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DOES POLICY MATTER?

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DOES POLICY MATTER?

This talk is about economic growth. Economic growth matters for people because it brings with it things like higher incomes, wider choices, more leisure and better environmental quality. Economic growth, driven by increases in productivity, is the only long-run source of improvements in average living standards.

Political parties make promises to improve economic growth because that is what voters want. The problem is with the delivery. The government says growth is its top priority objective. The business community is sceptical: only one respondent to a *New Zealand Herald* poll of business leaders after the May budget believed the government was serious about growth. What the business community is essentially saying is that it does not think that the set of policies being pursued by the government will improve the performance of the economy; indeed it sees many of them as anti-growth.

But do government policies matter? Are better policies really worth striving for? The answers to those questions may seem self-evident to most people, but by no means all.

Even in business there are some who think that policy doesn't matter. The former chief executive of Carter Holt Harvey, Chris Liddell, told the Knowledge Wave leadership conference earlier this year that "economic growth had nothing to do with government policy"; what mattered, he said, was the performance of business.[1]

There are many more doubting Thomases in journalism. To take just the *Herald*, one of its columnists, Brian Fallow, asked the question earlier this year, "how much can policy do to lift the growth rate?" He speculated that the answer was "less than the basic geographical and historical factors that we can do nothing about" – things such as the small size of our economy, its distance from major markets, and protectionist barriers faced by our exporters.[2]

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1 *Dominion Post*, 21 February 2003.
2 *New Zealand Herald*, 13 February 2003.

Another *Herald* columnist, Garth George, was more emphatic. Because of our small population and limited resources, he wrote recently:

> … we will never be able to foot it financially with the rest of the developed world … I have never been able to understand why we take comparisons with other OECD countries so seriously and why we always seem to be striving to climb up its ladder of wealth … We can't compete – and nor should we try. We need to find our economic comfort zone and live within it.[3]

To dispel these illusions you would think it would be sufficient to point out that New Zealand once had one of the world's highest average per capita incomes – higher than the United States in the late nineteenth century – and that the Soviet Union had a large economy, a location close to Europe and abundant natural resources, yet was an economic basket case. And you might think the Soviet Union's fortunes had much to do with its institutions and policies – in particular a totalitarian regime and central economic planning.

But these things can't be taken as self-evident. We constantly hear arguments that New Zealand underperforms not because of how it manages its affairs but for reasons of size, location, natural resource endowments, external trade barriers, business inadequacies and cultural attitudes. Even the Treasury has been musing about some of these things in recent years. So I propose to examine these six factors in turn, not to argue that they are necessarily irrelevant but to get some sort of perspective on how much they matter.

First, *size*. New Zealand had a population of under one million – less than a quarter of its present population – when it was one of the world's richest countries. Bermuda, with a population of only 60,000, has an average per capita income of US$37,000 – above that of the United States and more than twice New Zealand's. Other small countries like Hong Kong, Singapore, Luxembourg, Switzerland and Ireland have fared very well. Gary Becker, a Nobel laureate in economics, has noted that since 1950 real per capita gross domestic product (GDP) has risen somewhat faster in smaller countries than in bigger ones.

Becker makes the relevant point: economic size doesn't matter greatly provided an economy is open to international transactions. In economic terms we should think of New Zealand as if it were a state of Australia or even a small US state. There's little to stop us doing as well as such economic entities. We are not limited by the size of our domestic market: there's a big wide world out there to sell into and buy from. There may be some scale issues such as spreading government overheads across a small population, but even in some of these areas, such as defence, the costs can be reduced by less isolationist policies. And, as the examples of other small, high income countries demonstrate, the overall disadvantages are not large.

What about *location*? Well, to the best of my knowledge New Zealand's geographical position hasn't shifted from the time it was a high income country, and the relative costs of transport and communications have fallen dramatically since then. Nor has Ireland's location changed: recently it has been an economic success story but it was always close to affluent European markets and until its policy reforms of the late 1980s it was a poor relation.

