higher taxes in the future, there are also other risks associated with debt levels. Deficit financing is only a matter of concern when it is a result of a structural imbalance between revenues and expenditures such that deficits occur over many consecutive years. Recurring deficits are a symptom of a structural imbalance. Failing to correct the cause of recurring deficits can lead to the accumulation of debt which can be problematic by becoming a component of a structural fiscal imbalance. The expenditures required to meet interest payments on accumulated public debt become more of a constraint on government operations, and a significant component of deficits, as the level of debt increases. Furthermore, there is an added element of fiscal risk associated with higher debt levels. Upward movements in interest rates can significantly effect debt servicing costs.

Higher debt servicing costs can restrict fiscal flexibility. When a country is entering a period of recession, expenditures needed for counter cyclical programs, or to finance increasing demands on social programs, may be unavailable due to debt servicing requirements. The 1995-96 proportion of total Canadian federal government revenues required to service the debt was 36 per cent. In aggregate, for all the provinces and territories the proportion for the same year was 14 per cent (Dept. of Finance 1996b:17).

For fiscal years 1994-95 and 1995-96, the debt charge (interest on the debt) is estimated to be 5.5 and 6.3 per cent of GDP (IMF 1995:45). To simply illustrate the significance of the level of debt charges, assume the interest paid on outstanding public debt is 6.0 per cent of GDP, and GDP growth is 3.5 percent. To stop the growth in the debt to GDP ratio the government needs to run a primary surplus of 2.5 per cent. The factors that determine when the debt to GDP ratio will begin to decline are the growth rate in the economy, movements in real interest rates, and the level of the primary balance (Dept. of Finance 1996b:48). Current expectations for 1996-97 and 1997-98 are for a primary balance of 3.1 and 4.0 per cent of GDP respectively. Over these two years, net public debt is forecast to decrease from 75.1 to 74.0 per cent of GDP (Dept. of Finance 1996b:42).

Figure 5.2 shows the federal fiscal accounts, including the net federal debt, as a percentage of GDP for years 1989-90 to 1995-96. One feature is that there were only two years, 1992-93 and 1993-94, with modest primary deficits, otherwise primary surpluses occurred. This essentially means that deficits were by and large a product of debt charges

on already existing debt. This supports the governments objective of reducing the level of debt.

One noteworthy historical item is that from 1987-88 to 1992-93 Canada's primary balances was in surplus (Dept. of Finance 1996a:97). However, over this five year period, Canada's federal level of net debt to GDP increased from about 54 per cent to near 67 per cent (Kneebone 1996:48-9). In contrast, 1972-73 to 1985-86 was the longest period of primary deficits in Canada over the last 50 years. From 1974-75 to 1985-86 the federal level of net debt to GDP increased from 15.7 to 50.2 per cent. Certainly, this was a period of substantial debt accumulation, however, the failure to reverse the growth of the debt in the last half of the 1980s makes the current reforms necessary and their success critical for Canada's future.

Credibility, a critical element in the Bank of Canada's low inflation policy, is also an important part of the Federal government's restructuring program. The government's primary purpose during the last three budgets (1994-1996) was to restructure expenditures and revenues in a way to reduce debt levels in the medium term with a view to lowering future taxes. Premature tax cuts, or a small "token" tax cut, could have detrimental effects on the success of economic restructuring. Lowering taxes too early may result in a slower decline in the deficits. This, in turn, could result in a call for further public expenditure cuts when adjustments to smaller budgets resulting from earlier cuts are still occurring. Also, the affects of expenditure cuts should be assessed to determine whether or not any further fiscal adjustments are needed.

Although tax cuts can have positive effects on economic activity, reductions in public sector expenditures can negatively effect economic activity. The negative effects may be due to reductions in government purchases of goods and services as well as the possibility of lower consumer confidence as additional cuts are introduced to government programs, services, and departments. Finally, the problem associated with a small tax reduction is that it may be too selective, thereby not distributing benefits equally.

Personal income tax rates should not increase. Although there were some adjustments in the 1996 budget with respect to tightening tax preferences, as well as an increase in excise taxes on gasoline, there was no change in the nominal rate of personal income taxes. However, tax expenditures¹² have been reduced. The reduction of Old Age Security Benefits for higher income individuals, the reduction in the maximum allowable

¹² International Monetary Fund, 1995, p102. The term "tax expenditures" refers to special tax rates, deductions, credits, etc. usually intended to promote social and economic objectives. They may be considered as "expenditure" because they are similar to government transfers and subsidies.

