THE 1982 - 84 REVIEW OF EXPORT ASSISTANCE - PROBLEMS WITH PARADIGMS

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Unless otherwide specified, all views in this paper are my own and I am responsible for conclusions reached and recommendations made.

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1. Introduction

For some time now, export incentives to non-traditional exports have been an essential part of the Government's development strategy to restore sustainable levels of growth to the economy. New Zealand has had an indifferent record of growth in the 1950s and 1960s and over the last half decade of the 70s, growth has averaged less than 1% per year or under a third of the OECD average. This persistently bad record was not because governments of the day gave growth little priority in their programmes.

It has been long thought that the major barrier to economic growth is the balance of payments or foreign exchange constraint. The term 'foreign exchange constraint' alludes to the supposedly critical dependence of New Zealand on imports of raw materials (especially oil:) and capital equipment to increase the productive capacity of domestic producers. 1. Too often it seemed, economic growth grounded to a halt as payments for imports pushed ahead of export earnings. This leads to the suggestion that the main way to raise growth performance is to raise the rate of growth of exports and thereby relax the balance of payments constraint.

Export incentives had their origins in the early 1960s as a perceived means of encouraging the growth of exports in non traditional areas and of coping with balance of payments problems. Again, following a severe downturn in the external accounts in the mid-seventies new incentives were introduced to encourage rural output (SMP's) and alternative incentives introduced for the manufacturing and services sectors.

Despite a wide range of generous schemes over this period, growth performance has remained mediocre and balance of payments problems have persisted. Instead, export incentives have been seen as successful in terms of significant increases in non-traditional exports. From a base of close to zero in the early 1960s manufactured exports have increased to around

25 percent of the total value of New Zealand exports.

During these years the Government was firmly committed to a policy of actively encouraging non-traditional exports "as recently as 1979 the main question relating to export incentives would have been about what class of items was to be added next to the list of qualifying goods. In 1979 both main political parties were still advocating more generous allowances.[1]"

However, in the early 1980's the Government entered into a number of international commitments which made it extremely difficult, if not impossible to continue the major schemes in their present form. Under the CER agreement with Australia, performance based incentives were to be phased down from 1985 and eliminated in trans-Tasman trade by 1987. As well upon becoming a party to the GATT code on Subsidies and Countervailing Duties in 1981, New Zealand undertook to bring specific export incentives schemes into conformity with the Code within a reasonable period of time. In an exchange of letters, the United States provisionally recognised New Zealand's adherence to the Code on the basis of its expectation that our schemes would be brought into conformity with the GATT Code no later than their legislative date of termination on the 31 March 1985.

Thus, in early 1982 a working party of departmental officials from the major economic departments (Treasury, Trade and Industry, MAF and Prime Minister's Department) commenced a comprehensive review of New Zealand's current forms of export assistance. Their objective was to devise alternative means of maintaining exporters' profitability given that, in the light of New Zealand's international obligations, there would be considerable difficulty in maintaining the main forms of current assistance in the future. Although the international undertakings were to have a significant impact on the review, and could be regarded as external constraints on policy options, 1982 would have been a time for a review anyway since the main incentives were legislated to expire in 1985. Both the export performance taxation incentive (EPTI) and the export market development taxation incentive (EMDTI) were currently due to expire on 31 March 1985.

There were a number of concerns with the schemes themselves. They had come to involve a substantial fiscal cost at a time when a major priority is to reduce the fiscal deficit. One study has estimated the cost to have been around $400 million in 1980/81.[2] With a rapidly expanding base of non-traditional exports, the outlook in terms of fiscal cost was one of rising Government expenditure in this area. As well, there are substantial costs involved with administering and complying with the provisions of the various schemes themselves and the possibility of abuse through false declarations.

While the incentives had contributed to a growth in exports of a non traditional nature, there were inevitable problems associated with such techniques. They are at best palliatives that failed to address the basic problems. Thus, the review decided to go back to first principles in order to identify the broad arguments for assistance.

This part of the policy-making process is sometimes called problem-structuring or conceptualising the problem and is no doubt one of the most crucial but least understood aspect of the process. It often involves what Wildawsky[3] calls redefining the problem and if one can alter conceptions of what is problematical.....an entire series of actions may be affected.[4]

A new perspective emerged from the analysis of the policy issues. Although in the past important themes had been diversification of exports, providing an alternative to devaluation, increasing growth through exporting and easing the 'foreign exchange constraint', implicit throughout had been the idea that assistance was necessary to redress the relative ability of exporters to compete for resources. High levels of protection (especially through quantitative restrictions) promoted production only for the domestic market. Resources were therefore drawn from the export sector to be used in some instances with less efficiency behind trade walls. It was in this context that three broad arguments for the provision of assistance to exporters were identified.

- assistance designed to reduce the disadvantages to export arising from the high levels of assistance provided by protection to import-substituting activities.

- assistance to encourage the performance of certain export related activities (e.g. promotion) where it was considered that market incentives alone would result in an inadequate level of activity.

- measures which attempt to mitigate some of the cost disadvantages imposed on the internationally competing sectors such as the costs associated with internal transport regulation or in the operation of finance and insurance markets.[5]

The review concentrated on the first two issues. While exporters may at times be particularly disadvantaged by the cost excesses through for example the regulations in favour of rail transport, measures to correct them involved considerations wider than those encompassed by the review.

In many ways this review was unlike any other. In contrast with the review which led to the establishment of the EPTI in the 1979 Budget, the scope of this occasion covered all export activities. As the Agricultural Economist pointed out 'the review is focussing on the whole economy, rather than particular sectors, be they manufacturing, agriculture, retailing or whatever.[5]

Secondly, since export assistance is seen as part of the whole assistance structure, the review was not taking place in a vacuum, but rather within the context of the medium term assistance policies which the Government had been implementing. In protection reform these have focussed on progressive shifts from import licensing to tariffs, and moving to a more uniform protective structure while at the same time maintaining a reasonable level of protection overall. Thus again, in contrast with the previous exercise the orientation was not necessarily towards the replacement of one set of schemes with another, but in line with long term assistance policy in general.

However, what was to prove the most notable feature of this review (and of importance to public policy-making) was the change in conceptual framework around which participants debated the policy issues. The consequence of change was most apparent when submissions were called for from interested parties indicating what they saw as the form that alternative support measures should take. Very few addressed directly the issues as officials saw them. There was, by some interest groups, outright rejection of the new framework in favour of past considerations, even though the Government's view had been set out in several policy statements. As the 1982 Budget stated:

'The chief purpose of the export incentives is to compensate exporters for the high costs they face because of import protection. Export incentives are intended to be temporary in nature, designed to provide relief for exporters as the Government sets about correcting their artificially high cost structure.'[6]

It was evident that large sections of the community still regarded assistance to exports (and protection of import-substituting activities) as necessary to achieve balance in our overseas transactions and relax the so-called 'balance of payments' constraints on growth and employment. While balance of payments and assistance policies clearly have linkages, the former does not affect the efficiency with which resources are allocated among different activities within the economy, whereas the fundamental issues addressed in the review related precisely to that question. Thus, the linkage between protection and export assistance was central to the review of export assistance. What matters for efficiency of resource allocation and therefore the level of national income that can be generated by a given pool of resources, is relative levels of assistance among different activities. In the environment ofa small country such as New Zealand in which the prices of internationally traded goods i.e. exportable and importable goods, are determined largely on world markkets it is reasonably safe to assume that differences in relative levels of assistance among industries or activities will enable the highly assisted ones to attract resources from lowly assisted ones and shift the allocation away from that which would generate the highest levels of national income. The protection/export assistance linkage is simply a part of this general proposition i.e. if high levels of assistance to import competiting firms are provided by protection, the ability of export firms which do not receive such assistance to attract and hold the resources necessary to expand their production and export will be reduced. Recent analysis suggests deeper problems of economic structure and efficiency with which resources are used are the major constraints on growth. The balance of payments problem is more a symptom of these weaknesses.

The purpose of this research paper is to draw on the analysis by Thomas Kuhn of 'scientific paradigms' and relate them to frameworks or perspectives in public policymaking. We will see that frameworks guide both the range of questions to be asked and the solutions to be considered. In sections II and III the perspective underlying both the introduction of export incentives and the recent review will be addressed with a view to highlighting a feature of Kuhn's analysis involving the change from one 'paradigm' to another. A shift has such far reaching effects that it amounts in Kuhn's terms to a revolution. For a period, adherents of the two perspectives may be competing for the allegiances of their colleagues. Thus there will be indirections and lags for the new perspective to become relevant to all the participants in the policy-making process.

