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WHY IS NEW ZEALAND NOT DOING BETTER?

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The questions I want to address are ones that many New Zealanders have asked over the past couple of years. Why isn't the New Zealand economy doing better? Why hasn't there been a greater pay-off from the programme of economic reforms? Shouldn't there be more gain after so much pain?

Those are good questions, and more could be said about them than I can cover in this short talk. Before suggesting some answers to them, however, we need to ask a prior question: 'How well has New Zealand been doing in recent years?' Several points need to be made.

First, we can say with confidence that it is doing much better than if the post-1984 changes had not been made. I know of no serious commentator who disputes that proposition. Previous policies were simply unsustainable. They were generating ever-higher levels of public debt and rampant inflation as well as feeble growth and rising unemployment. Deep underlying and longstanding problems were being hidden by a tangled web of subsidies, protection and regulations, and ultimately by blanket wage and price controls. Our credit rating was falling, and in the absence of changes we could have become, within a few years, the kind of economic basket case we used to associate with regions like Latin America. Nor would slower adjustment with looser fiscal policies have produced better outcomes, as Japan's sorry experience this decade illustrates.

Secondly, if we look at indicators of economic performance such as productivity and economic growth, it is clear that New Zealand is doing better than it was. Contrary to some earlier findings, the latest research on productivity published by the Treasury points to substantial improvements from 1993, aided by the effects of the labour market reforms of the early 1990s. In respect of real growth in gross domestic product (GDP), finance minister Bill English has recently noted that, using reasonable assumptions for the next couple of years, the economy will have averaged around 3 percent growth in the decade since 1991 compared with half that rate in the previous decade. Measures of productivity and growth are sensitive to the assumptions used, but there is little doubt that there have been real

improvements.

Some ask why New Zealand is not doing better than Europe, since Europe has higher government spending ratios and is often regarded as more highly regulated. The differences are not self-evident, however. Although New Zealand is less regulated than Germany or Italy according to the Heritage Foundation and *Wall Street Journal's* 1999 Index of Economic Freedom, it is not ranked more highly than France or Britain, and Britain and Ireland have lower government spending ratios than New Zealand. In any case, New Zealand's rate of economic growth this decade is much higher in relation to Europe, the OECD average and Australia than in either of the two previous decades. Based on data in the OECD's December 1998 *Economic Outlook*, New Zealand's average annual compounded rate of growth will be 2.8 percent in the period 1991-99. This is 47 percent higher than the 1.9 percent rate projected for the European Union countries and 23 percent higher than the 2.3 percent projected for the OECD. However, it is only 79 percent of the 3.6 percent rate projected for Australia.

By contrast, in the decade 1981-91 New Zealand's average annual compounded growth rate of 1.7 percent was only 65 percent of the European Union average, 57 percent of the OECD average and 64 percent of the Australian average. Nor was New Zealand's relatively poor performance during this period an aberration. During the decade 1971-81, New Zealand's average annual growth rate was 1.8 percent, 67 percent of the rate in the European Union, 53 percent of the OECD average and 56 percent of the Australian rate.

Thirdly, other important indicators of economic performance, such as inflation and the level of public debt, have also improved markedly. Growth is inevitably suppressed during a period when inflation is being brought under control. And just as a household forgoes current consumption when it is paying off debt, so too does a nation mark time in respect of material living standards when public debt is being repaid. But these are major gains nonetheless: inflation is no longer undermining economic growth and we are no longer bequeathing a large legacy of public debt to our children.

