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LIFTING GROWTH AND LIVING STANDARDS

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LIFTING GROWTH AND LIVING STANDARDS

The New Zealand Business Roundtable has a key goal of raising living standards by growing the economy. A focus on creating wealth doesn't resonate with some people, but how else can we raise household incomes and expand the quantity and quality of education, health and other services?

Growth is a practical proxy for national welfare – albeit an imperfect proxy. We could probably get higher growth by passing laws that required people to work 60 hours a week, but who would want that? Leisure is part of the general quality of life. So too is a good environment, and there can be trade-offs between growth and the environment. There are many other things in life that people value that are not formally measured in gross domestic product (GDP), but it is the best overall measure we have of material living standards.

Successive governments have also proclaimed the goal of lifting growth rates, but too often their commitment has been rhetorical only.

In the Speech from the Throne at the opening of the current parliament, the government said that it:

... sees its most important task as building the conditions for increasing New Zealand's long-term sustainable rate of economic growth.

It set itself the target of restoring New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings. Dr Cullen stated that by mid-2004 it would be clear whether New Zealand was on track to achieving this goal.

The target is a demanding one. It means that real GDP per person has to grow by at least 4 percent a year on a sustained basis. Even at that rate it would take nearly 20 years to reach the government's goal. A Treasury paper estimated that per capita GDP growth would have to average between 4.6 and 7.4 percent per annum to put New Zealand back into the top half of the OECD in a decade.

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 GDP per head rose by only 0.8 percent per annum, well below average OECD rates. This meant our relative incomes fell until the beginning of the 1990s. Moving permanently overseas became increasingly attractive to many New Zealanders.

Unfortunately there has been a longstanding record of setting growth targets and failing to achieve them. The National Development Conference in the early 1970s targeted a 4 percent growth rate. The Planning Council in the late '70s opted for 3 percent. The Bolger-Birch government talked of 3.5–5 percent growth, and in his time as Treasurer Winston Peters talked of 6 percent. None of these targets was met. As finance ministers Roger Douglas and Ruth Richardson didn't set specific goals but instead put in some of the hard work needed to get faster growth – and the economy did grow by almost 4 percent a year in the five years to 1996. Mostly, however, it has been a matter of backing off the challenge – Jenny Shipley committed National to a target of 6 percent growth and Bill English promptly lowered it to 4 percent.

Clearly the present government has had a solid platform to build on. The reforms of the 1980s and early '90s created a much stronger economy. New Zealand was in the top third of the OECD countries for economic growth in the last decade. Employment growth has been high and inflation, interest rates and public debt much lower. It is a matter of regret that the benefits of these reforms to consumers, workers and taxpayers have been chronically undersold.

So New Zealand has probably stabilised its fall down the OECD rankings but, unlike Australia – which achieved average annual growth of around 4 percent in the 10 years to 2003, and is now in eleventh position – it has hardly begun to climb back up. Indeed its future performance is projected in the government's budget documents to fall away – Dr Cullen has failed to achieve his goal of lifting the economy's performance to a higher plane by now.

A point that needs to be made is that what matters for average incomes is not growth in real aggregate GDP but in real GDP per person. Only economic growth in excess of population growth – which is averaging about 1 percent, a year – raises average incomes. The economy grew by 3.5 percent in calendar 2000. However, because the population grew by a bit over 1 percent with relatively high levels of immigration, the increase in GDP per head was only around 2.5 percent.

Growth for the five calendar years 2000-2004 will have averaged around 3.5 percent a year. This is a solid performance, bearing in mind that the world economy was weak for a good part of that time. But New Zealand's better performance stretches back much further. The OECD pointed out in its report on New Zealand at the end of last year that:

New Zealand has been one of the faster growing economies within the OECD during the past decade. From 1992 to 2002 it grew at an average annual rate of 3.6 percent, and has maintained a robust pace of expansion during the more recent period of global downturn. This represents a marked improvement on the economic performance of the preceding two decades, during which per-capita income levels in New Zealand declined relative to the OECD average ... [This decline has halted], per-capita incomes having grown at an average annual rate of 2 ½ percent over the past decade, a little faster than for the OECD as a whole. It is encouraging that this has reflected not only a recovery of employment rates but also, more recently, a pick-up in labour productivity growth.