RRSP contributions, and the reduction in the allowable over contributions to RRSPs are example of reductions in tax expenditures (Dept. of Finance 1995a:59-60).

One aspect of personal income taxes that could be changed is the occurrence of personal income tax bracket creep. Tax brackets have not been adjusted during Canada's recent years of low inflation. Consequently, nominal increases in taxable income can move a tax payer into a higher tax bracket, even when the nominal increase is equal to or less than the rate of inflation. Thus, even when an individual's real income may decrease, they can move into a higher tax bracket.

A study by Paul McKeown and Alan Woodfield (1995), looked at the economic loss to employees over and above the tax revenue required. One outcome of this study was that although progressivity in New Zealand's tax structure was reduced, the combined effect of reduced exemptions, the introduction of a broad uniform rate GST, and tax bracket creep resulted in an increase in the effective weighted average marginal tax rate (McKeown et al 1995:56, 60). It would be easy to restore full inflation indexation of tax brackets. The removal of this built in, and hidden, annual tax increase would reduce revenues. However, with inflation currently near the middle of the target range, eliminating tax bracket creep would not be detrimental to revenues. Perhaps, more importantly, it would increase the tax systems transparency and enhance the perception of fairness.

The current primary surplus reflects a relative decrease (as a percentage of GDP) in the level of government expenditures *vis a vis* the level of government revenue. Since 1993-94 deficits have been on a downward trend due mainly to lower public spending. It is too early in the restructuring of the economy to lower marginal tax rates. First, more progress in reducing the debt to GDP ratio is must occur.

Reforms to Government

Chapter IV showed the public sector has already undergone significant reforms with respect to shifting the responsibilities of government departments and reductions in budgets and personal.

Over the last few years, the magnitude of reductions in public sector employment, and the fact that nominal wages increased by three per cent in 1992, with no increases in 1991 and none since 1993 would support the notion that discrepancies in compensation rates and employment growth between the private and public sectors may have undergone a correction. Although inflation has been relatively low during most of the public sector wage freeze period, real wages for most public employees have decreased.

Health Care and Education

There may be reason for concern when activities, such as core health care, primary and secondary education, and other programs containing an element of social value, are considered as candidates for privatization. Reforms in these areas are still under review and will be determined primarily by provincial authorities. Although in-depth discussions cannot be presented within the scope of this paper, governmental authorities must consider whether the forces which provide incentives in the private sector, mainly the profit motive, are applicable to healthcare.

The same applies to education. Education expenditures are an investment in the quality of the future workforce. However, education is also an investment with broader societal implications, for example, the quality and level of a societies education may effect the crime rate, family cohesion, and entrepreneurial activities. Any reforms to programs which contain elements of social value should be carefully evaluated.

Post secondary education (PSE) is funded by both federal and provincial governments through means such as grants and income tax credits. A 1992 report by the Economic Council of Canada suggested that a greater proportion of funding should be allotted to primary and secondary education since the social rate of return is higher than post-secondary education. Furthermore, PSE funding is not proportional between occupational groups (faculties) with subsidies being higher for medicine, engineering, law and business programs (IMF 1995:59-60).

One approach to restructuring expenses for PSE would be to convert a portion of cash transfers into an income tested student loan program where repayment schedules for the loans would be subject to the future income of graduates.

A notable difference between Canada and New Zealand are their responsibilities for, and approaches to, health care and education reform. Jurisdiction over these areas lies with the central government in New Zealand, while in Canada it lies with each individual province. Consequently, reforms in these areas may vary.

Social Effects of Restructuring

The effects of restructuring government programs on society has received more attention lately. An emergence of a greater awareness regarding social-economic interactions stems from the reforms that occurred throughout the private sector, and from the comprehensive reforms seen in New Zealand. Only recently have the effects of New Zealand's restructuring begun to be analyzed. This provides Canadian federal and provincial governments, along with other countries in the process of restructuring, insight into how to proceed.

In Maxwell (1996), the concept of "social capital" is presented. She concludes that any formulation of restructuring policies needs to consider the impact on a societies stock of "social capital". Essentially, social capital is linked to an unconventional notion of competitiveness. Cost minimization, associated with private sector downsizing, is a common view of competitiveness. Cost-minimization, and hence competitiveness, can lead to economic insecurity among workers, and polarization of jobs and incomes.