If we could put an outboard motor on New Zealand and push it close to the coast of California, there would be some minor benefits such as lower transport and communications costs, other things being equal. But on the other side of the United States is Cuba, within swimming distance of Florida, and no one puts Cuba's poverty down to location. Or think of the relative incomes in Canada to the north of the United States and Mexico to the south. And within Canada, only Alberta, the most free-market Canadian province, ranks with the most prosperous American states – real per capita GDP in the province of Quebec is only around 60 percent of that in neighbouring New York State. The lesson again is policies, and in particular the costs of policies that exacerbate any locational disadvantages. New Zealand's former barriers to trade and capital movements, restrictive immigration policies and inefficiencies in infrastructure like ports effectively cut us off from the rest of the world and were far greater handicaps than our location.

Do *natural resources* matter? Not to any great degree. Some people used to think that having oil was a ticket to prosperity: countries like Saudi Arabia, Iraq and Venezuela

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[3] *New Zealand Herald*, 6 March 2003.

have proved otherwise. The average income in Saudi Arabia has more than halved since its peak; it is now well below New Zealand's. Closer to home, Nauru is a similar story. It is often suggested that an abundance of natural resources can be a curse: countries like Argentina and the former Soviet Union have squandered their endowments. We think of Australia as having more natural resources than we do, yet it lagged behind New Zealand for much of the twentieth century.

By contrast, countries like Japan, Hong Kong, Singapore and Bermuda have few natural resources yet their average incomes are much higher than ours. Once again it comes back to how intelligently a country runs its own affairs. An open economy can import the resources it needs at world prices to complement its own comparative advantages in production. And, for that matter, New Zealand is hardly short of natural resources. This is another excuse for underperformance that doesn't wash.

New Zealanders have long bemoaned the existence of *external trade barriers*, particularly to our agricultural exports. This issue is real: the countries imposing these restrictions would be better off if they dropped them, and so would we. I helped fight the good fight in Brussels for continuing market access for butter, cheese and lamb at the time of Britain's entry into Europe. But I came to understand at that time that while other countries' policies inflicted harm on New Zealand, most of our problems were self-inflicted. At that time countries like Hong Kong and Singapore also faced high protectionist barriers for products such as textiles. However, they simply took the world as they found it, forced their economies to adjust through free trade policies, put their resources to other uses and rapidly overtook New Zealand's per capita GDP.

A high proportion of our actual or potential exports face no significant trade restrictions. What would it mean for New Zealand if all other barriers to our trade disappeared tomorrow? One consequence is that world prices for some exports – particularly dairy products – would go up so we would get more for what we sold. Another is that more resources (of land, labour and capital) would be drawn into activities like dairying that were newly profitable at the margin. But there would be obvious limits to this process – you can't have dairy farms half way up Mt Taranaki – and the net benefit to GDP would be only the difference between the value of what

these resources produced in their new use and their old one. At a guess, I suspect the total gain would not amount to more than 5 percent of GDP. And this would be a one-off gain, whereas with good management we could hope to see the New Zealand economy growing by 5 percent or more a year for many years, as Ireland did in the 1990s.

So while international trade liberalisation would be valuable for New Zealand, the benefits need to be kept in perspective. As a rule a country can reap most of the gains from trade liberalisation simply by removing its own barriers. New Zealand has demonstrated that over the last 20 years, and the government's decision in 2000 not to proceed with the removal of remaining tariffs was unwise.

To sum up to this point: I suggest it is unlikely that New Zealand is any more disadvantaged than Western Australia by the size of its economy, its location, its natural resources, or foreign trade barriers, yet Western Australia's average per capita income is now at least a third higher than New Zealand's.

Could it be then that the quality of *business management* is holding New Zealand back? Some people, such as journalist Rod Oram and former Fonterra chief executive Craig Norgate, have made this argument. But it is an idiosyncratic one. I have yet to come across any research on economic growth which suggests that the difference between low-growth and high-growth countries is accounted for by the quality of their business management. Could New Zealand really be alone in having a business sector made up of losers?