In the last few years, the economy's good run owes something to easy monetary policy, a low exchange rate and good prices for some of our exports. But more fundamentally, as the OECD noted, the better performance since the early 1990s is largely due to "the programme of reforms that began almost 20 years ago." The OECD said that the reforms had provided the economy with several important strengths including a sound macroeconomic policy framework, low inflation, a fiscal surplus, a flexible labour market and high quality public administration. In a working paper on growth released earlier this year the Treasury said much the same thing.

Could we get back into the ranks of the high-income countries if New Zealanders and political parties really decided that growth matters? Without a doubt. Economic research points clearly to the fact that the economic performance of a country depends primarily on the institutions

and policies it adopts. One recent study suggests that they account for approximately 85 percent of the disparities in incomes between countries. Its findings contradict those who believe the government must play an active role in attracting foreign investment, promoting international trade or fostering innovation. Instead, the authors conclude that once the proper legal, economic and political environment has been created, the government's job is largely done and it should concentrate on maintaining a level playing field and treating all citizens equally under a stable and just set of rules.

Research also suggests that factors such as a country's population size, location and endowment of natural resources are much less important in explaining differences in economic performance. Ireland's location hasn't changed in the last 15 years, nor is its population size very different. Yet Ireland has gone from being one of Europe's poorest economies to one of its richest – its average annual growth rate in the 1990s was around 8 percent – not by picking industry winners, as is sometimes thought, but primarily by adopting orthodox market-oriented policies.

A key to getting governments to take the growth objective seriously is to get New Zealanders to take it seriously. Unfortunately, the case for growth is often poorly articulated. Most people don't have a clue about what "getting up the OECD rankings" really means. The concept is far too abstract. Nor is the politician's typical argument that growth would allow more government spending – on health, education or anything else – the right starting point. Growth in the first instance is about producing more goods and services that people value. More output means higher incomes. Most gains in income would go on private spending. For people who are struggling, that would mean more food on the table, shoes for their kids and maybe the chance of a holiday. For others a growing economy would mean a better car, a chance to own their own home, more money of their own to spend on education or health services, or an earlier retirement.

With a growing economy it is also easier to create jobs. People on welfare can get work more readily. Richer countries are cleaner – contrary to the

views of the Greens, by and large growth is good for the environment. Richer countries are also healthier and safer. And, yes, tax revenues grow as well, so governments have more money to do the things we need governments to do.

A possible way of getting more traction for the growth message is to compare ourselves with Australia. Due partly to its good economic performance in recent years, Australia has rejoined the top half of the OECD income rankings. On a purchasing power parity basis its average per capita income, at NZ\$57,000, is \$13,000 or about 30 percent higher than New Zealand's average of NZ\$44,000. Think what a difference \$13,000 a year would make to many New Zealand households. If that gap were closed consistently across a person's working life, we could multiply that sum by around 25 (assuming a real riskless rate of 4 percent) to get an approximate lump sum equivalent value – namely an average of \$325,000.

Why are incomes in some countries higher than others? The answer is simply that their people are more productive. A higher income and standard of living are dependent upon higher productivity and output. In essence, output and income are the opposite sides of the same coin. Output is the value of the goods and services produced in an economy and income is what is paid to those who produce them.

Without higher productivity per worker there can be no increase in wages per worker. The average worker in the United States is more productive – better educated, works with better technology and benefits from more efficient organisation – than the average worker in China or India. Thus the average US worker produces approximately 20 times as much value of output as an average worker in China or India. American workers earn more because they produce more – and the average per capita income in the United States is about 40 percent higher than it is in Australia.

