

EMBARGOED UNTIL 7.00 PM MONDAY 14 MARCH 2005

SHEPHERDS' CLUB

---

WE SET UP THE ECONOMIC CONDITIONS AFTER 2010  
TODAY

---

ROGER KERR  
EXECUTIVE DIRECTOR  
NEW ZEALAND BUSINESS ROUNDTABLE

MASTERTON  
14 MARCH 2005

## **WE SET UP THE ECONOMIC CONDITIONS AFTER 2010 TODAY**

New Zealand is experiencing one of its most prosperous periods in several decades. Economic growth has averaged 3.7 percent a year over the last 5 years. The unemployment rate, at 3.6 percent of the labour force, is the lowest among Organisation for Economic Cooperation and Development (OECD) members. Inflation is currently low, the government budget is in substantial surplus, public debt is at comfortable levels, company profitability is high, investment is strong, productivity growth is better than in previous decades, and real wages are rising in the tighter labour market. Comparisons have been made with the 1950s, a so-called 'golden age' in New Zealand's economic history.

The main reason for this better performance is the two waves of economic reform of 1984-1988 and 1990-91. Even the government now acknowledges this. As it said in its recent Budget Policy Statement:

New Zealand's recent growth performance can be attributed to past structural reforms that began in the mid-1980s, which have resulted in a trend increase in New Zealand's growth rate since the early 1990s ... a more flexible economy better able to absorb adverse shocks and take advantage of favourable shocks, and sound macroeconomic policy settings.

With growth in real per capita gross domestic product (GDP) averaging 2.5 percent since 1993, the average income of New Zealanders is now around 30 percent higher than it was then.

Those who argued for the reforms have been proved right and their critics have been proved wrong.

However, a number of things need to be kept in perspective.

First, as the Budget Policy Statement noted, the 3.7 percent average growth rate in the past 5 years is no better than the average growth rate since 1993, when the benefits of the more coherent policy framework achieved in the early 1990s started to show up. The average for this whole period was also 3.7 percent. Moreover, in the first part of it the economy was hit by the Asian economic crises and unfavourable climatic conditions, whereas lately we have had the benefit of good terms of trade and a strong

world economy. Arguably our performance should have been even better in recent years.

Secondly, New Zealand's growth performance has not matched that of Australia in the last decade. The margin is not great: Australia has recorded a touch under 4 percent per annum compared to New Zealand's 3.7 percent. Australia has been labelled the 'miracle economy' and New Zealanders should also take pride in our greatly improved performance. However, Australia's edge has been sufficient to enable it to climb back into the middle/high income category of countries in the OECD whereas New Zealand is still in the low/middle income group. Other advanced countries have done even better, notably Ireland where growth has averaged over 7 percent in the past decade.

Thirdly, comparisons with the 'golden age' of the 1950s are not particularly flattering. A 1962 Monetary and Economic Council report noted that New Zealand had the worst productivity performance of the advanced countries in the post-war period. The costs of the country's earlier mistakes – particularly the establishment of import licensing, the regulation of the labour market and the growth of the welfare state in the 1930s – were showing up even then.

Fourthly, despite the progress made, there is still plenty to worry about. New Zealand's productivity levels remain much lower than those of Australia and the high income countries. Domestic inflation is too alive and well to be complacent. The Maori unemployment rate is still 8.9 percent of the labour force. There are over 300,000 people of working age on benefits at a time when many firms are desperate for labour. Many low income families continue to struggle.

Fifthly, and most importantly, what matters now is not past progress but the outlook in the period ahead. We set up the economic conditions after 2010 today. They are nowhere near as promising as they should be. I shall talk about future prospects in a moment.

Before doing so, I want to deal with some of the misconceptions that continue to confuse the economic debate.

The main one at present is the claim that real wages have not risen strongly and that many households do not feel they have got ahead during the present government's term of office.

To put this in a proper context, we need to go back further and understand the dynamics of the economy. In the early 1990s, New Zealand's unemployment rate peaked at around 11 percent. With the freeing up of the labour market under the Employment Contracts Act and the generally better economic framework, the numbers employed grew strongly and unemployment fell sharply. Critics at the time complained that labour productivity was not growing fast and nor were wages. But why would you expect firms to pay more for labour when it was in plentiful supply, or average labour productivity growth to be strong when large numbers of previously unemployed and low-skilled workers were finding jobs? This was surely a better trend than in the late 1980s when measured labour productivity growth was high as firms were restructuring and thousands of workers were losing jobs in the rigid labour market of the time.

