New Zealand’s Fiscal Reforms
1984 - 1996

Bryce Wilkinson
## Board of Directors

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<thead>
<tr>
<th>Role</th>
<th>Name</th>
<th>Company/Position</th>
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<tr>
<td>CHAIR</td>
<td>Rob Wildeboer</td>
<td>Executive Chairman, Martinrea International Inc., Vaughan</td>
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<td>Barry Sookman</td>
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## Research Advisory Board

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<tr>
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<tr>
<td>Janet Ajzenstat</td>
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<td>Brian Ferguson</td>
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<td>William Watson</td>
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## Advisory Council

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<td>John Beck</td>
<td>President and CEO, Aecon Enterprises Inc., Toronto</td>
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<td>Erin Chutter</td>
<td>Executive Chair, Global Energy Metals Corporation, Vancouver</td>
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<td>Navjeet (Bob) Dhillon</td>
<td>President and CEO, Mainstreet Equity Corp., Calgary</td>
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<td>Jim Dinning</td>
<td>Former Treasurer of Alberta, Calgary</td>
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<tr>
<td>David Emerson</td>
<td>Corporate Director, Vancouver</td>
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<td>Richard Fadden</td>
<td>Former National Security Advisor to the Prime Minister, Ottawa</td>
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Foreword: Fiscal Responsibility NZ Style


“We are dancing on a volcano that is rumbling even louder. The French are hooked on public spending. Like all addictions, it doesn’t solve any of the problems it is meant to ease. And like all addictions, it takes will and courage to detox.”

Uncomfortable truths from the French Prime Minister a day after the pomp and ceremony from his boss President Macron who staged his State of the Union address in the Palace of Versailles promising a “profound transformation”.

Detox remains the fiscal soupe de jour – plus ca change!
Public spending and debts at unsustainable levels have unhappily been an enduring blight on the prospects of most nations.

New Zealand in the early nineties when I became the Minister of Finance was no different. I was about to turn 40, and never in my adult lifetime had NZ balanced its books. We ran deficits to fund all too often inefficient and ineffective public spending and we had racked up huge debts in a doomed attempt to borrow our way out of structural deficiencies in our earning power.

I was determined that our road to fiscal redemption would be swift and sustainable.

This forward is not so much about the numbers, impressive as they have become, but about the policies and politics of reform.

New Zealand, ever the pioneer, saw us break new policy ground on three critical fronts.

We instituted an independent but accountable framework for our central bank, with an explicit inflation policy target contracted between the Governor and the Minister of Finance.

We instituted a performance management regime in the public sector with private sector style disciplines. Public officials were hired on merit and under contract and public finances were subject to generally accepted accounting practice. The budget moved from input to output allocations with government departments funded under stated performance classifications and responsible for every element of their balance sheet produced in accordance with the accrual rules.

It was left to me to complete the reform setting with the introduction of legislated fiscal rules. My Fiscal Responsibility Act of 1994 was a fiscal game changer at three levels.

The stated principles of fiscal responsibility were the first attempt to discipline the conduct of public finances by a defined set of fiscal rules designed to produce prudent levels of debt, balanced budgets, improved net worth, management of fiscal risks and predictable tax rates.

Principles are all very well, but the embrace of an open budget regime with the requirement to publish a budget policy statement prior to the presentation of the budget, a fiscal strategy report at the time of the budget and again at the half year, and a pre-election fiscal update all combined to bake in better budget behaviour to bolster the rules.
Finally the reporting requirements to a GAAP (Generally accepted accounting principles) standard not just secured the credibility of the figures, but enabled management of public finances at every level, cash, capital and contingent liabilities.

I became the first Finance Minister in the world to produce the Financial Statements of the nation in accrual form in 1992.

This financial architecture allows a proper assessment not just of the current state of the books but of the long term fiscal position. Importantly it allows an investment approach to be taken to each and every government intervention; social, economic, environmental, scientific, business and infrastructure.

The most recent Statement on the Long Term Fiscal Position (2016) opens on this note:

> There is a dynamic relationship between New Zealand’s long-term public finances and inter-generational well-being. Intergenerational well-being relies on the growth, distribution and sustainability of the four capitals- financial and physical capital; human capital (e.g. health and skills); social capital (e.g. institutions and trust); and natural capital (e.g. water and biodiversity). Firms, households, and the government combine these four capital stocks in various ways to generate flows of goods and services that are consumed by people and enhance their wellbeing.

Sustainable government finances are a precondition to improving long-term living standards. They reduce the risks associated with economic, social or environmental shocks, provide current and future generations with the opportunities to participate in society (by allowing governments to provide essential services and infrastructure), and give more certainty in the future for individuals and governments to plan.

This policy framework has totally transformed the politics of public finance.

The fiscal rules, while allowing some leeway for temporary departure in the face of unexpected pressures (NZ is prone to seismic as well as policy earthquakes), are so compelling that no serious political party would want to flout them for fear of incurring electoral wrath.

In the run-up to the General Election in NZ in September the Opposition Labour and Green parties have agreed on a joint set of budget rules including a pledge to run surpluses and cap debt.

In a further move to reassure voters the two-party Budget Responsibility Rules will be assessed by a watchdog independent of political parties.

The fiscal ‘fight’ is whether net debt should be reduced to between 10-15 percent of GDP (the Government’s target) or 20 percent (the Opposition’s).

Most nations would die for such cross-party discipline, let alone the low numbers targeted.

Each month the Financial Statements of the Government of New Zealand come in my post (the perk of being a former Finance Minister), a more substantial and frequent set of disclosures than shareholders in a public company would receive. The content of these statements and the tracking of the growth in surpluses feature heavily in the business and political media.

What’s more, six weeks before the election there will be a freshly minted Pre-Election Fiscal and Economic Update, signed as to its accuracy by the Secretary of the Treasury. No more the ambush of
electoral competitors with faulty or hidden figures during the campaign which licenses all manner of promises to be made only to be broken once the fiscal truth is revealed.

My motivation for the Fiscal Responsibility Act was to radically transform the conduct of fiscal policy and to forever change the politics of public finance.

