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**ELECTRA BUSINESS FORUM**

**GETTING SERIOUS ABOUT ECONOMIC  
GROWTH**

**SIR RONALD TROTTER  
HONORARY MEMBER  
NEW ZEALAND BUSINESS ROUNDTABLE**

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## **GETTING SERIOUS ABOUT ECONOMIC GROWTH**

I want to talk today about economic growth.

Our politicians also like to talk about growth. They especially seem to like talking about growth targets.

When politicians stand up to talk about lifting New Zealand's growth rate, or getting New Zealand back up the OECD league tables, we typically get a speech that is long on generalities, objectives, targets and – let's face it – wishful thinking. We have set plenty of growth targets in New Zealand, and have achieved a fair measure of consistency in missing them.

In the political domain, setting targets is a bit like a bidding round in a hand of poker – but one where everybody is bluffing.

Our experience of playing this game of poker goes back a long way. In the early 1970s I was involved with the National Development Conference, which opened the bidding with a 4 percent growth target. Later in the '70s, after the first oil crisis, the Planning Council, no doubt sensing New Zealand held a weaker hand, lowered its bid to 3 percent.

Following the hard work done by the Labour government between 1984 and 1988, the Bolger–Birch government raised the target to a 3.5 – 5.0 percent range. In his time as Treasurer, Winston Peters raised it again to 6 percent. He was clearly bluffing, and in fact dropped most of his cards along the way. He was eventually asked to leave the table.

Not to be outbid, Jenny Shipley matched Winston at 6 percent – another outrageous bluff on a weak hand. Bill English more or less folded by dropping National's target back to 4 percent. We should give him credit for being realistic, given that National's

recent approach to policy has been singularly unadventurous and, like Labour's, has no show of really lifting the trend growth rate.

Political talk of growth targets is pretty much a code word for avoiding the issue. Talk is, we might say, inexpensive.

And so we find the current government indicating that its top priority for this parliamentary term is to raise New Zealand's economic growth rate, a commitment that was highlighted in the Speech from the Throne at the opening of parliament recently.

But targets and intentions are of no value without policies to achieve them. A recent Tremain cartoon made the point rather well. One bystander at a gymnasium looking at a rather puny-looking Michael Cullen behind a set of weights labelled '4 percent growth' says to another, "Don't you wish he'd stop all the flexing and just step up and get on with it?"

In spite of our justifiable scepticism, we should hold our politicians to account. We must push and prod them to demonstrate that beneath the packaging there are policies of substance. Because the stakes are high. If we revert to another decade of second-rate performance, the outflow of talent we have seen will turn into a torrent.

Let's define a few terms. Growth is all about expanding output, the production of goods and services that people value and are prepared to pay for.

If output expands, so too, generally speaking, does national income. In fact output and income are opposite sides of the same coin. In national accounting terms, they are an identity: output equals income. So we can talk of New Zealand's growth performance in terms of output growth rates, or in terms of growth of national income.

Back in the 1950s we were not too far from the top of the international league tables for average income per person. But in the three decades to the end of the 1980s, real gross domestic product (GDP) per head rose by only 0.8 percent per annum, well below

average OECD rates. This meant our relative incomes fell up until the beginning of the 1990s. Moving permanently overseas began to look increasingly attractive to many New Zealanders.

This relative decline was halted in the 1990s, a decade in which our average per capita income grew at nearly the OECD average. Contrary to all the nonsense spouted about "the failed policies of the 1990s", the attached chart shows we were well up with the pack. In other words, the painful policy changes from the mid-1980s halted the decline, and we are now at least managing to hold on to our new, albeit more lowly, ranking.

How low is it? Well, in 2000 New Zealand's average per capita income on a purchasing power parity basis was about US\$20,000. Australia was about 30 percent ahead of us, at US\$26,300. And about 40 percent ahead of Australia was the United States. Despite all the anti-Americanism you hear from the world's cultural elites, it is no wonder that the United States is the number one country of choice for most of the world's migrants.

But why is it that most developed countries have a per capita income that is higher than ours? The answer comes down essentially to *productivity* – higher output per worker. Ultimately, the trend decline in our relative income reflects slower productivity growth than other countries have achieved.

So why is this? The answer is that, compared with New Zealand, the average worker in the United States and many other industrial countries:

- works with more and better capital ;
- is better educated, and thus is better able to utilise that capital;
- is surrounded by good physical infrastructure (eg efficient ports, airports, telecommunications, road and rail transport, and health systems);

- works in a relatively low-cost regulatory environment;
- in part of a labour market where businesses are able to quickly hire and fire, and thus can organise their operations at lower cost; and
- has a strong incentive to work because the welfare system is a low-slung safety net and the tax system does not massively erode the take-home pay of the average worker.