The following section discusses these points in more detail.

1. Michael Melton "How worthwhile are export incentives"? The Agricultural Economist Vol. 2 No. 3 1981 p.24

2. Syntec Economic Services Ltd : Structure of Industry Assistance in N.Z. an Exploratory Analysis p. 109

3. A. Wildavsky, Speaking Truth to Power: The Art and Craft of Policy Analysis, Little, Brown, 1979.

4. Ibid p.57

5. See Report of Departmental Officials (1983)

5. Editorial, The Agricultural Economist Vol 4 No. 4 1983

6. The Budget, 1982 p.10

Section I

2. Conceptualising the Problem

Lindblom and Cohen[1] have observed a convergence among policymakers similar to convergence among scientists on analytical frameworks such as what Thomas Kuhn calls 'paradigms'. That is, 'policymakers attack specific problems in the light of a general framework or perspective that controls both explanatory hypotheses and range of solutions that they are willing to consider'[2].

The term 'paradigm' has received wide currency through Thomas Kuhn's influential book 'The Structure of Scientific Revolutions'[3]. His basic concept of the scientific paradigm, although never explicitly defined, clearly refers to the body of presuppositions and beliefs held by the scientific community at any particular time. The presuppositions can be thought of as rules implicitly governing the choice of 'admissible' problems and the 'correct' standards of evaluating the solution of such 'legitimate' problems. A paradigm, such as Newton's work in mechanics, implicitly defines for a given scientific community the types of questions that may legitimately be asked, the types of explanation that are to be sought, and the types of solutions that are acceptable. It moulds the scientists' assumptions as to what kinds of entity there are in the world (Newton was interested in matter in motion) and the methods of enquiry suitable for studying them. 'Some accepted examples of actual scientific practice - examples which include law, theory, application and instrumentation together - provide models from which spring particular adherent traditions of scientific research'[4].

Normal science, says Kuhn, consists of work within the framework of a paradigm which defines a coherent research tradition. Scientific education is an induction into the habits of thought and activity presented by text books, and an initiation into the practice of established scientists. It leads to the acquisition of a strong network of commitments, conceptual, theoretical, instrumental and methodological. Paradigms illustrate ways of attacking a problem because they determine the way a scientist sees the world. Therefore they guide the direction of research which is 'an attempt to force nature into the preformed and relatively inflexible boxes that the paradigm supplies'[5].

Like solving a puzzle or playing a game of chess, normal science seeks solutions within an accepted framework; the rules of the game are already established. A shared paradigm creates a scientific community - a professional grouping with common assumptions, interests, journals and channels of communication.

Kuhn, according to his critics portrayed scientific choice as subjective and relative to particular scientific communities. His book gave historical illustrations to the claims that:

> all data are theory-laden; there is no neutral observation-language;
>
> theories are not verified or falsified; when data conflict with an accepted theory, they are usually set to one side as anomalies or else auxiliary assumptions are modified;
>
> there are no criteria for choice between rival theories of great generality, for the criteria are themselves theory-dependent.

His analysis has a number of implications for both social science in general and policy analysis in particular. If one accepts the analogy that rational processes in the social sciences are similar to rational processes in the natural sciences, then social science also deals in paradigms. Burrell and Morgan[6] have identified four distinct sociological paradigms - radical humanist; radical structuralist, interpretive and functionalist - which define fundamentally different perspectives for the analysis of social phenonema.

It is their contention that 'all social theorists can be located within the context of these paradigms according to the metatheoretical assumptions reflected in their work'.[7]

In the public policy process these paradigms have exactly the same effect as an ideology or world-view of a policy problem. According to one commentator 'an ideology is a value or belief system that is accepted as fact or truth by some group. 'It is composed of sets of attitudes toward the various institutions and processes of society. It provides the believer with a picture of the world both as it is and as it should be, and, in so doing, it organises the tremendous complexity of the world into something fairly simple and understandable'[8]

To illustrate the importance of world-views or ideologies in conceptualising problems, consider the various ways to define the problem of poverty. Poverty may be defined as a consequence of accidents or inevitable states of society, of the actions of evil persons, or of imperfections in the poor themselves. These definitions of poverty contain elements of a world-view or ideology insofar as each involves a selective perception of elements of a problematic situation.

Again, for some crime is a natural condition of all human societies while for others it is an understandable response to poverty and exploitation. The way we view crime as a problem depends on several factors. First different persons may agree that crime is a problem but disagree about the kinds of behaviours that constitute criminal activity. One person may define crime solely in terms of illegal acts against persons (homicide, armed robbery, rape) while another may focus on illegal acts involving property (theft, fraud, embezzlement, government corruption). Second, people may also disagree about the kind (class) of problem represented by criminal activities. Some persons see crime as an economic problem - one whose potential resolution lies in restructuring the production and distribution of goods and services in society - while others see it as a social, psychological, or administrative problem which may be resolved by providing greater opportunities for social mobility, by changing attitudes through education, or by strictly enforcing existing criminal laws. Generally, the way people classify a problem determines the way they will explain and attempt to resolve it. As Rittel and Weber suggest:

> "To find the problem is thus the same thing as finding the solution, the problem cannot be defined until the solution has been found."[9]

The perspectives of analysts themselves, as far as those perspectives are conditioned by the prevailing paradigms of social science, are ideological. This ideology leads the analyst to direct his inquiry to certain sources and ignore others or to alter the weights of various factors according to the perceptions of reality reflected in his model.

According to Lindblom and Cohen policy-making frameworks can be strongly influenced by perspectives or paradigms in social science. But if natural science can be taken as a guide, the accepted perspectives of one age may be the object of ridicule in a succeeding era. Kuhn points out that rational orderings of phenomena have changed over time. Newtonian physics has given way to Einstein's relativity physics which gives a vastly different perspective on the problems in physics than did the earlier view.

This research paper is about such a change in policy-making frameworks. As the set of anomalies grow, a sense of crisis may lead policy-makers to examine their assumptions and search for alternatives. Old frameworks become redundant in that they cannot offer answers to new and pressing questions. A new 'paradigm' may then be proposed which challenges the dominant presuppositions.

Kuhn shows that when a major change of paradigm does occur it has such far-reaching effects that it amounts to a revolution.

Paradigms are incompatible. A new paradigm replaces the old; it is not merely one more addition to a cumulative structure of ideas. A revolution from Aristotelian to Newtonian physics, for instance, or from Newtonian physics to Einstein's relativity theory, is a transformation of the scientific imagination in which old data are seen in entirely new ways. For a period, adherents of two different paradigms may be competing for the allegiance of their colleagues and the choice is not unequivocally determined by the normal criteria of research. Kuhn writes:

> "Though each may hope to convert the other to his way of seeing his science and its problems, neither may hope to prove his case. The competition between paradigms is not the sort of battle that can be resolved by proofs ... Before they can hope to communicate fully, one group or the other must experience the conversion that we have been calling a paradigm shift."[10]

Thus the implications for policy-making are that the shifts in the accepted perspectives of one age take time to be accepted as the norm in another. There are indirections and lags as the new perspective filters through to all the participants in the policy-making process to become accepted knowledge.

We can observe this process in what a former member of the British Civil Service, Sir Geoffrey Vickers[11], calls the 'art of judgement'. His central concept is that of 'appreciation' - his own word to describe the mixture of judgements about fact and about value which brings people to see a situation in a particular way and to reach a view about what action, if any, is needed. The existing situation can be interpreted, and alternative possibilities conceived, only within a given 'appreciative setting'. An appreciative system recognises a fact only when it bears an obvious relation to some value which it is conscious of, and cherishes at the moment. Conversely a blatant and repeated fact arouses a corresponding value connection sooner or later.

Vickers examines the effect of recognising that the actual state of affairs has come to differ significantly from the governing norm. A policy maker does not respond automatically, but 'appreciates' the situation in the light both of the information available and of value judgements. Vickers is indeed concerned with the need for timely educative changes in the appreciative system - 'educating' continuously through enquiries, reports and research. Every enlargement of the appreciative system simultaneously raises the 'ideal' as well as 'practical' norms of policy and often, though not always, increases the capacity of policy makers to meet them. Thus, changing the appreciative framework within which problems are perceived may do more than any other act to affect events in the future.