While I had to start my tenure in 1990 by taking a once in a lifetime axe to the level of public expenditure, my overriding ambition was to see the practice of fiscal responsibility sustained overtime, no matter the cut of the political cloth of the incumbent government.

Layers of sophistication have been added to the framework with Investment Statements that look across the portfolio of government held businesses and an investment approach to social expenditure, but the underlying disciplines endure.

Who would have thought that accrual accounting, output budgeting and fiscal rules would pay such dividends.

The pay off has been handsome - one of the highest growth rates in the developed world anchored by our best in class fiscal and monetary policy.

The tools to figure out real value for money in public spending, and the comfort of buffers from the inevitable adverse events.

Best of all the evolution of a responsible political mindset which is the ultimate guarantor of fiscal responsibility.

Introduction

New Zealand’s reputation as a strong fiscal performer is far from the natural order of things. It was just 33 years ago, in fact, when the country was facing a fiscal crisis. A sustained period of fiscal expansion had produced a protracted budgetary deficit and climbing public debt. New Zealand hit a wall in July 1984. Something significant needed to change.

That is precisely what successive governments did to restore the country’s public finances and unshackle its economy from the burden of fiscal profligacy and other symptoms of big government. The outcomes of New Zealand’s experience with fiscal reform in particular and a broader set of reforms in general (including significant supply-side tax reductions) are striking. The revival of its economy has been described as “one of the most remarkable economic liberalizations of modern times” (Brash 1996).

What is interesting about New Zealand’s story of fiscal reform is that they were launched by a Labour government.

This essay seeks to retell this story to a North American audience. It sets out the circumstances that led to fiscal reform in mid-1980s and details how these reforms were implemented and their positive outcomes. The goal is to set out lessons from New Zealand’s experience with fiscal reform that will be instructive in the on-going budget debate in Washington.
Setting the Scene: New Zealand’s Fiscal and Currency Crisis in 1984

New Zealand experienced a cathartic overseas currency crisis in July 1984. That set the scene for a decade of effort to turn fiscal deficits into surpluses. This essay explains New Zealand’s fiscal reforms between 1984 and 1993; but the currency crisis came first.

The crisis arose this way. New Zealand governments went into “borrow-and-hope” mode after the quadrupling of global oil prices in 1973-74. They did so for electoral and “Keynesian” reasons. New Zealand was an oil-importing country and it did not wish to see high rates of unemployment from fiscal retrenchment on top of the income losses from higher oil prices. The 1972-75 Labour government hoped that the external terms of trade (export prices divided by import prices) would rebound, easing the contractionary economic impulse and lifting export income and tax receipts. The 1976 budget from the new, incoming National government set out to sharply reduce the fiscal deficits, mainly by taking measures to increase revenues. But rising unemployment in 1977-78 saw the government revert to large fiscal deficits before the 1978 general election. The New Zealand economy at the time was not able to adjust rapidly and flexibility to the higher oil prices. On-going fiscal deficits became the norm. They were increased by a decision in 1982 to provide tax cuts in lieu of wage increases as an anti-inflation measure.

So New Zealand governments borrowed chronically and heavily in overseas and domestic markets. They needed to borrow foreign currencies because the Reserve Bank of New Zealand needed those foreign currencies to meet demand by domestic banks. The Reserve Bank was obliged to supply foreign currencies on demand under New Zealand’s adjustable peg currency regime.

Domestic banks needed to buy foreign exchange from the central bank continually because the country was running chronically large deficits in the current account of the balance of payments. Importers were buying more foreign exchange than the banks were obtaining from their exporting customers. The government would sell its borrowed foreign exchange to the Reserve Bank. The Reserve Bank would credit the government’s New Zealand dollar account at the Reserve Bank. The government would use those dollars to fund domestic spending in excess of its tax and other revenues. Doing so injected cash into the domestic banking system. The domestic banks’ New Zealand dollar deposit accounts at the Reserve Bank would rise accordingly, except when they used those accounts to purchase foreign exchange from the Reserve Bank.

So this was the money go-round that saw the “twin deficits” – in the balance of payments and the government’s fiscal accounts – funded for as long as the government could keep borrowing overseas.

The Treasury documented the extent of this decade of borrowing in its 1984 briefing to the incoming minister of finance. Between March 31, 1974 and March 31, 1984, the net official public debt rose from 4.4 percent of GDP to 29.6 percent, the net interest cost on the official public debt rose from 2.5 percent of total tax receipts to 11.5 percent, the portion of the public debt that was in overseas currencies rose from 12 to 38 percent and the interest on that portion rose from 2.6 percent of export income to 5.7 percent.

The official overseas debt was greater because that measure includes Reserve Bank overseas borrowing. It rose from 5.1 percent of GDP on March 31, 1974 to 27.2 percent of GDP on March 31, 1984. The interest cost rose from 2.4 percent of export receipts in the year ended March 1975 to 7.4 percent in the year ended March 1984.
Nor was any end in sight. In July 1984, the Treasury was estimating that the current account deficit in the balance of payments for 1984-85 would be 7.2 percent of GDP and the fiscal deficit would be of the order of 7 percent of GDP (New Zealand Treasury 1984, chapter 5, 81-92).

On June 14, 1984, Sir Robert Muldoon, then prime minister and minister of finance, called a snap general election for Saturday July 14, 1984. A run on the country’s official foreign exchange reserves occurred during the election campaign. The Reserve Bank sold $1.4 billion of foreign exchange during that month, as much as it would normally sell in a year (Bassett and Bassett 2006, 112). Most could see that a post-election devaluation was much more likely than an appreciation. It was one of those occasions when government-controlled exchange rates give alert individuals a one-way bet. By July 13, 1984, the Reserve Bank and Treasury had run through all their June 14 foreign currency cash reserves and deposits. Each had drawn on its short-term foreign currency borrowing facilities to maintain positive cash balances, to the maximum extent in the case of the Treasury. Treasury was also liquidating its medium-term foreign currency bond portfolio (for details see New Zealand Treasury 1984, 82-83).

Moody’s Investment Services was still giving the New Zealand government an AAA-rating for its overseas bonds at this point. Showing greater foresight, Standard and Poor’s downgraded New Zealand’s sovereign credit rating from AAA to AA+ in April 1983.

