A rationale for current Government policy towards forestry

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Over the last two years the Government has made a number of moves in the forestry sector which in total have had a marked impact on the way the sector will operate in the future. These include the introduction or announcement of:

- a wood pricing policy for the New Zealand Forest Service designed, over a period of several years, to recover the full costs of producing logs for sale;
- the establishment of a Forestry Corporation by April 1, 1987 to take over the commercial role of the Forest Service;
- a Government policy for the operation of State trading enterprises, including the Forestry Corporation, designed to ensure they better meet the commercial objectives set by the Government;
- wider Government policies on the pricing of State supplied inputs, such as electricity, designed to progressively recover their full cost of supply;
- the abolition of forestry encouragement grants, followed a year later by a new tax regime for forestry designed to ensure that investment in forestry is neither encouraged nor discouraged compared to other investments;
- the establishment of a Department of Conservation, incorporating some of the components of the Forest Service, the Department of Lands and Survey and the Department of Internal Affairs, charged with being the Government's agency responsible for conservation;
- the establishment of a forestry policy agency, the Ministry of Forestry, to take over the policy advice functions of the present Forest Service.

The question which I wish to address is whether these measures are an ad hoc series of changes or whether they are part of a broader strategy. I wish to suggest that they are in fact entirely consistent with and in fact are part of the broader economic strategy being followed by the Government. I will then go on to explain why I think this is so, and how the changes fit into this strategy.

To do this I have to stand back and address:

- what I think the aims of the Government are;
- how they are being achieved; and
- what is forestry's place in meeting these aims.

The Government's Aim

Several commentators have suggested that this Government's aims are entirely consistent with those of previous Labour administrations. For example, the Under Secretary of Lands stated in a National Business Review article last year that "the concern for social justice is the link of this Government" with traditional Labour Party policies. He stated: "It is the goal, the responsibility, indeed the duty of the Government to protect the real incomes of the low to middle income earners of New Zealand" and that "it is the duty of the Government to set about restoring the social wage of education, health, housing and social welfare that has been so badly eroded in the years of a National Government". If this is accepted as a definitive statement of the Government's objectives, a prerequisite to achieving them is the provision of adequate resources to fund such programmes. In essence, there are two ways that the Government can obtain these resources:

"It isn't so much that the Government is choosing not to intervene in the economy; rather it is choosing the best way to intervene."

- encourage a growth in the resources available within New Zealand so that all of society benefits, including the less well off;
- redistribute resources that are available so that those who are less well off are advantaged relative to those who are better off.

How the Government is pursuing its aims

The interesting issue as I see it is not what the Government is trying to achieve but rather how it is trying to achieve it. I believe that the Government's policy is based not so much on a free market approach as on one concerned with choosing a form of intervention which is most appropriate to meet particular Government objectives. It isn't so much that the Government is choosing not to intervene; rather it is choosing the best way to intervene. This is perhaps evidenced by those interventions which are inconsistent with pure laissez faire. For example, it has a Family Care programme designed specifically to redistribute income, and has increased expenditure on subsidized housing. In addition, many of the policies that it has introduced can be characterized as seeking both a free market and also greater equity. In his NBR article, Mr Butcher outlines three such policies:

- the relaxation of import controls results in a transfer of income from licence holders and manufacturers to consumers, as well as an increase in competition;
- the deregulation of interest rates both improves access to loan...
finance for less powerful and wealthy and increases interest payments to households which unlike businesses are on average net savers;

- the GST, which captures in the tax net more sophisticated consumers who are evading current tax laws, and will permit a major redistribution of wealth to the less well off.

