

CHAMBER OF COMMERCE TAURANGA REGION

**ECONOMIC SUCCESS: LESSONS FROM THE
WORLD**

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ECONOMIC SUCCESS: LESSONS FROM THE WORLD

The past few years have been good ones for the world economy, on almost any measure. In a large number of countries productivity and economic growth rates have been up, inflation has been low and stable, and budget deficits, debt levels and unemployment rates have come down.

It's hard to see the current slowdown in the United States lasting long. Its main origin seems to be a healthy sharemarket correction. Basic features of the US economy – low inflation, a sound budget position, technological innovation and a culture of enterprise – remain in good shape.

European economies have been performing better as their governments have been forced to accept the lessons of America's success and reduce tax rates, privatise industries, remove internal barriers to competition and begin to reform their bloated welfare states. Among the major economies, the exception to this pattern is the sad case of Japan. It's too soon to tell whether the recent change of leadership will see an end to a decade of political paralysis and bring about the structural reforms that Japan badly needs.

In general, the Asian region has bounced back after the turmoil of 1998. Critics of globalisation were quick to point to the crisis as a failure of liberal economic policies and to predict a retreat. They advocated capital restrictions and other government interventions. In fact the main reasons for the crisis were over-regulated financial markets, weak corporate governance and political cronyism, and most governments reacted by removing controls and promoting greater transparency. Despite the recovery, it remains to be seen whether enough has been done to correct the problems on a long-term basis.

There has also been good news in many parts of the developing world, including the largest countries China and India, and in Russia and in much of Eastern Europe. Contrary to a widespread perception about growing inequality, the ratio of the average income of people living in the richest fifth and poorest fifth of the world narrowed over the 1990s. More importantly, since a focus on poverty is more

important than a concern about income gaps at a particular point in time, a recent World Bank study showed that growth has been good for the poor. The countries that have not made progress are typically those that have resisted integration into the world economy, such as North Korea, Myanmar, Libya and Cuba. The problem for them and many African countries has not been too much globalisation but not enough.

Recently there have been some exceptional individual performances. Hong Kong grew by 10.5 percent in 2000. The Irish economy grew by an estimated 10.8 percent, continuing a record of 7 percent average annual growth over the 1990s.

For many years Hong Kong has been the best example of a free economy. The Hong Kong government today describes its approach in the following terms:

Hong Kong has established its credentials as a champion of free trade with an 'open door' policy on inward and outward investment ... a freely-convertible and stable currency, a duty and tariff-free port and one of the world's most business-friendly tax systems where companies pay only 16 percent profits tax and individuals pay no more than 15 percent salaries tax.

This pro-business environment is underpinned by the rule of law upheld by an independent judiciary, a clean administration, world-renowned anti-corruption enforcement, a level playing field for all who do business and a strong belief in 'maximum support – minimum interference' from government.¹

Instead of a focus on income redistribution and 'closing the gaps', the Hong Kong government has directed its efforts at assisting people to rise out of poverty. As it put it in its March 2001 budget:

A wealth gap is common among developed and developing countries. Some countries have tried to tackle this through welfarism and a high-tax policy. These measures have often created even greater problems than the ones they sought to remedy. They have brought upon their economies a series of structural problems. We must not make the same mistake. Our focus cannot be to remove this gap. Instead we must provide the poor with a basic level of social security and help them escape poverty ... the key to helping the poor is to ensure sustained economic development and

¹ 'Hong Kong: Asia's Premier International City', government of Hong Kong, 2000.

the creation of more job opportunities and, at the same time, to enhance their employment prospects through education and training. And, of course, we must also ensure that our people from all walks of life can move between different occupational sectors and progress to better jobs. We must all strive to excel and help our children to do the same.

I am looking forward to visiting Hong Kong later this year as a guest of the government. Hong Kong is one of the success stories of modern economic history. In the space of 30 years or so its average per capita income has moved from poverty levels to a level (adjusted for purchasing power) that is now over 25 percent higher than New Zealand's.

People with an interventionist itch studiously overlook the success of Hong Kong and promote as 'models' countries like Singapore and Ireland, which they regard as government-directed. This is an odd perspective. Singapore routinely ranks just after Hong Kong in the indexes of economic freedom: relatively speaking, it is an open, small-government economy. Singapore has had full free trade for 20 years. Ireland joined the European Union in 1973 and it has rocketed up the indexes of economic freedom in the last 10 years. Many of these countries' more interventionist policies have done more harm than good – Ireland's agricultural subsidies are a case in point. Singaporeans envy Hong Kong's more entrepreneurial culture and its more efficient use of capital. Both countries are continuing to reduce unnecessary government involvement in their economies. Ireland has cut its government spending ratio from over 50 percent of gross domestic product (GDP) in the 1980s to a level now approaching 25 percent. (The ratio for Singapore is around 17 percent whereas for New Zealand it is around 40 percent – the average New Zealander spends two days of every working week working for the government.) Both Singapore and Ireland have been actively privatising government-owned businesses.