As the 1990s wore on, productivity accelerated: according to the OECD, the acceleration of overall (multi-factor) productivity growth in New Zealand in the decade to 2000 was the sixth fastest among OECD member countries. Australia's productivity growth rate has been much the same but seems to have owed more to capital investment. This is not necessarily a mark in Australia's favour: with a more rigid labour market, its employment growth did not match New Zealand's, and New Zealand firms were able to run their operations more efficiently without adding to capacity. Uneconomic capital investment is never a good thing. Think Big would also have boosted labour productivity but lowered productivity overall.

There are other reasons why many of the benefits of the growing economy did not filter out in wages during the 1990s. Battered company balance sheets had to be restored. The government accounts had to be shifted from deficits to surpluses. The accumulated burden of public debt had to be reduced to more prudent levels. Low income workers nevertheless benefited from two rounds of tax cuts. These affected low tax rates, not high rates; they were not targeted at growth.

From the time of the National–New Zealand First coalition in 1996, government spending also took off and has continued growing apace. The present government has been spending a high proportion of the ‘growth dividend’ of recent years, particularly in areas like health, education and superannuation. Labour politicians like to call such spending the ‘social wage’. The government has also been running large operating surpluses. Unions can’t have it both ways: high levels of spending, taxing and public sector savings *and* rapid growth in wages. Moreover, the government has been legislating for things like paid parental leave and more holidays, and has imposed many other costs on businesses. These things inevitably come at the expense of growth in wages. It is no mystery that household disposable incomes have been pretty static.

Nevertheless, as spare capacity in many industries has been used up and the labour market has tightened, capital investment has increased and real wages have risen – and not only in high-skilled areas. This trend seems likely to continue, but there is no case for higher wage increases in all industries, occupational categories and locations. There are still many potential workers to be absorbed into the labour force, including the large numbers on benefits and older workers who are out of a job. Some firms still get dozens of applications for an advertised position. Unions seldom seem to care about the unemployed; their concerns are for their members who have jobs. Some Engineering, Printing and Manufacturing Union members are about to lose their jobs in Northland, where there is little alternative work, yet their union is calling for a blanket 5 percent pay increase! What’s more, it doesn’t take unions to achieve wage increases. Where labour is in short supply, profitable firms will simply have to pay more to retain and recruit workers. They will be attracted away from less competitive firms that will have to adjust or contract. That’s the way it should be; we all want rising real wages and a high productivity, high income, full employment economy. However, as we shall see in a moment, there are few signs of an acceleration in general labour productivity growth to justify higher wage increases across the board.

What then is the medium-term and longer-term outlook? Here the picture changes. The government’s own projections have GDP growth falling

away from the 3.7 percent average in the past decade to around 3 percent or below. By contrast, it projects Australia's growth to be in the 3.3-3.5 percent range, and a similar range for the average of our trading partners. Growth in per capita GDP is projected to fall significantly from the 2.5 percent average of the past decade to 1.9 percent, and labour productivity growth, at around 1.5 percent per annum, is not projected to increase. Other forecasters have similar numbers. So New Zealand is at risk of falling behind other countries again after holding our own in the past 10 years.

Why the deteriorating outlook? The answer isn't hard to fathom. In a presentation to a Business Roundtable meeting last month, Roderick Deane listed over 25 significant government initiatives that are harming our growth prospects. Leading items include the growth of government spending, the increase in the top tax rate, the restoration of the ACC monopoly, the re-regulation of the labour market, the slowdown in the pace of tariff reductions, the growth in state ownership of businesses, increasing regulation of banking, telecommunications and electricity, takeover regulation, more expansive local government legislation, ratification of the Kyoto Protocol, more central control of health and education and more lenient welfare rules. It would be easy to add to the list. In addition, problems in roading, water management and the Resource Management Act are not being effectively addressed. It is disingenuous of politicians like finance minister Michael Cullen to argue that things like the increase in the top tax rate in 2000 have had no impact because the economy remains strong. Any competent economist knows that the highest tax rates are the most damaging to growth, that other factors are impacting on the economy at any one time and can mask negative impacts, and that it is the cumulative effects of a series of bad moves that matter. And the cumulative effects are mounting: just as the benefits of the earlier reforms took years to show up, the costs of harmful moves will take time to materialise but they are now showing up in economic forecasts.

The point is not that the sky is about to fall in: New Zealand is still a good place to do business, but it is getting harder. The trends are going in the wrong direction. New Zealand's score for economic freedom has declined

after the earlier rise, and we have fallen back in the rankings of international competitiveness. The policies that brought us the gains are being eroded rather than extended. Japan and Germany – and Sweden, a country which the prime minister was recently extolling – are object lessons of what happens to countries that fail to sustain reform momentum.

There is now a marked contrast in the directions that New Zealand and Australia are taking, and the public debate in each country. In Australia, business, media organisations and government advisers are pushing the case for ongoing reform. Let me quote three recent examples.

