NEW ZEALAND'S ECONOMIC REFORM PROGRAMME WAS A FAILURE

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Abstract

Previous assessments of New Zealand's post-1984 economic reform programme have been optimistic about its overall success. This note challenges that optimism by drawing attention to what has happened to real gross domestic product and income distribution since 1984. If New Zealand had continued to grow at the same rate as Australia, it would have produced more than NZ$210 billion in extra output between 1985 and 1998. Over a similar period, the average per capita real income of the bottom four deciles of New Zealand's income distribution fell by between three and nine per cent.

Key words: Economic reform; Structural adjustment; New Zealand

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For fifty years after the election of its first Labour Government in November 1935, New Zealand's economic policy was based on strong State involvement either as a dominant supplier or heavy-handed regulator in virtually every sector of the economy. This approach reached a peak during 'the Muldoon years' (1975-1984) when new government policies included a large expansion of the country's tax-funded superannuation scheme, price subsidies for agriculture, extended tax concessions for manufactured exports, several 'Think Big' construction projects in the energy sector, and a general freeze on all incomes and prices in June 1982 that lasted nearly two years. The July 1984 election, however, produced a new government committed to 'comprehensive economic and social reform' (Douglas, 1984, p. 26). During the next six years Muldoonism was swept away: interest rate controls were removed, agricultural subsidies were phased out, New Zealand moved to a floating exchange rate regime, monetary policy was given a single statutory objective of maintaining price stability, detailed industrial and occupational regulations were replaced by a generic commitment to competitive markets, import quotas and tariffs were eliminated or reduced, public sector management was reformed, trading departments were converted into State-owned enterprises with a clear commercial focus, and a programme of selling State assets to the private sector was commenced. A change of government in October 1990 gave a further impetus: from 1 April 1991, social welfare income entitlements were cut by $1.3 billion (1.7 per cent of gross domestic product); and on 15 May that year New Zealand's system of industrial relations was transformed by the Employment Contracts Act 1991, designed to promote an efficient labour market by preventing employers or employees from imposing a collective agreement without the other party's consent. The government's accounts—now required by law to adopt generally accepted accounting practice—moved into surplus from 1993/94, allowing the government to pay off all its overseas debt and introduce two rounds of significant tax cuts in 1996 and 1998.

Without doubt, these reforms amounted to 'one of the most radical market liberalisation programmes initiated anywhere in the world' (Massey, 1995, p. xii; see also Evans et al, 1996, Henderson, 1996, Silverstone et al, 1996, p. 19, Brash, 1998, and Dalziel and Lattimore, 1999). Perhaps because the reforms were so comprehensively based on market principles, economists have generally evaluated the overall programme very favourably.[1] Evans et al. (1996, p. 1895), for example, concluded their survey in the authoritative *Journal of Economic Literature* with the following paragraph:

> The success of the reforms to date has strengthened support for free-trade policies within New Zealand's business community, perhaps to an unusual degree by OECD standards. Many of the lessons from the New Zealand experiences are worthy of emulation by other countries. Others, like its tardy labor market deregulation, provides a cautionary note. After decades of policy errors and investment blunders, New Zealand appears to have finally diagnosed its predicament appropriately and is on a trajectory to maintain its economy as a consistent high performer among the OECD. New Zealand once again appears to be emerging as a laboratory from which results will animate economic debate and policy throughout the world.

Other major surveys have been more cautious, but still optimistic. Massey (1995, p. 203) recognised 'significant short-term costs in terms of output and employment losses, while the benefits took much longer than expected to materialise’, but suggested ‘a number of grounds for optimism’, concluding overall that ‘it appears … New Zealand is now a more internationally competitive and dynamic economy as a result of the reform programme.’ Silverstone et al. (1996, p. 21) considered ‘it is still too early to conclude firmly whether New Zealand’s improved economic performance is sustainable’ but expressed ‘cautious optimism that this is the case, and that employment growth, improvements in income distribution, continuing operating efficiencies and price stability are all possible simultaneously with sustained economic growth’. Their view was based on a study by Hall (1996, p. 64 and p. 68) in the same volume, which found ‘insufficient evidence to conclude that New Zealand’s growth performance in the ten years since 1984 [was] both significantly and sustainably higher than the previous decade’ but ‘suggested that on balance there is scope for cautious optimism on the sustainability of New Zealand’s recently improved economic growth’.