Of course, Hong Kong is far from perfect: commentators often note, for example, that the housing market in Hong Kong is dominated by the government, which also owns the post office, and that those are two bits of its economy that do not work well. It may also lose some of its economic dynamism over time under the influence of China. But Hong Kong, Singapore and Ireland are all small economies that have prospered essentially by promoting economic freedom.

Like the majority of other countries that have pursued market-oriented economic policies over the past two decades, New Zealand has also improved in its economic performance. It is simply not credible for those who speak of New Zealand's

mediocre long-term economic record to fail to acknowledge the turnaround in the mid-1990s. Annual economic growth averaged over 4 percent in the five years to 1997, and the fall in the unemployment rate from 11 percent to 6 percent was the fastest in the Organisation for Economic Cooperation and Development (OECD) area. The expansion from the third quarter of 1992 to the fourth quarter of 1997 was the most enduring and consistent of the last three decades. This was far more than five minutes of sunshine.

Since around 1997, however, economic growth has fallen away, to an average annual rate of a bit over 2 percent. The outlook is for a similar lacklustre performance. This should not surprise anyone. Since the early 1990s the Business Roundtable and other commentators have been expressing concern that governments were losing their appetite for reform, and reverting to habits of excessive government spending and creeping regulation. It's hard to think of any major initiatives to promote growth since the Employment Contracts Act of 1991 and the Fiscal Responsibility Act of 1994 – now almost ancient history in a fast-changing world.

The current government has emphasised redistribution not wealth creation. Most of its economic policy changes have been seen as harmful for business; indeed the government itself has argued for them on social grounds and has not sought to make a case that they have been positive for growth. Its more recent focus on business development is welcome, but it has yet to deliver on any significant initiatives. Its failure to make any meaningful amendments to the Resource Management Act 1991 in the legislation before the house is not a good sign. Moreover, its unwillingness to cut spending in some areas to offset increases in others heightens concern that its most business-friendly policy to date, a reasonably firm fiscal stance, could be at risk.

This analysis of the reasons for New Zealand's recent economic rise and decline is disputed by some. The *New Zealand Herald*, for example, has consistently maintained that New Zealand has "one of the world's most welcoming

environments"² and that poor business management rather than deteriorating public policies is to blame for the slide.

I think the *Herald* is wrong on both counts. New Zealand enjoyed a rating of 9th position in surveys of international competitiveness in 1995; it has now fallen to 21st place. The *Herald* recently noted that New Zealand still ranks third in the ratings of economic freedom; it overlooked that the latest rankings are based on 1999 data and will almost certainly fall in response to recent policy changes. Investors, entrepreneurs and skilled professionals look forward, not backward, in assessing a country's attractiveness: for some years now they have seen New Zealand as a less attractive country, as evidenced by the fall-off in international investor interest, a lower credit rating, the decline in the currency and the renewed outflow of people. Similarly, as a recent paper by Bryce Wilkinson for the Business Roundtable shows, it is idle to blame New Zealand's fortunes on general business mismanagement; major losses of shareholder value have been concentrated in a handful of companies. Academic research suggests that 70-80 percent of the share price of a company is the result of macroeconomic, industry and other factors that are generally beyond the control of management. In the economic stakes it's the rules of the game not the incumbent players that matter most – worldwide competition in the market for managers tends to ensure roughly equivalent competence for given rates of remuneration. Would any serious commentator blame Japan's plight in the last decade on a decline in business skills?

Given the worldwide trends towards market-oriented policies, critics of New Zealand's earlier reforms have struggled to come up with coherent alternative strategies. One alternative viewpoint is that New Zealand should have followed a path more like that of Australia. Again this logic seems dubious. Most commentators put Australia's improved economic performance down to the structural reforms that began in earnest in 1983, and which overall are remarkably similar to those of New Zealand. The main differences were the Keynesianism of the Hawke-Keating government and the associated incomes policy Accord which New Zealand critics favoured in the 1980s. These have long since been discredited and have disappeared as features of Australian policy. One can endlessly debate

² *New Zealand Herald*, 27 April 2001.

differences of timing and sequencing between the New Zealand and Australian reform programmes, but these have little relevance to the future. The issue is what New Zealand should do today. In my view Australia's overall policy settings, while not outstanding, are now better than New Zealand's; I would be happy if New Zealand were 'more like Australia'.

Regrettably, Australia also looks likely to suffer a loss of reform momentum. Its politicians and business leaders have failed adequately to explain to the public the necessity of ongoing adaptation to changes in the global marketplace. As the Western Australian Chamber of Commerce put it in a recent publication:

It is a matter for grave concern that relatively few in public life, and outside politics, have sought to challenge this state of affairs. The academic crusaders for economic liberalism of a generation ago are now largely silent ... and it is difficult to find more than a handful of reputable media figures willing to promote the cause. The economic reform agenda is in danger of fading away – and with it, our chances of maximising sustained long-term prosperity.

Earlier this month the Business Roundtable published a study by economist Phil Barry entitled *How Do We Compare?: New Zealand's Public Policy Directions in an International Context*. Its purpose was to examine the direction of policies in other OECD countries since the early 1990s and to ask whether, like New Zealand, they had experienced a slowdown in the pace or a reversal in the direction of economic reform. In every area examined – fiscal policy, trade liberalisation, deregulation, labour markets, privatisation and social policies – the study concluded this was not the case.