It is apparent therefore that the traditional Labour Government concern about equity remains. Nevertheless it is probably fair to characterize the moves the Government has taken as being on the whole moves towards a "freer market". Because of these two facets, Mr Butcher calls this approach "market socialism". Nevertheless, even this approach conjures up images of what a Dominion editorial described as "the imbalanced society of an unfiltered marketplace". How then can an approach which builds on market mechanisms be regarded as useful to a Government with substantial equity objectives? The question is best addressed by considering how the resources available to society are to be used to generate income which the Government can then redirect as it sees fit to meet the aspirations it has for society. There are essentially two options. First the Government can decide what productive activities it considers to be best and then either encourage that activity by taxes and subsidies or enforce it by some more coercive methods. Alternatively it can adopt a more neutral stance, neither encouraging nor discouraging any particular sort of productive activity. In essence in the latter "market" case the Government is leaving individuals to decide for themselves what is the best method of using the resources they own. This approach is not without its difficulties. There remains a continuing need for the Government to set "the rules of the game" and to monitor the situation so that it is informed when its objectives are not being achieved.

Nevertheless the market-based approach has two clear advantages over the one in which the Government tries to make the productive decisions itself. Firstly, the Government can never have the degree of information that is necessary for it to make all relevant productive decisions. In contrast, since prices will in general reflect the cost to society of using particular resources, each individual has available to him all the information he needs to decide whether a particular resource use will be socially profitable or not. Secondly, and equally important, the individual is given the incentive to use the resources available to him through the market in the best interests of society. Because each resource user or producer directly bears the cost of his decisions he has strong incentives to use resources only when he expects that doing so will make him better off.

In brief then, this "market-based" approach does two things: firstly it transmits information to the individual about how much society values the resources he is about to use; and secondly it provides him with an incentive to use those resources only if by doing so he can generate resources which society values more.

It is useful to consider what happens when the Government decides to subsidize a particular activity. Firstly, it reduces the cost of the good to the consumer so that he/ she is encouraged to use the good even though the resources in it may be more valuable in alternative uses. Secondly, the resources required to pay the subsidy must come from somewhere and almost inevitably that means from the taxpayer. As a rule those taxes will increase the price of outputs of other activities, reducing demand for them and thereby the output, employment and income generated by those activities. The net effect is to encourage consumers to consume something which they do not particularly value rather than something which they do, and to encourage investment in activities which require propping up at the expense of investment and employment in activities which can stand on their own feet.

This then is the argument for a market-based approach to making decisions about activities. It is interesting to note that whether for these or other reasons this market-based approach appears to be increasingly adopted by Governments of all political colours throughout the world. For example, I have recently discussed this approach with representatives of the Governments of both Hungary and China. They both described to me how they were making moves in this direction.

I should perhaps emphasize that my argument set out above has been directed at wealth-generating activities. The market here is being used as a tool for meeting the broad social objectives of the Government. In particular the argument is not against Government intervention per se. There are clearly situations where Government "interference" with market signals is widely recognized to be a good idea. For example, it is commonly agreed that on the grounds of equity one should deliberately impose a tax on the rich to help the poor. Similarly, the Government has clearly concluded that particular interventions are needed to provide for an adequate protection of the environment and has accordingly set up a Ministry for the Environment and a Department of Conservation.

Application to Forestry

The above general points clearly can be applied to forestry in New Zealand. In the past, forestry has been expected to fulfill a wide variety of commercial and other goals. In particular there are a number of goals to which forestry could be expected to contribute:

- commercial productive values as outlined above;
- conservation and environmental values;
- wider goals such as employment.

There is no evidence in my mind that the Government considers that any of these goals are inappropriate. What it does appear to be doing is to deliberately distinguish between the ultimate goals and the means of achieving them. Is the path the Government is following focusing on commercial goals to the exclusion of others? I think the evidence is that it is not.

Environmental Values

Consider first conservation goals. Under the old regime there were several agencies responsible for various aspects of conservation. These included the Forest Service with respect to environmental forestry, the Department of Lands and Survey with respect to national parks, reserves and farm parks, and the Department of Internal Affairs with respect to wildlife activities. What the Government has done is deliberately impose a tax on the rich to help the poor. Similarly, the Government has clearly concluded that particular interventions are needed to provide for an adequate protection of the environment and has accordingly set up a Ministry for the Environment and a Department of Conservation.