The second notion of competitiveness associated with "social capital" considers the long-run prosperity of a society. Maxwell (1996) believes that for restructuring to succeed it requires the participation of citizens, the state, and employers. The turning points in social-economic policy outlined by Maxwell amount to an approach where "an ounce of prevention is worth a pound of cure". She stresses the importance of early childhood education and youth support programs, along with the development, support and role of non-profit organizations. Included with these three items is the need to reform the financing and accountability of post-secondary education. Although implied in the benefits of education, the provision of health care could certainly be included as an element which provides a sense of well-being to citizens.

Maxwell's paper is quite broad and conceptual, however, Tim Hazledine (1996) tries to explain the unimpressive performance of New Zealand's economy given the initial high expectations attached to the reform process. The paper examines two fundamental justifications for reforms in New Zealand. First, that reforms would produce substantial improvements in the allocative efficiency of industries. Second, that deregulation removal of bureaucratic "red tape" would reduce transaction costs.

By looking at the changes in occupations devoted to transaction activities and those devoted to transformation (production, manufacturing) activities, and their ratios, a measure of transactions costs before and after reforms is possible. The study found that, contrary to predictions of the reform minded, it appears as though transaction costs have increased.

The notion of "social capital", defined as the social structure which facilitates co-ordination and co-operation, is used to explain both the higher transaction costs observed by Hazledine, and thus the disappointing efficiency gains in the tradable sectors and the mainstream manufacturing sector in particular. The findings of Hazledine supports the importance of social capital in explaining the success or failure of reforms.

The Case for Revising the Inflation Rate Target

A stubbornly high unemployment rate has continued to plague the Canadian economy since the onset of the recession in early 1990. High unemployment has been attributed to the introduction and maintenance of the low inflation policy of the Bank of Canada, combined with the more recent decrease in government expenditures (Fortin 1996:783-4).

Pierre Fortin (1996), presents a case for allowing inflation to increase modestly to near 3 per cent. Essentially, revising the target range from 1 - 3 per cent to 2 - 4 per cent. The rationale is that the magnitude of the inflation-employment trade-off at low levels of inflation has been miscalculated by the Bank of Canada. Fortin concludes that this trade-off not only becomes more pronounced as the inflation rate is reduced to near zero through tight monetary policy, but continues as monetary policy is used to hold inflation near zero. The reason is identified as a nominal wage floor for employers. Essentially, they do not want to lower nominal wages below zero for fear of a negative impact on labour productivity (Fortin 1996:778-9, 784). Consequently, employers shed labour in order to reduce costs rather than reduce nominal wages.

The effects of high real interest rates on employment, domestic demand, and investment are clear. If the high cost associated with reducing inflation from its 1988 rate of 4 per cent to its current level can be mitigated by modestly adjusting the inflation target it is certainly worth considering. The current process of fiscal restructuring would be less costly if the estimates of an annual gain to national income of about \$50 billion for a 1 per cent increase in the inflation target are correct (Fortin 1996:782).

Summary and Conclusion

The restructuring process in Canada has progressed significantly over the last three years. The fiscal performance seems to be on the right track, considering that the early objectives of restructuring (lower deficits, declining debt growth) have surpassed budgetary forecasts. However, when considering the early unimpressive results of New

Zealand's reforms, and the considerable lag before meaningful growth resumed, there may be a need to stress a more balanced approach.

There is danger in attempting to reduce the level of debt too quickly. For instance, there may be a cyclical slowdown in the economy on the horizon which may require counter cyclical expenditures. This should be recognized as an equally important component of a fiscally responsible government. Furthermore, the notion of "social capital" seems to imply that reform for reforms sake is bad policy. The intangible "social capital" asset should be considered equally with the more tangible "dollars and cents" indicators.

The paper shows that New Zealand had a more or less discernible starting point to its restructuring process. In contrast, Canada has reformed different elements of its economy during different periods. Prior to 1980, social programs were expanded and the focus for structural reform into the 1980s was on trade policies. This culminated with the introduction of the Free Trade Agreement, and finally the NAFTA.