The purpose of this note is to challenge this optimism by drawing attention to what happened to real gross domestic product (GDP) and income distribution in New Zealand after 1984. This is important, because as the governor of the Reserve Bank of New Zealand has recently reminded us, the purpose of the reforms was not ‘to test some abstract theory, [but] to improve the social and economic outcomes for all New Zealanders’ (Brash, 1998, p. 166). Thus the ultimate test is not the extent to which each reform coincided with a particular economic model, but the extent to which all New Zealanders are now better off as a result of the overall programme. Is it the case, for example, that real GDP is higher than would have been likely under plausible alternative policies, and is it the case that all households are better off than before the reforms.[2] This note provides evidence that the answer to both questions is clearly ‘no’.

Debates within New Zealand about the impact of the reform programme on growth have been hindered by disagreement about what is a reasonable counterfactual for production if the reforms had not taken place (see for example, the exchange between Dalziel, 1998, and Evans et al, 1998). Brash (1998, p. 164) again provides a succinct description of the problem and an example of the solution that is widely adopted.

> Given that nobody can be absolutely certain how New Zealand's economy would have evolved in the absence of the reforms, it is, of course, impossible to be too dogmatic on the question of whether they have 'worked'. But I have not the slightest doubt that the reforms 'worked' in comparison to a situation where we tried to continue with the policies of the late seventies and early eighties, with extensive protection, subsidies, price and wage controls, high inflation, large fiscal deficits and all the rest.

The difficulty with this solution—and with all attempts to evaluate the reforms by simple comparisons of pre- and post-reform rates of growth—is that it is not plausible to suggest that New Zealand would have engaged in *no* reforms had it not embraced the comprehensive programme adopted after 1984. As the then head of the Economics and Statistics Department of the Organisation for Economic Cooperation and Development (OECD) has observed, 'at different stages from the late 1970s onwards, and to an extent that few people anticipated before the event, governments in all [OECD] countries chose to follow broadly a path of market-oriented economic reform' (Henderson, 1996, pp. 7-8). The decision to initiate reforms is not what marked New Zealand's reform programme as unique, but rather its *extent*, as Henderson (1996, p. 13) goes on to explain:

> In no other OECD country has there been so systematic an attempt at the same time (1) to redefine and limit the role of government, and (2) to make public agencies and their

> operations more effective, more transparent, and more accountable. It is this important extra dimension, as well as the range and scope of reforms that have more obvious counterparts elsewhere, that gives the New Zealand programme its special character.

The question to ask, therefore, is what might have happened if New Zealand had implemented reforms on a smaller scale more commonly accepted in the rest of the OECD? It is impossible to give a precise answer to such a question, of course, but it turns out that a clear qualitative statement can be suggested by comparing the growth rates of New Zealand and Australia between 1978 and 1998. These data reveal a striking similarity between the two countries' GDP paths (adjusted to a common scale) for the years before 1984, and an equally striking divergence after 1984 that shows no signs of closing fourteen years later. The cumulative gap after 1984 is enormous: if New Zealand had continued to grow at approximately the same rate as Australia (as it did between 1978 and 1984), it would have produced extra output between 1985 and 1998 amounting to more than NZ$210 billion in 1995/96 prices, or well over *twice* New Zealand's total GDP in 1998.

There is a more general acceptance in New Zealand that income distribution widened over the course of the reform programme, and that this led to increased poverty among some low income households.[3] Global trends undoubtedly contributed to this widening (see, for example, the discussion in Easton, 1996), but again the extent of the gap is so great—and the outcome so contrary to the stated objectives of the reforms—that it is again clear that the reform programme has failed by its own criteria. The second part of this note shows that the bottom four deciles of the income distribution saw their average per capita income fall by more than three per cent in real terms between 1984 and 1996, with the poorest decile losing nearly nine per cent.