In summary, then, change from one perspective to another holds a number of implications for the policy-making process. For it is ultimately the perception of policy-makers and the public in general of a policy problem that determines what is done. Export assistance, for almost two decades, was perceived as a balance of payments strategy to encourage growth. One of the major concerns of this latest review was to establish a new framework that saw assistance as necessary on resource allocative reasons. However, previous commitments to the 'old paradigm' were to prove a stumbling block for any quick resolvement of the policy dilemma the Government faced: that's, how to meet the international obligations on the one hand, and avoid a movement that is adverse to the export sector on the other.

The next section outlines the past considerations that went towards the policy-making framework for both the introduction of export incentives in the early 1960s and the only major review in the late 1970s. The final section explains the new framework, the reasons for change and the subsequent attempts to find alternative schemes.

1 Lindblom and Cohen Usable Knowledge : Social Science and Social Problem Solving, Yale University Press 1979

2 Ibid p 77

3 Thomas S Kuhn The Structure of Scientific Revolutions, 1962, University of Chicago Press; 1962

4 Ibid p 10.

5 Ibid, p 24.

6 G. Burrell and G. Morgan, Sociological Paradigms and Organisational Analysis, London. Heinmenn 1979

7 Ibid p.10

8 L T Sargent Contemporary Political Ideologies Homewood, Illinas : The Dorsey Press 1972 pg 1

9 Horst W J Rittell and Melvin M Webber "Dilemmas in a General Theory of Planning", in Policy Sciences No. 4 pg 156

10 Kuhn (1962) p 147, 149.

11 Sir Geoffrey Vickers : The Art of Judgement. Chapman and Hall, London 1965

Section II

Balance of Payments Strategy - old "paradigm".

Export incentives have been an important element of economic policy in New Zealand for almost two decades. When they were first introduced in the early 1960s the objectives were many:

- to encourage diversification of New Zealand's export base;
- a proxy for devaluation;
- increasing growth through exporting and easing the 'foreign exchange constraint'.

The overriding need was to increase exports. The newly formed monetary and Economic Council observed in 1962[1] that:

> 'During the past decade or so, the New Zealand economy has earned the unfortunate distinction of having one of the slowest annual rates of growth of productivity among all the advanced countries of the world.'

They concluded that:

> 'In our view, shortage of overseas exchange is likely to be a serious bottleneck in any programme to achieve the objectives of higher living standards, faster growth, full employment, and reasonable stability of prices ...'

The diagnosis in the early 1960s therefore focussed on foreign exchange shortages. Export incentives had their origins at that time as a perceived means of coping with balance of payments problems. By the late 1950s this problem had become quite severe.

Although during the 1950s the country had experienced unspectacular growth and short term current account deficits, it was only following a severe downturn in the balance of payments in 1958 that serious consideration was given to the question of structural problems facing the country. In the latter part of 1957 and in early 1958 the terms of trade changed substantially to New Zealand's disadvantage and a serious depletion of overseas reserves resulted from the effects of heavy importing in 1957 and the fall in prices of main export commodities. To reduce overseas expenditure and arrest the drain on the reserves, the Government reintroduced comprehensive import controls and maintained tight fiscal measures to restrain demand.

However, when the Government came to examine the extent and nature of imports that could be reduced, they found the scope to be limited. A policy of adopting a protective structure comprising tariffs and import licensing to encourage industrial development, had created import dependence of a different kind. 'Dependence' upon imports for final consumption goods was replaced by 'dependence' upon imports for growth not only via the availability of capital goods but also for employment and output, because the newly established factories could not produce without imported intermediate goods and raw materials.

Therefore, although industry had developed, the economy was perhaps even more reliant on imports. In the 10 years from 1948 to 1958 imports had risen by an average of 4.7 percent in volume each year, exports had increased by only 2.0 percent annually. The favourable terms of trade had helped finance the high rate of increase in imports. When the terms of trade fell dramatically in 1958, diminished reserves and current export earnings in 1958, were insufficient to sustain the rate of importing for more than a few weeks.

On the export side, earnings were dependent on the sale on world markets of a narrow range of pastoral products. About 94 percent of exports were derived from the sale of farm products. Thus with its dependence on a few main primary exports, wool, meat and dairy products, the economy was liable to meet serious reverses when the terms of trade went against it.

The conclusions reached were that if New Zealand is to escape from the adverse consequences of its vulnerable economy, a higher rate of growth and development was needed. This meant that any further industrial development would require more imports and by implication a growth in exports. However, the expansion of traditional exports to present markets was highly unlikely (especially the prospect of the main market, Britian, becoming part of the EEC) while agricultural protectionism limited the number of markets open to New Zealand.

Some form of encouragement was therefore needed to boost exports of a non-traditional nature. It was evident that manufacturers were only interested in the local market and exported only production in excess of local demand. This, of course, was no coincidence. A policy of protecting the home market through tariffs and quantitative restrictions promotes manufacturing only for the home market. They do not promote manufacturing for export, indeed they tend to divert manufacturers from the export market to the more profitable home market. As well, given a policy of maintaining a fixed exchange rate over this period, domestic inflation and a desire to protect budding domestic industries interacted to produce an overvalued exchange rate. Potential exporters of manufactured goods consequently found themselves caught in a vicious circle. The exporters' price quotation was either not internationally competitive if calculated on the basis of the official exchange rate, or the price quotation, adjusted downward to the level of world market prices, would not yield the proceeds required to make exporting as profitable as selling domestically or even worse, to cover the production costs.

The conventional economists' recipe in these circumstances would be to devalue the currency and maintain tight control on domestic demand. Why was this apparently simple solution not adopted? Basically, because there have been doubts about its effectiveness in the New Zealand situation. The arguments have taken two main forms.

What devaluation really does is take income off those who buy imports of goods and services containing imports and hand it to those producing exports. The natural reaction of those groups whose effective incomes have been reduced is to endeavour to recover what they have lost. Thus wage and salary earners raise their wage demands and producers selling on the domestic market raise their pricces. In a more open economy, this process would be quickly brought to a halt by competition from imports. In large sections of the New Zealand economy, however, such competition does not exist, or is severely limited, so that wage increases can be passed on as price increases. The result is in lation and erosion of much of the intended benefit to exporters.

A reluctance to use exchange rate adjustment to promote 'non-traditional' exports may emanate as well from the fact that foreign demand for primary products which accounted for the bulk of New Zealand's exports is generally inelastic. Exchange rate depreciation under these circumstances is likely to lead to a fall in export earnings from primary products which may exceed the possible gains in the form of an increase in export earnings from manufacturers.

Therefore as Makin[2] found:

> 'New Zealand's international trade policy appears to have been based on the assumption that a substantial currency devaluation would contribute little to the solution of the country's long term balance of payments problems'.

In 1962 the newly formed group of official advisors, the Monetary and Economic Council argued against a devaluation and emphasised that:

> 'It is of the utmost importance that every effort be made to earn overseas exchange, in order that suppliers of

> material and equipment from overseas, which will greatly facilitate growth, may be increased as far as possible in step with the rise in population and labour force.'[3]

Thus they recommended:

> 'Encouragement can be given by Government to the promotion of exports through the tax system. Such incentives could take the form adopted by Australia, of an increase in the deduction allowed against taxable income in respect of expenditure on export promotion, although, administratively this would be somewhat cumbersome. Alternatively, income from exports, or increases in earnings of overseas exchange, could be treated somewhat more favourably for tax purposes than other income.'[4]

So to cut a long story short. This led to the announcement in the 1962 Budget of a 150 percent income tax deduction for export promotion expenditure and the Increased Exports Taxation Incentive (IETI) in the 1963 Budget.

The IETI had two important features. First, it was based on the increase in export sales over the average of three base years. Second, only those qualifying exports (non-traditional exports) with at least 15 percent domestic content were eligible. Exporters either qualified and received the full benefit or they did not. The 150 percent incentive on the other hand, offered assistance for marketing effort rather than sales achievement.

In subsequent years, changes were made to the incentive structure in order to reduce the anomalies that had arisen. As well, additional schemes such as export development incentives and grant schemes for the development of new markets had been introduced to supplement them. However it was not till a severe downturn in the external accounts in 1974 that the Government considered a major review of incentives.