These are some of the key factors underlying productivity growth. Using them, let me briefly try to interpret for you New Zealand's slide down the income rankings until the 1990s. Later I will use this framework to look at what needs to be done now.

The decline in our real incomes relative to the rest of the world didn't just happen. It had reasonably obvious causes.

Firstly, New Zealand industries were sheltered behind high import licensing and tariff barriers for much of that time. Businesses had the incentive to invest in activities that were never likely to be internationally competitive. Thus much of our business capital spending was misdirected – into, for example, car and television assembly industries that were ultimately doomed. Fortress New Zealand resulted in the average worker working with second-rate technology and capital equipment. Protected markets have an immediate cost to consumers, but they have an even higher and longer lasting cost by channelling business investment into socially wasteful activities.

The lack of international competition allowed obsolete organisational practices to linger on. The worst was the labour relations system we inherited from Britain – a huge drag on productivity. Recall the decade-long construction saga associated with the BNZ head office building in Wellington and the endless industrial disputes in our forestry, meat, ports and shipping industries.

Over this 30–40 year period, the New Zealand worker faced an ever-larger tax grab from the government, while welfare policies got more and more expansive, making not working and not saving easier options. So dramatic has been this expansion of the welfare state that the Savage and Nash governments of the 1930s and '40s would have more in common with the ACT party today when it comes to welfare policy. Savage was concerned that welfare be a hand-up, not an open-ended handout. He insisted that pensions should be means-tested. Total government spending was under 20 percent of GDP in 1938, compared with around 40 percent today.

Singapore, by contrast, chose a better path. Lee Kuan Yew writes of watching the ever-increasing costs of welfare in Britain and Sweden and deciding that Singapore must avoid such a "debilitating system". In his words:

People did not have to work for their families' well-being. The handout became a way of life. The downward spiral was relentless as motivation and productivity went down. People lost the drive to achieve because they paid too much in taxes. They became dependent on the state for their basic needs.<sup>1</sup>

We used to give foreign aid to Singapore. Now there are plenty of Kiwis working in Singapore enjoying much higher incomes than they could achieve in New Zealand.

Looking back at our experience, it is perhaps a wonder that New Zealand was not even poorer by the 1980s. Part of the reason is that such decline happens at the margin, as capital depreciates and old attitudes of self-reliance gradually decay. Unfortunately, the same is true when you are trying to catch up – you start with your existing capital stock and your new soft-minded attitudes and habits.

Merely stopping the relative decline is not good enough. New Zealand has to find policies that will allow us to catch up, and to recover the losses of the past half-century.

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<sup>1</sup> Lee Kuan Yew, *From Third World to First: The Singapore Story 1965-2000*, Singapore Press Holdings, 2000, p126.

And we need to do this in a world where other countries are energetically trying to do the same – more energetically than we are in most cases.

In spite of this, catching up is not a forlorn hope. There is not the slightest need to be defeatist about it. There is so much, so easily identifiable, to be done. We just have to get serious again – as governments were for brief periods in the 1980s and '90s.

An obvious starting point is to focus on the things that lift productivity growth.

– **Allocation of capital**

Consider the capital that workers use. This is all about the scale of business investment, and the allocation of it. Capital is scarce and thus costly – which is why the government must stop wasting it. To allocate capital well, we need to continue to open the economy up to the world. We must work to reduce the burden of compliance costs that businesses bear. The more labour-intensive service sector is particularly sensitive to the regulatory environment and to labour market laws.

Where are we headed at the moment? Absolutely in the wrong direction. Tariff reductions are stalled and central and local government are wasting scarce capital by engaging in futile gestures with industry subsidies and uneconomic investments such as Kiwibank and rail schemes in Auckland. The regulatory burden is getting more oppressive, taxes have risen and become more complex, and employment is becoming more and more a hazard for employers who are not high court judges. All these trends unambiguously slow productivity growth and need to be reversed.

– **Infrastructure**

Two words exemplify the nature of the problem: Auckland roading. Australia is well ahead of New Zealand in operating infrastructure industries like roading and water on a commercial basis. Anyone who has travelled widely overseas is well aware of the scope for toll roads, public-private partnerships and user charges. These are areas where central and local governments are the problem, and they need to step out of the way.