Perhaps the most striking difference is in the area of government spending. New Zealand stands out as one of the few OECD countries where the overall government spending share of national income has not fallen in recent years, contrary to earlier targets. The government's move to raise the long-term objective for central government spending from 30 to 35 percent of GDP is probably its most important economic decision to date. Total government spending is now 10 percent above the OECD average, according to OECD estimates. Because government spending is the best measure of the overall tax burden, New Zealand ranks as a high-tax country, even by OECD standards. High levels of spending and taxation damage economic

growth. The failure to control government spending was the worst feature of the economic mismanagement of the Muldoon era – remember the 'great spendthrift' – and since the Bolger/Richardson government the bad old habits have returned. Anyone who holds up Singapore and Ireland as economic models should be arguing in the first instance for less government spending and lower taxes.

Many of the earlier critics of New Zealand's reforms now acknowledge that changes were necessary, and most of the changes are no longer in dispute. The minister of finance, Dr Michael Cullen, told a Japanese journalist last year:

Fundamentally we will not change our open market policies. It is not necessary. The structural reforms produced great results. Most privatised corporations have been successful. What the current government is doing now is not because the structural reforms were wrong, but because we want to adopt a pragmatic approach to do better.³

There is nothing wrong with being pragmatic, but is it being pragmatic, for example, to recognise that privatisation has generally been a success but to call a halt to it, as

³ Gentaro, Yoshino, Nihon Keizai Shimbun, 'Lessons from New Zealand's structural reform' speech to the New Zealand Studies Association, Tokyo, December 2000.

the government has, on "philosophical" grounds, and to set up a new state bank? And no country can rest on its laurels in a world that keeps changing. New Zealand's tax reforms in the 1980s gave us a comparative advantage over many countries, but others have now caught up. As American actor and philosopher Will Rogers said, "even if you're on the right track you'll get run over if you just sit there". This year the United States has again been showing the way with the Bush administration taking bold initiatives to constrain government spending, cut taxes, deregulate, abandon the economically damaging Kyoto Protocol and build on the welfare reform achievements of the Clinton administration. European and other countries will be under pressure to follow suit.

Discussing Australia's place in the international economy, the respected Australian economist Kym Anderson recently noted that one of the challenges ahead for Australia, if it is to reverse its slide down the per capita income ladder, is to *keep on* opening up and reforming *faster* than its trading partners. Dr Cullen has agreed with the view that given New Zealand's size and remoteness, it has to have better public policies than other countries if it is to progress. The United States and other leading countries must be our benchmarks.

The problem as I see it is the gap between these commendable sentiments and the lessons of economic success abroad. Phil Barry concluded that while New Zealand's overall policy settings are still within OECD norms, New Zealand stands out for the extent to which it is pursuing policies that increase the role of government in the economy and that restrict, rather than increase, individual choice and responsibility. If New Zealand's policies are only of average quality by OECD standards, our economic performance is unlikely to be more than the OECD average – say 2-3 percent growth a year – and it could be less given our natural disadvantages. If we let our policy rankings go backwards, the outlook will be weaker again.

Right now the outlook for New Zealand is far from robust. Despite a very favourable combination of circumstances, the economy has only been growing by 2-3 percent over the past 18 months. The increase in export volume growth has been disappointing – most of the increase in export values has been due to price changes and the lower currency – and may have slowed to less than 1 percent year-on-year

in the last quarter. The Treasury's economic forecasts have consistently been too optimistic over the past couple of years and look likely to be revised downwards again in next week's budget.

If one were to give an economic interpretation of the government's strategy to date, it would be that it has focused on cutting real wages through the currency depreciation – wages have not kept pace with import and export price increases – rather than raising productivity. This is not a sustainable long-term route to achieving international competitiveness and export success, as the continuing falls in the international competitiveness rankings show. Strong economies aren't built on weak currencies or low wages. Only productivity improvements based on incentives to work and invest, low taxes, stable prices, secure property rights and sensible regulatory policies underpin long-term increases in living standards. Broadly speaking, that was the environment that produced the so-called 'golden age' in the world economy in the 1950s and '60s. Much of the world is returning to the norms of that environment, although many countries have a long way to go. This largely explains the improvements in the international economy in recent years, and why the world seems set for continuing market-driven growth.

Against this background, the government's recent emphasis on growth-promoting initiatives is welcome, and the business community needs to engage with it constructively on projects such as the goal of reducing business compliance costs. If this exercise is to be meaningful it must involve revisiting decisions already taken – the increase in the top tax rate, for example, required 47 pages of new tax law. But the lessons from the rest of the world seem to be that more than a change of emphasis is necessary if New Zealand is to enjoy the economic success of other countries. Phil Barry's research suggests that since the government 'reset the compass', New Zealand has been headed in a different direction from most other countries. And while some may argue that the rest of the world is out of step rather than New Zealand, operating on that basis would seem to be a risky gamble with New Zealand's future.