The Government first announced in its 1975 election manifesto and confirmed in the 1976 Budget its intention to undertake a comprehensive review of the existing structure of export incentives. Its aim was two-fold:

- to consider the level and effectiveness of the current incentives in the light of their piecemeal development.

- to take a close account of the likely future requirements of exporters in response to the pressing need for correcting the long term balance of payments deficit.

Although the schemes had been effective in diversifying the composition of exports, balance of payments difficulties had persisted. Exports qualifying for the IETI had risen from around $10 million (around 3 percent of total exports) in 1963-64 to $650 million (just under 22 percent of total exports) in 1976-77.

Circumstances had therefore clearly changed. The pioneering phase was over and many companies were now firmly established in, and irrecoverably committed to, exporting. This had been, to some extent, recognised in ad hoc changes made to the IETI where the base period had been extended from the first three of the previous four years to the first three of the previous seven years and the rate of deduction lifted from an estimated 9 percent at the outset of 25 percent. But the IETI still discriminated between new and established exporters, to the disadvantage of the latter as new exporters generally worked from smaller average base years. The scheme, as originaly conceived was designed as an incentive which would naturally phase out as an exporter reached a plateau in his export development. It was therefore intended to help 'new' exporters more. It also did not directly reward net foreign exchange earnings because goods with high import content were favoured as well as goods with high local value added.

It was announced in the 1977 Budget that a new scheme was to be devised that would embody the following two principles:

- the incentive should be based on net foreign exchange earnings; and

- the incentive should be applied to a firms total exports rather than only to the increase in its exports.

The net foreign exchange earnings of an export is equivalent to the value added in domestic production which meant that the imported content (including capital) is not rewarded. In the calculation of 'domestic content' or value added a schedule was to be used to provide an estimate of net earnings from exports when applied to gross exports. The value added concept would also be based on the idea of a 'boundary'; those products receiving substantial assistance before, say, the farm gate would have this existing subsidy taken into account. Therefore it was envisaged that only the value added beyond this point (ie the farm gate) would be allowed for incentive purposes.

As well as rewarding net foreign exchange the purpose of the new scheme was to, at least partially, compensate exporters for the disadvantages they faced by having to produce export goods and services in the highly protected local market. The cost disadvantage suffered by New Zealand exporters is directly related to the New Zealand content of their exports - or more precisely, that part of the New Zealand content which cannot be purchased at world prices. This being the case, the argument is clearly in favour of uniform subsidisation in relation to value added, not in relation to gross value. However, in the light of the current balance of payments difficulties moves to reduce the cost disadvantages suffered by New Zealand exporters were not considered a viable option. Discussions with representatives of manufacturers therefore centred around replacements for the previous schemes.

Starting in late 1978, officials worked intensively with executives of the New Zealand Manufacturers Federation and its constitutent associations to develop practical proposals for implementing the principles enunciated in the 1977 Budget.

From the outset the Manufacturers Federation had fundamental criticisms of the proposed scheme. Under the IETI exporters of a particular product passed from a situation of receiving no incentive to receiving the full incentive based on the total increase in FOB sales as soon as that good is included. On the basis of the new proposed scheme those who may have been over-subsidised in the past (by doing minimum processing coupled with high value exporting) would lose some incentive with the scheme based on a high domestic content. By virtue of their position as representatives of manufacturers' interests they could not advocate any decline in welfare for the interests they represented. As well, Manfed felt that the schedule of domestic contents (based on inter-industry input-output tables 1972) did not establish with sufficient accuracy the domestic content of each commodity in a way which could be applied with fairness and equity to all units within an industry.

To overcome these objections two solutions were found. First, the existing incentives were extended to 1983 to enable exporters the choice of scheme. Second, joint officials and Manfed representatives met with various groups of manufacturers throughout New Zealand to show that the derivation of domestic content and incentive for their products was reasonably simple. This approach was viewed as extremely successful by both officials and the Manufacturer's Federation.

The new incentive, the Export Performance Taxation Incentive was subsequently announced in the 1979 Budget with exports of services and tourism brought into the scheme on the same basis as goods. The rate of incentive was to be 14 percent of the domestic value added in each dollar of net foreign exchange earnings.Those eligible for assistance were able to choose between the old and the new scheme until the former was due to expire in 1983. As well, assistance to export market development was channelled through two new schemes, the Export Market Development Taxation Incentive (EMDTI) and the Export Programme Grant Scheme (EPGS).

The impact of export incentives has proved difficult to measure. One independent analysis[5] suggested that by the late 1970s the volumes of qualifying exports were 22 percent higher than they would have been without incentives.

As John Whitehead[6] has noted 'these arrangements were clearly considered a success, not because the Balance of Payments deficits became any less frequent or severe, but because there were measurable and significant increases in the volumes of non-traditional exports'.

However overall export growth performance has remained mediocre. An analysis of the export growth performance of OECD nations over the 1960-1982 period shows that New Zealand's export volume growth has been one of the slowest of all 24 member countries. Over that period, the volume of New Zealand's exports (goods and services) inreased by a factor of 5.3 compared with an average for OECD members of 6.8 and a highest growth factor of 12.1 (for Japan). While New Zealands export growth has slipped a little relative to other OECD countries through the 1970s, it is clear from the OECD statistics that the problem of slower than average export performance had developed well before the oil price shocks of 1973/74 and the attendant terms of trade declines.

There is little dispute that an essential ingredient of any solution to the problems facing the government today i.e. high and persistent unemployment; an unsustainable external payments imbalance; little or no economic growth for some years, is an expansion of export volumes. But it is clear that the mix of policies adopted has not been sufficiently succcessful in meeting that key objective. More recent analysis suggests deeper problems of economic structure and efficiency with which resources are used are the major constraints on growth. The balance of payments problem is more a symptom of these weaknesses. If further growth of exports is to be achieved, more fundamental solutions were to be found.

1 Economic Growth in N.Z; Monetary and Economic Council Report No. 2; May 1962.

2 Kevin Makin 'Estimating the Effective Rate of Subsidy to Exports', Paper to N.Z. Association of Economists Conference August 1982, pg 1.

3 Monetary and Economic Council, Report No. 2, May 1962, pg 26.

4 Ibid, pgs 28-29.

5 Paul A. Wooding 'The Role of Export Incentives in NZ's manufactured exports to Australia' Paper presented to Australian and New Zealand Association for the Advancement of Science, 1982.

6 John Whitehead 'Export Incentives' paper presented to New Zealand Association of Economists 1983.

The 1982/84 Review of Export Incentives

Section III

Perhaps the most publicised reason which led to the decision to review export incentives was the two international undertakings entered into by the government. In 1981 New Zealand became a party to the GATT code on Subsidies and Countervailing Duties. The GATT Subsidies Code provides an Illustrative List of prohibited subsidies, which includes export tax concessions and other incentives of the type operated by New Zealand. New Zealand's acceptance of the Code was on the understanding that our existing incentives were not in full conformity with the Code and was subject to a commitment that they would be brought into conformity within a reasonable period of time.

At the same time, New Zealand entered into an Exchange of Letters with the United States under which the United States provisionally recognised New Zealand's adherence to the Code on the basis of its expectation that our export incentive schemes would be brought into conformity with the GATT Code no later than their date of termination, ie 31 March 1985.

New Zealand joined the GATT Subsidies Code primarily because a special problem had arisen in its trade with the US. The problem sprang from a quirk of history which related to the legal mechanics surrounding the imposition of countervailing duties (CVD's) in the US. Essentially this meant that the US did not have to establish injury to a domestic industry before imposing a CVD unless, either the product entered duty free, or the country of origin was a member of the GATT Subsidy Code.

The issue was brought to a head in 1981 when a CVD action was started against New Zealand lamb exports to the US. Fearing that a substantial subsidy element would be established and that this would be a precedent for the dominating trade interests of dairy products and beef, negotiations were made to provisionally apply the code to one another. In the US case this was based on an expectation that the New Zealand schemes would not persist beyond 31 March 1985

Although New Zealand did not acknowledge any commitment to fully conform to the Code by that date, the possibility of continuing the type of schemes, in the future would appear to be costly. In 1980/81 total exports were $692 million to the United States, one of our four largest markets.