By the late 1980s, focus had moved to the objective of price stability and partial tax reform. This period was characterized by high real interest rates and the introduction of the GST in 1991. The 1990s started with recession while monetary policy remained tight. These two factors resulted in low inflation rates, but high unemployment, which has persisted since economic growth resumed in 1993. Also, high interest rates have been identified as contributing to the increased level of debt over the late 1980s into the 1990s. From 1993 until early 1996, interest rates remained high compared to our major trading partners and over this period the Canadian government shifted its attention to deficit and debt reduction.

The New Zealand experience may have been made more difficult due to the sheer magnitude of structural imbalances and distortions built into the pre-reform economy. However, the rapid, and potentially reckless, imposition of total economic and social restructuring may well have increased the costs of the adjustment process. Sequencing problems may have contributed to some of the difficulties experienced in New Zealand. Many reforms in New Zealand were also likely implemented not so much for sound economic reasons, but rather due to a prevalent philosophy or ideology (Kelsey 1995:349-50).

Essentially, it seemed that if government was involved in any activity it had to be reformed. New Zealand continued introducing new and compounding reforms as quickly as possible without setting measurable objectives or without fully realizing or analyzing the effects of earlier reforms. A time for objective evaluation of policy actions was never taken. Many reforms occurred in an effort to rectify problems that were aggravated or

caused by previous policies. However, the government continuously attributed negative economic developments to a reform process that was either incomplete, too slow, or that time was needed for market equilibrium to be restored (Kelsey 1995:269).

From a "social capital" perspective, the pace and scope of reforms essentially affected every facet of New Zealand society. This may contribute to understanding the mediocre results seen so far in New Zealand.

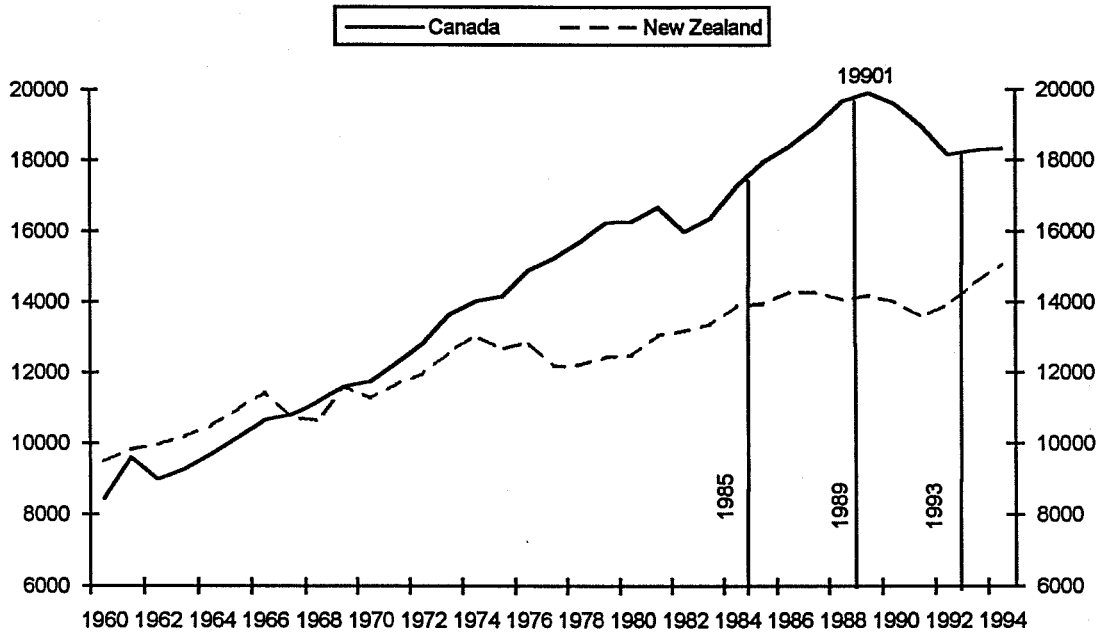
In 1994-95, New Zealand's net public debt to GDP was 37.5 per cent, down from close to 51 per cent in 1992. Although there has been recent progress towards debt reduction, it cannot be overlooked that in 1984 net debt was about 41 per cent. Over eight years of reforms, from 1985 to 1992, the proportion of net debt increased. The unemployment rate increased well above levels seen for decades, with most job losses occurring in the manufacturing sector, followed by the agricultural sector (OECD 1994b:197). Even if the last ten years was a period of adjustment, certainly reformers in 1984 had not envisaged that ten years would be needed before any significant growth in the economy would resume.