On July 14, the incumbent National Party government was roundly defeated. The Labour party won 57 seats, a gain of 13; National won 37 seats, a loss of 10. The next day, the most senior officials informed the defeated and outgoing prime minister, Sir Robert Muldoon, that the Reserve Bank lacked the overseas funds to meet likely demand if it opened its currency window on Monday. As one of his final acts, Sir Robert agreed that it should remain closed.

Both Treasury and the Reserve Bank recommended devaluation to the incoming government (as they had to Sir Robert before the July election). The incoming but as yet uninstalled government agreed. The constitutional crisis arose when Sir Robert refused to implement the incoming government’s devaluation instruction. His senior cabinet colleagues prevailed on him to change his mind.

A 20 percent devaluation occurred on July 18, 1984. The new government faced a massive challenge to back the devaluation up with supportive monetary, fiscal, and regulatory policies. The task was complicated by the need to also extricate the New Zealand economy from comprehensive controls on wages, prices, interest rates, rents, imports, and foreign exchange. The 20 percent devaluation made a continuing wage freeze politically untenable. Economic liberalization, fiscal consolidation, and disinflation had to proceed in tandem.

The Extent of the Fiscal Correction

It took a decade of tenacious fiscal measures by successive governments to restore surpluses to the government accounts. Treasury’s long-term fiscal time series (see Table 1) summarizes the revenue and expenditure changes between 1984 and 1994. The move from fiscal deficit to fiscal...
surplus during the decade represented a turnaround of 7.0 percent of GDP in a “before-and-after” sense. Expenditures, excluding finance costs, contributed only 0.8 percent of GDP (11 percent) of this turnaround.

**TABLE 1: Turnaround from fiscal deficit to surplus**

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<tr>
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<tr>
<td><strong>Cash Spending</strong></td>
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<tr>
<td>Social security, welfare, superannuation</td>
<td>10.9%</td>
<td>12.2%</td>
<td>Expenditure increase (-) -1.4% -19%</td>
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<td>Health and education</td>
<td>9.3%</td>
<td>10.2%</td>
<td>Expenditure increase (-) -0.8% -12%</td>
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<td>Other non-finance spending</td>
<td>10.3%</td>
<td>7.4%</td>
<td>Expenditure reduction (+) 3.0% 42%</td>
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<td>Financial net expenditure (excl finance costs)</td>
<td>30.6%</td>
<td>29.8%</td>
<td>Expenditure reduction (+) -0.8% -11%</td>
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<td>Finance costs</td>
<td>5.5%</td>
<td>4.1%</td>
<td>Finance cost reduction (+) -1.3% -19%</td>
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<td>Financial net expenditure</td>
<td>36.0%</td>
<td>33.9%</td>
<td>Net expenditure reduction (+) -2.1% -30%</td>
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<td><strong>Cash Revenue</strong></td>
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<td>Taxation receipts</td>
<td>28.0%</td>
<td>32.0%</td>
<td>Tax revenue increase (+) 4.0% 58%</td>
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<tr>
<td>Other receipts</td>
<td>1.9%</td>
<td>2.4%</td>
<td>Other revenue increases (+) 0.4% 6%</td>
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<td><strong>Cash Receipts</strong></td>
<td>29.9%</td>
<td>34.4%</td>
<td>Revenue increase 4.5% 64%</td>
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<td>Other Items**</td>
<td>0.0%</td>
<td>0.4%</td>
<td>Other 0.4% 6%</td>
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<tr>
<td>Total receipts</td>
<td>29.9%</td>
<td>34.8%</td>
<td>4.9% 69%</td>
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<td><strong>Treasury’s Fiscal Deficit Measure</strong></td>
<td>-6.1%</td>
<td>0.9%</td>
<td>Deficit turnaround 7.0% 100%</td>
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*Adjusted financial balance basis (cash).

**Primarily miscellaneous investment transactions.

Note that the 1994 accounts were also published on an accrual basis.

Cash spending on social welfare, health, and education combined rose from 20.2 percent of GDP to 22.4 percent of GDP during the decade. The overall 0.8 percent of GDP reduction in financial net expenditure excluding finance costs was achieved mainly by slashing spending on farm and corporate subsidies while keeping spending growth in other areas, such as defence and transport and communications, below GDP growth.

The biggest row item contribution was the lift in tax revenues from 28 percent to 32 percent of GDP.
Requiring state-trading enterprises to operate more commercially and pay dividends and taxes to the Crown also helped raise revenues.

The reduction in finance costs relative to GDP also helped. Finance costs peaked at 7.6 percent of GDP in March 1988, 23.5 percent of taxation receipts. The net public debt peaked at 49.9 percent of GDP in June 1992. By June 1994 it was down to 41.2 percent of GDP. In the second half of the 1984-1994 period, finance costs were reduced further through the use of proceeds from privatizations to reduce debt.

The “other items” revenue line in the table represents “net investment transactions.” They also affect the government’s financing requirement.

For a year-by-year picture of the part from fiscal deficits to surplus, see Figure 1.

FIGURE 1: The path from fiscal deficit to surplus

For the record, New Zealand’s public accounts largely remained in surplus until the global financial crisis of 2007-8. In June 2008, the net public debt was 0.0 percent of GDP and the gross public debt was 20 percent of GDP. Neither statistic has been lower since at least the mid-1860s (New Zealand Debt Management Office).

For greater completeness and of relevance to an international audience, Figure 2 tracks four of the OECD’s fiscal balance measures for general government in New Zealand from 1986 to 2016. (The OECD works on a closest calendar year basis, so its figures for 1986 for New Zealand would be based on official New Zealand statistics for the year ended March 1987.) The chart shows that all four of the measures were in surplus in New Zealand for the first time in 1994.
Figure 3 summarizes the annual movements in the net public debt between March 1972 and June 1997. The rising ratio to GDP from 1974 (the black line in the chart) reflects the on-going deficit spending through to 1994. The subsequent decline in the net public debt ratio reflects the subsequent fiscal surpluses, plus strong economic growth.

