LIBERALISATION, STRUCTURAL CHANGE AND EMPLOYMENT

The theoretical case for liberalisation is explained in simple terms, and the factors which will be important determinants of the length and severity of the restructuring process are examined.

The last two years have seen a wide range of policy measures which have been designed to liberalise the New Zealand economy. The rationale for these changes is the belief that the economy can better generate sustainable growth and jobs when the market, through price and profit signals, is allowed to determine where resources should be used, rather than when widespread government interventions are the norm. To that end a host of subsidies, regulations, protective barriers, tax incentives and so on which tended to distort market signals have either been removed or reduced.

While the ultimate aim of this process is to increase real income and to create jobs, recent economic indicators have not been particularly favourable. Real gross domestic product has not increased at all over the last year, while unemployment has been rising rapidly. While attention has focussed on the closure of large factories such as the Whakatu meat works, the number of full time private sector jobs declined in nearly every major sector of the economy over the year to May 1986. The only significant exceptions were in the business services and in the restaurants and accommodation services sectors. In many of the sectors that have been adversely affected the removal of subsidies and protection have been cited as one of the causes of the job losses. At first sight then the initial results of liberalisation do not seem consistent with its intent. This obviously raises the issues of whether liberalisation will actually work, when, and at what cost.

The purpose of this article is to address some of those issues reviewing, in a relatively simple manner, the theoretical and empirical arguments which suggest that over the longer term liberalisation will maximise national income. It then addresses the issue of adjustment and the factors which will determine the length and severity of the restructuring process.

The Case for Liberalisation

One of the problems that is commonly seen with liberalisation is that the removal of subsidies and protection will cost jobs. While this may be true for a particular sector, if protection is removed only from that sector, it does not follow that simultaneously removing the protective structure across a wide range of industries will have a cumulatively negative impact on output and jobs. To see why this is the case it is instructive to look at a simple hypothetical economy, with one sector which produces an export good, and one which produces an import competing good. If a tariff is imposed on the imported good, the domestic price increases and resources flow into the import competing sector increasing output and jobs. The impact on the export sector is, however, quite clearly negative. To the extent that importables are used as inputs in the production of the export good, then exporters' costs will go up and their competitiveness on international markets will fall. If imports are a consumption good then the tariff will increase the consumer price index. If workers seek to restore the real wage to its previous level then nominal wages and hence exporters' costs will increase. Both or either of these effects will lead to reductions in export sector profitability and output. So although the export sector does not bear any explicit tax, the effect of the tariff on imports is equivalent to an export tax. In principle this tax could be balanced by a countervailing subsidy which would be raised from the import competing sector. This in turn would lower the profitability of the import competing sector pushing its output back to the original pre-tax level. If we ignore the costs involved in administering the system of countervailing taxes and subsidies then it is at least theoretically possible in effect to obtain a free-trade outcome with zero protections and taxes for all sectors. Removing these devices would therefore make no difference to the level of structure and output.

To some extent the evolution of the protective structure in New Zealand over earlier years can be explained as an attempt to compensate the export sector for the costs imposed by protection given to other parts of the economy. The extensive range of tariff and quota protection for import competing industries was matched by a wide range of subsidies for agriculture and by export incentives for 'non-traditional' exports. In practice, however, the plusses and minuses were not neatly offsetting. In many cases the particular type and level of assistance was not set with reference to the impact of the existing protective structure but was aimed at ensuring particular employment or output levels in a sector were maintained. Given the large number of assistance devices, the complex ways in which they interact, and the possibility that assistance to one sector may be 'captured' by another (a significant part of the subsidies to the sheep and beef farmers, for example, probably eventually increased the incomes of the meat processing sector), it was in any case almost impossible to calculate the net effect of the protective system. What was clear was that rates of assistance varied widely, both within and between sectors without any clear economic and social rationale.