Firstly, it allows the agency to make decisions about what is the best way of meeting broad conservation goals from within the resources provided by Parliament. If for example the funding of
national parks is relatively poor compared to forest parks, the Minister of Conservation and his department can relatively easily shift resources from one to another. While this was always possible under the old system, there was little incentive on Ministers or departments which were relatively resource rich to give up those resources in favour of other, less-well-endowed related activities undertaken by other departments.

"...the shift to a Department of Conservation increases the control Ministers and Parliament have over the tax resources devoted to conservation objectives while reducing the need for Ministers to get involved in day-to-day management decisions..."

Secondly, it allows the department to consider what is the best way of meeting its objectives. Under the old system there was a presumption that, for example, resources devoted to environmental forestry would be spent within the Forest Service. Under the new system the Department of Conservation can if it so wishes still spend the money in this way by "contracting" with the Forestry Corporation to undertake environmental goals. However it also has the option of contracting with other agencies within the Government, and indeed with various private sector organizations to achieve its conservation objectives. There are in fact examples from overseas where conservation agencies have been quite successful in purchasing conservation covenants from commercial agencies to preserve particularly valuable resources.

Thirdly, because the objectives of conservation are grouped together as the responsibility of one agency, it is quite clear both to Ministers and to Parliament to what extent resources are being devoted to this end rather than other social or other objectives.

In brief therefore the shift to a Department of Conservation increases the control that Ministers and Parliament have over the tax resources devoted to conservation objectives while reducing the need for Ministers to get involved in day-to-day management decisions which are more appropriately left to departments.

Employment Values
Consider next the Government’s objective of improving the employment prospects of those who are disadvantaged within society. It is now being increasingly recognized that increasing employment is an objective that is very difficult to achieve. In particular, it is being recognized that simply subsidizing employment is unlikely to increase the level of employment over the medium term. The argument is complicated but it can be illustrated by considering the effect of those subsidies. While subsidizing employment in a particular industry can improve employment there, raising taxes to pay those subsidies places a burden on the remaining productive sectors of society. This places a wedge between cost of production in those sectors and the prices which must be charged, so increasing the prices and reducing demand for the products of unsupported industries. Furthermore because the resources are being taken from industries with a relatively high rate of return and shifting them towards industries with a low one, the contribution of industries in aggregate to wealth generation and therefore to investment in future employment growth is reduced. Accordingly, the effect of subsidizing employment in particular industries can therefore be to reduce employment prospects overall in the medium term. From this kind of analysis it is clear that the design of employment policies is a subtle question which is best addressed by an agency which has responsibilities for employment. For similar reasons to those advanced with respect to conservation objectives above, it can be expected that such an agency will be better placed to ascertain how employment objectives are best met and to pursue those objectives effectively. In addition, as before, Parliament will have a better idea of the resources it is devoting to this objective as opposed to competing objectives such as health and education.

It is worth summarizing the effect of the Government’s allocating responsibilities for particular objectives to particular agencies in this way. First I would like to emphasize what it does not mean. Separating responsibility for particular objectives into different agencies does not mean that those objectives will be pursued to a lesser extent. Rather it means that the extent to which those objectives are pursued is made explicitly by Parliament and is clear both to Parliament and to the public. Moreover because the agencies involved have a variety of ways to achieve those objectives, because trade-offs between different ways of meeting the objectives are easily made, and because the department can be expected to develop an expertise in the area, it is likely that the resources devoted to it will be used more effectively.

Commercial Forestry
Now I would like to turn to the question of the commercial aspects of forestry; that is to say those activities which generate the income necessary to fund the other activities of the Government and to provide individuals with income and employment. Before doing so I would like to emphasize that there is nothing special about forestry as a commercial activity. Forestry is important not in itself but because of the contribution it can make to the wider social goals of increasing standards of living and employment.

"...there is nothing about (commercial) forestry which makes it different from other forms of commercial activity. Accordingly it is important to ensure that forestry is undertaken only where it is as effective as other commercial activities using New Zealand’s resources to generate wealth."