The rising red line from 1974 to around March 1985 shows the effect of government borrowing overseas to fund the “twin” deficits under a pegged exchange rate regime. Floating the New Zealand dollar in March 1985 removed the need for government to borrow to obtain foreign exchange to defend the dollar. A subsequent decision to reduce gross official overseas debt to the level of official overseas reserves saw a zero net external debt position achieved by June 1997. The proceeds from privatizations helped achieve this adjustment.

**FIGURE 3: Turning the public debt spiral around**

Source: NZ Debt Management Office for debt as at March/June, NZ Treasury long-term fiscal time series 1972-2016 for nominal GDP.
How Was this Fiscal Correction Achieved?

Tax revenues were increased by major tax reforms. The philosophy was to tax income and spending broadly at a low rate, with few loopholes or exemptions. Parliament imposed a 10 percent Goods and Services tax from October 1, 1986, along with reform of wholesale taxes. It imposed a fringe benefit tax to broaden the income tax base. It also reduced the personal tax exemptions for superannuation contributions and life insurance premiums.

The government aimed to increase tax receipts as a proportion of national income while reducing top marginal tax rates for efficiency reasons. Parliament lowered the top statutory rate of income tax in two steps from 66 to 33 percent where it was aligned with the corporate tax rate. It introduced a full imputation system for distributed company dividends from the 1988-89 financial year. There were many other tax changes (Walker 1989, Appendix).

Other revenues were raised by greater recourse to user charges and full cost recovery. For example, the government increased the bulk tariff for state-supplied electricity by 225 percent from April 1, 1985 and road user charges by 46 percent from February 1, 1985.

Slowing the rate of increase in spending was much more difficult for the 1984-1990 Labour government. Spending interests in health, education, and social welfare were strongly represented within its ranks. It was much easier politically for a Labour government to cut subsidies for farmers. Another factor pushing up spending in the short-term was redundancy payments from state sector restructuring. After 1987, the biggest rise in registered unemployment since the 1930s added materially to welfare spending.

Market interest rates of auctioned government bonds were revealed to be 15 to 16 percent per year. That was about 5 percentage points higher than previously controlled levels (New Zealand, Reserve Bank 1985, 8). That increased debt servicing costs for new debt. So did the 20 percent currency devaluation and the need to add to the measured public debt as a by-product of marking assets and liabilities to market. Eventually, lower nominal interest rates, reduced fiscal deficits, and, after 1991, strong economic growth worked to reduce finance costs as a percent of GDP.

The National government that replaced Labour in 1999 found it easier politically to curb the growth in social spending. Spending on New Zealand superannuation fell from 6.8 percent of GDP in 1991 to 5.9 percent of GDP in 1994 (years ended June). Critics of the reforms have demonized the government for reducing the base rates for welfare benefits, perhaps for the first time in New Zealand’s history. They tend to ignore increased spending on supplementary forms of welfare assistance. Overall, the government increased spending on welfare, excluding on unemployment benefits and on New Zealand superannuation, from 4.9 percent of GDP to 5.6 percent between 1991 and 1994.

In short, achieving the outcomes shown in Table 1 was anything but easy. New Zealand had four prime ministers and three finance ministers along the way.
Macroeconomic Outcomes

Fluctuations in macroeconomic outcomes in New Zealand are typically closely correlated with those in Australia. Both countries have a common English institutional heritage. Until the last decade, Australia was New Zealand’s major trading partner. Australia still dominates the banking and capital markets and is the prime source of foreign direct investment in New Zealand. Public policy initiatives in New Zealand typically respond to developments in Australia. This was particularly the case in New Zealand in 1984. Reforms by the Hawke/Keating government in Australia, documented in another essay in this series, had influenced policy advisers in New Zealand prior to 1984.

The ratio of export prices to import prices

Economic activity in New Zealand has also been strongly influenced by fluctuations in world markets in the prices for its exports relative to its imports. These fluctuations have been marked largely because the commodities that New Zealand exports have been very different from those it imports. New Zealand has long exported primary goods and services (particularly agriculture and forestry) and used the proceeds to import oil, intermediate, and consumer goods.

Figure 4 illustrates the extent of those historical relative price fluctuations. World prices for New Zealand’s export/import mix was one of the most unfavourable in New Zealand’s history during the borrow-and-hope 12-year period from 1975 to 1986 (calendar years). The failure to adjust adequately to the relative price slump was a major reason for the rise in external indebtedness and the foreign currency crisis in 1984.

There was a material recovery during 1987 although the price ratio stayed below the long-term average until around 2004.

FIGURE 4: Near 1930s lows for the terms of trade during the deficit years

Source: Statistics New Zealand, Calendar Year Average.
Real GDP growth

Real GDP growth in New Zealand between 1984 and 1987 was stronger than Treasury expected prior to the reforms. The way the government went about the reform program sustained business confidence.

The minister of finance, Roger Douglas, put a lot of effort into communicating the logic and consistency of the intended reform program. The government’s focus was on making the changed policy directions credible and consistent. This was to encourage investment spending in less subsidized and protected areas in order to sustain economic activity, employment, and tax revenues.

Douglas used a carrot-and-stick approach. On the stick side, import protection was to be reduced, farm subsidies largely wiped out, the average tax take raised, and market interest rates restored (inevitably at a much higher level than the previously controlled rates). On the carrot side, top marginal tax rates were lowered, the dollar was floated, state-owned enterprises were increasingly exposed to competition, and economic freedom progressively increased. There were booms in the share market, mergers and acquisitions, and the commercial property market.

This all buckled when the government fell apart after the global share market crash in late 1987. The government lost its way, business confidence fell, and the share market collapsed – and stayed collapsed. A great many property and investment companies went bankrupt and the rate of unemployment skyrocketed. Real GDP in 1991 was no higher than in 1988.

The electorate threw out the government in the 1990 general election. The new National Party government inherited a still-difficult fiscal situation. It was aggravated by the need to bail out the government owned Bank of New Zealand. For decades it had been New Zealand’s biggest bank.

On taking office the government was informed by Treasury that on current policies the central government financial deficit would increase from 3.3 percent of GDP in 1991 to 5 percent in 1992 and 6.3 percent in 1994 (years ended June) (Kerr 1984). The new finance minister, Ruth Richardson, vigorously set out to reduce spending, reduce the fiscal deficits, and free up economic activity. The July 1991 Budget’s focus and goal was “strong and sustainable economic growth” (Richardson 1991, 7). Before it took office the National Party had aimed to “achieve economic growth of at least 3 percent per annum ... by the end of our first term” (Richardson 1991, 29).