As well under the Closer Economic Relations (CER) Agreement with Australia, New Zealand had negotiated in 1981 to phase out all performance-based export incentives on exports to Australia by 1987 and to commence phasing no later than 1985.

In addition, eliminated schemes are not to be replaced by other measures having similar trade distorting effects no new performance-based export incentives are to be introduced, and existing schemes are not to be expanded.

A dilemma existed therefore between meeting the international obligations on the one hand, and avoiding a movement that was adverse to the export sector on the other. As one report highlighted

'Manufacturers have come to depend on incentives for their export effort at the same time as the Government has entered into international commitments which make it extremely difficult, if not impossible' to continue with them in their present form.[1]

The question that needed to be addressed was why were these exporters dependent on subsidies to export? What was the nature of their problem?

The new 'paradigm'

Two main justifications were found. One was based on a protection compensation rationale and the other on market failure grounds.

Protection compensation

Essentially, the change in perspective can be likened to a change from a macro to a micro view. Instead of balance of payment problems, analysis concentrated on individual operations and found that 'The chief purpose of the export incentives is to compensate exporters for the high costs they face because of import protection'. 1982 Budget.

This means that the provision of export subsidies at rates similar to protection for the home market (in the form of tariffs and import restrictions) would lead producers to choose between selling to the home market and selling for export on the basis of relative returns. Accoring to Rob Cameron[2] what is at issue is 'the ability of different activities in the economy to attract and expand their use of resources is affected by the structure of assistance within the economy'.

Import protection is one such form of assistance. Imposing tariffs and quantitative import restrictions on a wide range of imports stimulates the production of import competing goods and drawing into such industries resources from the export industries which might have the potential to export. The aim, therefore of export subsidies may simply be to offset the diabilities imposed by these various devices. What are these disabilities and extra costs?

It has not been until recently that a framework for estimating the net protective effect of a countrys' entire set of import restrictions hs been developed.[3] In effect, this method illustrates the point that had been known all along, namely that a tax on imports is a tax on exports. The broad outline is as follows. We can divide domestic production into three classes - import substitutes, exportables and non-traded or home goods. Perhaps the most easily identifiable, although not necessarily measurable, is that direct input costs are raised. Imposing protection raises the prices of imports and, with a lag, import-competing goods. The difference between the domestic price and the equivalent world price is a cost to producers who use these products.

We now pursue the adjustments set in motion by this change. Imports are now more expensive so consumers shift part of their expenditure to import-substitutes, home goods and exportables. The increase in the price of import-competing goods increases profits, inducing firms in that sector to expand by bidding, labour and capital away from industries producing home goods and exportables. Both effects cause the price of home goods to rise. The same pressures affect the export sector, but world market competition prevents prices of exportable products from rising. The resulting decline in profits makes it difficult for the export sector to hold on to all the factors of production it was employing, with the result that most of the expansion of the import-competing sector is at the expense of the export sector. Any gains in the sector producing import-substtitues are thus offset by losses on the export side. Therefore, it can be seen that protection which enables some industries to maintain a large scale of operations than would otherwise to possible is 'paid for' by unintended and undesired shrinkage of other industries.

The Export Performance Taxation Incentive (EPTI)

The analysis that assistance to exporters has been justified in order to redress their relative ability to compete for resources had been set out in several government policy statements since the 1981 Budget and underpinned officials' analysis of proposals for export assistance.

The larger part of export assistance (notably the Export Performance Taxation Incentive - EPTI) reflects this. The EPTI has the distinct advantage of compensating qualifying exporters to some extent for the cost of protection in a relatively uniform way. The cost disadvantage suffered by New Zealand exporters vis-a-vis their overseas competitors is directly related to the New Zealand content of their exports - or more precisely, that part of the New Zealand content which cannot be purchased at world prices. Under EPTI, incentive payments are based on a graduated scale where the incentive payment is determined by the level of domestic value-added undertaken in each activity.

But assistance of this type can be seen to be inappropriate or inadequate for the following main reasons.

Fundamental criticism of the assistance compensation approach concerns the argument that there are certain 'unalterable' production and consumption distortions resulting from government interventions to restrict imports and that we should attempt to 'compensate' for them. However it is not clear which if any distortions are 'unalterable'. There is no reason why any particular pattern of protection (or industry assistance in general) need be regarded as permanent as government have the ability to modify the protective structure. On economic efficiency grounds the long-run objective should be the removal of these distortions.

The argument for compensatory assistance is that it may improve resource allocation and increase national income by drawing resources out of highly assisted import competing activities into relatively lowly assisted export activities. It is a reasonable presumption that activities which can operate with relatively low levels of assistance are more efficient than those which need high levels of assistance to be profitable. However, there is no hard evidence available to show whether, under the current structure of industry assistance in New Zealand, assistance to exports draws resources from highly assisted activities and thus improves the efficiency of resource use.

The difficulties with information make it impossible to determine the optimal level of assistance compensation. The current strategy with the EPTI is to provide uniform assistance (support to value added) to all qualifying export activities. However this option does not achieve uniformity because the effective rates of protection (ERPs) vary widely in the importables sector (some are negative, some are extremely high); and domestic excess costs of protection probably also vary widely in the export sector. As the report on the structure of industry assistance in New Zealand[4] found, the structure of New Zealand's protective measures, particularly import licensing, makes it difficult to track down its effects and offset them.

Finally, the costs of operating compensation mechanisms are clearly higher for both the Covernment and the private sector by comparision with a situation in which exporters operate in an environment with lower protection.

Although these do not exhaust all the possible arguments against selective export subsidies designed to compensate for protection, it is evident that in terms of economic efficiency they represent a second best approach compared with the option of attacking the primary protection distortion. The Government's assistance policies clearly involve a progressive movement towards lower, more uniform, tariff-based protection. The present compensatory assistance measures (ie EPIT) could therefore be seen as transitional measures, to offset, at least partially, the bias against exports caused by the current assistance structure while this movement occurs.

Market Failure - Export Market development and promotion assistance

The justification for assistance in this area is quite clearly separate from the other needs of exporters, ie the protection compensation argument. New Zealand has two schemes - a tax based scheme, the Export Market Development and Tourist Incentive (EMDTI) and a suspensory loan scheme, the Export Performance Suspensory Loan Scheme (EPSLS) which replaces the former grants scheme. As well there is further support for exporters in forms such as the Trade Commissioner service and trade fairs.

The forerunner of the EMDTI was the 150 percent tax deduction for market development introduced in the 1962 Budget. At the time of its implementation in 1962 the 150 percent deduction was the only incentive offered to exporters by the Government. It was at a time of minimal 'non traditional' exports and it was clear at that time, that any future development of this nature would depend heavily on the need to establish initial contact with overseas markets. The 150 percent was therefore designed to offer assistance for marketing effort rather than sales achievement.

At the time of the review of export incentives in 1979, officials sought to abolish the predecessor of the EMDTI. First, it was recognised that the introductory phase was past and that New Zealand producers had had increasing exposure to world markets. As well, officials who participated in the 1979 review were told of widespread abuse of the scheme including instances where collusion had been reported between New Zealand exporters and overseas agents to inflate the charges for services rendered.

Despite these charges, the proposal was met by adverse reactions from interest groups. Instead the 150 percent deduction was changed to a 67.5 percent tax credit and eligible expenditure was cut back slightly.

The 1982-84 review identitied the following as basis for government involvement. [5] Underlying government assistance in this area was the belief that without such support New Zealand exporters would not engage in sufficient promotional activity. A subsidy to this element in the cost of exporting has been justified on arguments concerning the learning process or the market penetration process in selling for export. The opening up of new export markets requires an initial investment in the collection of information and the exploration of export opportunities, in learning the business of marketing, in creating sales contracts and goodwill. It is possible to argue that exporters should be subsidised temporarily in making this investment. They are 'infants' in exporting and they should be assisted while they are growing up.

However the 'infant marketing' argument is subject to a proviso and should therefore be treated with caution. If the benefits from the learning process in marketing, or from the investment in goodwill go only to these exporting firms which actually make the investment - that is, if the benefits are internal to the firms, then there is in general no case for subsidisation on 'infant' grounds.

