COST OF LIVING WAGE ORDER HEARING

The following article is an edited version of the evidence given by Mr R. W. R. White, Governor of the Reserve Bank of New Zealand, before the Arbitration Court during the cost of living wage order hearing on 14 April, 1981.

INTRODUCTION

In assessing whether to make a general order at this time, the Court is required to 'consider whether an increase in rates of remuneration should be made in order to maintain and improve living standards, so far as it is within the capacity of the economy to sustain such an increase'. The Court is also required to take into account specifically a number of important economic and social considerations in reaching its decision. The qualification included in the first term of reference, namely the capacity of the economy to sustain an increase in wage and salary rates at this stage, is an important one in my view which requires the Court to satisfy itself that the effects, adverse as well as beneficial, of any general order will not place undue strain on the economy. I propose therefore to spend some time examining the present state of the economy and its prospects for the immediate future before referring in detail to some of the criteria set out in clause 5.2 of the Regulations governing this hearing.

The adequacy or otherwise of present living standards, and whether these can be improved by a substantial wage increase now can only be assessed by looking closely at the present characteristics of the economy. They must be judged in the context of today's circumstances rather than by looking back to a point in time when many of the realities of today's situation could hardly be imagined. Such a mixture of factors have borne on New Zealand's situation over the last seven years, both from outside and within, that any attempt to recapture the situation or the living standard which prevailed fleetingly in September 1974 must be unrealistic.

More appropriate by far is an approach which analyses the present economy, its strengths and its weaknesses, in order to identify policies which can help build on the strengths and so achieve in the future the higher living standards we would all like to enjoy. We can all support the objective of maintaining and, to the extent possible, improving living standards. But in every country there are constraints which limit the ability to achieve higher living standards. In New Zealand at the present time, and for the immediate future, the constraints which are particularly important are those imposed by the balance of payments and inflation.

The problem then is how to strike an appropriate balance between partially conflicting economic policy objectives such as:
— full employment;
— balance of payments equilibrium; and
— price stability.
while at the same time maintaining a high and increasing standard of living. To illustrate the nature of the problem I propose to examine the current state of the economy and its prospects in the immediate future. I will then explore the implications of an increase in the wage level requested in the submissions of the Federation of Labour and Combined State Unions. In subsequent sections I shall comment on the advisability of the Court making a general order with reference to some of the specific criteria of clause 5.2

THE STATE OF THE ECONOMY

New Zealand is emerging from a period when real growth in the economy has been almost non-existent through a combination of causes. Table 1 shows that in the years ended March 1976–1979 inclusive real growth in output measured by gross domestic product was non-existent. Provisional figures just recently released indicate a growth rate of 1.2 percent for 1979/80 while forecasts indicate a similar growth rate in the year just ended followed by about 2 percent in 1981/82. A contributing factor to the slow growth has been the instability in the international economy arising out of the massive oil price rises associated recessions in a number of key countries. This has placed a severe strain on the New Zealand economy necessitating some painful adjustments.

TABLE 1
THE TERMS OF TRADE AND REAL EFFECTIVE G.D.P.

March Years	*Real GDP Index*[1]	*Import Price Index*[3]	*Export Price Index*[3]	*Terms of Trade Index*[3]	*Real Effective GDP*[4]
1972	1174	139	124	90	4584
1973	1226	146	153	105	4959
1974	1314	155	186	120	5509
1975	1367	208	173	84	5275
1976	1390	268	190	71	5177
1977	1392	322	247	76	5195
1978	1354	343	267	78	5083
1979	1385	358	295	82	5263
1980	1401	430	366	85	5356
1981	1418[2]	538[2]	397[2]	74[2]	5229

Footnotes:
(1) 1965-66 = 1000.
(2) Estimates derived from Reserve Bank forecasts (March 1981).
(3) 1957 = 1000.
(4) 1965-66 prices. The Department of Statistics has yet to publish an official real GDP series based on the recently adopted System of National Accounts (SNA). The above series has been calculated by Reserve Bank staff using the official data from which an official SNA based series will be derived.

