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ROTARY CLUB OF AUCKLAND

ECONOMIC SUCCESS AND HOW TO GET MORE OF IT

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From the point of view of business and the economy (which means, in effect, the living standards of all New Zealanders), there are some promising omens arising out of last month's general election and the formation of the new government.

Commentators have interpreted the election result as a vote for policies of a more centrist nature. Support for the Green Party, the most anti-growth of our political parties, fell. The coalition agreements reflect the voting shifts. They foreshadow, for example, reductions in business taxation and the possible scrapping of the carbon tax.

In addition, the prime minister has said that the government plans to focus more on economic initiatives and less on social policy in this term. She has also spoken of governing more inclusively and building a better rapport with business. This is very welcome, and efforts will certainly be reciprocated. For its part, the Business Roundtable looks forward to working with ministers in the new cabinet.

For engagement with business to be meaningful, the government will need to listen not just to hand-picked individuals but to representative business organisations and the large segment of business opinion that saw the policies of centre right parties as more pro-growth than those of the centre left. As always, the proof of the pudding will be in the eating.

Clearly the election did not change the economic challenges and opportunities New Zealand is facing. The short-term outlook for the economy is becoming more difficult. Economic activity is slowing and business confidence is falling. Monetary policy is going to have to stay tight to contain inflationary pressures. Export industries are struggling to grow. The benefits of high terms of trade and immigration inflows in recent years are receding. Policy changes have made business operation in New Zealand harder.

The Reserve Bank has recently sounded a warning about "excesses" in the economy. It has valid concerns about inflation, but ought to have made the

point that trends such as high rates of growth of government spending, re-regulation, local government rate increases and a standstill on economic reform are making its job harder. Its comment that “A growing fiscal surplus has clearly made higher levels of government expenditure affordable in the longer term” is misplaced. The size of the surplus has nothing to do with the merits of government spending, and it ignores whether taxpayers are getting value for money. The Bank would have done better to point out the benefits of lower taxes in reducing costs and inflationary pressures.

Also misplaced in my view were the Bank’s comments about the low household savings rate and the current account deficit.

We can’t expect high levels of household savings when governments are over-taxing and running very large fiscal surpluses. The evidence for claims that the overall national savings rate (comprising government, business and household savings) is too low and that New Zealanders’ savings behaviour is irrational is not compelling.

As for the current account deficit, it cannot be expected to persist at its present level as a percentage of GDP, but that does not mean it is undesirable in the meantime. A current account deficit may indicate that a country is an attractive location for investment, particularly when other countries are running large current account surpluses. Moreover, the external debt servicing burden has dropped markedly since the late 1990s, and there is no reason why market mechanisms (such as a lower nominal exchange rate) won’t bring about necessary adjustments in the period ahead. The problem with mistaken analysis of these issues is that it gives rise to unwise interventions such as the KiwiSaver scheme and distracts attention from the real issues.

However, it is not these short-term factors but the longer-term trends that are more important in thinking about New Zealand’s future prosperity.

There is much good news in this part of the story. Thanks largely to the structural reforms of the 1980s and early 1990s and sounder monetary and fiscal policies, New Zealand’s economic performance has been strong for

over a decade. The economy is 55 percent larger than in 1993, and GDP per capita is 35 percent higher.

Some were slow to recognise the turnaround. Only a few years ago politicians and others were still talking about “failed policies”, Knowledge Wave backers (remember the ‘new economy’ talk?) were saying the world was passing us by because we produced a lot of commodities rather than computer chips, and even the Treasury was having doubts and publishing papers advocating selective interventionism.

The reasons for New Zealand’s success are much the same as those that have been behind Australia’s even stronger performance. As the Australian Secretary to the Treasury, Ken Henry, put it earlier this year:

... the basis of our prosperity lies overwhelmingly in having strong institutions, flexible markets, effective and well-targeted macroeconomic policies and credible regulatory frameworks.

Our counterpart organisation, the Business Council of Australia, has recently published a study that attempts to quantify the benefits of Australia’s reform efforts. It estimates that the average Australian’s real wealth (or assets) is \$83,000 higher (in today’s dollars) as a direct result of the reforms of the last 20 years. Some 315,000 extra jobs are put down to the benefits of Australia’s labour-market reforms.

Because New Zealand’s starting point was worse than Australia’s, I suspect the benefits of New Zealand’s reforms have been proportionally greater.

However, the parallels with Australia end here. As Anne Krueger, the highly regarded Deputy Managing Director of the International Monetary Fund, said earlier this year:

Reform is not a one-off process that governments can undertake and then put behind them. As economies evolve, the economic framework needs constant adjustment, to reflect the changes that are taking place all the time. Economic progress doesn’t pause for breath, and nor should the economic reform process.

It hasn’t in Australia. Over recent years the federal government has cut taxes, encouraged private sector participation in infrastructure and privatised nearly all its remaining state enterprises. It has now embarked on another wave of employment law reforms (which will make its regime

less restrictive than ours in many respects), welfare and education policy changes, and a wide-ranging review of business regulation. Further tax cuts are in prospect.

Australians seem to understand better than we do the long-run challenges our countries face from such things as globalisation and population aging. As prime minister John Howard has put it, "standing still is always riskier for Australia than going the extra mile on economic reform". Australian media reinforce this message much more than most New Zealand media organisations.

The Business Council of Australia study also looked at Australia's prospects over the next 20 years. It concluded that without further reform Australia's economy is likely to grow by less than 2 percent a year to 2025. On this basis, Australia could slip down the OECD prosperity ladder to 18th – exactly where it was before its reforms began in the 1980s.

By contrast, with a comprehensive but by no means radical reform agenda, the BCA considered 4 percent annual growth was achievable. This would increase the real wealth of the average Australian by \$74,000 by 2025, and Australia could be the third most prosperous OECD country.