Ask yourself some simple questions. If New Zealanders are poor at business, how come so many firms are exporting so many products to the rest of the world, and competing successfully with imports. How come so many New Zealanders are running overseas operations and heading New Zealand operations when firms have a worldwide labour market to appoint from? How come economic value added by New Zealand firms in aggregate stacks up against overseas comparisons, as theory would predict, as do our sharemarket returns?

To be sure, a few large New Zealand firms have destroyed large amounts of shareholder value, but counterparts in Australia, the United States and elsewhere have destroyed much more. It is overall performance that counts in any fair comparison. Of course not all firms are well run and many fail; that is a normal feature of a dynamic economy and a sign that competition is at work. There is no evidence that New Zealand business management overall is any worse (or better) than that of comparable enterprises abroad. New Zealand business improved greatly in the better economic environment that was created in the 1980s and early 1990s. It could do better again if the environment was improved further.

Finally, is our *culture* a handicap? I am not a great believer in cultural explanations of economic prosperity, at least as a general proposition. Consider the divided countries, North and South Korea, East and West Germany up to 1989, or mainland China and Hong Kong up to 1997. The people in each were the same, yet their economic fortunes were strikingly different. Or consider Japan prior to the opening up of its economy in the 19th century, when western visitors remarked on how lazy its inhabitants were, compared with the so-called Japanese economic miracle of the 1970s and '80s when westerners were complaining that the Japanese worked too hard.

I don't think there is anything fundamentally wrong with New Zealanders' genetic endowment. Our forebears were enterprising people who built a prosperous country. Maori were entrepreneurial and quick adopters of new technology. Young New Zealanders are keenly sought after abroad as hard-working, reliable people.

To the extent that we worry about cultural attitudes in this country – and I do – I think they have been shaped largely by poor policies and institutions. Years of protectionism and a union-dominated labour market bred sloppy attitudes towards quality and work. Expansive state welfare undermined personal responsibility. Our forms of pragmatic socialism contributed to an anti-business mentality and envy at achievement, just as official socialism did in the Soviet Union. I think these things are more important culturally than the fact that we have an easy lifestyle and good beaches: so has California.

But cultures can change. Attitudes have changed in New Zealand with the economic and social changes of the past 20 years. For example, surveys show that most young people regard government jobs as unattractive and don't want to join unions – a far cry from earlier years. But arguably some aspects of our culture have not changed enough, as the recent Industry New Zealand survey about attitudes to business indicated. There is much more that could be said about cultural factors in economic performance but I do not think they are dominant; there are no grounds for fatalism.

So I find myself in disagreement with those who think that New Zealand is condemned to live in some mediocre economic "comfort zone"; indeed I think acceptance of that view would mean it would not remain a comfortable place to live for very long. I have no problem with those like Jeanette Fitzsimons who think they are already too well off in material terms, or those who would rather 'go to the beach' – provided they don't expect others to support their lifestyles. But they are not the average New Zealander. Unions are typically not uninterested in wage rises and politicians promise growth because they know most voters prefer higher living standards to lower ones. And there is no reason why New Zealanders can't aspire to them. The six factors I mentioned are excuses – not reasons – for an inferior growth performance.

As we look across the world today, it should be obvious that the vast differences in material living standards – from average per capita incomes less than US$1000 a year in the poorest countries to over US$30,000 in the richest ones (on a purchasing power parity basis) – cannot be explained by factors such as size, location, natural resources and so forth. As I have hinted at various points, the main reasons for the differences in the wealth of nations are the decisions they collectively make themselves – the quality of the institutions and policies they adopt.

The American writer P J O'Rourke, who is visiting New Zealand next year as a guest of the Business Roundtable, came to the same conclusion in his book *Eat the Rich*. It's a rather good economic text. The book explores the question "Why do some places prosper and others just suck?" "It's not a matter of brains", O'Rourke found. "No part of the earth … is dumber than Beverly Hills, and the residents are wading in gravy. In Russia, meanwhile, where chess is a spectator sport, they're boiling stones for soup

… Natural resources aren't the answer. Africa has diamonds, gold, uranium, you name it. Scandinavia has little and is frozen besides." O'Rourke found the answer to his question was quite simple: countries prosper if their governments do a good job of running their affairs. But he also found that "there is a heartfelt and near-universal refusal to understand the basic economic principles behind the creation of wealth."