In particular it has imposed on New Zealand the need to make a major effort to increase the ratio of exports to total production so as to ensure a continued ability to import at a rate which would allow the economy to operate at or near to its full potential capacity. It is clear that to date we have not been fully successful in this. The continuing deficits being recorded in our balance of payments as shown in table 2 have placed constraints on our ability to import. This has made it impossible, in the last few years, to allow a level of domestic activity which would utilise all of our available supply of labour and domestic resources with the inevitable result that unemployment has grown and investment stagnated. However, considerable progress has been made in stimulating export industries and the export volume index for the June year 1980 shows a 43 percent increase over the index for 1975, the low point reached in the mid-1970's (table 3). Similar progress has been made in setting in train development projects in the energy sphere which will make a substantial contribution toward lightening the country's requirements for imported fuels. Apart from this, the policies of the last few years have also resulted in a 13 percent decline in the import volume index by 1980 from the peak of June year 1975.

However, the full benefits from these policy initiatives will not be felt for some time yet. In the meantime the balance of payments deficits place a constraint on our ability to import which we must live with. Any increase in consumption demand which carries with it a significant demand for more imports cannot be met on a continuing basis at present.

Within the domestic economy other factors have adversely affected its growth performance. Low productivity growth, even allowing for static production levels, has reflected an inability to come to grips with the urgent need to promote the highest levels of efficiency in production and the provision of services if we are to be in a position in the 1980s to compete effectively on world markets. The relatively high level of protection afforded our manufacturing sector in the past insulated that sector for some time from the realisation that for growth to continue to take place a broad range of manufacturers, as well as farmers, needed to devote a large share of their activity to exporting.

The painful lessons of the last seven years have brought greater awareness of the need to devote a sufficient share of production to export activity. The transition has been difficult because of the depressed international situation and is not yet complete. It has brought with it an appreciation of the need to foster conditions within our economy which will enable a wider range of manufacturers to be competitive with their counterparts overseas. A substantial increase in salaries and wages at the present time, unrelated to gains in productivity, and in excess of the current inflation rate, I would see as undermining that objective.

The significantly lower terms of trade which New Zealand faced during the latter half of the 1970s and in 1980 have compounded the effect of low real growth in domestic output. The amount of imports which our export earnings could buy has been eroded by the lower terms of trade and, if the real GDP figures shown in table 1 are further adjusted to portray the effective purchasing power of our exports, the effective real GDP thus derived has declined since 1974 and even in the year ended March 1981 is still expected to be 5 percent below the level of 1974. In looking at a request to restore living standards therefore the Court should be aware that, in the sense that the economy's real effective output determines the 'standard of living' that is possible for the whole country, it is lower today than in 1974. If one group, the wage and salary earners, is to get back to the standard of 1974 it will need to be at the expense of other groups in the community.

I would like now to refer in turn to each of the specific criteria which the Court is required to consider under Clause 5.2.

PROMOTION OF EMPLOYMENT AND GROWTH

It is not my intention to dispute that an increase in wages would mean an increase in nominal expenditure but it cannot be taken for granted that this necessarily implies a faster rate of economic growth. I believe it is necessary to maintain an adequate level of domestic spending in order to sustain an appropriate level of demand and therefore output. However, I would contend that this need has been met to a considerable degree by the fiscal and monetary policies already in place.

In the past year a number of policy initiatives have been taken to counter the possibility that a rather weak economic situation would deteriorate further during the latter part of 1980 and on into 1981. Early in 1980 monetary policy was eased from what had been a rather restrictive stance in 1979 to one which was broadly neutral in its impact. This has allowed a steady expansion of credit and credit limits to take place.