The possible scenarios for New Zealand are much the same. I have no doubt that New Zealand could achieve fast growth and even catch up with Australia over 20 years, given top quality economic management. As things stand, however, our economic performance is falling away. An extrapolation to 2025 of the Treasury's Budget 2005 projections suggests real GDP per head in New Zealand will fall from 86.9 percent of the OECD average in 2003 to 81.3 percent in 2025, assuming the OECD member countries as a whole maintain their performance of the last 20 years. We are not on track to achieve the government's goal of rejoining the leading countries, given present policy settings.

Will these change? There are some encouraging signs.

First, the terms of the debate have changed. To illustrate: when the present government came into office, Jim Anderton said everything the

Business Roundtable had stood for was wrong. Yet the government of which he has been a part has broadly maintained the key pillars of the economic reforms: the Reserve Bank Act, the Fiscal Responsibility Act, the open economy and – despite backward moves – a flexible labour market. The election result suggests these policies will stay locked in. To his credit, Mr Anderton, who once favoured a higher company tax rate, is now pushing for a lower one. His appointment as minister of agriculture suggests he is likely to be sympathetic to the farming sector's calls for more market-oriented reforms

Secondly, the prime minister's emphasis on the economy will need to be backed up by concrete measures if it is to be credible. We hope that the Speech from the Throne will reaffirm growth as the government's top priority goal. It will surely not want to go into another election facing criticism that, after perhaps 9 years in office, it has not succeeded in improving New Zealand's relative economic position – that we are not making progress up the OECD ladder.

Thirdly, the pro-growth policies of the opposition parties, which contrasted with the government's focus on redistribution, clearly resonated with the electorate. With a stronger contest in politics, we will surely see moves such as broader tax reductions.

However, much more will need to be done to develop a serious growth strategy, and there are risks of further deterioration.

A major concern is the trend in government spending. In the election campaign, finance minister Michael Cullen made much of the fact that government spending is lower as a percentage of GDP than when the government took office. However, this reflects GDP growth rather than expenditure restraint. Furthermore, the Pre-election Economic and Fiscal Update indicated that spending is set to blow out by over 2 percentage points of GDP in the period to 2008, and election and coalition commitments have added many hundreds of millions of dollars to that increase. Much of this represents poor value for money. New Zealand cannot expect to grow faster with a rising share of low-value government spending in the economy, nor will the average tax rate be reduced with this

trend. There can be no long-term tax reductions without reductions in the government's share of GDP.

Moreover, the coalition agreements also foreshadow further redistribution initiatives, anti-growth measures such as a large increase in the minimum wage, and a continuation of the creeping tide of regulation in areas such as telecommunications. Yet as recent World Bank research has confirmed, the more heavily regulated a country's business environment, the likelier it is to be poor.

The economy is not on a path to achieving the government's goals for growth. It is time for it to face this reality. Earlier this year the government heeded business sector views in backing off proposals to increase regulation of the share trading platform Unlisted, and to force additional financial disclosure on large private companies and cooperatives. These are minor changes of direction, however. More far-reaching improvements to business regulation, employment law, and the Resource Management Act are needed to promote flexibility and innovation if the government is serious about growth.

Changes in policies on infrastructure, state-owned enterprises, education, health and welfare must also be part of an agenda for economic success.

Nobody argues for economic growth for its own sake. Environmental, equity and other goals are also valid. Nor is economic reform an end in itself. All it means is continuous improvement in a country's economic framework to cope with a changing world and a changing society. It does not mean constant upheaval and pain – New Zealand has done the hard yards necessary to rescue itself from insolvency. But it does mean facing up to necessary decisions at a national level – just as Air New Zealand has recently had to do at a company level – rather than allow a backlog of adjustment to build up with painful consequences down the track. Avoiding change is not a compassionate policy. Only a productive, growing economy will reduce poverty, create opportunities and underwrite necessary government spending on public services and the disadvantaged in our society.

Just as it was improvements to New Zealand's economic institutions and policies that transformed the economy in the past 20 years, so will further improvements be the key to economic success in the next 20 years.

Too much commentary misses this point. Wish lists with items like a larger population, more business heroes, more big companies, forced increases in savings, mantras about innovation and partnerships between government and business, a focus on value added rather than profitability, harmonisation with Australia rather than first-best policies, and starry-eyed national 'visions' are not the answer. At best they are outcomes, not drivers of success.

The reality is that economic growth in the world today is primarily dependent on good institutions and policies that are consistent with high levels of economic freedom and allow entrepreneurship to thrive.

For a country that wants economic success, there is no substitute for a debate around institutions and policies such as limited government, the rule of law, secure property rights, competition, light regulation and low taxation. Empirical evidence confirms these are the key to prosperity. Among the institutions we need to focus on is MMP: in my view it is condemning us to economic mediocrity.

This debate must be an ongoing one, not one-off. As Ian Macfarlane, governor of the Reserve Bank of Australia, put it in a speech last year entitled 'Geography, Resources or Institutions?':

More and more, development economists and economic historians are coming to the conclusion that, at the deepest level, a sound institutional framework is the crucial ingredient for sustained economic performance, and that it is far more important than distance, geography or the presence of resources ...

It is the nature of a first-rate democratic country that it will constantly be involved in economic reforms, or at least constant updating of its economic framework, and that the changes involved will generate political uncertainty and resistance. But that is the price of achieving and maintaining a first-rate set of institutions, and that is an essential condition for our continuing economic prosperity.

The more the Reserve Bank, Treasury, business organisations and media pick up on these themes, the better the chance that governments will follow

and that New Zealand's prospects for economic success will greatly improve.