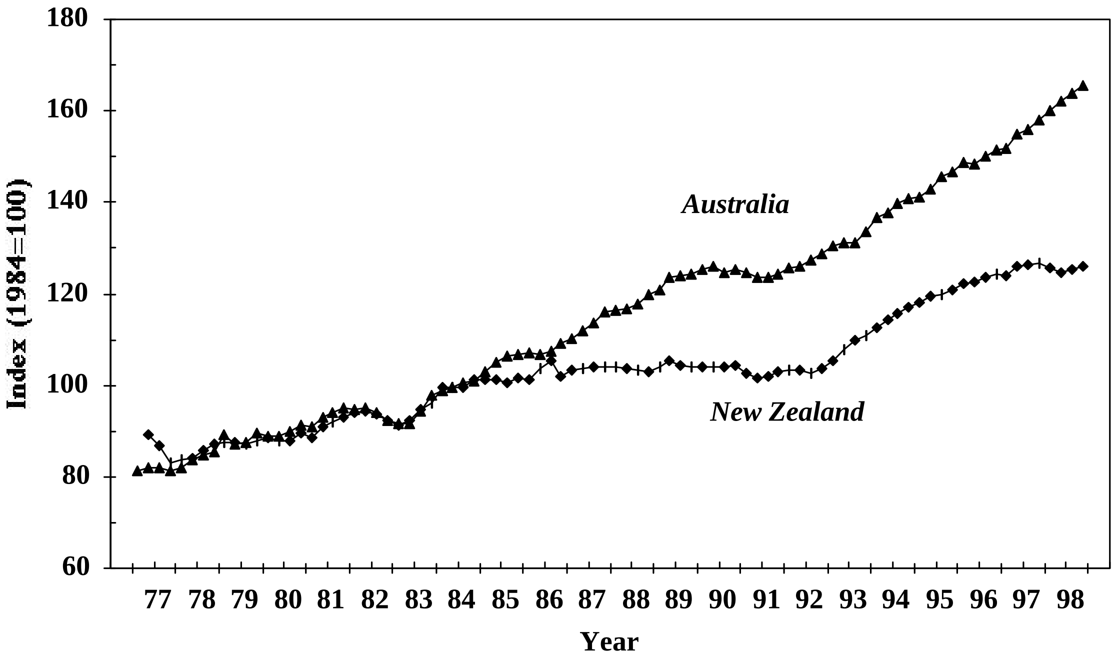
The paper concludes, therefore, with a cautionary note. The lesson from New Zealand is that its 'big bang' economic reform programme involved an enormous sacrifice of output during the late 1980s that showed no sign of being compensated for by higher growth rates in the 1990s. Further, the impact of this poor growth performance fell most heavily on the lower end of the income distribution, creating problems of poverty and social exclusion that New Zealand thought it had banished in the 1970s. In short, the price of radical market liberalisation in New Zealand was very high and was generally paid by those least able to afford it.

Real Gross Domestic Product, 1978 - 1998

Figure 1 shows quarterly seasonally adjusted real Gross Domestic Product for Australia and New Zealand between 1977 and 1998, scaled so that the average value for the calendar year of 1984 equals 100.[4] Between 1978 and 1984, the GDP paths in Figure 1 are very close—the respective business cycles were very similar during this period, and overall the average annual growth rate of the two countries differed by only 0.2 percentage points (see Table 1). After 1984, the two series diverge. Apart from a short-lived stimulus to output provided by the introduction of the Goods and Services Tax (GST) in October 1986, New Zealand's real output remained virtually static until the end of 1992, at which point it was only 3.2 per cent higher than in 1984. The comparable figure for Australia was 26.9 per cent, although Australia also experienced recession in 1991. After 1992, both economies recovered, and for just over two years New Zealand grew more quickly than Australia (from December 1993 to December 1995). This turned out to be temporary, however. Australia continued to grow by between three and five per cent on an annual basis every quarter during the last three years of the sample, but New Zealand's growth rate slowed considerably and slipped into recession in the first half of 1998.

Figure 1

Real Gross Domestic Product, Seasonally Adjusted
Australia and New Zealand, 1977 - 1998



Source: Australian Bureau of Statistics and Statistics New Zealand.

Table 1 breaks down the growth data for the two countries into three periods. The first period is the six years immediately before the reforms (1978 to 1984). During this period the average annual growth rate for New Zealand (2.7 per cent) was comparable to that of Australia (2.9 per cent). The second period coincides with the transition stage of New Zealand's economic reform programme. Between 1984 and 1992, Australia maintained an average annual rate of 3.0 per cent, while New Zealand's rate was only 0.4 per cent (that is, less than one half of one per cent throughout these eight years). To emphasise the scale of the sacrifice implied by these data, it is possible to calculate how much extra output New Zealand would have produced over this period if it had followed the same growth path as Australia: NZ$89,282 million (measured in 1995/96 dollars). Further, its level of real GDP in 1992 would have been more than one-fifth higher than it was in fact.