In the 1980 Budget the Government introduced a number of measures such as the 4 percent cost of living adjustment aimed at providing a limited stimulus to the

TABLE 2
NEW ZEALAND'S EXTERNAL CURRENT ACCOUNT BALANCE

March Years	*GDP $m*	*Current Account Balance BOP*	*Current Account Balance OET*	*Current Account Balance as % of GDP BOP*	*Current Account Balance as % of GDP OET*
1973	7,892	138.8	285.9	1.8	3.6
1974	9,135	- 91.5	- 30.0	1.0	0.3
1975	10,028	-1,364.4	-992.6	13.6	9.9
1976	11,487	-1,015.6	-814.5	8.8	7.1
1977	13,809p	- 825.5	-590.5	6.0	4.3
1978	15,236p	- 712.4	-509.5	4.7	3.3
1979	17,504p	- 469.5	-426.4	2.7	2.4
1980	20,908p	- 796.7	-481.8	3.8	2.3
1981	24,160[1]		-590 [2]		2.4

P Provisional
(1) New Zealand Institute of Economic Research estimates.
(2) Reserve Bank estimates.

economy and thus maintaining the level of activity. The Government also further recognised the severity of the unemployment situation by instituting changes in the temporary employment schemes to emphasise job creation and job training aspects so as to promote a recovery in employment and specifically meet the needs of the large block of new entrants into the labour force. Still later in the year, in the November Mini-Budget, further moves were announced. These included the cut in personal income tax rates which took effect from February 1981 and accelerated investment in some public sector projects designed to carry the economy through the next few months at about the present level of activity until the impact of investment in the major energy and industrial projects starts to be felt later in the year. In total these policy moves have assisted in moderating what might otherwise have been a quite sharp contraction in the economy, following the 1979/80 oil price rises and terms of trade deterioration. A steady expansion in activity can be expected from later this year as a result of further rises in export volumes and as the build-up in investment gets under way, bringing with it benefits in increased output and greater employment opportunities which should feed through to the benefit of all.

On the other hand, a further substantial increase in wages and prices of the order of magnitude implied by the current wage order application would produce results which would be detrimental to the controlled recovery beginning to get underway and to the longer-term growth and stability of the economy. The problem is that rises in prices and wages now react so quickly to each other that much of a wage increase becomes absorbed in subsequent price rises. This is self defeating. Higher inflation impairs our prospects for real sustainable growth by creating uncertainty and inhibiting investment. An excessive rate of increase in salary and wage income also leads to efforts by the rest of the community to restore their income shares, and this process may add further to inflationary pressures. To the extent that a wage increase impacts on real spending (as distinct from increasing prices), this may lead to greater demand for imports and tighten the balance of payments constraint. Because of these problems, the Government has been endeavouring to pursue faster growth by stimulating exports and investment, the only realistic path to sustainable growth.

It is of equal concern that, in recent years, high nominal wage rate increases have been accompanied by very sharp rises in unemployment. Because higher wages may increase the relative cost of labour, business firms tend to economise on their use of labour by introducing new methods or technologies. Without wishing to develop in detail the complicated cause and effect relationships the evidence does appear to suggest that rapidly increasing nominal wages tend to be reflected in price increases to a greater extent than in changes in real economic activity. Indeed, New Zealand's rate of economic growth in recent years has been disappointing and unemployment has risen strongly. Now that the stage seems to be set for somewhat more favourable growth in the 1980's, it would be unfortunate at this time to prejudice these prospects by an excessive wage increase. The only meaningful economic basis for higher real wages is higher productivity, i.e. increased real output per employee.

The sort of sustainable growth which should encourage higher productivity is now in prospect for the next few years. This is export led and investment based growth which provides a base for further expansion in the future rather than feeding the inflationary and unemployment spirals. The major projects in forestry, steel, oil refining and energy development are the sort of projects which provide a central impetus to further more widespread growth throughout the economy including expanded employment opportunities. The incentives given to agriculture and manufacturing are another example.

MAINTENANCE OF STABILITY IN THE BALANCE OF PAYMENTS

What needs to be recognised is the nature of the constraint which the balance of payments imbalance imposes on the economy. Much of the manufacturing sector and parts of the servicing sector require a substantial input of imported materials and products. Without the foreign exchange to pay for those imports industry cannot operate and in this sense the foreign exchange is, in effect, a resource like labour or any other input. Its lack constrains our ability to promote full utilisation of our domestic resources. While this is unfortunate it is nevertheless true. What is sometimes presented as a choice between achieving a long-term improvement in the balance of payments or concentrating on employment and domestic economy stimulation is really no choice at all when failure to grapple effectively with the one is likely to jeopardise achievement of the other.