The Canadian government should maintain a steady course, keeping its objectives clear and free of influence from vested interests. The goals of ongoing reforms in Canada are to reduce deficits and the level of debt. Maintenance of credibility requires that these objectives remain clear and that reforms continue to be based on realistic and prudent targets and assumptions---avoiding unpleasant surprises. Forecasting developments in economic factors such as interest rates, inflation, and employment growth is difficult. Especially when budgets plan several years into the future. Prudent assumptions increase the probability that any deviations from the assumptions will be beneficial, as in the recent experience with interest rates.

Provided global economic conditions remain favourable over the next three years, Canada's goals for lower deficits and a decrease in the debt to GDP ratio seem attainable. Canada is on the right track, although the lack of consumer confidence and stubborn unemployment are problematic. Considering the potential gains from modestly adjusting the inflation target range upward by 1 per cent, serious consideration regarding the current inflation target appears warranted.

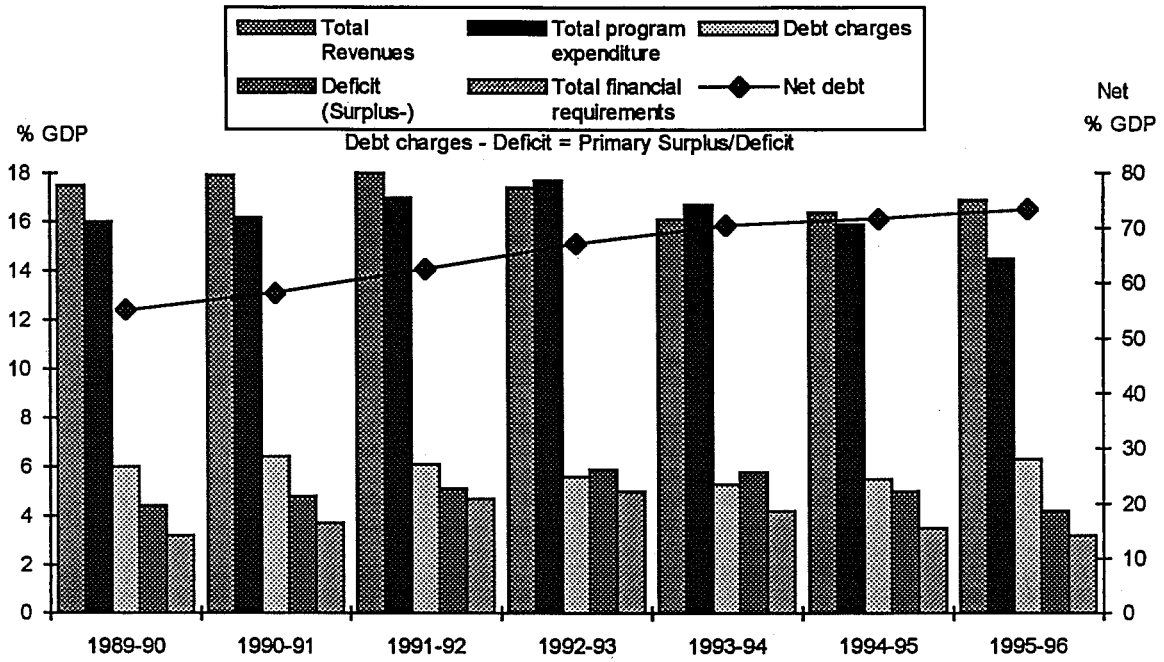
The approach to reforms in New Zealand and Canada are quite different. Despite the differences, New Zealand does provide insight for Canadian economic reforms. Above all, Canadian governments should set clear and reasonable objectives and appreciate and mitigate the costs of adjustment to maintain Canada's high level of social and human capital.

**Figure 5.1 - Levels of GDP per capita Canada and New Zealand
(1990 Geary-Khamis Dollars)**



Maddison, Angus; Monitoring the World Economy 1820-1992; Development Centre Studies, OECD, p. 194-7

Figure 5.2 -Federal Fiscal Accounts and Net Debt (% GDP), Canada



Source: IMF Staff Country Report No. 95/46; Canada-Economic Developments and Policies, June 1995, p. 45

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