The government’s July 1991 Budget was bold and controversial. It cut spending, including perhaps the first cuts in retirement and welfare benefit rates in New Zealand’s history. It projected that expenditure on the standard budget basis at the time would fall from 42.9 percent of GDP in 1991 to 37 percent of GDP in 1994 (years ended June basis) (Richardson 1991, 27).

It said the government was determined to create “the best possible environment for jobs and growth” and demonstrated its “resolve to control, reduce and eliminate the budget deficit over three years.”

The budget cuts attracted the ire of 15 academic economists at the University of Auckland. They wrote a letter to the major Auckland daily newspaper, The Herald. The key section read:

We wish to state in the strongest possible terms our view that in the present state of the economy, and in the midst of an international recession, the deficit-cutting strategy is fatally flawed. It can only depress the economy further and because of this it will to a considerable extent be self-defeating … (Cited in Lewis, Grimes and Wilkinson with Teece 1996)
Their case seemed to be naïve Keynesianism.

FIGURE 5: GDP growth after budget cuts that could “only depress the economy further”

Figure 5 shows what happened to real quarterly GDP in New Zealand during the next five years. It uses Australia and the total OECD as benchmarks. Far from deepening the recession, real GDP has never since been as low as at the time of the Auckland economists’ “it can only depress the economy further” prediction.

Budget cuts take time to have an effect, yet very strong real GDP growth commenced during the second half of 1992. For the next five years, real GDP growth in New Zealand handsomely outstripped that for the member countries of the OECD as a whole, and even outstripped that of high-performing Australia. Real GDP growth, seasonally adjusted, was positive for 17 successive quarters from September 1992.

Figure 6 shows a longer time series. New Zealand’s rate of economic growth far outstripped the government’s 3 percent per annum target for the end of its first term of office. New Zealand’s trend rate of growth in real GDP between 1993 and 2007 was 3.5 percent per annum. This was not significantly lower than Australia’s trend rate of 3.6 percent per annum. For the 15 years from 1991 to 2006, New Zealand’s real GDP growth matched that in Australia. It had not done that since 1960, at the very least.
What about the prediction that the budget cuts would not reduce the fiscal deficit? On the Treasury’s 2016 time series for that period, the fiscal deficit, as conventionally measured at that time, was 3.4 percent of GDP for the year ended June 1991. Three years later, it was in surplus by 0.9 percent of GDP. The National Party’s 1991 Budget target was achieved.

Research by Harvard University’s Alberto Alesina and colleagues and by the OECD has found evidence that fiscal adjustment by expenditure cuts is less costly in terms of forgone GDP than adjustment by revenue increases. The contrast between GDP growth in New Zealand in the period 1984-1991 and the period after 1991 is consistent with this view, but of course so many other factors were in play that it is no more than this (Alesina, Favero, Giavazzi 2015; Blochliger, Song, Sutherland 2012).

The fall-back position for opponents of economic liberalization is that the reforms were a failure nonetheless because they failed to deliver the improvements “that were promised by the reformers” (Guillemette 2009). I have never located any documented basis for this claim, and greatly doubt that any could be produced. On the other hand, as just shown, it is easy to document grossly pessimistic claims by those opposed to the reforms.

The 1991 Budget cuts were accompanied by legislation to free up the labour market. The government wanted to make it easier for people to find jobs. The Employments Contract Act 1991 was strongly opposed by the trade unions and other left-wing voices. Yet, for next five years, New Zealand had the fastest rate of employment growth in the OECD (see Figure 7). Fast employment growth and fast GDP growth typically go hand in hand.
FIGURE 7: Fastest employment growth in the OECD, 1991-1996

NZ had the 3rd highest growth in employment between 1991 & 2000 – behind only Ireland and Mexico

Source: OECD database Dec 2016.

Economy-wide productivity

Figure 8 compares total economy labour productivity growth between Australia and New Zealand.

FIGURE 8: Labour productivity growth similar to Australia’s, 1987-1997

Source: OECD Country Database.
New Zealand’s trend growth in labour productivity from 1964 to the early 1980s was dismal compared to Australia’s (and indeed to most OECD countries). Policy in New Zealand was more protectionist, and its tax burdens were greater.

The trend for measured labour productivity growth in New Zealand was faster than in Australia from around 1987 to 1991. New Zealand’s strong labour productivity growth during the 1988-1991 recession was a surprise. It reflected that companies were shedding labour as they restructured during the recession. There were major productivity gains in New Zealand Post and New Zealand Railways and other progressively restructured government-dominated industries.

Since 1993, labour productivity growth in Australia has been faster than that in New Zealand. Reformist zeal in New Zealand was essentially defeated when Ruth Richardson, minister of finance from 1990 to 1993, was not reappointed after the 1993 general election. The 1996 general election took place under a new system of Mixed Member Proportional Representation. A major purpose of the change to the voting system was to create coalition governments that would make government responses to any future crisis more compromised.

Figure 9 shows that there was also a lift in the rate of growth in multifactor productivity after the 1991 Budget and the Employment Contracts Act. The Labour party was re-elected in the 1999 general election. The new prime minister, Helen Clark, disowned the Labour’s 1984-1989 reforms and those that followed. She often disparaged them as the “failed policies of the past.” Her government raised top income tax rates, reregulated the labour market reflecting trade union pressure, and in time radically increased government spending. That period is labelled “Reform Retreat” in Figure 9.

**FIGURE 9: Pickup in multi-factor productivity growth after 1991**

![Graph showing productivity growth](source: OECD Country Database)

The unemployment rate

Figure 10 compares the unemployment rates in New Zealand and Australia from 1970 to 2016 using the OECD’s standard measure.
The greater protectionism in New Zealand, the tendency to disguise the extent of underemployment in the country by feather-bedding jobs in state agencies, along with heavy overseas borrowing to defer the day of reckoning, may help explain New Zealand’s much lower measured rate of unemployment prior to the post-1987 recession. But note that New Zealand’s measured rate was rising along with Australia’s.

