

EMBARGOED UNTIL 7.00 PM MONDAY 26 NOVEMBER 2001

**NEW ZEALAND INSTITUTE OF MANAGEMENT CANTERBURY
DIVISION**

GETTING UP THE OECD RANKINGS

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**CHRISTCHURCH
26 NOVEMBER 2001**

GETTING UP THE OECD RANKINGS

One of the messages of congratulations that I most appreciated when I received the 2001 NZIER Qantas Economics Award was from an academic and former winner of the award. He wrote: "It is good to know that some people can still distinguish high quality analysis from ideological advocacy". I want to talk about some basic economics today.

In particular, I want to look at what economics can tell us about the challenge of climbing back up the OECD rankings. This is the government's aim: in this year's budget Michael Cullen stated:

We need to set ourselves a goal of being back in the top half of the developed world in terms of per capita GDP – a position we have not occupied since 1970.

Leaders of other political parties have committed themselves to similar goals.

Talk of achieving much faster economic growth reflects a widespread feeling that New Zealand is not doing as well as it could or should economically. The Knowledge Wave conference, for example, was fundamentally about economic growth, and how we might get more of it.

To be sure, New Zealand has made some progress. In the decade to 2001, the economy grew at an average annual rate of 3.1 percent according to International Monetary Fund figures, better than the advanced country average of 2.8 percent and far better than New Zealand's average of 1.2 percent a year for the decade to 1991.¹ The idea that the reforms of the 1980s and early 1990s were a failure is sheer nonsense.

Over the past few years, however, little has been done to build on the earlier gains and backward steps have been taken. As a result, the economy's performance has

¹ International Monetary Fund, *World Economic Outlook*, May 2001, Washington DC, p 204.

deteriorated and the Treasury's estimates of growth have been too optimistic. In its October 1999 Update it forecast growth for the year to March 2001 of 3.5 percent; the actual figure was 2.5 percent. In its December 2000 Update the Treasury expected growth of 3.7 percent for the year to March 2002; the figure is again likely to come in at nearer 2.5 percent. For the period 2006-2011 the Treasury's projections in the 2001 budget are for average growth of only 2.2 percent per annum.

My overall assessment is that with the growth in inflation, government spending, deficits and debt during the Muldoon era, coupled with an array of economic distortions, the economy's potential growth rate was no better than 1-2 percent by the early 1980s. Following the two waves of economic reform in 1984-88 and 1990-91, it rose to perhaps 2.5-3.5 percent. With the subsequent stalling of policy reforms and the reversals of the present parliamentary term, I suspect our sustainable growth rate has fallen back to 2-3 percent per annum – say around 2.5 percent on average. This figure seems to be in line with Treasury assumptions and those of other economists.

A sustained improvement of half a percentage point a year in the economy's growth rate is very significant. Over 40 years – the working lifetime of many people – average incomes would be 22 percent higher with such an improvement than they would otherwise be, all other things being equal. That is a major lift in living standards. Getting a shift in growth of just half a percentage point a year, however, is no easy task.

What improvement in performance would be required if New Zealand were to achieve the government's goal of restoring New Zealand to the top half of the OECD rankings? A recent paper by two Treasury economists provided some useful numbers. It estimated that in order to reach this target in 10 years, real GDP per capita would have to grow at an annual rate of 4.6 to 7.4 percent depending on the measure of GDP used.² This assumes that other OECD countries grow at the rates they achieved on average over the period 1970-1999.

² Peter Mawson and Grant Scobie, 'Climbing the OECD Ladder: What does New Zealand have to do?', New Zealand Treasury, 4 April 2001.

To convert these estimates of growth in per capita incomes into the required rate of real GDP growth, we need to add about 1 percentage point to reflect likely growth in population. Thus if the government's goal were to be achieved over 10 years, it would require economic growth to be raised from its present sustainable rate of perhaps 2.5 percent to between 5.6 and 8.4 percent on average. Let's settle for a figure towards the bottom end of that range – say 6 percent. That happens to be the growth rate that the National Party is also targeting.³

Achieving a sustained 6 percent growth rate is a huge ask. But we have to believe that political leaders are serious about what they say and indeed to hold them to account – the prime minister has made much of delivering on commitments. Can it be done? I think economics tells us the answer is 'yes', in principle. In the decade to 2001, two other small economies, Ireland and Singapore, achieved average growth rates of 7.1 percent and 7.2 percent respectively, according to IMF figures. But achieving such a goal would require political leadership, community consensus and outstanding economic management on a sustained basis.