Thus, the justification for government intervention clearly rests on the view that such activity may involve market failure resulting in a divergence between its private and social benefits and that consequently a sub-optimal level of activity may be undertaken. This 'under promotion' by exporters could result from either or both of the following:

- information deficiencies because the individual exporter cannot capture the full benefits that his knowledge gives to other exporters and/or

- external benefits of export promotion. If it is difficult for the producer to differentiate his product (eg all New

Zealand food exporters reinforce one anothers' marketing) then other New Zealand producers benefit if he undertakes promotional activities.

It should be remembered that the market failure rationale for government intervention is not unique to this area. A divergence between private and social rates of return can provide a rationale for government involvement in many areas of the economy for example, in the area of pollution control.

Before any policy conclusions could be drawn from this analysis, a number of issues were addressed. For instance, how widespread are the external benefits, and are they spread over the export sector as a whole? Are they likely to persist or are they essentially temporary in nature? Given that a market failure exists, can firms be left to internalise the benefits of promotional activity without government involvement? It was essential to realise that since export promotion is only one element in the current cost of exporting, an overall subsidy to this element could bias the pattern of expenditure by exporters towards wasteful activity.

In theory the degree to which information becomes a source of market failure is based on the extent to which information (gathered by an individual agent) contains public as opposed to private good properties, ie an inability to exclude non-contributors from consumption of the good. This will depend on

- the nature of the product or industy

- the ability of the industry to internalise benefits from information gathering and provision

- the degree to which the market has already been developed by New Zealand exporters

The importance of external benefits as a source of market failure will also hinge on the following:

- the nature of the commodity involved, that is, the more differentiated the less likely its promotion will confer external benefits;

- the ability of exporters who export similar products to market their product jointly, ie NZ Meat Board; NZ Dairy Board;

- the degree to which the market has already been developed by New Zealand exporters, ie through just being a 'New Zealand product".

The overall conclusion from this analysis was away from general types of subsidy towards more selective forms of assistance. Both the general nature of the Export Market Development Taxation Incentive (EMDTI) and the high level of assistance (around $35 million in 1981-82)[6] would tend to suggest that at present government assistance can not be justified on market failure grounds.

It may be politically convenient to subsidise exports indirectly by reducing the costs of some of their inputs, rather than to increase through the operation of a direct subsidy, the exporter's return in national currency. Some disadvantages should, however, be borne in mind. A number of undesirable distrotions may be created which will lead to a net loss in real income. If exports are subsidised non-uniformily, the result may be, in effective rate terms, that the increase in net exports may not be obtained in the cheapest way. Distortions may be created between the use of different inputs and an industry's own primary factors of production, with the result that the subsidised inputs tend to be used excessively. These are general and well-known arguments.

Since export promotion is only one element in the current cost of exporting, a subsidy to this element could bias the pattern of expenditure by exporters, with the same effects as in the case of an input subsidy. Industries which are 'promotion - intensive' will be encouraged more than others, and industries might tend to spend too much on export promotion as compared with other ways of increasing exports, such as improving the quality of the product.

In reviewing the Australian marketing and promotion assistance, the Industries Assistance commission (similar to New Zealand's Industries Development Commission) made the following remarks:[7]

(a) there may be market failures of this type, but it is not clear that the benefits of government intervention exceed the costs;

(b) difficult to know how much under-promotion the Government should attempt to compensate for;

(c) as experience in exporting grows, the case for such assistance declines.

The Search for Alternatives

The main implications for policy from the overall conceptual framework were therefore seen as: the Government was committed under CER to remove export performance incentives by 1987. Further, there was an expectation on the part of the United States that New Zealand will bring export incentives into conformity with the GATT Subsidies Code by 1985. If these commitments were carried out in isolation there would be a significant reduction in the profitability of manufactured exports and a movement of resources towards more highly assisted, and generally less efficient production. Thus, in the absence of safisfactory replacements for the present export performance incentives which meet the international obligations the need for advances on the protection front is increased.

With a view to exploring ways of reducing the assistance bias in the light of these considerations, officials entered into discussions with various interested parties from the private sector. Submissions were called for outlining their suggestions concerning alternative methods for providing export assitance. Numerous alternatives to the EPTI were proposed. A more detailed examination of these proposals can be found, in 'Report by Departmental Officials' (1983). Essentially the conclusions reached by officials were that either the proposals did not assist exporters in particular, as does the EPTI (eg accelerated depreciation allowances, lower taxes on business income, devaluation, various input subsidies); or if they did, they were equally vulnerable internationally and less effective than EPTI.

However, what was fundamentally important was that no options addressed the assistance disparities issue between exports and import substitutes. It became evident that there was a genuine lack of understanding in the community concerning the conceptual framework that officials used as a basis for their review. The old framework concerning balance of payments problems dominated their considerations. Export assistance in this framework were necessary to expand involvement in exporting. If various schemes achieved this then they addressed the central issue which was to relax the so-called balance of payments constraint on growth and employment. As in Kuhn's analysis of a paradigm change, previous commitments to the old framework dominated most interest group's considerations.

If further advances in assistance policy were to be made, a greater understanding was needed of the conceptual framework and the Government's position.

Officials therefore entered into a series of discussions with representatives of manufacturers with a view to developing two proposals that had emerged from submissions. To a large extent there were no precedent or past experience. In the 1977 - 79 review in this type of discussions - officials and representatives debated the content rather than the range of schemes. However, it was hoped that greater understanding would be reached in the difficulties of designing alternatives to performance based incentives that are internationally acceptable and of the issues involved in the assistance debate in general.

The first was a scheme that had most of the characteristics of a direct/indirect tax switch. The other was a proposal called a restructuring incentive that originated from one of the Manufacturers' Federation submissions. The following is an account of the conclusions reached.

<u>Value-added taxation system (VAT) and export incentives</u>

One proposal[8] that achieved a great deal of attention, suggested that in effect, the introduction of a general indirect tax such as a VAT could replace the EPTI. In other words, exempting goods destined for export from such taxes would provide a subsidy to exporters in a manner similar to that of EPTI.

The question therefore arises: what is the significance of this exemption? Does it give special advantages to exporting or does it simply avoid a disability?

Since EPTI compensates exporters for the high level of protection afforded to many import-substituting activities it is not merely a substitute for a devaluation. A devaluation, if successful, benefits both exporting and import competing production. It tends to redistribute income towards exporters and home producers of imported goods away from importers and other non-export sector income earners. However it will not remove the existing bias between production for export and the domestic market caused by protection.

The introduction of a general indirect tax such as a VAT with border tax adjustments could have an effect similar to that of a devaluation of the currency. (Border tax adjustments impose a tax on imports at the same rate as that of the value-added tax while exempting goods destined for export from payment of the tax). If the exchange rate is not readily alterable, the use of border tax adjustments is a way of improving the balance of payments by encouraging both import competing and export production. However, as in the case of a devaluation, the bias between import-substitution and export production would continue to exist without some form of compensation as delivered by EPTI or reductions in import protection.

Another way of looking at it is by analysing the profitability of exporters under EPTI and under a VAT.[9]

In the simplified example the top set of accounts compare the relative profitability

No VAT But EPTI

	Exporter	Import Substitutes	Imports
Imports	50	50	100
Wages	30	30	
Profits	20	20	
Selling Prices	100	100	100
After tax profit (45%)	11	11	11
With EPTI (14% of value-added)	18 (11+7)		

VAT But Not EPTI

	Exporter	Import Substituter	Imports
Imports	50	50	100
VAT (10%)		5	10
Wages	30	30	
Profits	20	20	
VAT (10%)		5	
	100	100 ?	110
After tax profits	11	11 ?	

of a firm producing a good for export and a firm producing a good for domestic sale as an import substitute. For simplicity it is assumed that there are no tariffs or quantitative restrictions on imports. The import substitute therefore sells at the worl (imported) price. Before the EPTI is applied both firms earn the same profit. The EPTI then works directly to increase the profits of the exporter thereby effectively subsidises the exporter vis a vis the import substitutes.

Increasing the profitability of exporting vis-a-vis import substituting is the desired effect if 'compensating' for border protection is what is being aimed at. In practice border protection (through tariffs and in New Zealand's case, import licensing) allows the import substituter to raise his selling price above the world price thereby increasing his profitability. To bring the profitability of the exporter back in line with that of the import substituter protected by licensing, some sort of subsidy such as EPTI is required.