To get a sense of why rates of assistance can vary widely it is necessary to distinguish between nominal and effective rates of protection. The nominal rate of protection is measured by the percentage by which the domestic price can exceed the international price. The effective rate of protection is the percentage by which the value added component of the protected good exceeds the value added component of the world price - in other words it is a measure of the rate of protection of the protected *activity*. Because of different technical relationships within the economy, a protective structure with a relatively narrow range of nominal protective rates can yield a much wider range of effective protection rates. The point can be easily illustrated by a simple example. Imagine that the economy has two industries, clothing and textiles, both of which are protected by

tariffs of 25 per cent. In both cases it is assumed that three-quarters of the price of each product consists of intermediate inputs and the other quarter value added. Let us also assume that the only intermediate input in the cloth industry is cotton which, because it is not produced in the country, does not bear a tariff and that the only intermediate input in the clothing industry is cloth. The effect of the tariff is to allow the price of cloth to be raised from say $10 to $12.50, an increase of 25 per cent. The return to the factors (capital and labour) employed in the sector however, rises from $2.50 to $5, an increase of 100 per cent. This is the effective rate of protection. Clothing prices also rise by 25 per cent but three-quarters of that increase is taken up by the increased price of cloth. Thus the increased value added and hence the effective rate of protection is only 25 per cent. It is easy to see then that industries with a high nominal rate of nominal protection and which use a high proportion of inputs with low or zero rates of protection will receive very high rates of effective protection. Indeed studies of the New Zealand system have uncovered activities where the rate is well over 100 per cent.

One way of interpreting effective protection rates is that they are a measure of the additional resources required to produce an additional unit of income from that activity. Thus if the economy produces one unit less of the heavily protected good and one unit more of the lightly or negatively protected good then resources will be free to increase production and hence income. In a pure free trade situation (found only in textbooks, in the extreme version described here) where effective rates of protection are equal (at zero), each activity will be using the same amount of resources to produce the marginal unit of income and there are no production swaps that will yield additional resources. This is what is meant by the standard proposition in economic theory that free trade will lead to an efficient allocation of resources which will maximise income. While there are debates about it, most economists agree that this proposition is applicable to the real world economy in a weaker form. Given New Zealand's highly distorted price system, the majority view is that there are therefore strong theoretical reasons to believe that a process of liberalisation will lead to a rise in national income.

The importance of liberalisation to economic success is not a proposition that is based solely on abstract economic reasoning. It is also supported by the experiences of a wide number of countries. The liberalisation of the international economy following the second world war was accompanied by perhaps the fastest and most widespread period of economic growth in the world's economic history, and while there is no simple positive relationship between the degree of liberalisation and the level of economic success, the evidence tends to show that those economies that have tried to insulate themselves from the world economy are heavily weighted in the group of poor performers.

While the standard theory predicts that free trade will maximise income it needs to be noted that this is a proposition about the long run outcome, when all resources can be assumed to be fully employed. In reality there will be adjustment costs. When protected industries lose their artificial advantages output and jobs can be lost very quickly and while production will be encouraged in industries that were previously subject to implicit taxes, this process can take some time. Newly profitable opportunities have to be recognised, markets developed and capital investments put in place. Frequently the job growth will come from new or small firms and they may take some time to make a significant difference to aggregate employment. In addition there are likely to be skill and regional mismatches between the labour shed from declining industries and that required for the new.

A second point to note about the proposition that liberalisation will maximise national income is that it does not imply that everybody's incomes will increase equally or even that some groups might not be worse off. It simply means that the long-term gains will outweigh any losses. There are obviously some individuals and groups who have suffered some short-term losses because of liberalisation. This is less a source of concern if it is accepted that individual winners and losers are an inevitable outcome of any growth process. There may, however, be more of a problem if it can be demonstrated that liberalisation systematically disadvantages some groups that society may wish to protect against the full impact of market outcomes.