The international chain of events of the last few years, as they impinge on New Zealand's external trade scene, have made much more difficult but urgent the task of coming to grips with a basic structural imbalance within our economy where a domestically orientated

TABLE 3
EXPORT AND IMPORT VOLUME INDICES

	Current Account Balance BOP	*Import Volume Index*[1]	*Export Volume Index*[1]
1971	- 225.8	1,000	1,000
1972	- 15.6	1,027	1,048
1973	138.8	1,086	1,074
1974	- 91.5	1,431	953
1975	-1,364.4	1,468	929
1976	-1,015.6	1,193	1,094
1977	- 825.5	1,250	1,211
1978	- 712.4	1,092	1,170
1979	- 469.5	1,219	1,275
1980	- 796.7	1,284	1,332
1981		1,207[2]	1,406[2]

(1) June years, 1970/71 = 1000.
(2) New Zealand Institute of Economics Research estimates.

manufacturing sector had for too long contributed too little to the foreign exchange earning needs of the economy. But the needs have been recognised and addressed in a number of ways which will make a lasting contribution to balance of payments stability. To promote increased agricultural production a range of development policies have been put in place with noticeable effect over the last two years. Similarly export incentives offered to manufacturers to encourage them to diversify into exporting have had their effect. Movements in the export volume index (table 3) show a 12 percent rise in the two years to June 1980 and a further rise of 5-7 percent is expected in the current year. Other policies adopted in recent years which should help promote a more stable environment for those involved in exporting include:

— the supplementary minimum prices for agricultural products;
— the flexible exchange rate mechanism.

These aim to give an increased degree of certainty to farmers and exporters about their future prices and profitability of exporting, thus reducing the inhibiting effect of uncertainty on investment in these areas.

Although the effects of these policies have been somewhat concealed by the lack of improvement in the foreign exchange current account balance in 1980, I believe they are making a positive contribution to balance of payments stability and, in conjunction with appropriate policies, will continue to do so in the future.

MOVEMENT IN INCOMES OF WAGE AND SALARY EARNERS RELATIVE TO THOSE OF OTHER SECTORS OF THE COMMUNITY

In considering an application for a general wage order the Court is required to look also at movements in the incomes of wage and salary earners relative to those of other sections of the community. On previous occasions when this has been a concern of the Court it has been possible, using the former National Accounts classification, to derive a comparative series showing the distribution of private income before tax. Under the System of National Accounts now adopted it is not possible at present to reproduce such a table showing the complete disposal of private income. However, it is possible to produce a series showing movements in important aggregates of private income shares and by comparing these it is possible to distinguish trends in their movements which indicate whether one group's income share is growing more rapidly than another's. Table 4 shows a set of comparative series for compensation of employees, farm incomes, company incomes and business and investment incomes. There are some anomalies which make it inappropriate to use the series to assess whether the absolute level of compensation of employees is at a desirable level compared with farm incomes, for instance. Some elements of farm capital expenditure are treated as current expenditure and therefore deducted from the farm income total so that in absolute terms the farm income total will be understated.

Unless there are significant policy changes with respect to these anomalous areas which would distort the pattern of the series during the period being examined, the comparative process of examining the relative share changes over time can still be validly undertaken. In the present case the situation which applies throughout the time period covered is that farm incomes have been understated by some amount.

A question also arises as to whether the comparison should be on a post-tax or gross income basis. There are problems in creating a comparable post-tax series disaggregated to the same extent as the gross income table. However, there are reasons which make the gross income comparison preferable. The taxes people pay go in large measure to fund the services and benefits which people receive back from the Government. In this sense they contribute materially to the living standards people enjoy and should be included, as they are in gross income comparisons. The tax system can be and is used by the Government to effect redistributions of income between different groups in society. If company income for example has not kept pace with the growth in salary and wage earners' incomes, amendments to the tax system may be introduced to redress this situation. In assessing whether trends in income shares point to the need for a general wage order therefore it is more appropriate to identify the trends in gross income shares for it is these which are instrumental in determining the nature of the Government's response through the tax system, not the reverse.

