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(McKinnon, M., 2003)

MALCOLM McKINNON

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> The sharp decline in volume of imports is contributing to an inflationary situation which requires corrective action. The government aims to maintain stability by avoiding both inflation and deflation. Firm monetary and fiscal measures provide the most equitable method of achieving this.[130]

'I was one of those', recalls one economist,

> who supported the 'Black Budget'. It was a fiscally responsible Budget, but framed around the policies which they had promised to deliver. They had promised a tax cut, and they had also promised significant increases in expenditure to implement their welfare policies. Nordmeyer explained that they could not do this responsibly in [the] circumstances that had emerged, so put up indirect taxes — [but] on things that were politically disastrous for Labour.[131]

Did the traditional concern for the public accounts weight advice towards fiscal restraint? Possibly, but Keynesian notions of demand management are also evident:

> In the inflationary situation now faced, fiscal policy must be designed to equate demand with the reduced volume of goods. The increased taxation will serve two purposes — provide sufficient revenue for Government needs and diminish demand.[132]

McKinnon, 2003

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THE BUDGET POUND FOR 1957–58
CONSOLIDATED FUND AND SOCIAL SECURITY FUND

Where it comes from	Per cent	Portion of £1	£ million	£ million	Portion of £1	Per cent	Where it will go
INCOME TAX	35·80	7/2	99·0	80·5	5/9	28·94	SOCIAL SECURITY SERVICES
SOCIAL SECURITY	23·91	4/9	66·0	67·0	4/10	24·28	OTHER SOCIAL SERVICES
CUSTOMS DUTY	10·87	2/2	30·0	25·0	1/10	9·06	DEFENCE
SALES TAX	8·33	1/8	23·0	26·0	1/11	9·42	ADMINISTRATION
BEER DUTY	2·54	6d.	7·0	13·0	11d.	4·71	STABILISATION
ESTATE & RACING DUTY	5·43	1/1	15·0	13·0	11d.	4·71	MAINTENANCE OF WORKS
INTEREST	4·35	11d.	12·0	17·0	1/3	6·16	DEVELOPMENT OF INDUSTRY
TRADING PROFITS	1·81	4d.	5·0	25·0	1/10	9·06	DEBT SERVICES
DEPARTMENTAL RECEIPTS	6·89	1/5	19·0	9·0	8d.	3·26	REPAYMENT OF PUBLIC DEBT
				1·0	1d.	·35	OTHER
TOTAL REVENUE	100·00	£1.	276·0	276·0	£1.	100·00	TOTAL EXPENDITURE

How they explained it. The 1957 Budget in pictures and percentages. T1, 3/3/57. Archives New Zealand

£3.7 million had been anticipated for the 1956/57 financial year, an overall
cit of £10 million now seemed likely, following an £11 million deficit for
56; 'at a time when Government finance should be supporting and not u
mining, bank credit restraints, this would be a particularly serious and undes
result.'[123]

The Treasury attitude towards and influence over stabilisation polic
powerfully tested during the 1958 balance of payments crisis. A Labour go
ment took office after the November 1957 election to find a probable Bu
deficit for 1957/58 of £24 million, even if it did not implement election pr
ises or repay Reserve Bank advances to the dairy industry account. And it w
be most unwise to finance government expenditure by borrowing overseas
cause a fall in receipts for all the principal export commodities had depl
overseas reserves to about £50 million: 'after eight years of very high export p
the overseas funds would only pay for six weeks' imports'.[124]

> It is obvious that the strain on the exchange reserves must be removed and that important decisions about reducing Government expenditure and increasing Government revenue ought to be made immediately, especially

Arnold Nordmeyer, the architect of the 1958 'Black Budget' that took fiscal restraint off the political agenda for a decade. New Zealand Free Lance Collection, Alexander Turnbull Library, C-26201-1/2

> when it is recalled how long a time usually passes before the full effect of changes in policy is felt. It is highly desirable that as much action as practicable be initiated before the approaching holiday season.[125]

overnment did not act before Christmas, apart from reintroducing import
ng to protect the balance of payments.[126] Not many people at the time
have predicted that this would last another 30 years. At the beginning of
, Greensmith reported to the new Minister of Finance, Arnold Nordmeyer,
scale of the government's probable financial deficit for 1958/59. At £99
n, this was *ten times* the deficit of three years earlier. Labour had no money
which to implement its election promises, such as an increase in pensions.
smith recommended that £55 million be raised through a variety of in-
d taxes, especially indirect taxation and the social security tax. He stressed

> the measures adopted ought to be adequate and rigorous rather than lenient or chance-taking. Heavy and expensive borrowing can be justified to meet a short-term emergency but not to support a long-term living in excess of

income. The price of so doing, even if feasible, would be a lowering standard of living and probably a forced, rather than any planned, devaluation. Employment and other transitional difficulties are probable but should not be allowed to delay the requisite substantive action.[127]

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New Zealand applies to join the International Monetary Fund in 1961. Ralph Hanan, the Attorney-General (left), and Prime Minister Keith Holyoake (right) sign the documents, and Minister of Finance Harry Lake blots their signatures. Dominion Post, Alexander Turnbull Library, F-50970-1/2

The balance of payments improved markedly in the 1958/59 season. To take just one example, the London butter price in July 1959 was 344s per cwt, compared with 203s per cwt at the lowest point in 1958. And imports were 19 per cent lower in 1958/59 than in 1957/58. By the 1960 election, therefore, the economy was in much better shape than it had been three years before. However, Labour suffered from the memory of the 'Black Budget', as had the Australian Liberals from the 'Horror Budget' of 1951. National returned to office, only to be confronted by a balance of payments crisis remarkably similar to that which Labour had faced in 1958:

> I well remember Keith Holyoake coming into the caucus in February or March of 1961 and the shock that it gave a brand-new backbencher when he told us that the honeymoon was over and that we were faced with a serious situation, in repect of both the Government's accounts and our overseas transactions.[133]

It may be that Treasury thought that such advice would be more palatable in a post-election year. 'Demand management' was in this instance a matter of restraining demand, not buoying it up, a fact that drew attention to the cyclical character of economic activity, a grasp of which Keynesians believed was crucial to the successful application of monetary and fiscal policies. As the wage/price spiral continued, Treasury advice, under the aegis of Deputy Secretary Noel Lough (the new Secretary, Lang, was travelling with the Minister), became even firmer later in 1970, addressing in this instance fiscal, monetary, price and incomes policies as well as liberalisation. While incomes policies were fashionable elsewhere in the world, they had failed in Britain in 1969 — so it was unsurprising that while they were explored in New Zealand, they were treated gingerly by politicians. Treasury recommended a 'general deflationary policy' and consideration of a temporary wage/price freeze. The latter was implemented, and in March 1971 a Stabilisation of Remuneration Act introduced a new system of pay-fixing to replace the one that had collapsed with the Arbitration Court's nil wage order.[73]

The uncertainties of macroeconomic management were well demonstrated in 1972. Early in the year's Budget round, Treasury had feared that 'growth in the economy in the early part of [1972/73] could be small as investment is lagging ... an increase in government expenditure in excess of the anticipated growth rate in output, which would have a stimulating effect on the economy, could therefore be contemplated.'[74]

Barely a month after this advice was proffered, the new Prime Minister, Jack Marshall, agreed with Treasury on stabilisation measures that included a six-week price freeze and pay pause, partly on the grounds that the 'monetary and fiscal policy were not in themselves enough to manage excess demand.'[75] In fact 1972/73 was to see the country's biggest boom, other than 1950/51, since the Second World War, as rising export prices fuelled a surge in consumption. Nevertheless, Labour, forming a government at the end of 1972 for the first time since 1960, moved swiftly to dismantle what it saw as some of the more draconian of its predecessor's stabilisation policies, in particular the Remuneration Authority established in March 1971 and the regulations promulgated at the end of the February/March 1972 price freeze and pay pause.[76]

Treasury adjusted its advice to the requirements of the new government. To observe that 'the recovery of economic activity had now advanced to the point [that there was no] need for the continued stimulus of a very expansionary

balance between government revenue and expenditure' was an understatement that was predictably ignored.[77] A 1973 Budget report on the government's economic strategy was noticeable not for discussion of possible fiscal, monetary or incomes measures, but for the way it related Budget measures to the strategy, which centred on full employment, population growth, and 'micro-economic' policies in areas such as industry development and the labour market.[78]

When the Middle East war of October 1973 was followed by an escalation in the price of crude oil, New Zealand encountered a severe balance of payments crisis. What was to be done about this? The post-war philosophy of stabilisation, especially as it was interpreted by a Labour government, ruled out deflation, with its likely consequences of unemployment and bankruptcies. Devaluation — Muldoon's 1967 remedy — was disliked because of the price increases that would come in its train.