Table 1

Average Growth Rates
Australia and New Zealand, 1978 - 1998

Period	Australia	New Zealand
1978 - 1984	2.94	2.71
1984 - 1992	3.02	0.40
1992 - 1998	4.24	3.30

Source: Calculated from Figure 1 data.

The third period coincides with New Zealand's recovery. The architects of the reform programme recognised that there would be 'short-term pain before long-term gain' (see especially Economic Monitoring Group, 1989, pp. 25-28), and New Zealand's economic growth rate did bounce back after 1992 to be 3.3 per cent on average between 1992 and 1998. This is well above the 2.7 per cent achieved in the six years before the reforms began, which perhaps explains why commentators have generally been optimistic about the final success of the reforms. Table 1 shows, however, that this improved growth performance was almost a full percentage point *lower* than Australia achieved during the same period, in part because New Zealand demonstrated considerably less resilience than Australia after its first major international shock in the post-reform period (the Asia currency crisis beginning in July

1997).[5] This means that the vertical gap between the two series in Figure 1 has increased further to reach 29.8 per cent by 1998. Summing up this gap over the entire post-reform period, it is possible to say that if New Zealand had followed the same growth path as Australia did after 1984 it would have produced extra output between 1985 and 1998 amounting to NZ$214,695 million in 1995/96 dollars.

The point about this statistic, of course, is that it is enormous—equivalent to 2.25 times New Zealand's total gross domestic product in the calendar year of 1998. It would be unreasonable to place all the blame for this dismal performance at the door of the reforms—but even if only half of this lost production was due to 'the special character of New Zealand's reform programme', it still amounts to more than a year's worth of income having been sacrificed.

Income Distribution, 1984 - 1996

The previous section has described how New Zealand appears to have sacrificed a very large amount of aggregate income after 1984 compared to its nearest OECD neighbour. This section supplements that analysis with an examination of how New Zealand's income distribution changed between 1984 and 1996, drawing on a recent paper by Podder and Chatterjee (1998). Podder and Chatterjee used unit record data from Statistics New Zealand's Household Economic Survey (HES) to show that the Gini coefficient of income inequality increased in New Zealand from 0.353 in 1983/84 to 0.404 in 1995/96. Their study was interested in documenting changes in the income shares, but for the purposes of this paper it is necessary also to calculate the changes in the absolute average income received by each decile. This is easily done using Podder and Chatterjee's decile income share data reproduced here in Table 2.

Podder and Chatterjee's (1998, pp. 11-12) method involved calculating per capita income in each household which was then weighted by the number of its members when determining the deciles in Table 1. This has the effect of assigning each individual of the population with the per capita income of their household, and then ranking all individuals from lowest to highest income. If s_i denotes the income share of decile i, Y_i the aggregate income of all individuals in decile i, and Y is the aggregate income of all households, then the income share of decile i reported in Table 2 above is given by:

$$s_i = Y_i/Y \tag{1}$$

Denote the number of households in decile i as N_i, and total population as N. Then equation (1) can be rewritten as:

$$s_i = \{(Y_i/N_i)/(Y/N)\}(N_i/N) \tag{2}$$

The first term on the right-hand-side is the average income of decile i, which will be denoted by lower case y_i; and the second term is aggregate per capita income, denoted y. The ratio N_i/N is ten per cent for each decile. Rearranging equation (2) to isolate the average income of each decile produces the following equation:

$$y_i = s_i y/0.1 \tag{3}$$

Table 2

Shares of Aggregate Income
New Zealand, 1983/84 - 1995/96

Decile	1983/84 (Per Cent)	1991/92 (Per Cent)	1995/96 (Per Cent)
Lowest	2.05	1.63	1.71
Second	4.25	3.87	3.73
Third	5.45	5.15	4.82
Fourth	6.56	6.27	5.79
Fifth	7.57	7.37	6.88
Sixth	8.85	8.55	8.26
Seventh	10.55	10.29	10.09
Eighth	12.94	12.85	12.61
Ninth	16.16	16.62	16.47
Top 10%	25.62	27.39	29.61
Top 5%	15.28	16.97	19.04
Gini Coefficient	0.353	0.382	0.404

Source: Table 1 of Podder and Chatterjee (1998, p. 14).