In table 5 the relevant data are presented in order to make clear the trends which have taken place during the last decade. Indexes are prepared for each series to show the overall trend through the decade. It is immediately apparent that the income trends in farm and company incomes are much less stable than those for compensation of employees or for business and investment incomes. The question which this raises is whether the instability conceals within it an erosion of relative shares. By comparing the percentage shares in

TABLE 4
INCOME SHARES

March Years	*Compensation of Employees*	*Farm Incomes*[1]	*Company Incomes*[2]	*Business and Investment Incomes*[3]
1972	3,499	542	650	525
1973	3,926	695	891	583
1974	4,637	548	1,032	668
1975	5,565	418	989	786
1976	6,401	634	1,144	898
1977	7,185p	871	1,226	995
1978	8,241p	763	1,070	1,097
1979	9,604p	1,077	1,260	1,209
1980	11,214p	1,392	1,606	1,355
1981	13,475[4]	1,310	1,935	1,507

P Provisional
(1) Ministry of Agriculture and Fisheries sourced estimates by Reserve Bank.
(2) Inland Revenue Department sourced estimated by Reserve Bank.
(3) Monthly Abstract of Statistics to 1978, Reserve Bank estimates thereafter.
(4) New Zealand Institute of Economic Research estimates.

TABLE 5
INDEX OF INCOME SHARES
Base 1972 = 1000

March Years	*Compensation of Employees*	*Farm Incomes*	*Company Incomes*	*Business and Investment Incomes*
1972	1000	1000	1000	1000
1973	1122	1282	1371	1110
1974	1325	1011	1588	1272
1975	1590	771	1522	1497
1976	1829	1170	1760	1710
1977	2053	1607	1886	1895
1978	2355	1408	1646	2090
1979	2745	1987	1938	2303
1980	3205	2568	2471	2581
1981	3851	2417	2977	2870

each year of the individual aggregates to the total for that year it becomes obvious that a very substantial expansion has taken place in the relative share of compensation for employees. In looking to the indexes of the movements in these aggregates over time one is wise to exercise caution since the choice of base year can materially affect the results one gets. However, results obtained using either 1971 or 1972 as base years have shown the same trend, namely a more rapid expansion of compensation for employees than for the other income aggregates. Even if some movement in favour of compensation for employees was considered inevitable through that period it is difficult to believe that a 29 percent faster growth in compensation for employees than company incomes, or a 59 percent faster increase than farm incomes constitutes grounds for a further boost in compensation of employees at this time through a general wage order.

MOVEMENTS IN PRICES, REMUNERATION AND RATES OF PERSONAL INCOME TAX

The rapid upsurge of inflation in recent years has awakened an awareness to the effects of a progressive income tax structure in taking a progressively larger share of income as taxes when incomes rise. In earlier times these effects were welcomed for their redistributive and stabilising consequences. However, under our present higher rates of inflation there is growing concern that the effects may no longer be beneficial.

It is therefore of some value to examine what has been happening to salary and wage earners' incomes not just in gross terms but also in after tax terms, adjusted for inflation. This is done in table 6 where a series is developed which represents an index of real after tax income standardised for changes in the labour force. A number of features are worthy of comment.

In the March ending years in the series, all but 1976 and 1977 showed gross compensation of employees rising faster than the consumers' price index while only in 1976 and 1979 did employees' disposable income rise as fast as their gross compensation. As a consequence of this latter trend real after tax standardised unit income showed increases only in the first three years and in 1979.

Such an examination suggests that there is room to consider whether the appropriate measure of income for judging the need for a general wage order is gross or post-tax income, but it must be remembered that a large part of the money paid in taxes comes back to employees in the form of public services or amenities such as health, welfare and education services, law enforcement, benefits and national parks.

Nevertheless, even judged on the basis of the real after tax standarised income series shown in table 6, the case for a substantial wage order at present does not look strong. Movements in this series over the last four years show an increase of just over 1 percent. In the same period real effective GDP is estimated to have risen by about the same amount. In the year ahead the Reserve Bank estimated that the series will show an increase of 0.2 percent against a forecast rise in real effective GDP of 2.2 percent. To achieve a comparable rate of growth in the series to that forecast for real effective GDP would require either an increase in gross compensation of 2 percent or a reduction in the proportion taken in tax from the forecast 29 percent to 27.9 percent, still higher than that forecast for the current year (27.0 percent).