In any case, the collapse in the balance of payments was so severe that for a few months it was difficult to think beyond the very short term. In March 1974 Treasury (supported by the Monetary and Economic Council two months later) predicted a $400 million balance of payments deficit for the 1974/75 year. If this came about, it would be far worse than any similar downturn since the Second World War, mitigated only by the fact that New Zealand's reserves were at unprecedentedly high levels.[79] Six weeks later, Treasury stressed that economic prospects were 'deteriorating rapidly'; stagflation (a formerly unknown, and still unwelcome, combination of inflation with lack of growth) accompanied by acute balance of payments problems was expected throughout 1975/76.[80] By January 1975, the balance of payments deficit for the 1974/75 year was expected to be $800 million (in fact, it was to amount to a staggering $1.3 billion in the calendar year 1974, and over a third more than that in 1975).[81]

Treasury now recommended 'corrective measures' — that is, a contraction — but as a long- rather than a short-term strategy so as to minimise growth in unemployment in 1975/76. The best approach would be to resume overseas borrowing on a substantial scale, whilst squeezing the domestic economy.[82] What neither the officials nor anyone else were prepared for was that the deficit would be twice what they had predicted. The 1974 and 1975 deficits 'were equivalent to about 13½ per cent of GNP ... the largest recorded among OECD Member countries in each year'.[83] 'There was a period', recalled David Preston, who had succeeded Galvin as head of Internal Economics in 1973, 'when what was happening was unbelievable. We were feeling, "There must be some mistake" ...

The nadir of the relationship between Muldoon and his officials came in mid-June 1984 when, after deciding his perilous parliamentary majority was in doubt, he called an election for 14 July, four months early. The sequence of events, including the run on the New Zealand dollar in the days after the election was called, has been discussed in detail by both Gustafson and Muldoon. By this time Muldoon was uncompromising in his determination to resist the pressure on the exchange rate, a sharp fall in which would compromise the anti-inflation gains of the two-year-old wage and price freeze. He had turned down recommendations from the Reserve Bank and the Treasury for a 15 per cent devaluation in December 1982, and for a return to the crawling peg in February 1984.[121] In the week before the election, the currency outflow speeded up again. On the Monday after the election, Lange, the newly-elected leader, called on Muldoon, who would constitutionally remain Prime Minister for another two weeks, to devalue. Muldoon, convinced that a joint statement by Lange and himself would end the pressure on the exchange rate, refused to order a devaluation on the grounds that this should be a decision for the new government, which should accordingly take office immediately. When it became evident that the change of government could not be accelerated, it was therefore 'equally clear that we must act for the new Government; and that we did.' The New Zealand dollar was devalued by 20 per cent on Wednesday 18 July.[122]

A theory that the Treasury and the Reserve Bank facilitated the run on the dollar so as to precipitate the devaluation they had both long advocated was advanced shortly after the election.[123] Muldoon himself did not believe this charge. But he was viscerally angry that his anti-inflation strategy had been destroyed at a stroke. The devaluation made it impossible to negotiate a restrained exit from the wage–price freeze. In the aftermath of his crushing election defeat, Muldoon was desperate to demonstrate — to convince himself as much as anyone else, perhaps — that the devaluation had been avoidable, that his strategy would have worked if it had been supported by proper advice from Treasury and the Reserve Bank. That advice had been provided principally by or through Roderick Deane at the Reserve Bank and Graham Scott at the Treasury, and it was this pair who were in Muldoon's sights.

In late August Parliament's Public Expenditure Committee, on which Muldoon sat, established a subcommittee to investigate the circumstances surrounding the decision to devalue the dollar. Only one day of hearings was held before the government decided to close it down:

the three people who were [to be] the principal witnesses were me, Scotty, and Peter Nichol in the Bank. We were the three who were most heavily involved in writing and overseeing a lot of the material. I was the only one to appear. When I got back to the Bank, I wrote a letter to the Prime Minister [Lange], which I informed him would be an open letter if they did not resolve matters rapidly in terms of my rights. That letter disclosed matters which, if it had been published, would not only have been very difficult for Muldoon and the previous government, but also very difficult for the present government.[124]

Devaluation had also been a sensitive issue for Labour during the election campaign. National had highlighted assumed divisions in the Labour Party on the question, and the new Labour MP Jim Anderton, also a member of the subcommittee, sympathised with Muldoon's stance.[125] But the published record of the single day of proceedings provides a sense of the raw state of this phase of minister–officials relations. When Galvin proposed to give the committee a paper 'outlining the public facts so as to get indications of what other issues the committee wanted information on', Muldoon riposted that 'this inquiry was not going to be structured by officials, and that Treasury and the Reserve Bank were not in their usual role since they were at the centre of the issue … it was inappropriate that they should act in what would be a normal advisory role.'[126]

Both Galvin and Reserve Bank Governor Spencer Russell sought to be present when officials of their departments were being questioned. 'There was nothing', Galvin said, 'any officer had done that he would not take responsibility for … the documents were official advice, with the bulk being signed by him and that if it was a question of policy advice he must take responsibility.' But Muldoon, who was not in the chair, answered, 'No, the committee had resolved that that would not be the case'; he later commented that 'the Treasury was not a monolithic body speaking with one voice.'[127] In the published record of Deane's appearance, the majority of the questions come from Muldoon. The questions are technical, but all were directed at demonstrating that the Bank and the Treasury were biased in favour of a devaluation and had bent their advice to that end. Thus Muldoon commented that 'Treasury had a figure of 15% being recommended before the question of an election had come about, and yet after a direct and positive threat, they still put in a figure of 15% and then four weeks later it had become 20%.' When a few [illegible]utes later he asked whether one measure had been advocated in order to 'put the wind up the Minister of Finance', the record

and monetary policy, which had been Muldoon's exclusive domain for years, was largely handled by the Reserve Bank — and these were key areas of policy change. On other economic issues, the Minister of Finance and the two associates worked together to convince their colleagues until they were sure of a majority in Cabinet.[40] A good example came in March 1985 with the decision to float the dollar:

> In early March, when they had these meetings, Lange had gone to London and Palmer was in the meeting with us initially. We agreed to float, then Palmer left and Douglas said, 'Well, we can't have Geoffrey simply chair the meeting because we're not sure we'll get it through. So we'll have to get Lange to help orchestrate it.' So then they said, 'Well, we'll have to send somebody to London to brief him, so that he's got somebody with him when he calls up the different critical players' [the Cabinet ministers]. So it was decided that I would go. Because they didn't have a Cabinet meeting over floating. They called them in, one by one, and got them to sign.[41]

So the Douglas/Prebble/Caygill nexus was central to the policy revolution. For its part, Treasury could see opportunities to advance both the politics and the economics of economic management that would have seemed improbable just twelve months earlier.