First, our counterpart organisation in Australia, the Business Council, which comprises the CEOs of 100 of Australia's leading companies, has recently said:

The BCA's central message is this: Australia must act now to make further fundamental reforms to lock in its current prosperity and create the conditions for sustainable growth ...

The reality is that Australia will eventually find [its growth rate declining] unless steps are taken now to raise the long-term growth path ...

Similarly, in various recent editorials, the *Australian Financial Review* has written:

... the pickle most Western European countries are in now because of past failures to confront reform is a salutary warning that reform must go on ...

Australia stands at a crossroads. Economic reform has enhanced our prosperity, but too many people don't share in it because key pillars of social policy – education, health, welfare and income tax – have not been updated to cope with modern demands. Without a third wave of reforms to help more people participate in the economy, Australia could lose momentum and face yawning budget deficits when the baby boomers start to retire later this decade.

And in an address in Melbourne, the governor of the Reserve Bank of Australia, Ian Macfarlane, recently commented:

It is in 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.

In addition, in its latest report on Australia, the OECD has said that the Australian economy needs a reinvigorated reform programme to avoid sliding back towards lower growth and lower living standards.

The re-elected Howard government has on its agenda further reforms of tax, industrial relations and welfare, and further privatisation. The second Bush administration has a similar general orientation. By contrast, New Zealand's policy directions are more aligned with the economic losers of Europe in areas such as employment law, welfare, taxes and the Kyoto Protocol.

The Business Roundtable has been pointing out that no OECD government has sustained economic growth of 4 percent plus – the kind of growth rate the government is targeting – with total government spending (central plus local) at New Zealand's level of around 40 percent of GDP. The government studiously ignores this factual observation. Does it really think New Zealand can achieve what no other OECD country has managed? If it is serious about its growth target, it should set about reducing the government spending share of the economy in the forthcoming budget. Currently it plans to increase spending by a further two percentage points of GDP over the next few years. Its track record is to spend more without regard to value for money just because its coffers keep filling up, and without asking whether the money would be best left in taxpayers' hands.

Big and expanding government has always slowed the New Zealand economy down, from the Muldoon days to the present. For this reason the Business Roundtable has recently advocated tighter constitutional constraints on government spending, perhaps through rules that would limit spending growth to changes in population plus inflation, with surplus revenue being returned to taxpayers unless they supported higher spending increases in a referendum. The minister of finance dismissed the idea as "ideological", seemingly unaware that similar rules or spending caps have been applied in many US states and several countries. Just as shareholders in a company should ultimately sanction actions by their board of directors, so should taxpayers in a democracy sanction the actions of their agents in government.

We have also advocated moves towards a lower and flatter tax structure along the lines of the 2001 McLeod tax review, with maximum personal and company tax rates of 25 percent. This is not a radical proposal: Singapore and Hong Kong are two countries with lower rates, and many east and central European countries have been implementing low flat taxes. The annual fiscal cost of our proposal would be around \$3.6 billion, which would be readily achievable over a few years given the state of the government's accounts. Such a tax structure would dramatically increase New Zealand's attractiveness as a place to invest and work.

A further constitutional measure we have advocated is a Regulatory Responsibility Act to curb and roll back New Zealand's growing regulatory burden. Roderick Deane recently described the growth in regulations as "[t]he most difficult problem facing New Zealand boards", and noted that "[e]xcessive regulation reduces the adaptability and flexibility of the business world, and it's the business world after all that generates growth." As is the case with many spending programmes, many regulations benefit special voting interests rather than the community as a whole, and constitutional constraints on spending and regulation could help politicians resist interest group pressures.

In recent reports on New Zealand, the OECD has also highlighted problems of government spending, taxation and regulation, as well as the case for less government involvement in business, more choice, competition and private sector participation in health and education, and tighter welfare rules. New Zealand business organisations are saying much the same thing. We need more media organisations, politicians and government advisers explaining the need for ongoing reform, along the lines of similar voices in Australia. Within the bureaucracy, the Treasury and the Reserve Bank, unlike in the Muldoon days, seem afraid to tell the government that, as far as a growth strategy is concerned, the emperor has no clothes.

It would be a tragedy if it took another period of mediocre economic performance and relative economic decline for New Zealand to get back on to a serious reform path again. There is no cause for complacency: New Zealand has many vulnerabilities, not the least of which are population

ageing, ever-increasing global competition and the nasty shocks that routinely occur in economic life. Better institutions and policies are the key to economic progress, and these are within our own control. They take the form of moves to greater economic freedom and scope for private enterprise, not 'hands-on', 'busy', 'active' government. Such moves brought us our current level of prosperity, but we need more of them if New Zealand is to achieve its true potential. Looking back at the progress New Zealand has made over the last 20 years, the Business Roundtable sees the glass as being half full, not half empty, but we want to see it a lot fuller yet.