RELEVANT CHANGES IN FISCAL POLICY

The thrust of Government fiscal policy during the past year has been directed towards the maintenance of a level of activity in the short-term which would not fuel a renewed upsurge in inflation and yet would avoid the opposite danger of a substantial decline bringing with it even more pronounced unemployment problems and recovery problems later when the major projects start to take effect. The objective has been fostered by actions in a number of areas. The adjustment to income tax rates from February this year was designed to prevent a decline in consumption levels. The accelerated investment programme in government projects will give a boost to employment and investment. In its approach to the financing of its fiscal deficit the Government appears to have chosen a path which in the circumstances of the present relatively moderate growth in the money supply figures may be appropriate although likely to contribute to some increase in the monetary base and the potential for expansion of credit and economic activity. But the measures have been taken as a careful response to a situation where any excessive stimulation could rebound against the community in a rapid upsurge in inflation and balance of payments problems. In the circumstances the risks associated with a substantial wage order at present would appear to outweigh the possible short-term benefits to the recipients of such an order.

CONCLUSION

In this submission I have identified constraints which would limit the effectiveness of an increase in wage rates at present to stimulate the economy and lift real incomes of employees. I have endeavoured to show that, given the current situation and policies, a sustainable increase in production to meet increased domestic demand is not likely to be feasible because of the shortage of foreign exchange, a vital element in the production process. This means that any gain in real disposable income for employees would have to be achieved at the expense of those groups in the community who will not benefit directly from any order made by the Court.

For the most part, self employed people are in a position to maintain their real incomes by increasing their charges to match any increase in salaries and wages granted. This they will do, thereby increasing their prices and boosting inflation. Exporters will receive the benefit of exchange rate adjustments to compensate for their higher domestic costs, but of course those adjustments too will add to inflation through the cost of imports. Many employers of labour will have difficulty in absorbing a wage increase, either by reducing profits or by passing costs on to borrowers, because of the lack of growth in the economy. For these a further increase in wages is likely to intensify the pressure to shed labour where this is possible.

The net result then of an order by the Court is likely to be reflected mainly in an increase in prices, in a small but indeterminable amount of absorption into profits and by some increase in unemployment. Against this of course must be weighed the positive effects which an order might have on industrial harmony. These I have not taken into account.

The country is now moving into a period in which we hope to see renewed prosperity and growth based on expanded export activity and investment in productive enterprises. It is important to pursue policies and make decisions which will contribute to, and not detract from, that process. I believe that any substantial wage increase would detract from the recovery.

TABLE 6
INDICATOR OF SALARY AND WAGE EARNERS' REAL DISPOSABLE INCOME

March Years	*Compensation of Employees*	*Direct[1] Tax*	*Employees' Disposable Income*
1972	3,499	654	2,845
1973	3,926	743	3,183
1974	4,637	932	3,705
1975	5,565	1,266	4,299
1976	6,401	1,470	4,931
1977	7,185p	1,766	5,419
1978	8,241p	2,260	5,981
1979	9,604p	2,366	7,233
1980	11,214p	2,864	8,350
1981	13,475[2]	3,641	9,834

	Labour Force	*Index of CPI[4]*	*Employees' Standaridsed Real Disposable Income*
1972	1.000	1.000	2,845
1973	1.014	1.063	2,953
1974	1.051	1.161	3,036
1975	1.078	1.299	3,070
1976	1.087	1.503	3,018
1977	1.095	1.743	2,839
1978	1.093	1.997	2,740
1979	1.097	2.216	2,907
1980	1.112[3]	2.563	2,884
1981	1.126[3]	2.986[2]	2,925

P Provisional
(1) Income tax, PAYE from salary and wage earners less refunds (net flow into public account), Reserve Bank estimates for 1981.
(2) New Zealand Institute of Economic Research estimates.
(3) Department of Statistics labour force projection (medium growth) applied to Employment Index.
(4) Average annual % change.