1984 to 1987

The three years of Labour's first parliamentary term were arguably the most exciting and stimulating in the Treasury's entire history. Since the 1960s Treasury had been frustrated with Cabinets which would not take all — or sometimes any — of its advice on economic management. While the advice had changed over the years, the frustration had not — until 1984. With the perspective of nearly twenty years' hindsight, 1984 seems an irreversible turning point, but to Treasury officials at the time it looked more like an almost unbelievable window of opportunity. Indeed, Treasury was initially sometimes startled by the speed with which Douglas wanted to implement his policies, as when he wrote to it complaining that 'the time frame you envisage for the introduction of a major indirect tax will create major political problems. The entire package is put at risk if this cannot be put into effect soon.'[42] And whereas the Reserve Bank was ready to float the dollar straight after the election, Treasury held back. According to Roderick Deane, they 'were just nervous about the banks' ability to handle it

The Evening Post

Wellington, N.Z. — Saturday, March 2, 1985 — 30c

NZ floats $

NEWSFRONT

LANGE TIPPED

Oysters few, far between

Samoans float, too

Urquhart top miner

Douglas: It's the best way out

New Zealand's dollar is to float from Monday, the Minister of Finance, Mr Douglas, announced at 10.30am today.

Prices up, dollar down

Experiment

The dollar floats – but up or down? Evening Post, 2 March 1985

all ... they were second-guessing the Reserve Bank, which had extensive interaction with the trading banks'. In *this* instance, Douglas did not act until Treasury advised him to, a few months later.[43]

Treasury adapted to Douglas's pace soon enough, especially in the sphere about which they and he were most passionate — liberalisation, microeconomic reform. For Douglas, tax reform 'was a fundamental part of the programme and something I enjoyed', whilst one official reckoned that 'most of the Treasury was micro-oriented — and didn't think macroeconomics was very important. Even though [it was covered] in the post-election briefings and obviously macro stabilisation was important, there was quite a period there in the 1980s where the macro side was seen as less important than the micro side ... we used to have that discussion quite a lot, and there was a sort of — "those guys in forecasting, what really matters is what we're doing in reform."' For another official, microeconomics was fundamental, while macroeconomics was 'hygiene'.[44] Within the broad parameters of a commitment to liberalisation, there was enthusiastic debate on these matters amongst Treasury officials and with Douglas: 'there was almost a sense of mission in the place. Maybe we were a little naive, a little

idealistic, but there was a sense that we were doing something very important in terms of shifting New Zealand onto a higher growth track, and that ultimately the reforms would lead to that.'

This bias towards microeconomics partly reflected scepticism about Keynesian macroeconomics, but also the fact that new directions in monetary and fiscal policy had been set so rapidly. A series of announcements from the Reserve Bank in the latter part of 1984 gave effect to Douglas's willingness to tighten monetary policy as the primary weapon against inflation. This speedy action had the effect of reducing the amount of attention Treasury gave to monetary policy, as did the belief that the conduct of such policy was properly the domain of the Reserve Bank. While Treasury remained involved in providing advice on monetary policy, the issues were technical rather than fundamental so long as the government's objectives in this area remained unchanged. Douglas was determined to forego tinkering with fiscal policy and to reduce the deficit. Although this goal was to prove elusive, its existence further inclined Treasury to direct its energies towards structural reform (which could be expected to facilitate disinflation and fiscal balance, insofar as it made the economy in general more efficient and tax revenues more buoyant).[45]

Thus it was in the areas of regulation, taxation, and the institutions of government that the most energy was applied between 1984 and 1987: in the reform of taxes and benefits, the winding back of assistance to industry (including import licensing and tariffs), reform of the labour market, and the introduction of a corporatist approach to the state's trading activities. The Commerce Commission was constituted to 'promote workable and effective competition', and the Economic Development Commission to (at least from a Treasury perspective) promote informed thinking about competition and regulation. The drive to establish these new institutions was part of Treasury's deep commitment to liberalisation: 'it was quite noticeable that whenever we went to an OECD meeting or whatever, people always expected that they were going to get a microeconomic foundations lecture from the New Zealand Treasury. Partly because, in a lot of those other countries, there is also an outfit called a Ministry of Commerce, or a Ministry of Economics, or something or other.'[46]

The window was open, but for how long? The political winds were boisterous. The government soon came under bitter attack from farmers and manufacturers suffering from the high exchange rate that became the norm from the middle of 1985 — indeed, the belief that Treasury was directly responsible

for the rural downturn provoked the oft-cited ironic call to 'cut out the middl man, elect the Treasury'.[47] More threatening were rumblings within the Labo Party. As early as the economic summit of September 1984, one leading tra unionist expressed his belief that

> some of the statements made by the ministers responsible for economic management, trade protection, wage levels and monetary controls suggest the Treasury line of thinking was having an influence on them. He believed those ministers had been placed under an enormous amount of pressure, particularly since they came to power, by big business organisations, public service advisors, Treasury and the Reserve Bank to adopt a more market, less protectionist attitude towards economic management than the previous government.[48]

Lange knew, according to a report in March 1985, 'that some of the party I expressed misgivings about aspects of the Government's economic policy .. ask you not to use labels as a substitute for analysis . . . the New Zealand econo is unique. Roger Douglas is unique ... it is clear that in some cases market fo decide the best and most efficient use of economic resources.'[49] Criticism wa and waned over the next two years. Before the introduction of GST, Cay remembered a series of Labour regional conferences in 1985 'to which the nance ministers were sent to debate the issues. This was an idea of Marg Wilson's — ultimately it proved to be a very sensible idea because by the time got to the national conference, we had won the debate about the GST at I th five out of the six regional conferences.'[50] The announcement of plans for corporatisation of state trading activities generated comparable criticism fi within the party in 1986.

Was Treasury itself at risk? In January 1985 John Stone, the long outspo and recently resigned Secretary to the Australian Treasury, spoke at the N Zealand Treasury on 'The role of Treasury — what are the limits to a Treasu public role?'[51] Bruce Jesson questioned, as the title of his piece — 'The Hic Persuaders' — suggests, the nature of Treasury's advice and the departm effectiveness in getting it implemented.[52] The *Listener* editorialised that

> in the past Treasury has been expected to offer impartial professional advice to the government on options for action. The dominance of any school of thought within Treasury must diminish its ability to develop alternative strategies for consideration ... diversity in our economy offers us the best

measure of security. The same principle should be applied to the development of economic thinking within Treasury.[53]

There was an 'eruption from within' when Bob Tizard, the Minister of Energy, who had been Labour's last Minister of Finance, publicly challenged Treasury's advice on the corporatisation of his Ministry. But after that outburst, Lange stressed that Treasury was 'a department which does not make decisions. Government makes decisions ... let's stop getting silly about the Treasury. Treasury brings a report down when government asks it to bring a report down.'[54] Anyone familiar with the processes of government knew that the latter statement was correct only in form — Treasury frequently put up reports annotated, 'to note'. But Lange's loyalty was a significant factor in ensuring that Treasury retained its role as the principal provider of economic advice to the government.

The sense that there was a 'window of opportunity' also influenced relations between Treasury officials and other economists. In the 1984 issue of *New Zealand Economics Papers*, Victoria University economists co-ordinated by John Zanetti had reviewed both *Economic Management* and the Reserve Bank's post-election briefing papers. They had criticised Treasury's macroeconomics in particular, challenging its arguments about monetary policy and the exchange rate from a broadly Keynesian perspective. The Association of Economists asked its authors to make a presentation to their 1985 conference. 'The organisers of the conference', one of the participants recalled,

> had suggested that Zanetti and the rest of us who had contributed talk to the paper. To our surprise we arrived to find a room jam-packed with perhaps 100 people, some lining the walls, some from overseas, many interjecting. Treasury officials were passionate and quite emotional about the work they had done, for reasons we had not appreciated.[55]

That Treasury felt it had an historic opportunity that could all too easily be forfeited was evident in the published Treasury reply, written by Graham Scott and others. This conveyed not only a sense of disagreement on macroeconomic theory, but also of a gap between academic economists focused on issues of macroeconomics, and policy-makers who were also focused on microeconomics and institutional reforms.

