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EXCELLENCE ISN'T OPTIONAL

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As an engineer by training, I can confirm the wisdom of the saying that when you are in a hole you should stop digging. That is the first step towards formulating a sensible plan for getting out. And it is roughly where the government appears to be at, judging by last month's budget and more recent statements. It has stopped digging. It is no longer in denial that New Zealand is facing real economic problems, and that action is required.

It took quite some time for the business community to get that message through. Last year the treasurer was claiming the government had done everything the business community wanted, and rejecting arguments that New Zealand was going badly off track. The minister of finance was criticising the Business Roundtable for suggesting that the prospects of a credit rating *upgrade*, which was widely anticipated only two years ago, were receding. He said we were "needlessly and irresponsibly fuelling overseas concern".

So it was good to see a budget that at least represented a move in the right direction, and our new prime minister must be given some credit for the change in climate. The tariff decisions in the budget were welcome, as were the moves to begin opening up the ACC to competition and to end the statutory powers of the producer boards. There were also some positive moves on work-testing of beneficiaries, although these only scratch the surface of our welfare dependency problem. This is implicitly acknowledged in the Treasury projections accompanying the budget which show no fall in beneficiary numbers in the next three years. Clearly the Treasury realises that without employment market reform such welfare changes will have a negligible impact.

When it came to the overall fiscal picture, there were unfortunately only minimal indications of a new sense of realism. Only $300 million was shaved off the coalition agreement's $5 billion of new spending – a mere 6 percent reduction. Moreover, out of the $400 million in spending cuts sought by the treasurer last year, the budget revealed that just $147 million in ongoing savings had been found.

Overall, government spending is still rising rapidly, and placing far too great a burden on the private sector. Over the past two years core spending has risen by an average of 5.5 percent annually. It is set to grow on average by 3.6 percent over the next two years – maybe twice the rate at which the economy will grow in that period, according to some forecasters. In the fiscal year just ending, total spending as a share of gross domestic product (GDP) is projected to have risen to 34.7 percent, and it is likely to rise further this year. Repayment of debt will now be substantially slower than was forecast even a year ago, and net public debt is expected to rise this year for the first time in seven years.

It is still the official objective to reduce the spending ratio to below 30 percent of GDP. But it is hard to believe that the government is taking that objective seriously. In the 1995 budget, the 30 percent target was forecast to be reached by the 1998/99 fiscal year. Now it is not expected to be reached until 2006/07, even under the most favourable of the medium-term fiscal scenarios published with the budget.

Some in the business community over-praised the budget. They were relieved that the government was starting to recognise the damaging effects of the spending build-up and of the virtual suspension of a reform agenda since the beginning of the last parliamentary term.

But the budget fell well short of a credible response to current problems, and the last month has seen more bad economic news. The New Zealand dollar has fallen further, our overseas debt has blown out to nearly $100 billion, our credit rating is likely to be downgraded, and the current account deficit in the March quarter was still a worrying 7.2 percent of GDP.

It is therefore pleasing that the government is reassessing the state of the economy and its economic programme, and we must hope that next Monday's special cabinet meeting draws the right conclusions. The lesson ministers need to focus on is why the economy was performing so well in the mid-1990s with strong economic growth, rapidly falling unemployment and no serious inflation or balance of payments pressures, and why economic performance has deteriorated so much since then. Economic growth and business and consumer confidence peaked around 1994 – well before the recent Asian crisis.

To date, some reactions by ministers and others to recent events in financial markets have been ill-considered. For example, the current account deficit is being seen by some in too narrow a context: it is not simply a savings story. New Zealand's national savings ratio is not particularly low, and countries with much lower savings ratios (like the United States) are not plagued by current account problems. Nor would a compulsory savings scheme help, as it would do little if anything to raise overall savings. Australia has a compulsory savings scheme, a lower savings ratio than New Zealand and also a weak current account position. Besides minimising savings distortions and looking after its own savings, the government has no particular role in influencing New Zealanders' decisions on the balance between what they earn and what they spend: the savings rate largely takes care of itself in a healthy economy.