Basic trade theory suggests that when protection is removed those factors which are used most intensively in the most heavily protected industries, will lose relatively and perhaps absolutely. The theory, however, is only suggestive and it is difficult to make even qualitative predictions in real world situations. Because the protective structure that is being removed is so complex it is almost impossible to determine which factors are receiving a positive rate of protection and at what rate. While overseas experience suggests that some initial pressure may be placed on the market clearing wage rate for unskilled workers, these results might not be directly applicable to New Zealand. Some of the activities which are heavily protected are also significant users of skilled labour which is currently in short supply. In addition many of the subsidies such as low interest rates and accelerated depreciation rates, tended to favour more capital-intensive processes so their removal could tend to increase the overall demand for labour.

Clearly then the relation between the adjustment costs, how those costs are shared and the eventual gains from liberalisation will be critical in determining the overall value of the exercise. The analysis so far implies the eventual gains will be large. The next section looks at some of the factors that will determine the magnitude of the adjustment costs.

Factors Affecting Adjustment Costs

Before looking at some of the specific factors, it is pertinent to make three general observations. The first is to emphasise the point made above that liberalisation creates winners as well as losers and that some of the gains may flow fairly quickly. The finance sector, for example, has clearly adapted quickly to the removal of regulation, rapidly expanding business and increasing its work force by nearly 10 per cent over the last year.

Second, liberalisation has not occurred overnight. There is a degree of gradualness, particularly in the manufacturing sector, which is intended to ensure that the capacity of the economy to absorb the surplus resources from contracting areas is not overstretched.

The third point is that it will typically be the least valuable output that will be lost as enterprises close down or contract. In many cases there may be little real income loss and in some cases there will probably be gains. The contraction of the sheep meat industry, for example, will mean that the income that was received from rendered down carcasses and from sales on disposal markets will be lost. As these revenues were below the marginal costs of production national income will actually increase.

While the temporary national income losses will probably not be very great, it is not as easy to be as sanguine about the prospects for employment. Unemployment in several major western economies is much higher than in New Zealand and has remained high despite an extended period of economic recovery. Job creation is a difficult problem which cannot simply be dismissed by the assumption that somehow resources will all be employed in the long run. Even though the jobs that are lost may not have made a substantial contribution to national income, for a variety of reasons, employment as such is valued highly by the community and a significant rise in unemployment is a factor that has to be incorporated into the cost benefit equation. The real issues therefore are the way in which liberalisation will affect the labour market, and the source of new jobs.

A critical factor will be the state of the international economy and in particular the rate of growth of New Zealand's major trading partners. Other things being equal a more rapidly expanding world economy will mean a greater demand for New Zealand's exports, a higher terms of trade, and better opportunities for the expanding sectors of the New Zealand economy. Although the world economic recovery is now several years old and some slowdown is possible (it is already a reality in the Australian economy), the overall medium to longer-term prospects appear reasonable. There are still a number of immediate problems and uncertainties with respect to trade protectionism but these are balanced by the prospect that in the long term at least the major industrial countries might make further moves to reform their agricultural protection system. The starting point, however, is not so favourable. New Zealand's terms of trade are currently close to their lowest point since the depression and the full effects of this are yet to feed through the economy. The pastoral farming sector has responded to the reality of lower international prices by cutting maintenance and capital expenditure which will inevitably have an impact on future production. In addition, part of the growth that New Zealand did achieve over the last decade was bought at the cost of a large expansion in external indebtedness. At nearly 60 per cent, the ratio of debt to GDP has reached a level where any significant further expansion in net indebtedness would be imprudent. Weaning the economy off an excessive reliance on overseas savings and paying the large interest bill on the accumulated debt must inevitably detract from the economy's potential growth rate for a period.

The other factors which will be critical to the adjustment path are the level of the real exchange rate, the average real wage and structure of wage rates. Other things being equal a lower real exchange rate will tend to ease labour market adjustment. Export and import competing industries will be more profitable and there will be fewer job losses from marginal sectors and enterprises. While, in the longer run, theory suggests the real exchange rate can be expected to adjust to ensure that the right level of resources are channelled into the traded goods sector to maintain internal and external balance, in the short run the exchange rate factor may be unfavourable. This is because of a phenomenon known as exchange rate overshooting.