Nevertheless, the stakes are very high. At a 6 percent rate of economic growth and population growth of 1 percent a year, average real per capita incomes would double in 15 years. In an open, competitive economy, those improvements would be widely shared. Think of the difference they could make to the outlook for struggling families, the quality of health and other social services, the availability of resources for enhancing the environment, and the attractiveness of the country as a place to live, work and do business.

What would we have to do to raise our economic game to this level? The answer is fairly clear-cut. Modern economic research tells us that we don't need to worry a great deal about such things as our endowment of natural resources or management skills – where these are lacking we can easily access them on world markets. Far more important is the quality of policies and institutions, including our political arrangements. One summary of the lessons from the modern growth literature lists six

³ Rt Hon Jenny Shipley, 'Lifting incomes and lifting New Zealand', speech to National Party Annual Conference, Auckland, 21 July 2001.

key rules: accumulate capital, keep government small, open the economy to foreign trade and investment, respect property rights and the rule of law, do not burden the productive sector with excessive government controls and regulation, and invest in human capital.⁴ The overriding requirement could be summed up as greater economic freedom: the link between economic freedom and growth is well-established. I don't believe there is much debate today among leading economists about this prescription.

For New Zealand, moving in this direction would require big changes, but no bigger than countries like Ireland and Singapore have accomplished. There are plenty of examples of 'good practice' policies around the world that New Zealand could emulate

⁴ William Beach and Gareth Davis, 'The Institutional Setting of Economic Growth', *1999 Index of Economic Freedom*, Heritage Foundation and *Wall Street Journal*, p 8.

or indeed improve upon – as a small, remote country we need to strive for superior policies to offset our natural disadvantages. So the challenge is not insuperable: achieving it is essentially a matter of political leadership and public understanding.

How can we identify more precisely the key changes that would be necessary and quantify the general contribution they might make to achieving politicians' goals? Let me give you a personal assessment. In most cases the estimates I offer are fairly subjective. They represent my best judgment of what better policy settings might offer.

Recall that we are discussing how to raise New Zealand's average annual growth rate from around 2.5 percent per annum to around 6 percent. That is a 3.5 percentage point difference. I can think of three changes that might add perhaps 0.5 percentage points each to the growth rate and another eight that might bridge the remaining 2 percentage point gap.

Policy # 1: Lower the government spending ratio

There is little doubt that the massive increase in government spending in the Muldoon era was a major drag on the economy. Winston Peters' \$5 billion spending package (subsequently slightly reduced) and the planned \$6 billion increase in the current parliamentary term have had similar effects. A leading researcher on economic growth, James Gwartney of Florida State University, has recently commented that:

New Zealand is still a big government welfare state. Government spending continues at nearly 40 percent of GDP, a figure much too large for maximum growth. I do not know of any country that has sustained per capita income growth of 4 percent or more with that level of government spending.⁵

In other words, politicians should stop talking about 6 percent growth rates if they are not prepared to significantly reduce the size of government in the economy. Winton Bates has recently estimated that a reduction in government spending of 10 percentage points (for example from 40 percent of GDP, the present level of central and local government spending in New Zealand, to around 30 percent, the level of countries like Ireland and the United States) would add about 0.5 percent per

annum to economic growth over 10 years.⁶ This does not imply a 'slash and burn' attack on government spending, even though there is abundant evidence of waste and poor targeting. Bates points out that if government spending is held constant in real terms – without any overall cuts – and the economy grows at just 3 percent per annum, this would result in a drop of more than 5 percentage points in government spending as a percentage of GDP over 5 years. So shrinking the government's share of national income is a first and essential step towards faster economic growth.

Policy # 2: Labour market and welfare reforms

I believe labour market and welfare arrangements along the lines of the United States or Hong Kong and Singapore would add another half a percentage point to New Zealand's growth rate. These countries have low levels of unemployment and much less welfare dependency than New Zealand. Flexible labour markets and welfare arrangements that minimise disincentives to work are the key to these achievements. The out-performance of the United States relative to Europe in high technology industries owes much to hiring and firing rules that encourage entrepreneurs to innovate and take risks. Venture capital investors need to be able to reduce workforces easily if projects don't work out. People should be free to decide on the terms of their own contracts. US welfare reforms have halved welfare rolls. New Zealand's growth rate would be boosted by absorbing into the labour force those who are unemployed and many other beneficiaries. As they gained skills in the workplace they would contribute to further improvements in labour productivity. A more restrictive state safety net would boost private savings, as the experience of Asian countries demonstrates. Labour market and welfare reforms would also yield benefits in the form of lower fiscal costs, less crime and improvements in other social indicators.