This meeting was often mentioned to the writer, and not only by those who were present. This may suggest that the clash was an unusual one for the

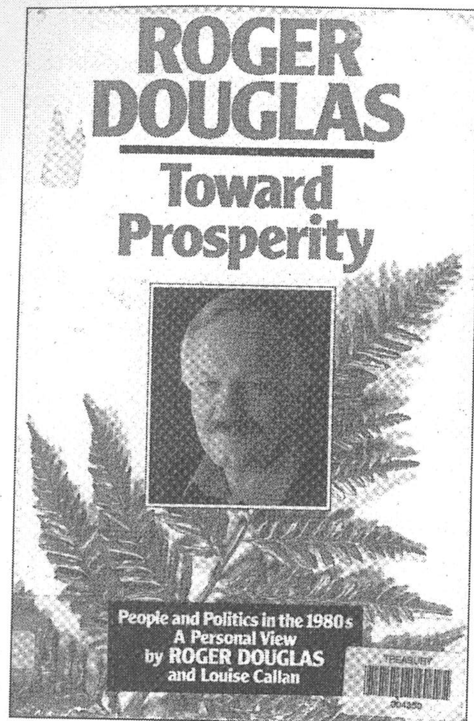
economics profession. It took place only a couple of weeks before the floating of the dollar, a decision which gave a specific cast to economists' criticism of the 'Treasury line'. In the first months of the float the dollar did not move far from its post-devaluation US 44 cents. But it rose steadily during the 1985/86 year as the impact of a tight monetary policy and high interest rates attracted capital to New Zealand. By late 1987, with the New Zealand dollar hovering around US 60 cents, Brian Easton noted a 'growing demand for a change in the Government's policy stance. This call includes almost all the economists who publicly protested against the Muldoon economic policies'.[56] Numerous comments in the press and in journals during 1986 and 1987 record the debate.[57]

One argument accepted the premise of liberalising the economy, but contended that the order in which the various markets were liberalised would make a big difference to the success of an adjustment programme. Robert Buckle cited one overseas economist to the effect that the

> scope and sequencing of financial reforms must be closely linked to other trade and fiscal changes ... trade reforms — including removal of import quotas and lowering protective import tariffs — should come early in the overall reform process. The liberalisation of financial markets should also be introduced early, but gradually ... international capital controls, it is agreed, should be relaxed only at the final stage of the reform process.[58]

Brian Easton observed in mid-1986 that 'as far as can be told, fiscal and monetary policy are made without reference to the exchange rate'.[59] If the fiscal deficit were reduced the government would have to borrow less, thus reducing the pressure on interest rates. Equally, a 'tight' monetary policy would result in high interest rates and a high exchange rate.[60] For Treasury this was an unresolvable dilemma, given the government's determination to follow a tight monetary policy and its less settled stance on fiscal policy. Did this mean that Treasury should forswear the favoured monetary policy? With the benefit of five years' hindsight, Graham Scott was to concede that 'firm monetary policy had put upward pressure on the exchange rate'.[61] But at the time, it seemed best to press ahead. Deane, a proponent of the reform, had a robust view:

> The big dilemmas were round the fact that they didn't pull government expenditure back fast enough to get the fiscal deficit down fast enough. So too much weight was thrown onto some of the other policy parameters. My



Toward Prosperity: an optimistic pre-election view from Douglas, but the political climate was souring. Treasury

> own view of all of that was that we were doing so much, so quickly, that it was better to get it done, and behind us, because the window of opportunity to get it done was going to be so short. My judgement was that you don't get many windows of opportunity, having been through that process for so long. Douglas's own view was, 'Look, we've just got to get it done. I'm just going to have to grab the opportunities when I can, I'm not going to be able to do everything at once because there's practicalities around it, there's politics around it'.

The high point of Douglas's influence was reached in 1986. In that year he was instrumental in getting Deane appointed to chair the State Services Commission, with results that will be discussed in chapter 9. And while Roger Kerr, to whom Douglas was close, left Treasury to become executive director of the New Zealand Business Roundtable, Graham Scott succeeded Bernie Galvin as Secretary to the Treasury, even though the latter was only 53. Galvin had not always been comfortable in the new environment. When Deane was asked by Douglas to go to London in March 1985 to get Lange's agreement to the floating of the

dollar, Galvin said to him, Deane recalled: '"You've got to be the good public servant, Roderick, you've got to go and brief the PM, but do not try to persuade him to this view — you've got to let him reach his own judgement." He was being very proper. As usual, I told Lange what we recommended and why, in no uncertain terms.'[62] For his part, looking back, Douglas conceded that 'to be fair to Bernie, we never really got that relationship going, although I had a lot of respect for him, for what he'd done earlier. But he wasn't always a well man. And there was a *huge* pace going on.'[63]

During this period, Lange remained loyal to Douglas. In a lengthy interview he gave the *National Business Review* to mark the government's second anniversary in July 1986, Lange stressed that Douglas had been 'the economic strategist ... he is not some sort of fiscal psychopath. There is a hard Labour core to him which is not often appreciated.'[64] Eight months later, Lange likened the members of a new Labour left group to 'economic neanderthals' with views bearing 'an extraordinary similarity to Muldoonism'.[65] Polls suggested that the government would become the first Labour administration to win a second term since 1938: 'New Zealanders, even in the hardest-hit provincial areas', reported one journalist in June 1987, 'may be preparing to give the Labour government a more favourable endorsement than any government has received since 1951.'[66] While unemployment had risen in provincial areas, in the principal cities it had remained lower in a reflection of the buoyancy of the financial markets. At the time of the election, 65 per cent of Labour's voters thought that the government was going in the right economic direction, while another 21 per cent liked the direction but thought the pace too fast.[67]

It is useful to remember what goals Treasury had not seen realised during this parliamentary term. Even in Douglas's heyday, it was more difficult for Treasury to make progress in some areas than in others. This was a Labour government which had strong links with the trade union movement and with public sector workers. A great deal of effort had been expended in negotiating an exit from the freeze with union leaders, and in 1985/86 wage settlements averaging 15 per cent were tolerated. The Labour Relations Act passed early in 1987 was regarded by Treasury as flawed on key points, but it had taken months of negotiations and Treasury was unable to get its amendments enacted.[68]

Monetary policy was also not *entirely* to Treasury's liking. Looking back in 1990, Scott thought that the combination of the 1985/86 wage round with rising interest rates and other costs and the high exchange rate had 'rapidly eroded

the competitiveness gains associated with the 20 per cent devaluation in July 1984'. But he also reckoned that 'monetary conditions were allowed to ease prematurely over concerns that the economy was weakening rapidly as a result of high interest rates and exchange rate pressures'. While this easing produced reductions in short-term interest rates and a fall in the exchange rate, 'the increase in inflationary pressures forced the Reserve Bank to tighten monetary policy towards the end of 1986. As a result a year was lost in the disinflationary process.'[69]

Changes in social policy were also shaped by Labour Party politics. Douglas had concentrated on tax and regulatory reform, and cleaning up the trading side of government. Government spending on health, education and to a lesser extent welfare remained largely outside his and Treasury's ambit, despite the attention that was paid to social policy in the 1984 briefing papers. Benefit reform was driven not only by Douglas but by the desire of the Minister of Social Welfare, Ann Hercus, not to see too many cuts in her area: 'there was kind of a duel going between the two of them.'[70] Social policy generally remained in the hands of Cabinet's Social Equity Committee, which was chaired by Russell Marshall, a senior Cabinet minister who had challenged Lange for the leadership in 1983. Marshall was the Minister of Education, a portfolio in which there were big increases in spending in Labour's first term.[71] A Treasury report of January 1986 noted that 'as yet we have undertaken little review work on the structure of compulsory education'.[72] Similarly, in the health area Treasury was 'not yet in a position to form a firm view on what system would be most efficient'.[73] Lange's Royal Commission on Social Policy (see chapter 9) had no input from Treasury.

