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Labour's legacy: a lost decade for productivity

The worst policy failure of the 1999-2008 Clark/Cullen government was the dramatic slump in productivity growth in that period.

Economist Paul Krugman of Princeton University once observed that “productivity isn’t everything, but in the long run it’s nearly everything”. Productivity underlies economic growth and increases in living standards.

Krugman points out that “Economic history offers no example of a country that experienced long-term productivity growth without a roughly equal rise in real wages”.

This insight is important. Firms facing competition can’t sustain paying workers more than their productivity warrants. But nor can they pay their employees less, or they will be lured away by other firms.

Productivity is often misunderstood. It is not about working longer hours. Labour productivity is measured as a ratio of output (what workers produce) to labour input (typically hours worked). Working longer hours may increase production but not productivity.

Nor does productivity have much to do with workplace discussions between managers and unions, as the previous government seemed to believe.

It is far more about the quality of a country’s institutions and policies. Mexican immigrants to the United States quickly become 4 or 5 times more productive because they benefit from that country’s rule of law, stronger property rights, better infrastructure and higher-quality human capital.

Productivity growth increased significantly in New Zealand following the economic reforms of the 1980s and early 1990s, but fell with the reversal in policy directions this decade.

These trends have been documented by Statistics New Zealand, which in recent years has done an excellent job of measuring productivity trends for 73% of the economy (essentially the business sector).

A fortnight ago it updated its series to the year ended March 2008.

Although labour productivity growth was 2.0% that year, from 2000 to 2008 it averaged just 1.3% annually.

This growth rate compares with rates averaging between 2.5% and nearly 3% during the 1990s.

Statistics New Zealand also measures multifactor productivity growth, which it defines as growth that cannot be attributed to capital or labour, such as technological change or improvements in knowledge, methods or processes.

This form of productivity, which can be regarded as a measure of the success of the previous government's 'economic transformation' agenda, grew by only 0.6% a year between 2000 and 2008, less than one third of the average 2% growth rate achieved in the 1990s.

An interesting feature of this year's release is new data which account for differences in the skill composition of the workforce.

Some apologists for the recent productivity decline have attributed it to the absorption of low-skilled workers into the labour market with the falling unemployment rate.

However, if this were true, adjusting for this factor should raise measured labour productivity growth. Instead, Statistics New Zealand reports that composition-adjusted productivity growth averaged 1% annually in 2000-08, a rate materially lower than the unadjusted figure.

Nor is the low productivity growth problem due to reductions in capital per worker. Statistics New Zealand finds that capital inputs increased by nearly 4% annually in 2000-08 "due to strong business investment in fixed assets."

We do not know the productivity performance of the 'unmeasured' sector of the economy, which includes the public sector.

However, a study published by the Business Roundtable late last year found that annual productivity growth in public hospitals was significantly *negative* between 2000/01 and 2005/06.

These dismal trends must be reversed if the National-led government is to achieve its goal of lifting wages and other incomes to Australian levels by 2025.

That will require sustained economy-wide annual productivity growth rates of 3-4% a year – somewhat above those of the 1990s, but not unachievable given superior economic management.

The Treasury has published numerous papers on productivity in recent years but far too few of them identify the central issue: the need to adopt institutions and policies that foster entrepreneurship and economic dynamism.

The late economist Mancur Olson once wrote that economic success doesn't depend on population size, natural resources or location (factors stressed by the New Zealand Institute) as much as on "the degree of stupidity of the policies and institutions of the country."

Olson is famous for research that showed how democracies are vulnerable to special interest groups that use the agency of government to claim an ever-larger share of economic output. Slow but sure ossification and decline inevitably follow.

Olson's analysis is relevant to the massive expansion of government in New Zealand in recent years. Total (central plus local) government spending is now around 45% of GDP (compared with 35% in Australia) and there have been large increases in tax and regulatory burdens.

The new government is to set up a commission to advise it on how to match Australian income levels by 2025.

Productivity, and the institutions and policies needed to raise productivity growth, must be at the centre of its work.

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