Likewise foreign investment and privatisation should not be blamed for the current account position. When New Zealanders sell assets to foreigners, they own more of the rest of the world and foreigners own more of New Zealand. New Zealanders can earn more overseas and non-residents can earn more from New Zealand. Foreign investors account for around 60 percent of the equity of New Zealand listed companies, but this is not a surprising figure for a small, open economy. Equally, according to one estimate, 60 percent of New Zealanders' equity investment in managed funds is now invested offshore, thus diversifying the risks to which they are exposed. Only if there is a differential in the earnings rates of equivalent amounts of onshore and offshore investment might the current account balance be affected. Given open and competitive capital markets, such a differential is unlikely on any long-term basis. Foreign investors in New Zealand have suffered with the fall in the currency, and this week's balance of payments figures indicate that their returns on investments in New Zealand have also fallen while the returns on New Zealanders' investments abroad have risen. Even if New Zealanders decide to spend some of the proceeds from the sale of assets to foreigners, this is a decision they could have taken in the absence of privatisation, simply by borrowing. As it happens, governments have largely used the proceeds from asset sales to foreigners to reduce official overseas debt.

Another mistaken reaction is to suggest that cutting government spending would depress the economy further. If higher government spending was the answer to our problems, the economy ought to be booming on the back of a cumulative increase in spending since 1993 of over $7 billion dollars by the end of this parliamentary term, compared with a cut of $660 million in the 1990-93 parliamentary term. Commentators who think that spending cuts are recessionary seem to have forgotten that, together with labour market deregulation, they were a major factor in the recovery that began in 1992. We need more of both today.

Instead of being sidetracked by misleading diagnoses of the problem, the assessment that ministers should be making on Monday is that, in addition to the impact of external events, the deterioration of the current account position and our general economic performance and outlook is largely due to the progressive weakening of the government's whole policy framework. Fiscal discipline has been eroded and opportunities to make the economy more efficient have not been pursued. The build-up of central and local government spending in recent years has pushed resources into the domestic – non-traded – sectors of the economy and it has added to domestic demand while doing nothing to add to the productive capacity of the economy. In the process, export industries and those competing with imports have been squeezed, growth has slowed and the current account has blown out. We have been killing the goose that laid the golden eggs.

Financial markets were not unduly concerned about a current account deficit of 3 to 4 percent of GDP when economic growth rates were higher and external debt ratios were actually falling. Now that growth is running at half previous levels and the current account to GDP ratio is twice its previous size, they are far more concerned. By marking down the currency, financial markets are signalling that resources must be drawn back into foreign exchange earning and saving activities, a shift which government spending policies were resisting.

It follows that any effective strategy to deal with the present problems must start with government spending. A reduction in low quality spending would help the necessary reallocation of resources into internationally competing industries and help avert the risks of further currency depreciation. Reductions in government spending would also reduce the pressure on monetary policy and allow interest rates to fall. Now that the dollar has fallen we must also ensure that the benefits to internationally competing industries are not lost through inflation or higher domestic costs.

In addition, the government needs to recall on Monday the lessons of the microeconomic reforms of the 1980s and early 1990s for international competitiveness and economic performance. Initiatives such as privatisation, labour market reform, deregulation of markets like telecommunications and transport, improvements to the tax system, local government reorganisation and port reform all produced large economic benefits.

Since then, however, microeconomic reform has largely come to a standstill. New Zealand cannot afford to rest on its oars. We have a number of natural disadvantages as a country. New Zealand is distant from major markets, many of our exports are still commodities, our local market is small, and our natural resources are limited. We can only overcome these handicaps and raise living standards by being excellent in everything we do.

There are many dimensions to excellence. In business we must accept a responsibility to strive for continuous improvements in the cost structures of our operations, in quality and in customer service. As a country, we must be prepared to compete with the world's best. This means, for example, that we must do away with remaining tariffs – tariffs merely help some industries at the expense of others, they are a tax on exports and add to the disadvantages of distance that our exporters face, and they do nothing to increase overall employment. Similarly, we need to dismantle the archaic producer board structures which prevent competition and innovation in our main agricultural industries. The government is moving far too slowly to deregulate agricultural marketing and to encourage moves away from the inefficient and distorting cooperative structures operating in those industries.

The penalties for standing still are illustrated by developments with taxation. Tax imposes a heavy economic cost on open economies: we should be aspiring to excellence by lowering high income tax rates and simplifying the tax system. In 1989 the OECD considered New Zealand probably had the least distorting tax system of all OECD countries. In its recent report on New Zealand, the OECD says we are no longer in the front rank – other countries have caught up. We should be working to reduce the role of the government in the economy and lowering the tax burden.