We need a major kick-start to privatisation, which has stopped and even reversed. Electricity is predominantly a private sector industry overseas, but in New Zealand is still state-dominated. Other countries have shown we need to move further – even countries like Germany and Sweden have privatised postal services, hospitals and universities.

– **Education and health**

Education and health are also part of the infrastructure of the country.

A progressive lowering of educational standards is affecting literacy and numeracy, arguably with a bigger impact on families in lower socio-economic groups who can't escape under-performing local schools. Much of this reflects the typical problems of a public monopoly. Labour relations in these state monopolies have a time-warp feel to them, an unpleasant reminder of what things were like back in the 1970s and '80s.

Why do we have this absurd fetish about governments running our schools? Plenty of countries don't have the old public sector model. In Ireland most schools are private but publicly funded, and the Netherlands, Denmark and Sweden have all moved away from a state monopoly education system. In the United States the school choice movement is rapidly gaining ground. Even in Australia, 30 percent of children attend non-government schools. The story is much the same in tertiary education.

Our monopolised health industry is a shambles and a disgrace. Better models for New Zealand are those of some European countries where private insurance plays a significant role, and where there are many private providers. In France one third of hospitals are private, in Germany half, in the Netherlands 85 percent.

The government seems pathologically hostile to the very idea of private schools and hospitals. The convictions of most of its members seem to date from the liberal-left politics of the 1960s and '70s. They are the survivors of an ideological shipwreck, leaving generations of students floating on the wreckage of their devotion to the concept

of a monopolised state education system. In the health sector patients are still waiting in queues for the lifeboats, with the ships listing badly.

The problem is well analysed; there are plenty of successful international precedents for a private sector role. Why the government refuses to consider experimentation must be more a psychological question than an empirical one.

- **Regulatory environment**

New Zealand businesses face a bewildering thicket of intrusive regulation. The statute book contains around 2,000 public, local and private acts, comprises 89 volumes and about 65,000 pages. We must now be approaching ten thousand commandments. Most of them reflect the political success of special interest groups rather than the overall public interest. The resulting environment is a spectacular productivity killer, greatly increasing business costs and uncertainty, and wasting vast amounts of time, energy and capital. The Resource Management Act stands out as a massive roadblock to development. All New Zealanders lose from excessive regulation. One wonders how many times we have to shoot ourselves in the foot before the painful message finds its way back to the brain.

- **Labour market**

Labour relations are crucial to the productivity story. When the Employment Contracts Act came in we saw spectacular gains in productivity – in spite of the efforts of the Employment Court. Unemployment fell and real incomes rose strongly in the latter half of the 1990s. The Employment Relations Act was a backward step, and some of those gains will inevitably be lost.

Opponents of a freer labour market do not seem to understand that if it is easy to fire people, businesses will enthusiastically hire them. In a growing economy there is a lot more hiring than firing. But if policy makes it costly for a business to downsize when necessary, employers will be reluctant to hire. The survival instinct is strong, so firms

will put people on short-term or part-time contracts, and will substitute capital for labour where possible. This is fine for those still employed, but not so good for those wanting a job.

Labour market regulation is one of many areas where good intentions – the desire to protect particular workers – typically lead to disastrous results for the community at large. Even Australia's labour laws are now better than ours in many respects, and that is a serious issue for trans-Tasman competitiveness.

– **Welfare and tax policies**

We are also going backwards with tax policies and welfare. Taxes have risen already, and with the government's enthusiasm for spending, assisted by the need under MMP to placate coalition partners with their pet programmes, the drift of the overall tax burden can only be upwards.

Our welfare policies are going in the opposite direction to those of the United States, Australia and other countries. The core feature of the US welfare reforms has been the conviction that work, not welfare, should be the norm. Intensive efforts to get beneficiaries back to work, coupled with time limits on assistance, have halved welfare rolls and improved social indicators across the board.

In respect of pensions we should, like Australia, ensure that they are a safety net that is targeted, not universal, with both income and asset tests.

**Where to now?**

The government has a reputation – and a deserved one – for moving in a measured, predictable, and single-minded manner. There is a steady hand on the wheel. It is just a pity we are headed in the wrong direction. My real worry is that the government doesn't seem to realise it yet.

The economy is still benefiting from the reforms of the past 15 years or so, and we have had a boost from a relatively strong world economy and high export prices over the past few years. The golden weather, however, looks to be ending. And in economic management, the costs of bad decisions, like the benefits of good ones, take time to show up.