The second set of accounts shows the case if a VAT is applied with full border adjustment (a tariff on imports and a rebate for exports). The profitablity of the exporter is unaffected as he pays no VAT. The tariff on imports, however, raises the domestic selling price of imports. This means also the import substituter raises his prices and hence maintain his profitability. Applying a VAT therefore does nothing for the exporter. Compared with the situation without a VAT but with the EPTI the exporter is in fact worse off vis-a -is the import substitutes.

However the introduction of a VAT could have a number of benefits for exporters. The current systems of indirect taxes have arisen in an ad hoc fashion. Because of the methods of collection and documentation involved these cannot be fully rebated for exporters. To the extent that they are not rebated the exporter is disadvantaged. Therefore, the replacement of existing ad hoc indirect taxes by a comprehensive VAT which could be fully rebated would assist exporters.

A value added tax, or for that matter a switch from direct to indirect taxes has considerable merit from the point of view of general tax reform. The advantages that it might give to exporters however could not be regarded as a major argument in favour of introducing a value added tax or substituting it for income taxes.

Restructuring Incentive

In theory, the Manufacturers' Federation proposal termed a 'restructuring incentive' would be used to achieve a more uniform assistance structure in the manufacturing sector or the tradeable goods sector as a whole. It was originally conceived as a possible response to the international pressures for the removal of performance-based export incentives, but developed into a broader initiative related to providing a more uniform assistance environment for industry in general. This represented a significant advance in the Federation's thinking on industry assistance issues from previous discussions and seemed to indicate a willingness to grapple with the problems being addressed in the review.

In broad terms, the Federation's original proposal was for a subsidy to all domestic production of traded goods, both importable and exportable. In principle, such a production subsidy would have similar effects on competitiveness and resource allocation as an equivalent single rate tariff on imports (which protects importables production) coupled with a single rate subsidy on exports (which assists export production).

The Federation's original proposal modified this simple production subsidy concept in two important ways. First, in an attempt to take account of the existing tariff structure, the subsidy to domestic sales was to be correspondingly abated. In this form the proposal would raise all assistance to domestic producers up to the level of the most highly protected, who would receive a zero subsidy. Exports would get the full subsidy. A second modification, however, limited total fiscal assistance to the present level of the EPTI. Since this would effectively redistribute current fiscal assistnce under the EPTI across lightly protected importables as well as exports, the incentive to export would be much less than under the EPTI. The average level of assistance to the economy as a whole (protection plus subsidy) would be unchanged. To illustrate the scheme, suppose the rate of incentive were 10 percent of the domestic content of output. An exported good with a domestic content of 60 percent would receive a tax credit of 6 percent of gross output (ie 10% x 60%). A good with a 60 percent domestic content sold domestically and receiving nominal protection of 50 percent, by tariff only, would receive a tax credit of 3 percent of gross output (ie 10 % x 50% x 60%) - half the assistance given to the exporter.

Although assistance to exports would have been less than the present levels provided by the EPTI, assistance to many import substituting activities would have been increased, albeit with a discount for existing protection. Thus, the proposal would add to, rather than diminish, the present assistance bias against exports, although the increase in bias would be less than if the EPTI were not replaced at all. The scheme could still have been open to many of the same international objections as the EPTI.

To grapple with these difficulties further modifications to the original proposal were agreed to which would involve taxing highly assisted activities. Thus, production for the domestic market which was highly assisted by protection would actually incur a tax penalty rather than simply a lower subsidy rate. This formulation would also maintain the average level of assistance across all traded goods production. The objective, however, would be to achieve greater uniformity of effective rates of assistance*, ie a greater reduction in the bias against exports within existing fiscal constraints.

Each activity then, would be graded in a schedule according to its level of domestic context and level of protection. Accordingly activities which had a high level of domestic content and a low level of protection would receive tax credit while activities with the reverse attributes would pay a high rate of sales tax. As exports have no protection they would qualify for the maximum level of incentive. As well since it was assumed that there was to be no change in the current amount of fiscal support for the manufacturing sector exporters would be as well off under the scheme as they currently were with the EPTI.

Because the scheme would operate economy wide it could be formulated in a way which only indirectly related to export performance, and thereby, it was envisaged, comply more readily

* The concept of the effective rate of assistnce (ERA) is a generalisation of the effective rate of protection concept (ERP), familiar from the industry studies programme. The ERP is a measure of the assistance afforded an activity by border protection. The ERA measure broadens this concept in an attempt to measure the rate of assistance being delivered to an activity by other government assistance policies, as well as by border protection.

with our international trade obligations. Thus the proposal was to embrace two features in one package - the need to maintain current levels of assistance to exporters while shifting towards more uniform rates of assistance in the manufacturing sector. Its form could look something like this:

CCCN No	Product	Description	Domestic*(a) Content%	Rate of*(b) Protection	Tax Band
	Export Sales	Domestic Sales			
	Product A	65%	0	C	
		Product A	65%	15%	D
	Product B	75%	0	B	
		Product B	75%	7%	C

*(a)Information now available in Export Incentive Schedule

*(b)The problems associated with this measure are outlined later

A manufacturer would find the tax band for his product in the schedule. There would be an index explaining the banding, eg.

Band A	10% tax credit
B	5% tax credit
C	Zero
D	10% tax rate
E	20% tax rate
F	30% tax rate
G	40% tax rate

In the example above, a manufacturer of Product A would have Band C (pay no tax) on all his export sales and have Band D (pay 10% sales tax) on all his domestic sale. Then to calculate his net tax payable the manufacturer would simply apply the appropriate tax rates to export and domestic sales and calculate the net amount accordingly.

Theoretically, it would be possible to devise a tax-subsidy system which would 'compensate' for the present 'unalterable' product distortions in the economy. In this way resources would tend to be attracted to activities withe the greatest cost advantages given the prevailing pattern of relative prices. These resource movements and adjustments would occur not only between major sectors of the economy, but also, and equally important, within industries and even among commodities produced by one firm.

However in practice the scheme would prove to be unworkable.

Examples were developed to give a number of companies the opportunity to comment on practical issues raised by the scheme. Manufacturers' Federation representatives suggested that the plastics industry would provide a suitable case study, mainly because a large proportion of plastic products are subject to import licence tendering. Import licence tendering information is useful in the absence of data on world prices in estimating the assistance afforded by import licensing. A sample of plastic products were therefore used to illustrate how the proposed restructuring incentive might offset producers of selected plastic products if it were introduced.

Plastic products	ERA %*
Kitchen table utensils	123
Stoppers and closures	47
Plastic floor coverings - all kinds	27
PVC pipes	523
Collapsible tubes and nestable containers	90
Apparel	34
Polyurethane foam	47
Bathroom and toilet fittings and other household articles	128

* Effective Rate of Assistance Formulae

It is assumed that the Plastics Industry receives no assistance other than by border (tariffs and quantitative restrictions) protection.

The ERA formula can be expressed in a number of equivalent ways. The most useful for this example were:

$$(1)\ ERA = \frac{VA' - VA}{VA}$$

where VA' = Domestic value added with government assistance (in this case border protection)

VA = domestic value added without government assistance

$$(2)\ ERA = \frac{df - xdm}{1-x}$$

where df = nominal rate of assistance on output (in this case due to tariffs and licencing on final goods)

dm = nominal rate of assistance on inputs (in this case due to tariffs and licencing on importable inputs)

x = importable inputs to output ratio <u>expressed in world prices</u>

The effect the restructuring incentive would have on a firm's gross revenue was also estimated. The benchmark ERA used in the example is 40%. This choice was arbitrary and made for illustrative purposes only.

<u>Plastic Product</u>	<u>Tax/subsidy rates as percentage of total output</u>
Kitchen table utensils	22.2
Steppers and closures	(0.2)
Plastic floor coverings all kinds	(4.6)
PVC pipes	33.6
Collapsible tubes and nestable containers	11.6
Apparel	(6.1)
Polyurethene foam	1.9
Bathroom and toilet fittings and other household articles	21.1

From the working examples it became evident that the data requirements for the restructuring incentive would be formidable Estimates of ERPs and ERAs at a highly disaggregated level would be needed. It would not be adequate to band at a broad industry level because the present uneven structure of border protection means that ERPs vary widely even within industry groups. The example of plastics illustrates this point. Other factors which would frustrate the scheme's objective of delivering more uniform assistance would be the continued use of import licencing. A characteristic of import quotas is that they compensate protected activities 'automatically'. That is the effective rates of protection to these activities shift with changes in world prices, increased when world prices fall and vice versa. Changes in the world prices of licenced good would tend, therefore, to frustrate the restructuring incentives objective of delivering uniform effective rates of assistance. Information from the Syntec

Report on the structure of assistance in New Zealand, suggests that the difficulties of calculating detailed ERPs in this situation are probably insurmountable.