The Government has stated that it intends to maintain monetary policy on a setting which is consistent with reducing price inflation over a medium-term time horizon to the average level of our major trading partners. In a small open economy, effective monetary restraint generally means that some upward pressure is maintained on the nominal exchange rate. If domestic cost inflation continues to run above the world inflation as will usually be the case during the transition to lower inflation, then this means that the real exchange rate will appreciate. If output and job losses are not too severe then the rate of domestic cost increase must be slowed quickly. As wages are ultimately the larger part of domestic costs a large part of the onus for adjustment will fall on the labour market.

Two types of adjustment may be required. First the average level of real wages needs to settle at a level which is consistent with a high level of employment. While there is considerable debate about the degree to which real wages are related to employment there is a widespread consensus that some reasonably strong relationship does exist. This view tends to be supported by the follow-on effects from the last wage round. The significant increase in real wages (about 7 per cent over the year to June 1986) has been followed by a decline in employment opportunities. Secondly, there may be a role for some adjustments in relative wage rates to accommodate the shifting demand patterns that restructuring will bring.

It is not possible to be very specific about the pattern, degree, or even the direction of these adjustments, but in general a wage setting process which is cognizant of the relationship between wages and employment will perform better than one that is not.

This is not to imply that labour market flexibility will do away with all adjustment costs in the labour market. Skill and geographical mismatches will take time to overcome, although the New Zealand labour force is probably a good deal more adaptable than those in many other industrial countries. New Zealand is therefore less likely to experience a high level of long-term structural unemployment as occurred in countries like Great Britain.

Secondly, the labour market does not act like an auction market where prices always adjust immediately to equal supply and demand. There are good efficiency reasons why employers and employees will tend to strike mutually advantageous agreements that limit the degree of volatility in remuneration rates and place a degree of the adjustment burden on employment numbers.

Finally, the obvious influence of technological constraints on the speed of adjustment should be mentioned. There is likely to be a wide mix of experience here. On the one hand some manufacturing industries will be able to quickly rationalise their product using existing factories and equipment. In the primary resource area, however, some of the lags can be very long and biological constraints can place an absolute limit on the rate of restructuring. Even here, though, there is scope for resources to move to more profitable activities surprisingly quickly. In the sheep farming industry, for example, there have been short-term switches in the types of lambs produced and in the mix between meat and wool production.

Where Will the New Jobs Come From?

The counterpart of the difficulty in determining which sectors were advantaged by the old protective structure and by precisely how much is the fact is that it is equally difficult to determine exactly which sectors will benefit by its removal. Past experiences with this type of prediction would also suggest caution. It is not very many years ago for example that predictions were being made that advances in computing technology would mean that there would be widespread redundancies in the banking industry. Last year employment in banking grew faster than every other major sector of the economy.

With these caveats in mind some general observations can be made. It is unlikely that there will be dramatic shifts between major sectors of the economy. Every sector will have some areas which will decline and some which will expand. Agriculture and forestry will continue to play an important role in the economy. There may be a contraction in the traditional pastoral sector but this will be counterbalanced by increased production from horticulture, deer and goats, as the past investments which have been made in these areas begin to come on stream. The forestry processing industry is set for a major expansion in the 1990s when available wood supplies are forecast to expand by a factor of two and a half.

Potentially the largest changes could come in the manufacturing sector although this will depend on the eventual extent to which protection in the sector is lowered. As yet most of the industries that would be most affected are covered by industry plans and most still receive quantitative protection. Quotas have or are shortly to be phased out for other sectors but the pace of tariff reductions has been relatively slow.

Although manufacturing has experienced a gradual decline in its share of total employment since the mid-1960s New Zealand is one of the few countries in the OECD that has maintained the total level of manufacturing employment over the last decade. Table 2 shows that manufacturing employment fell in every OECD country except Canada and Austria during the period 1974-84. In some cases, such as the United Kingdom, job losses in manufacturing were very severe but even in countries which had a better record in increasing total employment than New Zealand, significant declines were recorded.