Given the size of New Zealand’s exotic forestry estate, the output from forestry will be for the most part exported. Accordingly, forestry can be regarded as a black box into which one pours a number of scarce resources—land, labour, and capital goods—to generate after a long period of time a sum of foreign exchange. Apart from the lead time involved, this is no different from a wide range of other products produced by the commercial sector of the economy. Viewed in this way it is clear there is nothing about forestry which makes it different from other forms of commercial activity. Accordingly it is important to ensure that forestry is undertaken only where
it is as effective as other commercial activities using New Zealand’s resources to generate wealth.

(a) Subsidies

In particular this implies that both the inputs and the outputs used by forestry should be priced at their full cost to society; that is to say they should not be subsidized nor discriminated against by taxation. This is necessary as noted earlier to ensure that producers have both the information and the incentives to act in society’s interests. A number of recent Government measures can be interpreted as steps towards achieving this. For example, the moves to ensure full cost recovery in electricity pricing.

Similarly though less obviously, floating the exchange rate is a move in the same direction. Both forestry and other export industries are foreign exchange earners. Foreign exchange is equally valuable, no matter which industry earns it. Furthermore the exchange rate is floating, which implies that its price reflects the value of that foreign exchange to importers in their purchases of foreign goods, after taking account of capital flows. There is therefore no argument for subsidizing particular exporting sectors to earn foreign exchange. The value of their earnings is reflected in the price they are paid in the market.

(b) Taxation

The recent moves away from the forestry encouragement grant to the latest form of forestry taxation can also be interpreted this way. In order to fund activities which the Government considers are desirable, it is necessary to raise tax revenue. New Zealand like most countries in the world has an income tax system, which necessarily implies that there is a wedge driven between the national rate of return earned by a project and the rate of return it generates for its owners. In designing the tax system, the Government has to ensure the wedge is approximately the same for different sorts of activities, so that one activity does not displace another which has a better return to the nation. The peculiar thing about forestry is the long time between the initial investment and the receipt of cash revenues from that investment. The tax system should therefore be designed to ensure that long-life investments like forestry are treated no better or worse than short-life investments. In other words it should not matter whether an investor undertakes one 30-year investment or 30 successive one-year investments. The system should be designed so that the return to the investor of the former is higher only if the return to the nation is. The Minister of Finance apparently recognized this in his economic statement last year in which he indicated that in the Government’s view “the returns on investment should be directly related to the efficiency with which investors use resources, rather than the skill with which they avoid tax”.

(c) Forestry Corporation

The other major move that the Government has made in the forestry sector is to establish a commercial forestry corporation to undertake the Government’s commercial forestry activities. In his economic statement last year the Minister of Finance indicated a set of principles for the management of State trading enterprises. As I read them these principles had three main objectives:

- to ensure that corporations, insofar as was consistent with competition, recovered the full cost (including the cost of capital) involved in operating them;
- to ensure that they were operated in such a way that the cost of providing their output was minimized;
- to ensure that the corporations are subject to competition in the same manner as private sector businesses so that they will continue to survive and prosper to the extent and only to the extent that they can provide their products at lower cost than their private sector counterparts.

All these objectives are consistent with the principles I outlined earlier. In particular by ensuring that the activities recover the cost of their operation, the Government appears to be endeavouring to ensure that it is not providing subsidies to any particular sector which uses its products. Similarly, by ensuring that the enterprises are operated efficiently, it is ensuring that resources are not wasted.

Conclusion

The Government’s approach appears to be one of seeking the most appropriate form of intervention to achieve the objectives it sees as socially desirable. It is recognizing the power of the market to provide both information and incentives to both private sector and public sector organizations. This is the justification for establishing the Forestry Corporation. At the same time it is recognizing that the use of the market in this way is simply a tool for achieving its broader social objectives. When the Government considers that its objectives are not being met or not being met sufficiently by this mechanism, it is adopting a variety of other interventions. In turn these other interventions are also being deliberately designed to ensure that they do in fact achieve the Government’s objectives in the most efficient manner possible. In this approach the Government is following a trend which is apparent among Governments of all political colours in other countries.

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