Having said this, one has to say that many economic trends, particularly since the mid-1990s, have been disappointing. The big gains in terms of economic growth, falling unemployment, substantial fiscal surpluses and low inflation followed the 1991 budget and the Employment Contracts Act. Recently New Zealand has been losing ground. Growth has decelerated to the point where the economy went into recession last year. After falling from around 11 percent to 6 percent, the unemployment rate rose sharply and is still over 7 percent. Our external debt ratio which was also dropping is now rising again due to a very large and worrying balance of payments deficit. Far from regaining a triple A rating as seemed likely at one stage, our credit rating has been downgraded. Despite a very large fall in the value of the NZ dollar, our international competitiveness ranking has fallen from 8th to 20th position. The agricultural sector is in dreadful shape. Although drought is currently partly to blame, more important causes are high tax burdens, land and environmental regulation and producer board monopolies. Meanwhile other statistics, such as welfare dependency, educational underperformance and crime, rightly concern people. The economy is regaining some momentum this year, but it is an unbalanced recovery and the outlook is not exciting. Why isn't New Zealand doing better?

To find what I believe is the right answer to that question, we have to go back several years. A country's long-term economic performance depends on underlying structural factors which change only slowly. Current events will always have a bearing on growth – the Asian crisis and the recent drought have clearly had an impact, as did the Gulf War and the electricity shortage earlier this decade. Monetary and fiscal stimulation or contraction will alter the economy's short-term path. But the factors that affect long-term performance for good or ill usually take many years to show up. The strong performance of the US economy in the past 7 years owes much to the deregulation and restructuring of American industry in the 1980s. Commentators on Australia's good performance today typically put it down to 15 years of reform efforts by federal and state governments. Their efforts have not always been as well-designed and as radical as some of New Zealand's reforms – many would say Australia did not need to take such drastic action – but the difference is that they have been sustained. Australia's ratio of government spending to GDP will have fallen for 8 successive years to 33.3 percent in 2000,

according to the OECD's December 1998 *Economic Outlook*. New Zealand's ratio is projected to be 40.4 percent in the same year, fractionally higher than in 1994.

When we look back, we see that New Zealand really had only two bursts of serious reform over the past 15 years – under a Labour government from 1984 to 1988 and under National in 1990/91. These were followed respectively by the Lange and Bolger teabreaks. Since the last teabreak has gone on for seven or eight years, during which time other countries like Australia have implemented most of our earlier reforms and done more, it is galling but not surprising that New Zealand is now lagging again.

The warning signs have been unmistakable for a long time. I recall that in 1992 I gave a speech which had the title *A Rattle of Teacups?* In it I quoted the advice of the most recent Organisation for Economic Cooperation and Development (OECD) report on New Zealand:

To build on the reforms of recent years and to underpin the much-needed improvements in the country's medium-term growth prospects, it is essential for New Zealand to consolidate and extend the policy orientation pursued since the mid-1980s.

I pointed out that that wasn't happening. In its budget that year, the government had already shifted its stance. In 1991 it had clamped down on its spending even though the economy was in recession, and this action was a major factor in the export-led expansion that began that year. By the time of the 1992 budget, however, it was already easing up on the grounds that it didn't want to kill off the recovery. The logical inconsistency was glaring. At the same time Jim Bolger was declaring privatisation of electricity and postal services off-limits. I pointed out that many other obstacles to a better growth performance, such as producer board reform, restrictive practices in the legal profession and the absurd rules governing pharmacy ownership, remained unaddressed. They are still in the too-hard basket today. In conclusion I noted that there was growing acceptance of the merits of the changes that had been made but said:

The real argument is not about what has been done. The real argument today is about whether we are prepared to do more to achieve assured success or whether we are content with a still

fairly mediocre and risky outlook, and want another teabreak.

After the 1993 election and the dumping of Ruth Richardson, it was perfectly clear what was in store. Early in 1994 the then chairman of the New Zealand Business Roundtable, Douglas Myers, gave a speech entitled *Two Scenarios for New Zealand*. One of them he called the 'fast-forward' scenario, under which New Zealand pressed on with efforts to improve its economic structure as the OECD had recommended. The other was the 'rewind' scenario, under which he said New Zealand could snatch defeat from the jaws of victory by reverting to high spending and growth-destroying policies. He mentioned the recent introduction of a youth minimum wage as the start of a process which Max Bradford had described as "death by a thousand cuts". Regrettably, the 'rewind' scenario is the one that, by and large, New Zealand has followed.