The OECD, which represents the collective wisdom of its advanced country members, has made a number of recommendations in recent reports on New Zealand. Among other things it has said:

- the government's focus should be on the economic fundamentals, not on its 'hands on', 'active government' policies;
- these include lower and better quality government spending: no OECD country has achieved 4 percent plus per capita growth rates with government spending at New Zealand's level of around 40 percent of gross domestic product (GDP);
- the tax scale should be flatter and tax rates should be lower than the OECD average. The 2001 McLeod Tax Review and the Treasury have also advocated reductions in high marginal tax rates – ideally the adoption of a flat rate of income tax – in the interests of growth;
- the government should drop its ideological opposition to further privatisation;
- the trend towards greater rigidities in the labour market should be reversed. In particular, the OECD has said that dismissal rules should be liberalised “to give marginal groups, such as young people and immigrants, a better chance of getting their foot in the door”;
- in transport, the emphasis should be on reform of roading management, including better road pricing, rather than on rail and public transport;
- in the electricity industry, the problems of uncertainty, creeping re-regulation and the impact of the Resource Management Act (RMA) need to be addressed;
- there should be less central control and more private sector involvement in education and health; and

- the government's welfare moves run counter to international trends and should be reversed in favour of time-limited benefits and stricter work requirements;

A common theme that runs through the Business Roundtable's stance on New Zealand's growth strategy is the idea that, at the margin, the public sector is too large and generates net economic costs. Consider some of the excesses of the public sector.

Our welfare state has grown massively. In some respects, even the Savage and Fraser governments of the 1930s and '40s would have more in common with the ACT party today than with the Labour party 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. It has doubled to around 40 percent today.

New Zealand businesses and households also 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 Resource Management Act stands out as a massive roadblock to economic development.

Unlike in some other countries, the state in New Zealand dominates sectors like education and health. 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.

In France one third of hospitals are private, in Germany half, and in the Netherlands 85 percent are private.

Education and health, together with electricity, roading and water supply, are the main state-dominated sectors of the economy, and the sectors that are the main source of public dissatisfaction. Is this just a coincidence?

Another way of thinking about the economic efficiency of the public sector is to focus on its cost of capital. Private firms understand that the only way they can produce economic value for their owners is if their projects at least meet the firm's marginal cost of capital. For government projects, the relevant cost of capital is the deadweight loss of taxation, given that government expenditure of resources has to be financed from present and future taxation.

The deadweight loss of taxation is a measure of the destruction of economic resources arising from the imposition of a tax. One way of understanding the concept is to realise that in markets, people engage in activities – such as working, consuming and saving – right up to the point where the benefits from those activities match their opportunity costs. After that point, costs exceed benefits. What taxes do is artificially move up the price (cost) of taxed activities and kill off transactions that would have otherwise occurred in the absence of the tax. The deadweight loss is a measure of the loss in economic welfare arising from this distortion to market pricing.

Economists Erwin Diewert and Denis Lawrence have undertaken useful studies on deadweight losses in New Zealand. The first report was released in 1994 and estimated marginal deadweight losses in the case of taxes on labour income in 1991 to be 18 percent. This means that of the last dollar of tax collected on labour income, 18 cents evaporates as a result of the tax distortion to behaviour. The benefits from the public expenditure financed by this last dollar have to be worth at least \$1.22 for New Zealanders collectively to be in the same economic position as if the tax were not imposed.

The 1994 study did not measure the cost of raising the last dollar of tax on income from capital, which was the subject of a follow-up study. It is

generally accepted that the deadweight losses for capital are higher than labour – perhaps of the order of 50 cents in every dollar – because capital is a more mobile factor of production and therefore more tax-sensitive.

Let me conclude with a remark on the way New Zealanders think about political parties. I believe we must try to shift our focus from party politics (or what I might call tribalism), namely cheering on the home side and booing the opposition. Ideally, we need to hold all governments to account, irrespective of their political colours. While the power of the ballot box is the ultimate form of accountability, ongoing leverage can only be achieved through public opinion. I would prefer New Zealanders were more circumspect about the role of government and thought more dispassionately about where the true comparative advantages of governments lie. The inevitable obstacles to more discriminating judgments are apathy, self-interest and tribalism.