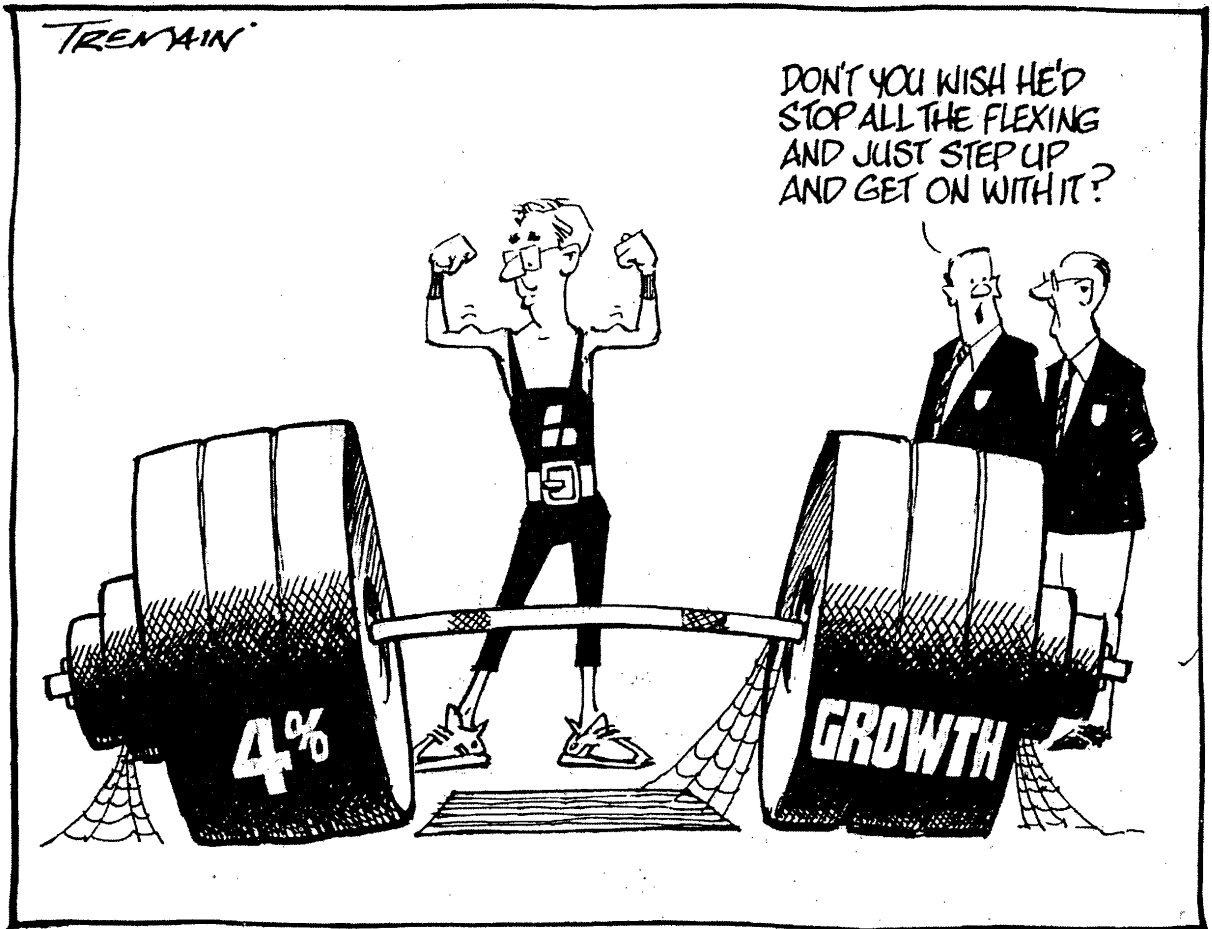
We know that most of the countries whose income levels we aspire to, and to which our citizens are migrating, are moving ahead with much of the reform agenda I have outlined. On current policies, our income levels, after holding their own for the past decade, will resume their decline relative to countries like Australia and the United States.

If we continue on this path for another decade, we may find our living standards not 30 percent behind Australia's, but 50 percent. And if that happens not many energetic people will want to stay.

Ironically, it was a Labour government in the mid-1980s that started the reforms that helped arrest New Zealand's relative decline. It looks like being the singular achievement of its successor to put New Zealand back on a declining path.

My vision of the future for New Zealand is not as a rest home for the retired and a trap for the unsuccessful, with a sideline business as a picturesque, low-cost theme park for the wealthy from overseas.

We can do much better than that.



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