Social policy proved to be the ground over which the Lange–Douglas alignment broke. In thinking about the 1987 Budget from late 1986, Douglas moved beyond tax and benefit reform into the social policy area as a whole, driven by the desire to see yet more efficiencies in public spending and thereby reduce the public debt, but also with a vision of quite different social policies: there was discussion, for instance, about the scope for commercialisation in the health and education sectors.[74] Treasury and Douglas agreed that, with savings having already been made in the departments that were to become state-owned enterprises (see chapter 9), they must now be sought in the area of social policy.[75] Douglas recalls that one paper he wrote 'had three options. A do-nothing option, a middle-of-the-road option that resulted in a Budget surplus, and a really radical option that would have taken personal and corporate tax down to 16⅔ per cent; that meant a big programme of privatisation and some social changes. And that

was when Lange got scared.'[76] Treasury was involved: 'He instructed us to work on a scenario along the lines of, "Let's sell the roads, let's privatise the schools and a whole swag of the rest of social services." It led to correspondence between Lange and Douglas which was one of the most tense bits of work which those of us doing it have ever had to get involved in.'[77]

In March 1987, the Prime Minister and other ministers rebelled. They were not prepared to delegate to Douglas as they had done with previous Budgets. Ministers were sceptical of a Budget strategy so preoccupied with a deficit reduction that was to be accomplished through expenditure cuts rather than tax increases. Scott reported that

> the Prime Minister raised the question with me as to what is the right ratio of Government expenditure to GNP; Mike Moore asked why we shouldn't raise taxes by other means, in particular wealth and capital taxes to fund schemes which had been postponed for the whole of this Government's period in office; Russell Marshall accused the Minister of Finance of blowing $700 million on the tax–benefit package. Phil Goff asked why does a deficit matter anyway; Stan Rodger said there would have to be asset sales.[78]

So even as the government was enjoying good political news, its commonality of purpose frayed. The immediate outcome of the standoff was a foreshadowing of asset sales rather than expenditure cuts in the 1987 Budget: 'any further large scale cuts could now only come from health, education or social welfare spending ... any wholesale cuts in these areas would be socially disastrous. As a Labour government we are not prepared to contemplate that. That has left us no option but to sell some government assets and use the proceeds to pay off debt.'[79] But the longer-term impact was to distance Douglas from many of his Cabinet colleagues: 'he did, under the frustrations of arguing with those big-spending ministers in the Cabinet ... become harder-edged, more definite in his beliefs'.[80]

This alienation in turn had implications for the Treasury. The three years since the 1984 election had provided a vivid demonstration of the crucial importance of politics to economic management, in this instance mostly — but not entirely — to Treasury's advantage. But success had depended on two vulnerable elements: the Lange–Douglas alliance, which was now under stress, and the state of the economy. Colin James predicted in 1986 that if the latter went sour, 'that would mean, and would for some time go on meaning, more unemployment for which Rogernomics, and so the big changes it has catalysed, would be blamed.'[81]

'With the heady success of Labour's first term', one commentator has written, 'Treasury's ambition and confidence reached a high-water mark.'[82] Given the rumblings around the Cabinet table, this may be an exaggeration, but the result of the August election provided some justification for it. Labour increased its vote, and the result was widely interpreted as a victory for Lange and Douglas. It was received favourably by many — 'market euphoria greets poll', read one headline. But careful analysis of the poll suggested the fragility of Labour's position: its support from low-income and Maori voters had fallen, and National's vote had increased by more than Labour's.[83] Internal disaffection became explicit at Labour's post-election party conference in November. Activists 'clearly considered their party had been hijacked from beneath them and they were determined to wrest back a say in [its] direction. It was hard to believe, at times, that just three months ago the party had won a historic second term in power.' While Douglas was the 'chief bogeyman', Lange also needed to be protected from protesters by security people whenever he arrived or left the conference.[84]

But Lange had already staked out a different terrain to Douglas. In forming his Cabinet after the election, he gave himself a key position in social policy by assuming the Education portfolio as well as the prime ministership, and transferred Prebble and Caygill from their Associate Finance roles, replacing them with the more junior Michael Cullen and David Butcher. Prebble remained close to the Treasury as Minister for State Owned Enterprises, but Caygill shifted to Health. Cullen, who was seen as being on the left of the party, was expected to challenge Douglas on policy matters, and other ministers were also clearly at odds with the Douglas agenda. New Housing Minister Helen Clark found favour with the conference when she declared that market culture should not run rampant through social policy. Outgoing party president Margaret Wilson highlighted concerns that 'the same methods of deregulation and non-intervention of the state [applied to economic policy] will be applied to reforms in social policy'.[85] In December, Deputy Prime Minister Geoffrey Palmer, who now chaired Cabinet's Social Equity Committee, launched an initiative of his own to co-ordinate social policy.[86]

What did these changes signify for Treasury and its vision for economic management? Perhaps nothing? The department published its post-election briefing papers, which focused heavily on social policy, after receiving requests for some

THE DOMINION

NORTH FRIDAY OCTOBER 23 1987

Treasury proposes radical reforms

THE TREASURY has urged the Government to significantly increase the goods and services tax, abolish universal benefits such as the family benefit, and privatise nearly all state trading enterprises.

By JANE CLIFTON, Political Reporter

Rowdy teenagers shut down library

Dwarfed by primeval past

Brokers still wary about recovery

THE SHAREMARKET failed to respond ... world recovery yesterday, having ... vous about the future.

Treasury hits the headlines. Dominion, 23 October 1987

of them under the Official Information Act. It was clearly still imbued with the sense of confidence that had flourished over the preceding three years. Release of the complete set of papers, 'by exposing our views to a wider public scrutiny would contribute to a more informed debate on policy.' But it was recognised that this exposure was 'likely to cause some public questioning of the government and its advisors'.[87]

The latter certainly occurred. Indeed, there was more criticism of Treasury at this time than at any other, with the exception of the period of benefit and expenditure cuts and high unemployment in 1991. One large-format newspaper headline read 'Treasury proposes radical reforms', with the elaboration that 'the Treasury is pressing for some extreme extensions to the Government's free-market policies', while a columnist in the same paper speculated that Treasury had 'outflanked' Douglas.[88] Liz Gordon of Palmerston North wrote to the *Dominion* that the papers, which were published with the title *Government Management*, constituted 'a failure on the part of this government department to recognise its true role in New Zealand society. Treasury staff seem to have forgotten they are policy advisors and instead they have become politicians ...

Frankly it seems clear to me that Treasury is little more than a highly paid lobby group and I object to it being paid out of taxpayers' money when its work is so clearly in the interests of only some groups in society.'[89] At the annual conference of the New Zealand Sociological Association, a paper entitled 'The Treasury: A Sociological Analysis' was presented.[90] For one citizen, *Government Management* demonstrated that there was 'a need for an independent investigation into the functioning of Treasury, its neutrality, and the competence of its advice'. For another: 'the Treasury needs to be reminded that it does not set government policy ... nor for that matter does Treasury run the government.'[91] Jenny Kirk, the Labour MP for the Auckland electorate of Birkenhead, reported that she kept

> getting queries from constituents, and from Labour supporters, about who exactly are the Treasury. If you could answer the following questions I will be able to pass on this information. Who are the Treasury? What are their qualifications? How old are they? How long have they been in the department? ... Do they have experience of working in business firms outside the government departments?[92]

Had Treasury forgotten the old public service saying, 'Remember the whale — it's only when it spouts that it gets harpooned'? The publication of *Government Management*, and the reaction this elicited, raised two important questions about the place in government of Treasury and the advice it provided. In an address at the University of Canterbury in 1965, the long-time Secretary of External Affairs Alister McIntosh had argued that 'the diplomat must always remember that he is a servant, that he possesses power without substance ... The civil servant can advise; he cannot, he does not, he must not, decide. When a civil service begins to think it is the government, it is no longer a servant but a political party in embryo'.[93] 1987 was different from 1965: Treasury's advice was supported by its minister, and the Official Information Act had diluted the private character of advice to government. Nevertheless there remained, in the way *Government Management* was titled and presented, and in the inclusion of 80 pages of background material on social policy, a sense that Treasury had crossed the boundary separating the official from the political, the official from the theoretical — and certainly the digestible from the indigestible. Even given Treasury's determination to provide only what it saw as the best advice, however unpalatable, a different kind of production might well have enhanced — and would not have limited —

Treasury's ability to get policies it favoured adopted.