The extent of labour shedding in New Zealand during the 1988-1991 recession is illustrated by the fact that by 1992, the unemployment rate in New Zealand had caught up with that in Australia. The New Zealand rate was by far the highest the country had experienced since the 1930s depression. It was a searing time.

One factor that aggravated unemployment was the prolonged need to maintain a tight monetary policy in order to reduce inflation. Inflation was markedly repressed in the mid-1980s by an extensive wage and price freeze. It would have been desirable to exit the freeze with a low rate of increase in wage rates (and prices). That was not achieved. The CPI rose by 15.4 percent in the 1985 calendar year. The pressures to push up wage rates were immense. On September 10, 1985, the government’s Higher Salaries Commission announced that it was recommending wage increases of up to 38 percent for senior public servants and politicians. That inflationary precedent set the scene for negotiations with trade unions and for private sector increases that started the very next day. By September 1986 the prevailing wage rate index for central government administrative and managerial staff was 35.0 percent higher than in September 1985. The average increase across all sectors and industries was 19.9 percent, representing an average real wage rate increase of 11.8 percent (Evans et al. 1999, 1880 [bibliography]). That set the stage for a major confrontation between monetary policy and inflation. It was not until 1992 that CPI inflation was brought down into the then-government’s target range of 0-2 percent per year.

**FIGURE 10: Unemployment rate roughly tracks that in Australia**

![Unemployment rate graph](source: OECD Database: December 2016)
It is intriguing that New Zealand’s unemployment rate fell more quickly than Australia’s from 1992 through to 2007. That may reflect in part the greater labour market freedom that New Zealand achieved.

**Economic freedom and economic growth**

Between 1985 and 1995, New Zealand’s reforms increased economic freedom for New Zealanders from 26th to 3rd in world rankings on the Fraser Institute’s measure. New Zealand’s ranking and scores have remained at the top end internationally, but its rate of economic growth has been much lower than that in the two top-ranked countries, Singapore and Hong Kong.

One dramatic point of difference is the much higher tax burdens in New Zealand, as measured, for example, by government spending ratios to GDP. New Zealand’s ratio of general government spending to GDP has exceeded 40 percent more often than not since 1985. Very few countries with such a high spending burden have been able to sustain very high rates of economic growth.

**Political and Policy Context (Including Any Intellectual Opposition to the Reforms)**

The polarizing personality of Sir Robert Muldoon combined with extreme dirigiste policies, even by European standards, had created a wide constituency for change in New Zealand, including in the business community. The landslide election result in 1984 reflected this view.

The fact that leaders in the business and farming community supported moves to a more open economy with much less protectionism and reliance on farm subsidies was important for what was to come.

The initial opposition to more orthodox policies came from the academic community and traditional trade union representatives. Both were well represented in the ranks of the new Labour government.

Academic opposition in New Zealand to fiscal restraint and economic liberalization was intense from the start. The public closure of the Reserve Bank’s foreign currency window led to an abundance of “wild rumours and conspiracy theories” (Bassett and Bassett 2006, 115). Concerned about the prospect of a devaluation, several academic economists from the Victoria University of Wellington attempted to see the just-elected government to give it alternative advice. Roderick Deane, then deputy governor of the Reserve Bank, reports that some blamed him for the foreign currency crisis and wrote to the new government calling for him to be sacked (Bassett and Bassett 2006, 115).

The mainstream media was more pre-occupied by the constitutional crisis at this point.

The new government, appalled by the degree to which the severity of the growing economic crisis had been hidden from the public, committed itself to much greater transparency. One early move was
the unprecedented publication of Treasury’s and the Reserve Bank’s traditional post-election briefing documents of the incoming government. The main messages from Treasury’s post-election briefing were that spiralling public, overseas debt, and an over-controlled economy were all problems. The briefing made the case for much more orthodox economic policies. Naturally these represented a major shift away from the existing heavy reliance on import protection, comprehensive controls on wages, prices, rents, and interest rates, and a fixed and a vulnerable exchange rate.

Another early step the new government took was to allow itself to be manoeuvred into setting up a parliamentary inquiry into the events leading up to the devaluation. The inquiry was to be led by a government MP with a trade union background who was an opponent of the devaluation and economic reform. Its sole meeting was dominated by the entirely partisan outgoing prime minister, Sir Robert Muldoon. That meeting took the form of a star chamber inquisition directed personally at the Reserve Bank deputy governor, Dr. Roderick Deane, and Treasury assistant secretary, Dr. Graham Scott (Bassett and Bassett 2006, 122-23). They were not permitted legal representation. Nor were their chief executives permitted to accompany them. Each man had led the preparation of their respective organization’s post-election briefing documents. To discredit the government’s key advisers personally could help to undermine the government that had taken their organizations’ advice on devaluation. The events of that first meeting induced the government to abort the inquiry.

A next step came from a group of Victoria University of Wellington’s economists who wrote a critique of the Treasury’s and Reserve Bank’s published post-election briefings for the new government. The critique was particularly disapproving of the Treasury briefing. It considered that Treasury was underestimating the short-term costs of fiscal consolidation and liberalization because Treasury was underestimating adjustment or transaction costs. However, it did not demonstrate that delayed adjustment from prolonging “borrow and hope” would be less costly. Nor did it seem to appreciate the importance of reducing adjustment costs to make it easier for decision-makers to reallocate resources. Treasury’s eclectic framework was drawn in good part from the microeconomics literature. On the macroeconomics side, Treasury eschewed monetary aggregate targeting and was informed by open economy Keynesian theories. For example, the influence of monetary policy depends on the choice of exchange rate regime and exchange rate dynamics affect adjustment paths. On the economic efficiency aspects, as a more astute Australian economist observed, it might have been more accurate to describe the framework as Austrian than neoclassical. Arrangements that reduced transaction costs, harnessed widely dispersed information, and internalized incentives, were very much part of Treasury’s thinking.