The next step is to calculate aggregate per capita income, *y*, for each of the three years in Podder and Chatterjee's study. Because income rather than output is being analysed, gross national product (GNP) is the more appropriate macroeconomic variable to use, rather than GDP. Table 3 presents the calculation of per capita real GNP used in this note. This statistic actually fell in value between the eight years of 1983/84 and 1991/92, confirming the substantial sacrifice made during the reforms. By 1995/96, it had recovered to be 9.4 per cent above its 1983/84 value.

Table 3

Per Capita Real Gross National Product
New Zealand, 1983/84 - 1995/96

	1983/84	1991/92	1995/96
Gross National Product (GNP) (NZ$m)	33,564	67,853	85,734
GDP Deflator (1991/92 = 100)	51.55	100.00	108.05
Real GNP (1995/96NZ$m)	70,356	73,314	85,734
Mean Population (Thousands)	3,231	3,416	3,597
Per Capita Real GNP (1995/96NZ$)	21,778	21,462	23,833

Sources: Row 1 comes from Statistics New Zealand's INFOS series SNBA.SA9. Row 2 comes from Dalziel and Lattimore (1999). Row 3 is calculated from Rows 1 and 2. Row 4 comes from Statistics New Zealand's INFOS series DPEA.SBIC. The final row is calculated from Rows 3 and 4.

Table 4 presents the changes in average real incomes calculated using equation 3 and the data in Tables 2 and 3. There was a substantial shift in New Zealand's income distribution during the reform period. First, there was a large loss of income suffered by the lowest income deciles during the depths of the recession in the early 1990s. The average income of the lowest decile in 1991/92 was 21.6 per cent lower than in 1983/84, and that of the second decile was 10.3 per cent lower. These two groups shared in the post 1991/92 recovery, but by 1995/96 their average incomes were still 8.7 and 4.0 per cent lower than in 1983/84. Second, half of the New Zealand population had lower real incomes in 1995/96 than they had before the start of the reforms, and for 40 per cent of the population the loss of income was greater than 3 per cent. These data support reports by a wide variety of church and other community groups in New Zealand during the

1990s that poverty and social exclusion have caused widespread problems, particularly among low income households with children.[6] Finally, Table 4 shows that large gains were made by the richest households in New Zealand during the recovery that peaked in 1995/96. Compared to 1983/84, the average income of the top ten per cent of households had increased by more than one-quarter (26.5 per cent) and of the top five per cent by more than one-third (36.4 per cent).

Table 4

Average Per Capita Real Income
New Zealand, 1983/84 - 1995/96

Decile	1983/84, measured in 1995/96$	1991/92, measured in 1995/96$	Percentage change from 1983/84	1995/96, measured in 1995/96$	Percentage change from 1983/84
Lowest	4,464	3,498	-21.64	4,075	-8.71
Second	9,256	8,306	-10.26	8,890	-3.95
Third	11,869	11,053	-6.88	11,487	-3.21
Fourth	14,286	13,457	-5.81	13,799	-3.41
Fifth	16,486	15,817	-4.06	16,397	-0.54
Sixth	19,273	18,350	-4.79	19,686	2.14
Seventh	22,976	22,084	-3.88	24,047	4.66
Eighth	28,181	27,578	-2.14	30,053	6.65
Ninth	35,193	35,670	1.35	39,253	11.54
Top 10%	55,795	58,784	5.36	70,569	26.48
Top 5%	66,553	72,841	9.45	90,756	36.37

Source: Calculated from the data in Tables 1 and 2 using equation 3.

Conclusion

Evans et al. (1996, p. 1895) concluded their review of New Zealand's reforms with the comment that 'New Zealand once again appears to be emerging as a laboratory from which results will animate economic debate and policy throughout the world'. This note reports from the laboratory that the experiment was a clear failure. During the transition stage of the reforms (1984-1992), for example, New Zealand's real gross domestic product remained virtually static while the Australian economy grew by three per cent per annum. After 1992, the New Zealand real growth rate recovered, but between 1992 and 1998 it was still almost a full percentage point below that of Australia. As a result, the New Zealand economy in 1998 was almost a quarter smaller than it would have been if it had grown at the same rate as the Australian economy after 1984. The cumulative loss of output between 1985 and 1998 implied by this counterfactual was more than NZ$200 billion. Further, the costs of this sacrifice were disproportionately carried by those least able to afford it. Indeed, the bottom four deciles of New Zealand's income distribution experienced a fall in their average real per capita household income of between three and nine per cent between 1984 and 1996.