I felt it was worth reminding you of these assessments because, if you were to believe many letters in newspaper columns, the Business Roundtable has been running the country for the past 15 years. The reality is that through perhaps a third of that period we have supported efforts by governments to implement policies that we saw as broadly correct for New Zealand, and that we have become increasingly at odds with the direction and drift of policies for the past several years.

Coming closer to the present time, the problems were compounded with the change to the Mixed Member Proportional (MMP) electoral system and the coalition government that followed the 1996 election. These added further uncertainty to the country's directions and the business environment. The worst result of the coalition negotiations was the totally irresponsible commitment to a further \$5 billion of generally low quality government spending, on top of an already strong upward trend. The extent of this irresponsibility still seems to be poorly understood by New Zealanders. The \$5 billion sum over 3 years can be contrasted with the additional spending plans of the Australian government announced in this week's budget which total under NZ\$4.5 billion over 3 years. Australia is an economy nearly seven times larger than New Zealand. More recently, the government's spending plans have been marginally cut back, but government spending has accounted for a larger share of the economy in each of the last 3 years. It is little wonder that the private sector has been struggling throughout this period.

Since the coalition broke up, there have been a few worthwhile initiatives such as the partial opening up of the accident insurance market and the sale of Contact Energy, but overall not much has changed. The business sector is still burdened by developments in recent years such as the re-regulation of the labour market by the courts, inefficiency in local government, and the economic and compliance costs of the Resource Management Act and legislation on human rights, privacy and occupational health and safety. There is a strong momentum towards increasing regulation of land use, businesses and commerce. According to the office of the minister of commerce, over 1,600 new pieces of legislation and 3,600 new regulations have been introduced in the past decade. The current drive to regulate for hazardous products, heritage sites, biodiversity, energy efficiency, biogenetic labelling and carbon emissions illustrates the pressures. We are busy making ourselves another Tasmania. In contrast, there is no real momentum behind initiatives like privatisation, producer board deregulation and roading reform. In some areas we are seeing backward movements such as the proposals to bring in paid parental leave, reintroduce price controls on electricity and move away from light-handed regulation under the Commerce Act. For all these reasons, I suggest the answer to the question: 'Why is New Zealand not doing better?' is fairly plain.

What's more, the answer I have given you is very much the same as the assessment by the OECD in its latest report on New Zealand which came out last week. The OECD said that New Zealand had been on the right course since the mid-1980s but pointed out that achieving strong economic performance depends on the government getting many things right. It was critical of the inconsistent progress towards a more prudent fiscal position and of the quality of spending. It pointed out that "the attainment of long-term fiscal goals that had been within reach [had] now been pushed well into the next decade." It commented that businesses were hampered by cumbersome redundancy and dismissal procedures, advised the government to avoid a further increase in the minimum wage, and repeatedly criticised the slowness on producer board reform and bulk funding of schools. It urged the government to follow through on the "largely stalled programme of privatisation" and to introduce more competition in health, education and local government. Overall, the OECD noted that many policy commitments had been

made but remained unfulfilled, and stressed the need for "an ongoing – rather than stop-and-go – reform effort."

Are there alternative explanations for New Zealand's mediocre performance that are worth considering? Frankly, they're hard to find: around the world the arguments for greater economic freedom as a means to growth have largely been won. At an APEC meeting involving small and medium enterprises (SMEs) in Christchurch last month, I was struck by the consensus on the fundamentals that have been stressed in New Zealand over the past 15 years: sound monetary and fiscal policy, reducing barriers to trade and compliance costs, deregulation to create competitive markets, protection of property rights, reducing tax distortions, private sector involvement in infrastructure, and the promotion of an enterprise culture and business skills. One of the few critics of these priorities, the *Business Herald*, has dismissed them as "formulaic" and "increasingly irrelevant". But how many of them can be regarded as more than partially achieved in New Zealand today?