Excellence also means efficient, world class infrastructure industries. The government should press on with its proposed roading reforms – congestion problems in Auckland and elsewhere are a major economic cost. We need similar commercial structures for water and sewerage to those being proposed for roads. New Zealand is lagging far behind the rest of the world in moving electricity into the private sector, and it is absurd that we still have around 35 power companies. The ports industry is in need of rationalisation which would be facilitated by private ownership. And local government is seen as a major barrier to business development across the country. The government should drop its ill-conceived plans for the Auckland Regional Services Trust, build on its roading reforms and go back to the drawing board with a basic overhaul of local government.

Excellence also applies to our human resources – to compete with the best in the world we need to promote high levels of employment and an educated and adaptable workforce. Initiatives in employment and education should be high on the cabinet's agenda on Monday.

Consider first employment. After the rapid inroads into joblessness made possible by the Employment Contracts Act, the government has overseen the gradual re-regulation of the labour market. The minimum wage has been raised in value and increased in scope, which is destroying several thousand job opportunities for young and unskilled workers. The Employment Court has been allowed to progressively water down the principle of freedom to contract, particularly through its interpretations of personal grievances. The minister of labour is 'reviewing' the operation of the Employment Court and the personal grievance provisions of the Employment Contracts Act. Yet this simple exercise has already taken 18 months, and there is every indication that the outcome will be mere tinkering with the problem. In the meantime, the unemployment rate has risen to over 7 percent from its low point of 6 percent when the coalition took office, and it may well climb to 8 percent in the next 12 months.

I would like to dwell on education for a moment. There were some very positive initiatives in the budget on education, such as the move to put state and private tertiary institutions on the same funding basis and the jettisoning of the expensive coalition commitment to remove the income test for student allowances. The extension of bulk funding in schools is also positive. But the government should long ago have simply made bulk funding mandatory in state schools, rather than fiddling around with inducements to schools to take it up.

Bulk funding does not currently give boards the right to offer differential pay (except through more management units). Its main advantages are the opportunities that more flexible funding within the school allows to either employ more teachers or more support staff.

In secondary schools, the collective employment contract (CEC) remains a major problem. While it is possible with effective appraisal systems to remove poorly performing teachers, the difficulty lies in the area beyond classroom teachers – ie middle and senior management – where job descriptions are less clearly outlined in the CEC and where qualities of competence become more difficult to describe in a practical way.

Renegotiation of the CEC to remedy these problems does not appear to be on the agenda, at least as far as I know – the government does not consult school boards on these matters. In fact, boards and parents have little say in much of education, including the setting of teacher pay and conditions of employment, the development of curricula and decisions relating to the qualifications framework and national examinations.

And perhaps this is why the government has flirted with the bizarre notion that educational excellence can be achieved by a qualifications framework built on unit standards. Unit standards are inflexible and fail to set challenging targets. They break subjects down into bite-sized pieces which dilute the excitement of progressive learning that the education process involves. Technology intensive businesses in deregulated markets face rapid demands for changing skill sets and standards. The ability of standards certification to keep up with marketplace developments is limited.

And where in all this is the vision? Isn't it clear that in 50 years' time one of the main determinants of New Zealanders' wealth will be the quality of their education? Isn't it obvious that we should employ the very best people to teach our children, and if that means abandoning rigid national awards, moving to employment contracts at the school level, improving teachers' salaries and introducing incentives for performance – however difficult this is to measure in a teaching environment – then let's get on with it?

I am troubled that despite the innovations of the early 1990s, parents remain disenfranchised from most important decisions in education; I am troubled that there is no acceptance of the need for excellence in education outcomes; I am troubled by the seemingly casual expectations that many parents have for their children's education and the performance of teachers; and I am troubled that the wonderful resource that we have in most of our teachers remains smothered by the constraints of the system and that their energies are dissipated by mindless bureaucracy.

If we are to move into the fast lane economically and recapture some of the ground we have lost against the rest of the world in the last few years, we will need a further transformation in education, just as we will need it elsewhere. It is nonsense to suggest that the necessary reforms in this country are over. The hare that bounds ahead and then takes time out will be overtaken by the tortoise. And the competition for excellence in business and government is one that has no end point.

The economic crisis in Asia could be a blessing in disguise if it shocks us out of the complacency of recent years. New Zealanders need a wake-up call. Excellence isn't optional if we want to be a high productivity, high income, high employment economy. We have to excel in all areas over which we have control. The important question now is whether the government will move from problem recognition to problem solving. It deserves the full support of the business community if it responds with effective action.