There is a joke in New Zealand that an economist is anyone who can say with a straight face, "I know things have turned out to be the opposite of what I predicted, but imagine how much worse it would have been if you hadn't followed my policy advice." This reflects the common practice of advocates for New Zealand's economic reform programme to say that outcomes such as those described above would have been worse if nothing had been done in 1984. The argument of this paper against this response is two-fold. First, the alternative in 1984 was not 'no reform' but rather to reform at a pace and to a degree more comparable with the rest of the OECD. Second, the statistics presented here are simply too large to be dismissed in this manner. The criticism is not just that the New Zealand economy did not grow as quickly as expected, but also that it sacrificed up to *two and a quarter years worth of output* (and income) compared to its more orthodox trans-Tasman neighbour. Similarly, the criticism is not just that New Zealand's relative income distribution widened after 1984, but rather that the lowest income households (weighted by family size) experienced *substantial cuts* in their real purchasing power of up to 8.7 per cent between 1984 and 1996. The evidence in these statistics provides a clear *prima facie* case for the claim in this paper's title.

There is also sound economic theory that can be drawn upon to explain this result, in both classical and Keynesian economics. The extensive industrial restructuring that took place during the reforms involved large-scale destruction of capital that had few alternative uses—the closed freezing works and car assembly plants, for example. This must have had an impact on the growth of New Zealand's supply-side capacity. At different times after 1984, high unemployment, high interest rates, large cutbacks in government spending, and a high value of the New Zealand dollar produced slowdowns in private consumption expenditure, investment expenditure, public consumption expenditure and net export expenditure respectively. This must have had an impact on the growth of New Zealand's aggregate demand. New Zealand's experience of 'Big Bang' economic reform suggests that Australia and the rest of the OECD were sensible to implement their market liberalisation programmes more cautiously.

Endnotes

[1] There have been criticisms by economists of particular aspects of the reforms; for example, there is widespread acceptance that in an ideal world the sequencing of reforms might have been improved, particularly by freeing up the labour market before liberalising financial markets (Buckle 1987; Spencer, 1990; Bollard, 1994; Evans et al., 1996; Hall, 1996; and Brash, 1998).

[2] Note that the test proposed here is close to the traditional Pareto-efficiency criterion for policy evaluation; namely, that a policy change should make at least one person better off without making anyone worse off. A notable non-economist critic of the reform programme has argued that such an economics framework is too narrow, and that the reform programme should also be criticised for the 'social, democratic and cultural deficits' that emerged during the late 1980s and early 1990s (Kelsey, 1997).

[3] See, for example, Saunders (1994), Stephens et al. (1995), Easton (1996), Podder and Chatterjee (1998), Statistics New Zealand (1999) and Stephens (1999). Some economists have argued that this may not be true for lifetime incomes; see especially Barker (1996) and Creedy (1997).

[4] Both series are official data provided in seasonally adjusted form by the Australian Bureau of Statistics and Statistics New Zealand respectively. The Australian series begins in March 1977, but the New Zealand series does not begin until June that year—hence 1978 is adopted as the starting point for the comparison that follow.

[5] This last observation has been the subject of critical comment in *The Economist* (6 March 1999, p. 78), which puts the blame on inappropriate monetary policy in New Zealand. Reform of the Reserve Bank of New Zealand to give it a sole statutory objective of maintaining price stability (in contrast to the Charter of the Reserve Bank of Australia which also allows an output stabilisation role) was, of course, one of the core components of New Zealand's reform programme.

[6] Examples include *Neither Freedom Nor Choice* (People's Select Committee, Palmerston North, 1992), *Windows on Poverty* (Council of Christian Social Services, 1992), *Making Ends Meet* (Citizens Advice Bureaux, 1993), *Making Choices: Social Justice for our Times* (Church Leaders Social Justice Initiative, 1993), *Child Poverty in Aotearoa/New Zealand* (Council of Christian Social Services, 1992), and *Feeling Stretched: Women and Families in Transition* (West Auckland Women's Centre, 1994).

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