This shift is explained by a number of reasons including the movement of unskilled and semi-skilled manufacturing processes to the newly industrialising countries; the faster rate of productivity increases in the manufacturing sector, and changes in tastes as countries become richer. Output and employment have moved to the services sector which has grown in both absolute and relative terms.

Table 1
Distribution of the Labour Force by Industry[1]
% of Total

	1971	1976	1981	1985
Agriculture, Fishing, Hunting, Forestry	11.68	10.42	11.22	11.00
Mining	0.48	0.39	0.36	0.40
Manufacturing	25.46	24.80	24.13	23.70
Electricity, Gas and Water	1.83	1.86	1.80	1.17
Construction	8.48	9.07	6.65	6.78
Wholesale, Retail trade, Hotels and Restaurants	17.91	17.49	16.92	17.24
Transport and Communication	9.34	8.88	8.47	7.76
Financial Services	5.88	6.45	7.20	7.79
Community and Personal Services	18.55	20.30	22.95	24.13
Total	100.00	100.00	100.00	100.00

[1] Note totals may not add to 100 percent due to rounding

Table 2
Employment in Manufacturing
% of Total

	1974	1984	Change in manufacturing labour force % 1974-84	Change in total employment % 1974-84
Austria	30.2	28.5	+ 1.2	+ 7.5
Australia	25.2	17.7	−22.8	+10.4
Canada	21.7	17.9	− 0.5	+20.5
Denmark	23.6	19.6	−13.3	+ 4.3
France	28.2	23.8	−16.1	− 0.6
Germany	36.4	31.9	−16.4	− 4.7
Japan	27.2	24.9	+ 0.8	+10.1
Netherlands[1]	25.0	19.6	−16.0	+ 7.0
New Zealand	25.6	23.6	− 1.3	+ 7.4
Sweden	28.3	22.4	−14.9	+ 7.4
United Kingdom	32.5	24.1	−29.3	− 4.6
United States	24.2	20.0	− 0.1	+21.0

Source OECD
[1] Netherland data is for 1975

Table 3
Employment in Services
% of Total Employment

	1975		1984	
	Financial Services	Total Services[1]	Financial Services	Total Services
Austria	4.7	47.9	5.3	54.2
Australia	7.4	59.7	9.6	65.9
Canada	6.3	64.6	8.1	68.8
Denmark	6.3	58.7	7.5	66.4
France	6.3	51.5	7.9	59.1
Germany	5.3	47.6	6.5	53.1
Japan	3.3	51.5	6.6	56.3
Netherlands	7.5	59.4	9.9	68.1
New Zealand	6.4	53.5	7.7	56.7
Sweden	5.3	57.1	7.4	65.1
United Kingdom	6.5	56.8	8.8	64.5
United States	7.5	65.3	9.9	68.2

Source: O.E.C.D.
[1] Total Services include Wholesale and Retail Trade, Restaurants and Hotels, Transport and Communications, Financial Services, Personal and Community Service.

There has been a similar trend in New Zealand. Of the total increase in employment of 116,000 over the period 1975-85, 105,000 were accounted for by the business, community, and personal services sectors. While roughly half of the employment in this area is in the public sector, the private sector accounted for two-thirds of the increase. The fastest rate of growth was in business services which grew by 44 per cent over the last ten years adding 25,000 jobs.

Despite these trends New Zealand has tended to lag behind developments in the industrialised countries: ongoing protection has meant that a disproportionate share of resources has been devoted to producing goods. Table 3 shows that the proportion of labour employed in services is well to the lower end of the international range, despite the relatively large size of the New Zealand public sector. This would tend to suggest that there is still further scope for growth in the absolute and relative size of the services sector.

Conclusion

To summarise, this article has looked at the theoretical and empirical arguments for liberalising the economy. It showed that there are strong arguments to suggest that a relatively deregulated economy will maximise national income over the longer term. However, adjustment costs in the labour market and possible distributional consequences are factors which have to be taken into account in assessing the overall sequencing and speed of liberalisation.