It is vital that there should be ongoing debate about how New Zealand can do better: nobody has ever accused our organisation of being afraid of debate. But proposals need to be based on a coherent understanding of how an economy works, and be backed by sound economic theory and evidence. It is not enough to make assertions unsupported by reputable research and authorities. It is not enough to look at a country and fasten on one element of policy without assessing whether it is helpful or harmful and how it relates to other, possibly far more important, reasons for that country's success or failure. Two years ago the *Herald* was telling us that nothing was wrong with New Zealand's policy framework and that business should stop criticising and get on with the job. Today it is saying New Zealand needs new directions – basically more "active government" – and should be going in for things like preferential tax rates and subsidies, regulation of company takeovers, heavier regulation of electricity and telecommunications services, and big increases in spending on education.

None of these approaches is recommended in the report of the OECD, which reflects mainstream economic thinking. Most have been tried and failed in the past. Tax concessions and subsidies to one industry are inevitably a cost to other industries.

Capital and other economic resources are misallocated away from industries that can stand on their own feet to those that are only profitable with taxpayer assistance. An open market for corporate control is vital for business efficiency: the consensus at a recent conference of business law professionals convened by the Ministry of Commerce was that "the [takeover] code should be buried for good". Deregulation of the electricity and telecommunications markets has produced large benefits for consumers, and price controls have never worked. Finally, while education is obviously very important, there appears to be no strong, systematic relationship between school expenditure and student performance. The relationship between a country's educational spending and its economic performance also appears problematic. In any case, the billion dollars of extra spending on education in recent years has had no clear, positive results. The urgent need is to address the dysfunctional aspects of the system, especially the extent of the state monopoly of education.

Whether the message is boring or not, I believe the business community must keep focused on the basics. It took years to achieve better policies during the Muldoon era, but good arguments finally won out. We learned in that period that there is no magic bullet, no salvation in expedient quick-fixes. The business community said 'thanks but no thanks' to the \$100 million of so-called business assistance offered by the coalition government, and argued for lower spending and taxes instead. I hope it maintains that position. Good long-term growth is about maintaining a sound and predictable economic environment, rejecting protection and privilege, and striving for smaller and more effective, not bigger, government.

As a final point, I believe modern economics teaches us that there is no difference between the economic policy interests of large and small businesses. The SME conference in Christchurch came up with essentially the same prescription for growth as that promoted by the OECD and by our organisation. After all, large businesses are usually just small businesses that have succeeded and grown because they have produced what consumers want to buy. In any case, few of New Zealand's businesses are large by international standards, some are collections of smaller businesses, and still others are divesting non-core activities in line with worldwide trends. Large firms may have more systems to cope with burdensome regulations than small ones, but small ones may just ignore them: either way, the

community as a whole suffers through more costly goods and services or disregard of the rule of law. What the community needs is efficient businesses, whether large or small, and we should reject suggestions that the business sector has divided interests.

So, if we want New Zealand to do better, as I and most people I know in business most definitely do, then I suggest the way forward is pretty clear. It is to return to the path that New Zealand was following when we were making good progress, and to press ahead. It also means finding more effective approaches in many other areas such as education, health, welfare, superannuation and the Treaty of Waitangi. All of these feature on the work programme of our organisation because the business community recognises that good policies in these areas are vital for economic and social progress.

There is no reason why New Zealand cannot achieve much greater economic and social success. But doing better will require better policies, as well as continuing efforts by businesses of all sizes to improve their contribution to the economy. At present the quality of New Zealand's policies is no better than average, and therefore we should not expect better than average economic performance. We must improve the quality of policies if we want to rejoin the ranks of the world's most successful countries in the early part of the next century, and we should aspire to nothing less.