Again, the motivation for the academics’ critique appeared to be in good part political. Indicatively, the media heard about the critique before Treasury did. Treasury responded to the criticisms and the Reserve Bank supported Treasury, as did many economists. One indefatigable opponent was Brian Easton, then a director of the Wellington-based New Zealand Institute of Economic Research. He published an article in 1985 praising the “Victoria School.” In another article, he criticized Treasury economists whom he alleged had uncritically imported into the Treasury “Chicago School” views. For decades he has portrayed Treasury’s thinking at the time as radical monetarist and “New Right” and been very critical of the policy decisions taken.
Brian Easton is one of New Zealand’s most prominent economists in the public eye. He has achieved New Zealand’s highest level of award from his peers. For decades, he has disparaged the reforms and the reformers. So, what is his major economic criticism of them? In his 1997 book In Stormy Seas: The Post-War New Zealand Economy, he asserts that a Treasury “mistake” in its July 1984 post-election briefing “cost New Zealand 20 percent growth of GDP in the next seven years.” That is a grievous charge. What is its basis?

In support of this assertion he cites a single sentence in the Treasury 1984 briefing (Easton 1997a, 237). It is one sentence in four pages of discussion of nominal exchange rate adjustment options. The sentence observes essentially that with a floating exchange rate it will be harder for governments to squeeze the traded goods sector through a fixed, overvalued exchange rate defended by heavy overseas borrowing.

As I recall, I wrote that sentence. What I had in mind was New Zealand’s post-1974 experience of overseas borrowing with a fixed exchange rate (see Figure 3). Under a floating exchange rate, the same on-going fiscal deficits and loose monetary policy settings could have seen the currency depreciating due to reducing investor confidence. Inflation would be a problem, any external trade deficit might not be. The sentence was qualified because squeezing the traded goods sector through macro policy is still possible, as shown by the well-known, highly stylized, Mundell-Fleming model. A government could squeeze the traded goods sector under a floating exchange rate by increasing its fiscal deficits while keeping monetary policy tight. But a tighter monetary policy would be a harder policy mix politically than the post-1974 easy money policy.

So what is the major “mistake”? Easton essentially proposes that it was failing to spell out the stylized Mundell-Fleming result. The quoted sentence merely allowed for it; it did not spell it out. Larger fiscal deficits would increase an external trade deficit if monetary policy was non-accommodating.

Well, as author, I can say that the decision not to spell it out was neither an error nor a mistake. It was a judgement call about how technical and complete to be in a briefing document. A briefing document canvasses relevant issues and possibilities. It can lay a path to future decisions, but Cabinet decisions arise from different processes. Ministerial recommendations to Cabinet are a separate and different exercise.

Putting that to one side, how does Easton argue that the omission cost 20 percent of GDP?

First, he must assume that the Cabinet took the decision to float months later without any further consideration on the matter. That proposition is not just ridiculous, it is preposterous.

Second, his argument requires the government to be increasing its fiscal deficits. But it wasn’t. It was doing the opposite, as Table 1 and Figures 1 and 2 show. By his own argument, that must have been adding to GDP, not subtracting from it.

Third, he misunderstands the model. Under this version of the Mundell-Fleming model, fiscal policy has no effect on (equilibrium) real GDP. Its effect is solely on the trade balance.

Fourth, the trade balance also moved in the opposite direction to that which he proposed. It moved from sustained deficits to sustained surpluses following the March 1985 floating of the dollar (see Figure 11). That should have put less pressure on the borrowing costs in New Zealand and therefore less incipient upward pressure on the exchange rate. Part of this improvement was due to better export prices relative to import prices (see Figure 4). Export volumes were higher relative to import volumes after 1985 (see Figure 12.)
In short, Easton’s charge seemed to have no substance. The GDP loss assertion misunderstands this theory and the rest of it is contrary to the facts.

FIGURE 11: Net exports increased after the exchange rate was floated in March 1985

Source: Statistics New Zealand: Long-term time series, year ended March (date missing here?).

FIGURE 12: No post-float reduction in real net exports

Concluding Observations

Extreme dirigiste policies had New Zealand on the cusp of having to approach the IMF for support in July 1984. The situation was so dire that the incoming Labour government set out to do the “right thing,” thinking it had little chance of getting re-elected in 1987, even if it failed to take effective action.

It took far reaching action and got handsomely re-elected in 1987. This result is encouraging for the view that well-explained and executed fiscal consolidation and liberalization can be politically successful.

The government fell apart in 1988. The prime minister and the minister of finance were at loggerheads over reform with the latter resigning first and the former subsequently.

The economic job was still not done. The battle to control inflation using monetary policy was still in the balance. Fiscal deficits were still large. New Zealand experienced a searing recession from 1988 to 1991 (see Figures 5 and 7). It was triggered by the October 1987 global share market crash that hit New Zealand harder than almost anywhere else. A large proportion of listed investment and property companies were wiped out. Business confidence fell, not aided by the government’s loss of direction.

The Labour government limped through to the 1990 general election, replacing its prime minister twice and its finance minister once. It knew it had lost the support of the electorate. The National Party won that election in a landslide. It campaigned on a reformist economic strategy. As documented above, under the new minister of finance, Ruth Richardson, it set out with vigour and coherence to increase economic growth to 3 percent per year, reduce unemployment, and achieve fiscal surpluses. It also pledged to get inflation down into a 0-2 percent band. It achieved all those goals. In the 1993 calendar year the consumer price index was only 1.3 percent higher than in 1992.

Even so, National almost lost power in the 1993 general election. Broken promises over national superannuation were a factor. Yet, the key reform – market interest rates, a floating exchange rate, and presumptions in favour of low inflation and fiscal surpluses have endured successive electoral tests.

This is not a message opponents of economic freedom would accept. Many academics appear to be strongly opposed to it. The term “neo-liberal” is commonly used as a mantra in social science academic circles in New Zealand.

Critics of liberalization have tended to blame it for the 1988-1991 recession. Critics of fiscal stabilization have tended to blame the recession on austerity. Neither argument is convincing. The austerity proposition dismally failed the test presented to it by the 1991 government budget.

Neither argument puts weight on the role of monetary policy in fighting inflation or the effect of the commercial property and share market collapse on business confidence and spending.