Policy # 3: Abandon MMP

A third reform that could deliver a dividend of perhaps half a percentage point in my view would be the abandonment of the mixed member proportional (MMP) electoral system. The main argument against MMP is not economic; it is that MMP is a poor democratic system because it leads to unrepresentative outcomes, gives too much power to minority parties, leads to deal-making behind closed doors, and lacks clear accountability – it is not easy for voters to remove a government they dislike. In addition, as we have seen, MMP leads to policy paralysis, low quality

⁵ Quoted in Winton Bates, *How Much Government? The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, 2001, p 26.

⁵ *Op cit.*

compromises on legislative measures, fiscal excesses as deals are done between coalition partners, and generally weaker government. A small country needs to be decisive and nimble in responding to external events and seizing opportunities to raise its performance. Japan's decade-long stagnation owes much to policy paralysis under an electoral system similar to New Zealand's. My own preference would be a return to a first-past-the-post system. It is absurd to regard a system born in the world's oldest democracy, Britain, and also used in the leading democratic nation in the world today, the United States, as somehow undemocratic.

The next eight policy reforms might account on average for an increment to growth of about a quarter of a percentage point each.

Policy # 4: Tax reform

The greater integration of the world economy has increased the mobility of capital and labour and imposed heavier penalties on high-tax countries. The tax burden is primarily a function of government spending but the tax structure also matters. To boost growth and 'stand out from the crowd' with tax rates that would help attract and retain capital and skilled people, New Zealand should be aiming for top personal and business tax rates no higher than 25 percent. That would still leave New Zealand rates much higher than those in Hong Kong which has a company tax rate of 16 percent and a top rate on wage and salary income of 15 percent.

Policy # 5: Privatisation

The worldwide evidence in favour of privatisation is now compelling. As a recent survey article put it: "We know that privatization 'works', in the sense that divested firms almost always become more efficient, more profitable, and financially healthier, and increase their capital investment spending."⁷ New Zealand research has confirmed that privatisation has yielded additional gains over and above those achieved from corporatisation. The argument is not that government-owned firms always under-perform and private firms succeed. Clearly there are successes and failures in both categories – both the BNZ in public ownership and Air New Zealand this year are examples of failures. Rather, the argument is that on average and over time private firms do better, and it is

⁷ William Megginson and Jeffrey Netter, 'From State to Market: A Survey of Empirical Studies on Privatization', *Journal of Economic Literature*, Vol XXXIX (June 2001), p 381.

this general tendency that should determine policy. At central

government level the most important candidate for privatisation, partly in the interests of strengthening market competition, is electricity generation, which is mainly a private sector industry around the world. Privatisation should also include ACC: industry estimates put the gains during the brief period of deregulation at around \$300 million. At the local government level there is no need for councils to be running ports, airports, power companies and many other commercial ventures.

Policy #6: Commercialisation of roading and water supply

There are large gains to be made by operating roading and the supply of water on a more commercial basis. Both are very large infrastructure industries. There have been discussions about moving to more commercial models going back several years, but very little has happened. The costs to the economy of traffic congestion in Auckland have been estimated at close to a billion dollars a year. Proper pricing of roads and water supply needs to be introduced for both economic and environmental reasons. Both forms of infrastructure could remain in public ownership under commercial structures, but there is no reason to exclude private sector participation through franchising or other arrangements. Developments of this kind are commonplace around the world.

Policy # 7: Limit local government to a public goods role

Local government is a major sector of the economy. Its spending accounts for around 4 percent of GDP and its net equity is about \$42 billion, well in excess of the total equity of companies listed on the stock exchange which is around \$27 billion. The range of council activities is excessive and there is abundant evidence of waste and poor returns on assets. Councils should be refocused on their core role of ensuring the provision of local public goods – goods and services that the private sector can't adequately supply on a commercial basis. The government's current proposals to give councils expanded roles and powers go in the wrong direction. Local democracy is weak, as the recent low election turnout confirmed. I would favour specifying the core functions that councils should undertake, listing activities that councils would be prohibited from undertaking, and providing for a ratepayer referendum (requiring the support of, say, two-thirds of ratepayers) if councils wished to undertake functions beyond the specified core.

Policy # 8: Reform of the Resource Management Act

In the recent government review, the RMA came out as the number one issue for businesses after taxation from a compliance cost standpoint. Overseas investors have said it is a deterrent to doing business in New Zealand. It is idle to put most of the blame for costs and delays on council officers or vexatious objectors. They are only responding to the constraints and incentives in the law. As an exercise in regulatory reform, the process that gave rise to the RMA was hopelessly flawed; a valid framework and set of guiding principles were never established. A review should be based on proper public policy criteria. It should put emphasis on the importance of secure private property rights for both economic and environmental reasons, allow takings only on established public good grounds, and provide for payment of compensation for such takings.