The second important field of debate that was opened by the publication of *Government Management* concerned the nature of 'economic management'. As we have seen, the term had arisen in the heyday of Keynesian-style macroeconomics, and the terrain to which it was applied was from the 1960s one of the two foci of the Treasury's role in government. By the 1980s it had acquired different connotations, including a much greater focus on microeconomics. As economic management acquired this progressively stronger 'micro' focus (and as this was explored by the Task Force and the Planning Council in the 1970s), it could not overlook social policy. It was one thing for the Labour Party to assent to the liberalisation of finance, trade and taxation, but what of the universalist, publicly funded welfare state? *Government Management* was released a week before the sharemarket crash, which reduced the value of leading New Zealand shares by 15 per cent on its first day, 21 October, and soon greatly intensified an economic slowdown of which there had already been some warning signs. Debate about the direction of economic management now intensified. Within months, Auckland manufacturers were reporting that 'many firms ... are shedding labour in [a] desperate bid to survive the economic recession and many others are seeking advice about making employees redundant. Manufacturing was the worst hit area, job losses reflected the downturn in the economy not only because of the share-market but also the restructuring which had been going on in the economy.'[94]

An economic statement in December 1987 was partly designed to boost economic confidence in the aftermath of the crash, but it also took tax and benefit policy even further into the domain of social policy than had been the case with the 1986 reforms. The statement proposed the introduction of a guaranteed minimum family income, an increase in the GST from 10 to 12.5 per cent, and cuts in both company and income tax to a single low rate — a radical proposal that had been initiated by Douglas and worked on by Treasury and other departmental officials over the preceding three months.[95] Whilst it had been inspired by Douglas, the package was presented jointly by all the key Cabinet ministers, including Lange. However, in the eyes of Lange and the other ministers these proposals were just that, whereas Douglas saw them as settled. On 28 January Lange announced that they would not proceed. Douglas, who was out of the country at the time, learnt of Lange's statement from a journalist. On his return a few days later, he contradicted it,[96] and the relationship between the two men

collapsed. Personnel changes in Lange's office probably did not assist, though one staffer recalled 'a number of times where the two of them got together for breakfast and I sat there in a note-taker position. *Just the three of you?* Yes.' But within weeks, even that informal liaison had ended.

In addresses over the next few months, Lange sketched *his* vision of the balance between economic management and social policy. In effect, it was a matter of separate spheres. On the one hand, 'in all the OECD countries it was plain by the late 1970s that a new approach to economic management was needed ... Much of what has happened in economic management in the last three years can only be understood in terms of the removal of ineffective, distorting or damaging interventions.'[97] Lange had 'no problem with a programme of privatisation. In fact I believe that we should be quite honest and apparently ruthless about it and enhance the return to Government by selling control at a premium instead of the ostensibly populist process of selling to the broad spectrum and then letting them take their profit selling to the investor who is prepared to pay them for control.'[98] But on the other hand, he stressed his belief that the state must have a central role in social policy: 'I do not think that failings in the social services focussed dissatisfaction with the activities of government in the acute way that failings in economic management did', and defended the 1987 Labour Relations Act, with its limited liberalisation of the labour market.[99]

Treasury got caught in the Lange–Douglas crossfire, most seriously in the lead-up to the 1988 Budget. Douglas's recollection is that 'there was a lot of talk about Treasury making big mistakes. We'd done all this work, and we felt we were getting on top of the position, when all of a sudden we were faced with a deficit of $3.2 billion. Graham Scott gave me the papers on the plane and left me to it. But with hard work we'd got it down to $1.2 billion, which I wasn't worried about.'[100] Weeks later, however, Lange drew attention to the earlier shift in Treasury's forecast for the deficit from $1.8 to $3.2 billion. Should this have been dealt with by cutting expenditure or increasing revenue; and if the latter, should revenue have been increased through selling assets or raising taxes? The nub of Lange's intervention came when he stressed that while the government had had to restrain spending, 'we cannot find the money we need wholly on the spending side ... There are some possible sources of additional non-tax revenue [and there is] tax. It would be irresponsible of me to speculate on the various options'.[101] But in the Budget, Douglas confirmed that tax reductions — a modified version of the December 1987 package — which had already been announced would

proceed. Some new measures to limit tax avoidance were introduced, but the only tax increase, on tobacco, was expected to bring in a mere $110 million in a full year.[102]

If Lange did not get his way, neither did Douglas. Unable because of political constraints to pursue his social policy agenda, the Budget focused on the common ground of economic management — on financial management in the public sector, a new status for the Reserve Bank, and a swathe of privatisations, including of the Bank of New Zealand and Postbank.[103] As for Treasury itself, the 'scare' prompted Scott to initiate an internal enquiry into Treasury's work on the Budget. Following a reorganisation in 1985, responsibility for the Budget had been allocated to the Fiscal Affairs Branch and for macroeconomic policy to the Economic Affairs Branch. This separation of macroeconomic policy and forecasting from the Budget may have been intended to 'insulate' Budget-making from the temptation to use the kind of short-term fiscal measures that Muldoon had frequently resorted to, and about which Treasury had been so sceptical. Following the enquiry ordered by Scott, a Budget Management Branch was established to bring together 'those parts of the Treasury that are involved in the core work associated with the preparation of the Budget, and in providing the related economic policy and financial advice to the Minister of Finance'. Tax forecasting and modelling, macroeconomics, policy co-ordination and development, and the preparation of the Budget all came within its ambit.[104] The 'scare' of 1988 also prompted the appointment of Treasury's first communications official, Nikitin Sallee, who was recruited from the *National Business Review* and was to stay in the job until 1995.

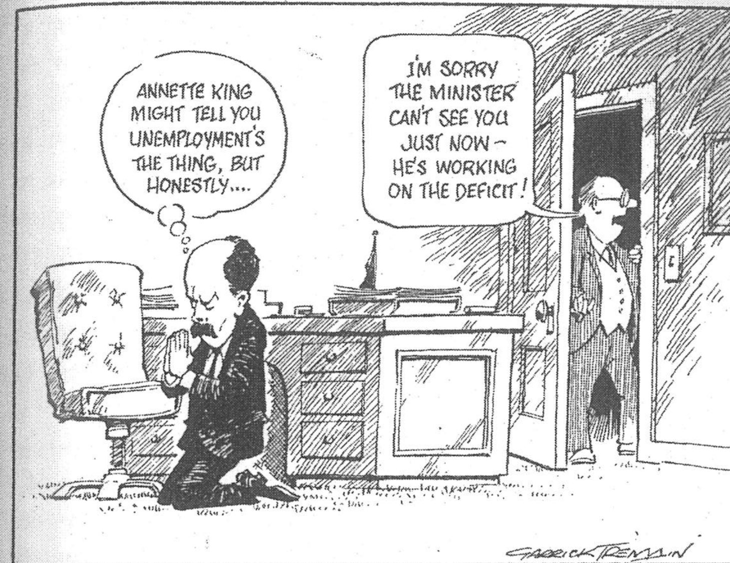
If there was a point when the direction of 'core' economic management seemed likely to change, it came with the events that unfolded after Lange sacked Prebble in November 1988. Douglas resigned within a month, a climacteric which saw the political world 'a battlefield' above which 'political murder' was 'still hanging in the air'.[105] Some commentators predicted the 'death of Rogernomics'.[106] Graham Scott recalled that

> [the journalist] Richard Griffin had told me that the news from the ninth floor [the Prime Minister's office] was that I was to be sacked. I replied that 'if I get sacked it is by the State Services Commission, not by whoever you've been talking to on the ninth floor'. During that period I half expected to be got rid of. There were rumours flying around that that was going to happen.[107]

Scott was not sacked, but the sniping continued through the following months. The *Dominion* in particular campaigned against the 'extremist ideologues' of the newly 'orphaned' Treasury. It endorsed Opposition leader Jim Bolger's suggestion that the department be reined in through a partition: 'the Treasury should lose its role as macroeconomic advisor. A monopoly on such crucial advice is bad enough, but when it is held by the department which also holds the purse-strings, power is concentrated in too few hands. It is an added danger that a small group of ideologues are now running the monopoly.' Both the *Dominion* and Bolger advocated a division of the department along the lines of Fraser's 1976 split of the Australian Treasury (though this was not cited as a precedent), between economic advice, which would go to a new entity, and control over spending, which would stay with a Treasury which 'should in effect be retained in an accounting capacity only'.[108]