In recent years there has been an outpouring of research by academics and by organisations such as the OECD emphasising the importance of institutions and policies in economic growth. By institutions is meant things like a country's electoral system, the independence of its judiciary, the rule of law, security of property rights, freedom of contract and a free press, as well as informal institutions such as ethical norms, customs, work and business practices (for example, the ability to rely on statements like 'my word is my bond'). By policies is meant the choices governments make in relation to their spending, tax, regulatory, ownership and social welfare roles.

The findings of this research are good news. Institutions and policies are things that can be changed, unlike, say, a country's location. One study found that as much as 85 percent of the variation in income per capita across countries can be explained by differences in their institutions and policies. Important consequences of sound institutions for growth are that property will not be expropriated (by excessive regulation, taxation or inflation) or contracts repudiated. People and firms will then invest for the future. On the policy side, the research points to the importance of economic freedom to create incentives for entrepreneurship, work, saving and risk-taking. Effective government is essential to create these conditions, but having established them the research suggests the government should largely stand back. In particular, it finds that the government should not "play an active role in attracting outside capital, enticing foreign investment, promoting trade or acting as the prime driving force in development" – not a lesson Jim Anderton and others in the government have taken on board. The evidence is that investment will largely look after itself if a good environment is created. Finally, the research suggests that

cultural and religious differences offer little to explain the great differences in wealth between nations: "people are pretty much the same the world over".[4]

Since the mid-1980s, New Zealand has moved a long way in the direction of greater economic freedom, in line with the findings of this research, although on the institutional side the move to a mixed-member-proportional (MMP) electoral system and the plans to jettison appeals to the Privy Council are arguably negative for economic growth. What's more, the path towards a freer economy has been a zig-zag and stop-start one, and recent moves have been predominantly backward. This creates uncertainty and deters investment and innovation. The re-regulated business environment and workplace are making business operation more difficult. Social welfare incentives have not been aligned with the new economic incentives. New Zealand is now a less free economy than it was in the mid-1990s and has a low score for the overall size of government – 38th place in the Fraser Institute's economic freedom ratings. The Business Roundtable has been pointing out for some time that no country has achieved sustained annual growth in real per capita GDP of 4 percent or more with New Zealand's level of total government spending.

Today it is apparent to most people that New Zealand has a far better economy than it had 20 years ago. In the 10 years to 2002, we achieved average per capita income growth of 2.5 percent a year, a 28 percent rise over the decade and a far better result than was achieved in the 1970s and '80s. Treasury research points to a significant lift in productivity growth, perhaps as much as 1 percentage point a year. But there is no evidence that further improvement is in sight, contrary to the government's goals. Michael Cullen has said that by the middle of next year – five years after the government was elected, which is indeed a reasonable marker – it will be clear whether the government is on track to achieving 4 percent plus economic growth. Many like myself in the business community think the evidence will confirm that it is not.

The failure to date to lift New Zealand's trend rate of growth beyond that achieved by the mid-1990s should bring us back to the central theme of this talk. What primarily

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[4] Richard Roll and John Talbott, 'Why Many Developing Countries Just Aren't', www.worlddevelopmentnow.com

matters for economic performance is not factors we can't change, but rather policies and institutions that we can. To the limited extent that natural factors such as size and location are a handicap, we need better policies and institutions than other countries to match their performance.

New Zealand is not condemned by circumstances beyond our control to be just an average economic performer, or worse. The fault, so to speak, is not in our stars but in ourselves if we are underlings. When the secretary of the Australian Treasury, Ken Henry, was in New Zealand earlier this year accompanying the Treasurer, Peter Costello, he was asked what explained Australia's much improved economic performance in the 1990s and subsequently. He replied, "Good policy". When asked what else, his reply was, "Good policy". Those who want to see New Zealand improve its economic standing further should take Mr Henry's words to heart.