Policy # 9 Free trade

The previous government took a decision to phase out remaining tariffs but this has been frozen. Tariffs misallocate resources away from activities that can stand on their own feet and into industries that are only profitable because they can raise prices to domestic consumers. They also reduce competition and stifle innovation. Because of past tariff reductions the adjustments now required on the part of protected industries to cope with full free trade are not large. Such a move would allow much of the customs bureaucracy to be dismantled, and protectionist anti-dumping law could be replaced by normal Commerce Act rules. Other industry subsidies should also be removed. Not only do they have the same distorting effects as tariffs but they cannot possibly have a material impact on growth one way or another. Even on the most unrealistic and optimistic assumptions, I estimate that a programme of \$100 million of business assistance would only boost growth by 0.033 percentage points; in all likelihood it would reduce national income.⁸

Policy # 10: Dairy industry reform

Dairying is New Zealand's largest industry. The removal of the single desk export

⁸ See Roger Kerr, 'Think Small' is no better than 'Think Big,' in *Can New Zealand Afford to Replay the Economic Past?*, New Zealand Business Roundtable, 2000, p 101-106.

monopoly and the introduction of competition into the industry were long overdue. However, the industry remains highly regulated, which is a recipe for ongoing economic losses and corrosive industry politics. With the exception of simple provisions to deal with quota markets, there is no need for special legislation for dairying and the industry should be normalised as soon as possible. Little has yet been done to remove the price distortions associated with the bundling of on-farm and off-farm returns in the payout

to farmers. According to one estimate, the costs of these distortions to the economy could be as high as \$480 million a year.⁹

Policy # 11 Linkages with the United States

On his recent visit to New Zealand, former Canadian prime minister Brian Mulroney spoke of the immense benefits to Canada of that country's economic links with the United States. New Zealand should vigorously pursue the idea of a comprehensive free trade agreement with the Bush administration. It should also look seriously at the idea of adopting the US dollar. This could reduce the cost of capital to New Zealand firms by as much as one and a half percentage points and lower the transactions costs of dealing in foreign currency.¹⁰ Even more important than the trade and investment gains could be the benefits of greater exposure to the institutions, policies and cultural attitudes that make the United States the world's most successful country.

This list of policy changes omits some that are vital to New Zealand's long-term performance. An obvious one is education. However, the reality is that the badly needed changes to move away from the public monopoly in education and introduce greater choice and competition would have little impact within a 10-year period. Reversing the dumbing down of education would take time, and most of the workforce will be unaffected by any feasible changes (although resources within the education sector would be used much more efficiently). The same goes for immigration, which is a long-term policy.

Obviously there can be arguments about the priorities I have identified, and whether the rough estimates of the contributions of the suggested policy changes to GDP growth are in the right ballpark. Equally, there are many other steps that could be taken. For example, there is a strong case for a first principles review of many regulations that are constraining business growth. A former minister of commerce estimated that New Zealand governments introduced over 1,600 new pieces of legislation and 3,600 new

⁹ Winton Bates, *Farmer Control of Processing and Marketing: Does it serve the interests of farmers?*, New Zealand Business Roundtable, 1998, p 6.

¹⁰ See Martin Lally, *The Real Cost of Capital in New Zealand: Is it too high?*, New Zealand Business Roundtable, 2000.

regulations in the past decade alone. Hong Kong is reported to have fewer than 1,000 regulations in total that affect business, and some in Hong Kong regard that number as too high. A regulatory statute along the lines of the Fiscal Responsibility Act would help

to impose greater discipline on regulatory policy making.

However, I think economics teaches us that any credible programme to bridge the gap between New Zealand's present sustainable growth rate and a rate that would lift incomes to average OECD levels would look much like the one I have outlined. Some aspects of it are axiomatic: the job simply can't be done with central and local governments spending 40 percent of national income. Much more room and freedom needs to be given to the private sector. The changes required are certainly large but hardly radical; similar arrangements are in place in many successful countries, and it would be possible to improve on them in some cases. There is certainly no reason in economics why New Zealand could not become a Kiwi Tiger, as our political leaders are suggesting. But to do so we need to walk the walk. The Treasury paper I quoted earlier suggested that on present policies New Zealand's ranking among the OECD countries will probably continue to go down rather than up. If politicians and the community are not prepared to debate and embrace a credible programme of better policy settings to match ambitious goals, they should stop talking the talk.