The criticism highlighted the continued adherence of the new government to the anti-inflation policy that had been pursued fairly consistently since 1984, despite the deepening recession. There were signs of an upturn in business confidence in September and October 1988, but these faded later in the year. At the end of November 156,000 people were registered as unemployed or in subsidised jobs, compared with 104,000 a year earlier and 87,000 the year before that. By March 1989 the number of full-time jobs was at its lowest level for fifteen years.[109] But both a tight monetary policy and fiscal balance — 'the deficit obsession', the *Dominion* called it — remained goals under the new Minister of Finance (Douglas's associate minister from 1984 to 1987), David Caygill. Asset sales continued, and GST was increased to recover the revenue foregone by the October 1988 personal income tax cuts (which did not entail a flat tax, but were still substantial). 'Caygill did something which always surprised me', Scott recalls. 'Without consulting the Treasury, as far as I know, he just announced, "We're going to have Rogernomics part II"; then, a little later, "We're going to have a 2 per cent inflation target". He did that on his own, as I recall it.'[110]

Yet the political environment *had* changed following Douglas's departure and the arrival of new ministers around the Cabinet table. One official remembers that 'you didn't have the situation where the Treasury minister says what he'll have, and it gets done. You had Cabinets trying to decide. Cullen's important. Clark's important. Caygill was a sort of compromiser.' Scott reported later in 1989 on comments senior Labour members made to officials when an Imprest Supply bill was going through the House: 'the only concern I have about the bill



The minister (David Caygill), the deficit and the deity. Garrick Tremain

is the perception held by some in government that the Treasury had got its figures wrong … the three instances were said in a joking manner and I hope were not criticisms of our work.'[111] And in March 1990, the Cabinet Office circulated proposed changes to the Cabinet Office Manual procedures for departmental submissions to Cabinet and Cabinet committees which appeared to circumvent the 'current policy of requiring a Treasury report on all proposals with economic and financial implications'. Treasury's memorandum to its minister pointed out that some of the problems had occurred because ministers by-passed requirements to consult, and added that although it had subsequently been told that the proposals did not imply an end to the current policy, it nevertheless wanted to 'advise you in the strongest possible terms that your ability to determine overall fiscal stance is threatened if a Treasury report is not mandatory for all spending proposals.'[112] The process of compiling the 1990 Budget tables, in which a financial surplus of $89 million was reached partly through a debatable allocation in the accounts of revenue from the sale of the Crown's commercial forests, did not help morale in Treasury.[113]

So how should we assess the impact of Labour's second term on economic management? Between late 1988 and 1990 the government went through many transmogrifications. In March 1989, Jim Anderton left the parliamentary party

and set up New Labour. Lange resigned as Prime Minister in August 1989, a week after Labour's caucus invited Douglas to return to the Cabinet. Palmer became Prime Minister until — just six weeks before the election — he was dumped in favour of Mike Moore in a futile bid to prevent a heavy loss to National. But through three prime ministers and two ministers of finance, what we can call the '1988 compromise' held good. Caygill followed Lange rather than Douglas in stressing that he was not prepared to rely on the market to provide education or health.[114] Despite Treasury's efforts, social policy and labour market deregulation remained outside the ambit of economic management. But that aside, macro- and much microeconomic policy continued along the lines that had been mapped out since 1984.

We can draw two conclusions from this that are germane to the Treasury. Firstly, Treasury's advice-giving *role* survived. The professionalism of Treasury's officers, both as officials and as analysts, stood the department in good stead at this juncture. The parameters within which debates were conducted may not have been as broad as they had been in the 1970s, and

> subsequently you heard people saying, 'It's quite hard to put a contrary view.' And I think that was probably because the predominant view had *such* wide acceptance. I think the overriding thing was a feeling of ... debate around the edges, but in terms of overall direction, you had a feeling of an organisation which hugely agreed with itself. But the debate was vigorous.[115]

The vigour was important, and the resulting reports were not tracts. Thus Treasury's detailed response to Douglas's tax/benefit proposals of September 1987 reiterated the objectives (improving incentives to work, earn and invest, and simplifying the tax system, which 'we strongly support'), constraints (the need for the proposals to be fiscally neutral, to safeguard — or at least not significantly worsen — the income position of low-income earners and recipients of benefits) and other desirable attributes (transparency, reduction of distortions, fairness and consistency) of any tax/benefit reform proposal. It then went on to argue that the original proposal met some but not all of these standards — notably, it was probably not fiscally neutral (that is, it would lose the government more revenue than it gained); the proposed increase in GST threatened the anti-inflation policy and blurred the net effect of the package; and effective marginal tax rates for low-income earners would remain high.[116] And the road to this careful position had been marked by intensive debate within Treasury itself

> about equity/efficiency trade-offs — [there was] a lot of debate about the gains you [would] get in terms of work incentives and investment incentives and what difference that would make. Some people argued quite strongly that this was going to be positive, others were concerned about equity trade-offs.[117]

In seeking independent advice on the tax/benefit proposals in January 1988, Lange implicitly questioned the objectivity of the Treasury, but this was apparently the only occasion he did so during the increasingly bitter exchanges between the two formerly close colleagues. And there seems also to have been only one occasion when Lange's team criticised the quality of Treasury's work — in relation to its failure to notice that the part-time earner rebate would cost $120 million. 'Your advisors', replied Douglas, 'have apparently emphasised [the omission] as evidence of the Treasury incompetence the Labour Party is so keen to discover'.[118]

The journalist Richard Harman said of Lange's decision to 'go public' over the forecasting issue in 1988 that it 'could only raise questions about the political future of Roger Douglas, and the political credibility of Treasury which has been linked so closely to Rogernomics'. But even at that time, Lange's reply was at least formally protective:

> REPORTER: Can I put it to you that if a manager in a private enterprise made an error in his forecasting of that scale, he'd either be down the road or in receivership so quickly you wouldn't be able to see him. Why shouldn't that apply to Mr Scott at the Treasury?
> LANGE: Oh no, that is unfair to him because you see there was an inherent difficulty. If you have your estimates being prepared at a time when you haven't even got your tax flow data, it's not surprising that you get problems.[119]

As the political commentator John Roberts wrote in 1987, 'Treasury's dominant position is not evidence of a covert bid for power by unscrupulous bureaucrats. Each step in the chain ... has been an instance of deliberate political choice. Treasury is at the centre of the process because it suits politicians that it should be.'[120] Lange himself was to say later that he didn't 'blame Treasury ... I have more respect for Treasury than I have for the Labour Party, in the sense that they were a consistent, cohesive ... group of people that exercised strength and muscle and an all-pervasive right to go to the Prime Minister to achieve their end'.[121]

One clue to the consistency of the government's response to Treasury's advice

lay in the political economy. Just as before the Depression, financial interests shaped political outcomes. In the decades between these two eras, the government's management of monetary conditions had reduced the power of these interests within New Zealand. Treasury had argued for the liberalisation of financial markets on efficiency grounds — that resources would be better used — but liberalisation also conferred power on the participants in those markets to shape the environment within which the government made monetary and fiscal policy. That this was always the case internationally had been painfully emphasised in 1939, during the oil crises, and with the downgrading of New Zealand's credit rating by an international lending agency in 1983. Now it was also true domestically:

> The shock to the economy from the stock market crash worsened a fiscal situation that was still weak, notwithstanding the improvements that had been made from 1984 to 1987. From then on, any bad news in fiscal policy, as on several occasions, was quickly translated into rises in interest rates, and the exchange rate, thus tending to slow down the economy. This was caused by the imbalance between fiscal and monetary policy made apparent because of the growing credibility of the newly independent central bank and the deregulated financial markets.[122]