Perhaps the most prevalent complaint today by the critics of liberalization is that it has not delivered even better economic outcomes.
Yet that criticism has a cargo cult feel to it. Reform is not a one-off thing that cures all problems. New Zealand is not a nirvana of limited government. General government spending remains of the order of 40 percent of GDP on the OECD’s measure. Welfarism remains a serious problem. Government still dominates in education, health, and in many other sectors. The low quality of extensive on-going government regulation is of great concern. Serious economic reform has not been on any government’s agenda since the change to general elections based on the German MMP system in 1996.

The case that reform should have produced much faster increases in living standards has not been convincingly made, but there is much debate about this. Pessimists argue that New Zealand’s remoteness and lack of scale are factors. Those who find the relationship between economic freedom and prosperity convincing emphasize that more needs to be done (Douglas 1993; Kerr 1999; and Richardson 1995, 197-230).

None of this is to argue that New Zealand did everything right in some textbook sense. Politics is the art of the possible. Fiscal consolidation and liberalization is messy, particularly given powerful entrenched interest groups. Disinflation is usually painful. The New Zealand experience had all these features.
Bryce Wilkinson is a Senior Fellow at The New Zealand Initiative, and also the Director of the Wellington-based economic consultancy firm Capital Economics. Prior to setting this up in 1997 he was a Director of, and shareholder in, First NZ Capital. Before moving into investment banking in 1985, he worked in the New Zealand Treasury, reaching the position of Director. Bryce holds a PhD in economics from the University of Canterbury and was a Harkness Fellow at Harvard University. He is a Fellow of the Law and Economics Association of New Zealand.

Bryce is available for comment on fiscal issues, our poverty, inequality and welfare research. He also has a strong background in public policy analysis including monetary policy, capital markets research and microeconomic advisory work.
References


Endnotes

1. The fiscal deficit range for 1984-85 was 6.2-7.6 percent of GDP (New Zealand Treasury 1984, 79). The text explained that this was lower than the deficit of 8.7 percent of GDP for 1983-84 in part because two government agencies, the Rural Bank and the Housing Corporation, were being permitted to borrow from private markets independently. (The fiscal deficit measure being used in those days was a home-grown measure designed to reconcile annual spending, revenue, financing, and investing transactions with changes in Official Public Debt. Accrual accounting was adopted in the 1994 fiscal year.)

2. Prior to the general election Labour had signalled support for a devaluation.

3. And, of course, the difference between the average interest cost and the nominal GDP growth rate.

4. The government’s July 1976 Budget (page 6) identified four major economic problems: “record and growing inflation,” an increasing fiscal deficit, a “massive external current account deficit,” and high and rising unemployment (Muldoon 1976). The Budget perceived that structural changes to the economy were required. Fourteen pages of budget text (pages 9-21) came under this heading. The measures were entirely dirigiste. Thirteen of the 14 pages were devoted to ad hoc and distorting measures to subsidize farming and investments in export-related activities more broadly. None were directed at freeing up economic activity. The incoming government in 1984 faced the same problems, along with much greater debt levels.

5. See below for some discussion of the open economy Mundell/Fleming/Keynesian model.

6. In private email correspondence in May 2009 I asked the lead author of the OECD working paper for documentation of the basis for this assertion. His reply provided none. It merely said that his “understanding was that the reformers promised more than stopping the slide in relative living standards.” I doubt Roger Douglas or Ruth Richardson ever promised that. Roger Douglas’s imperatives, while minister of finance from 1984-1988, were to stabilize the public accounts and free up economic activity. The need was to explain the necessity, and make the government’s determination credible. “Blue sky” was never on the horizon. Ruth Richardson, as minister of finance from late 1990 to 1993, over-achieved her targets.

7. In a 1997 article, Brian Easton considers that “[t]here appears to have been little economic benefit, if any, from the ECA, other than perhaps for employers at the expense of workers” (Easton 1997b). He prefers to see the upswing in GDP and employment as cyclical, despite the budget cuts.

8. On the Fraser Institute’s index (5B) for labour market freedom, New Zealand’s score in 1995 was 7.5, compared to 5.4 for Australia. This freedom was greatest in Hong Kong with a score of 8.6. New Zealand’s score put it 3rd equal with Japan and the USA. Malaysia’s score was 7.6.

9. For example, on the Fraser Institute’s chain-linked index New Zealand’s score was 6.21 in 1985 and 8.84 in 1995. Its country ranking had risen from 26th to 3rd.

10. See for example, Kerr (2003). Of course this is not to argue that this is the only consideration. Some government regulation, (particularly the Resource Management Act) and issues of location and scale are also relevant considerations.
Bassett (2010). One can only assume that he had no idea how parlous the foreign exchange position had become.


Economists in New Zealand at the time seemed to be divided into those whose major concern was to avoid or delay transitional adjustment costs and those whose time horizons were longer.

See Evans et al. (1996, pp. 1862-1863) for a much fuller treatment of the intellectual foundations.

Easton (1985) and Easton (1998). There was rarely any factual content to these characterizations. The main rhetorical device was innuendo. Treasury advice was extremist by assertion and its top advisers were hard-hearted ideologues.

In his 1997 book *In Stormy Seas*, Easton (1997a, 33 and 34) divided economic schools of thought into 4 categories, traditional vs. market Keynesians and traditional vs. radical monetarists. The latter group was the only one that favoured a floating exchange rate and price stability.

The cited Treasury sentence is: “With a floating exchange rate, there is less risk that poor monetary and fiscal policies will impoverish those industries exposed to world trade while generating spiralling external debt problems” (Easton 1997a, 238).

I had sat in on Rudiger Dornbusch’s lecture course in MIT on this topic in the late 1970s and was thinking of the Mundell-Fleming small open economy models where domestic policies cannot influence world prices or interest rates.

In the stylized model, increased fiscal spending on goods and services worsens the trade balance because real GDP cannot increase because the floating exchange rate allows the government to fix the (real) money supply and world markets dictate to a small country with open capital markets the world real interest rate.


Richardson 1995, 177 also mentions health reform and political strategy. She was not reappointed as minister of finance after the 1993 general election.

Auckland University economics professor Tim Hazledine’s letter to the editor of *The Listener* on March 24, 2012, is an example.

Mayes and Chapple (1994) usefully discuss the issue of the costs of disinflation in a New Zealand context.

Also of major current concern is land use regulation. The median house price in Auckland sits at around 11 times median household income.

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