Finally, along with the possibly large administrative burden of operating a new system of taxes and subsidies, its international status could not be assured, especially vis-a-vis Australia.

Therefore to be administratively practicable, the restructuring incentive would require simplifying modifications which would substantially erode its capacity to achieve more uniform assistance to the production of exports and import substitutes in the absence of the present EPTI.

As well its tax drawback elements would be inferior in all respects to gradual and predictable direct reductions in import protection.

It was concluded by officials that from an economic viewpoint, the restructuring incentive was clearly inferior to more direct approaches to protection reform, that is movement towards lower, more uniform tariff based protection, in conjunction with phasing down assistance to exporters.

1 'Coming to Grips with Export Assistance' Industrial Business Magazine August 1984 p 7

2 R Cameron 'Competition for resources' Paper presented to NZ Institute of Agricultural Science 1983 p.1

3 See L A Sjaastad & K W Clements 1981 'The Incidence of Protection: Theory & Measurement', Paper prepared for the Conference on the Free Trade Movement in Latin America

4 Syntec Economic Services <u>The Structure of Industry Assistance in New Zealand</u>: An exploratory analysis. Feb 1984.

5 See Report of Department Officials (1983).

6 Syntec Report p 109.

7 Industries Assistance Commission : Draft report on Financing Promotion or Rural Products June 1976.

8 From the Business Roundtable submission to the Export Assistance Review.

9 Summary of unpublished paper by B Carrie, Department of Trade and Industry

Conclusion

Considering the intentions of the Government needed to be made well before March 1985 to reassure exporters, the review was lengthy and troublesome. Announced in the 1982 Budget, the Government still had not made any final decision by elections in July 1984.

The first part of this paper highlighted that in policy-making, as in the sciences, participants attack specific problems in the light of a general framework or perspective that controls both explanatory hypotheses and range of solutions that are considered. Over time these frameworks can change for a number of reasons. Problems may be seen in a new light. Old frameworks may not offer answers to new and pressing questions. As the set of anomalies grow, a sense of crisis may lead participants in the policy-making process to examine their assumptions and search for alternatives.

According to Kuhn, a framework or 'paradigm' change has such far-reaching effects that it amounts to a revolution. Previous commitments to the old paradigm mean that shifts in the accepted perspectives of one age take time to be accepted as the norm in another. To become accepted knowledge a new 'fact' must in Vicker's terms bear an obvious relation to some value which it is conscious of. Although the process of change may be indeterminate, a blatant and repeated fact arouses a corresponding value connection sooner or later.

The latest review of export assistance involved such a change. Initially, the review was triggered by a number of international obligations but was influenced mainly by domestic concerns. Most important of these was the continued search for economic growth. Export incentives had their origins in the early 1960's as a perceived means of resolving reoccuring balance of payments problems. Too often it seemed, economic growth grounded to a half as payments for imports pushed ahead of export earnings. Thus, the dominant theme in this framework was the commitment by the Government to actively encouraging through subsidies and other incentives a policy of export led growth.

Despite a range of schemes, regularly revised, both export and growth performance remained mediocre and balance of payments problems have persisted. More recent analysis suggests this is no coincidence. In this new perspective both exports and growth are inhibited by deeper problems of economic structure which hinder the efficiency with which resources are used. Balance of payments problems are merely a symptom of an underlying structural fault.

As the report on the structure of Industry Assistance in New Zealand emphasised:

"Industry assistance affects efficiency because it discriminates between economic activities. Providing one activity with more assistance than others means that if is advantaged relative to others in its ability to attract and hold resources - including labour and capital .... A relatively high level of assistance for an activity is usually indicative of inefficient resource use." (p. 6)

Therefore high and sustained levels of economic growth can only come about if the resources of the economy are consistently directed into those activities which produce the highest returns. The New Zealand economy has had problems in achieving this aim. The signals in the market place have been confused by a range of government interventions. By far the bulk of assistance to manufacturing is provided through import protection (tariffs and import licensing). The combined effect of licensing and tariffs results in a strong bias against exporting both because direct input costs are raised and because the prices of factors such as land, labour, and capital are bid up.

Export subsidies and incentives have attempted to redress this imbalance with mixed results while the schemes have contributed to growth in exports, there are inevitable problems associated with such techniques. They are at best palliatives that fail to address the basic problems. They are not comprehensive in coverage; practical difficulties exist in ensuring their impact is appropriate; and there are costs involved with administering and complying with the provisions of the various schemes. Thus, the level and pattern of export assistance necessary to counter the bias against exporters arising from New Zealand's import protecion, is difficult to implement in practice in an efficient way and involves a large fiscal cost. An analysis of export marketing and promotion assistance highlighted that, although the significance of this factor seems small, an external economy in the trade sector would justify an export subsidy in the product lines affected.

The conclusions reached were that in the light of international obligations export competitiveness could be best maintained through speeding up the movement towards general assistance reform rather than the replacement of one set of schemes with another. In addition to such changes general macroeconomic measures to 'free' up the economy such as deregulation of the finance and insurance market would enhance their competitiveness.

However, change of this type is dependent on the wide acceptance of the general framework outlined in the review. Events from this review tend to support Lindblom and Cohens' observation that wide acceptance of a new framework takes time. Indirections and lags due to previous commitments to the old framework can mean that the transition is by no means a smooth one.

Post-Script

Decisions on the phase-out of performance based export incentives were made in August 1984, shortly after the devaluation. EPTI was to be phased out for all markets between 1985 and 1987. The EMDTI was, however, extended to 31 March 1986 to enable agreement to be reached on the future form of assistance in this area.

On the protection front, measures were implemented at the same time to accelerate the pace of import protection reform, and reduce the average assistance to import substition. The main instrument of the acceleration was the decision to increase global import licence allocations to the minimum of 10 percent of the domestic market, except for goods covered by industry plans. Further annual increments in global import licence of around 5 per cent of the domestic market are envisaged.

APPENDIX 1

Classification of assistance to non-traditional exports

The present system of export incentives which apply to non-primary products and services can be broken down into three functional categories.

(a) Performance-related schemes, including the export performance taxation incentive (EPTI) which replaces both the old increased exports (IETI) and new markets increased exports (NMIETI) over a three year period ending in 1982-83;

(b) export promotion incentives, which include the export market development taxation incentive (EMDTI) and the export programme suspensory loan scheme (formerly a grant) and

(c) export development incentives, which include suspensory loans, manufcturing investment allowance, sales tax exemptions and research and advisory services.

For more detail and estimated cost of such schemes see "The Structure of Industry Assistance in New Zealand: An Exploratory Analysis' by Syntec Economic Services Ltd, Feb 1984 p.99-109

APPENDIX 2

Supporting Tables and Charts

Table 1 : Growth

	Period Averages		
	1949-59*	1963-73	1973-79
OECD Group Real GDP Growth Rate		4.9	3.2
New Zealand Real GDP Growth Rate	3.7	3.9	1.1

Source: OECD Economic Outlook, July 1984
* Estimate

Table 2: Export Volume Growth

Country	Period Averge 1960-82
Japan	12.1
Smaller European	6.8
New Zealand	5.3
Total OECD	6.8

Source: OECD Economic Outlook, July 1984

Table 3

New Zealand Index Numbers of Import and Export Prices and Terms of Trade 1948-58

(Base Year 1954 = 100)

Year	Import Price Index	Export Price Price	Terms of trade
1948	84	68	80
1949	77	65	85
1950	84	92	110
1951	98	108	111
1952	107	87	81
1953	101	97	96
1954	100	100	100
1955	99	102	103
1956	102	100	98
1957	105	98	93
1958	105	83	79

Source: Dept of Statistics

Table 4

Volume Index Numbers of External Trade

Base = 1952 (= 100)

1948-58

Calendar Year	Exports	Imports
1948	86	65
1949	89	67
1950	86	80
1951	76	89
1952	100	100
1953	90	76
1954	90	99
1955	94	118
1956	100	107
1957	100	116
1958	106	112