In the early stages of the spat about Treasury forecasts in June 1988, a Treasury official attached to the New Zealand High Commission in London asked what he should tell financial interests in the City. When Prebble was dismissed from Cabinet on 4 November, the dollar dropped by nearly a cent against the US dollar.[123] Domestic investors too wanted tight monetary and fiscal policies, even if the short-term effects — high interest rates, unemployment — were unpalatable: 'Mr Caygill has likened the deficit to a black frost blighting the landscape ... [he] assumes that once business has confidence in the Government's direction, and knows that a lower deficit will bring lower interest rates, it will invest and the economy will grow.'[124] And Caygill stuck with the Reserve Bank Bill that Douglas had introduced, shepherding it through the House in 1989. Thus were two legs of the economic constitution tripod of the 1930s — the balanced Budget and the gold standard — firmly clamped on. The liberalisation of the financial markets was thus a much more profound change in the structure of the political economy than it may have appeared to be at first sight. As one economist put it, commenting in this instance on the floating of the dollar, 'the most significant effect of Roger Douglas' policies is not their medium-term impact on the exchange rate; rather, it is the institutional changes he has made that will make it very difficult for any future governments to reverse his policies.'[125]

The arguments for giving investors this power might have centred on the gains in efficiency that would result, but the power was there irrespective of whether or not the outcomes were efficient. When Douglas returned to Cabinet (albeit for only a few months until Palmer removed all the ministers who were intending to leave Parliament at the next election), the durability of the '1988 compromise' was underlined yet again. But that also meant that Treasury's rounded vision of economic management — which, in seeking fiscal balance and efficient outcomes necessarily addressed the social area — remained off-limits. So did reform of the labour market. Indeed, with respect to the latter, both the compact and the growth agreement that were negotiated with the Combined Trade Unions (CTU) in December 1989 and October 1990 respectively attempted to realise a version of the accord which had governed relations between the labour movement and the Labor government in Australia since 1983. The compact, recalls one of those involved in the negotiations,

> was a relatively sophisticated agreement — wage increases were to be tamed to 2 per cent, and everything else had to be explicitly backed by productivity gains. The Reserve Bank wasn't formally a party to the agreement, but there was a tacit understanding that they would ease monetary policy to create some employment impetus. And the government would engage the unions on industry policy and social policy in the budgetary process.[126]

But the government had no time to implement the compact before it was swept out of office by an electoral landslide to National. As for Treasury, some of its agenda remained unfinished, so the conversion of economic management into an economic constitution had some way to go.

1990 to 1993

The Labour vote fell by more than a quarter, from 878,000 to 641,000, in the election of October 1990. While some of the lost voters went to the New Labour Party or the Greens, National's vote increased from 806,000 to 872,000 — 48 per cent of the total. Would the new government introduce or permit an economic management regime that would address what Treasury saw as the oversights

back, Ball saw the new common ground between accountancy and economics as of crucial significance:

> In the financial reporting area, accountants had traditionally adopted the notions of historic cost, recording the actual price of the transaction, whereas economists wanted to look at the subsequent value or opportunity cost of that same asset. [But] over the past probably twenty years, the area of intersection has become larger. Some of the work in positive accounting theory has explained the reasons why accountants do things in the way that they do. That's been of interest to economists. And also, economics has taken a greater interest in information, and what gives accounting information value. I think that has led, amongst good accountants and good economists, to an understanding of the two disciplines as being very closely related, rather than being at odds.[140]

Scott and Ball also brought public-sector accountancy into line with private-sector practice. Tony Dale was a younger Treasury official who played a key role in the drafting of the Public Finance Act. After winning the CBA Young Accountant of the Year Award in 1992, he commented that 'if the award had been running five or six years earlier it is most unlikely that we would have seen public sector accountants being recognised in this way ... it is a recognition of the changes in the public sector part of the profession'.[141] Thus, whereas in the 1920s accountancy had been seen as the key professional skill, and in the era of economic management economics had assumed that role, now the two were combined. More accountants were recruited to Treasury, 'mainly from the private sector. We offered comparable remuneration. The State Sector Act allowed us to do that, and on a contract by contract basis.'[142]

Financial expertise was also central to the work of the SOE Advisory Unit. While Treasury was not prepared to be represented on the boards of SOEs, it could not be indifferent to their activities. The unit, which was administratively linked to Treasury, monitored the performance of the SOEs, its role being to provide the Minister of State Owned Enterprises with 'relevant, timely and independent advice in respect of his responsibilities' under the Act. In 1993 the Crown Company Monitoring Advisory Unit (CCMAU) assumed the tasks of the unit and two related bodies, the Crown Research Institutes Steering Committee and the Crown Health Enterprises Monitoring Unit. Like its predecessors, it was designed to 'monitor the performance of these organisations in terms of risks they might leave with the taxpayer'.[143]

credit rating from international credit rating agencies, such as Moody's. Peter Harris of the Council of Trade Unions argued that the fiscal responsibility provisions gave legislative authority to the current policy status quo and would constrain fiscal policy too narrowly.[14] But the bill passed, which strengthened National's commitment to the approach to economic management favoured by Treasury — including the emphasis on the distinction between 'fiscal' and 'economic' — and made it more difficult for a subsequent government to change course. The Fiscal Responsibility Act also strengthened the place of Treasury in government. Along with the Public Finance Act 1989 and the State-Owned Enterprises Act 1986, it was one of the relatively few acts that the Treasury administered; along with the Public Finance Act, it was also one under which it operated. The obligation to prepare the published six-monthly economic and fiscal updates entrenched Treasury's role as the government's financial and economic adviser.

The economy began to recover from the second half of 1991. The resulting revenue gains (coupled with the 1991 expenditure cuts) facilitated the attainment of the government's fiscal goals. A small surplus in the public accounts in 1993/94 was followed by much more substantial surpluses thereafter. It was predicted that the government would have no net foreign currency debt by the end of the 1996/97 fiscal year.[15] Birch recalled that Murray Horn, who became Secretary to the Treasury in 1993, like Birch himself, 'took a keen interest in getting the debt down. The two of us made a very strong commitment to getting the public debt down. It was at an unsustainable level when we took office.'[16]

The political climate was much less conducive to an acceleration of microeconomic reform; indeed, some critics argued that the reform process stopped when its momentum should have been maintained.[17] Senior Treasury managers agreed in April 1995 with the conclusion of an in-house paper that there was 'substantial potential for catch-up' by New Zealand with other countries in areas such as reducing tariffs, education, the labour market and immigration.

The paper speculated that attitudes, aside from those of the business community, were not conducive to growth.[18] Whether or not that was the case, public-sector reform in particular proceeded neither as far nor as fast as some argued for. The welfare state was not dismantled, and the pace of privatisation slowed. This partly reflected the fact that many of the biggest potential sales had already taken place, but it was also a response to political sensitivities. When Consumer Coalition 93 opposed the sale of Electricorp, 'Bolger, always the pragmatist went cold on the proposal', although the SOE was split into two parts.[19]

A sardonic view of Bill Birch's 1996 tax cuts. Malcolm Walker, Alexander Turnbull Library, H-258-001

Public opposition to privatisation did not wane in the new parliamentary t
The sale of the Forestry Corporation provoked the Alliance party to camp
for an indicative referendum on the subject in 1996; a petition secured 242,
signatures.[20]

Tax reform was one area in which common purpose survived. A Trea
review of the relationship between taxes and growth early in 1992 noted th
strategic decision had been taken in the early 1980s to move towards a b
based direct income tax and an indirect expenditure tax ... Since that time
focus had been on achieving that objective in an increasingly open and dyna
economy'. One preliminary 'key message' of the research was that 'there
little in the theoretical or empirical material' to suggest that New Zealand sh
'move away from its "broad base, low rate" approach'.[21] On his side, Bi
enthusiasm for lower taxes was sufficient to make low and stable taxes a
economic strategy. Tax reductions and related social policy programmes
announced in February 1996, just nine months before the next election.
bottom tax rate was to be reduced from 24 cents to 19.5 cents, and the next f
28 cents to 21 cents, in two stages — a move which matched Douglas's re
tions in the top rates between 1986 and 1988.[22]