feature article

Faster Growth?

If New Zealanders Want It

Don Brash

A seismic shift in attitudes towards wealth creation is required in New Zealand if the country is to pursue policies that result in stronger economic growth.

Many New Zealanders do not see increasing economic growth as a high priority objective. But the reality is that if we want better housing, better healthcare and better education, we need economic growth. We have difficulty funding our collective desire for health care and education now, and those costs look certain to rise in the years ahead. If we want to retain a relatively egalitarian society, we absolutely need economic growth—without it, too many of our highly skilled people will leave our shores, forcing up the relative incomes of the skilled people who choose to stay. Perhaps surprisingly, even if we want more attention paid to preserving our natural environment, we need growth—international experience suggests that it is the relatively affluent countries which can afford to spend resources on protecting the environment. So economic growth is not 'just about money', but concerns many of the issues of vital relevance to all.

Growth performance to date

How has New Zealand been doing in the economic growth stakes? Unfortunately, not too well if we judge from the last three decades. Over that period, growth in GDP per capita has averaged 0.8% p.a., compared with an average of 2.0% p.a. in the countries of the OECD.[1] As a result, New Zealand has slid from 9th in the OECD 'rankings' in 1970 to 20th in 1999 (comparisons made on a purchasing power parity basis, rather than at market exchange rates), and has also been well surpassed by some countries which are not OECD members at all (Singapore being the best example).

As recently as 1990, New Zealand's GDP per capita was roughly on a par with Ireland's and Singapore's. By 1999, both countries had very considerably surpassed us. In 1990, Australia's GDP per capita was only some 5% above New Zealand's; by 1999, it was nearly 40% above New Zealand's.[2]

What should we make of these figures? The first thing to note is that for a whole range of reasons GDP per capita is not a very precise measure of human well being. As Paul Carpinter recently observed, quality of life measures often show Auckland in the top ten cities worldwide,[3] something hardly consistent with New Zealand being towards the bottom of the OECD 'ladder'.

Having said that, there can be little doubt that there has been some relative decline in living standards in recent decades.

At first sight, this relatively slow growth seems surprising. We've had an extensive period of economic reform, specifically designed to help us to grow more quickly. Doesn't our poor growth performance suggest that the reforms of the mid-1980s and early 1990s were seriously flawed? Not at all. There is little doubt that the reforms have helped our growth potential a great deal. The decade of macroeconomic stability

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delivered a huge reduction in the net public sector debt, from over 50% of GDP in the early 1990s to under 20% at the present time. The reforms also delivered a big improvement in the quality of service in areas such as banking, retailing, telecommunications, postal services, healthcare, and airlines.

Recent years have also seen very rapid growth in a whole host of relatively new industries—wine, mussels, software, furniture, specialised manufacturing, education services—to say nothing of a rapid increase in the sophistication of some traditional industries. Moreover, while GDP per capita grew at a rate of only 0.8% p.a. over the last three decades on average, it grew at almost 1.7% during the 1990s, virtually identical to the average OECD per capita growth over the same decade.[4] So the reforms seem to have arrested our relative decline, but not, as yet, enabled us to begin the process of reducing the gap in per capita incomes which emerged over earlier decades. We are now keeping up, roughly, but not catching up.

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What about the future?

In recent times, many political leaders have suggested that as a country we should be aiming to return New Zealand's income levels to the top half of the OECD. As far back as 1990, the Trade Development Board, now Trade New Zealand, proposed that that goal be achieved by 2010.

Would it now be feasible to raise New Zealand's per capita GDP to the median OECD level by 2010? What such a goal would imply in terms of growth rates over the next decade would clearly depend in part on how fast other OECD countries themselves grow over the decade, but plausible numbers—which assume that other OECD countries achieve the same per capita growth rates over the next 10 years as they did in the 1990s—would require GDP per capita growth in New Zealand of about 3.6% p.a., somewhat more than double the growth in per capita GDP achieved by New Zealand in the 1990s.[5]

Can a doubling of our per capita growth rate, as compared with the 1990s, be achieved? It would certainly be extremely difficult, but perhaps not impossible. Some other small countries—Finland, Ireland and Singapore are the most frequently cited examples—have achieved similar or even greater increases in per capita income, but it has been a very rare achievement, sometimes made possible in part by starting from a situation of economic collapse (Finland), and sometimes made possible in part by being able to bring very large numbers of unemployed people into the workforce (Finland and Ireland). Finland and Ireland also derived substantial benefits by being inside the European Union. New Zealand does not start from a position of economic collapse, and our unemployment rate is already low compared with that in many other OECD countries. We do not have large numbers of unemployed people with appropriate skills and attitudes waiting to leap into the workforce. We are not part of a large market of 300 million people.

To have any chance of doubling our per capita growth rate we will need to see quite radical changes in people's attitude and behaviour, and quite radical changes in public policy to encourage those changes in attitude and behaviour. Minor changes at the margin simply won't do the trick. Even major changes might not do the trick, since we seem to have some deeply-engrained cultural characteristics which are not conducive to rapid growth—surprisingly widespread disdain for commercial success, no strong passion for education, and a tendency to look for immediate gratification (as reflected in our very low savings rate and strong interest in leisure)—and it usually takes years, and perhaps generations, to change such cultural characteristics.

This attitudinal change is probably the most important single need if we are to radically increase our per capita growth rate. We need to *want* faster growth or, in personal terms, higher income.

What might be required?

Increasing per capita GDP is about increasing the proportion of the population who are contributing to the production of goods and services in the market economy, and about increasing the productivity of those people.

What scope is there for this kind of increase? Certainly, not nearly as large as was the case in Ireland and Finland when they began their period of rapid growth, with very high levels of unemployment. Participation in the workforce by those between 15 and 64 is currently around 66% in New Zealand, not far below participation rates in Singapore and Ireland (68 to 70%) currently. Unemployment, while higher than anybody feels comfortable with, is already approaching levels which are relatively low by OECD standards.

Getting still more people into employment in the market economy may involve making some difficult social and political trade-offs. For example, does the present welfare system—with largely unrestricted access to benefits of indefinite duration, and with a very high effective marginal tax rate for those moving from dependence on such benefits into paid employment—provide appropriate incentives to acquire education and skills and to find employment?

Nobody in New Zealand wants to deny those who are temporarily down on their luck sufficient income support to enable them to get back on their feet. In that respect, we are not willing to pay the price that Singapore paid to achieve very high growth, a society almost devoid of taxpayer-funded income support. But increasingly it is recognised that we will not achieve a radical improvement in our economic growth rate while we have to provide income support to more than 350,000 people of working age—60,000 more than when unemployment reached its post-World-War-II peak in the early 1990s—to say nothing of the 450,000 people who derive most of their income from New Zealand Superannuation.

This is partly because of the huge fiscal costs of these transfer payments—amounting to an estimated $13 billion this financial year, or some 11% of estimated GDP (both figures include the fiscal cost of New Zealand Superannuation). This cost substantially constrains the government from devoting more resources to education, law and order, research and development, and tax reduction.

Are there ways in which we can change the incentives facing people now receiving such transfer payments? Could we, for example, drop all benefits to the able-bodied and scrap the statutory minimum wage, so that pay rates could fall to the point where the labour market fully clears, but simultaneously introduce a form of negative income tax to sustain total incomes at a socially-acceptable level? Could we introduce some kind of lifetime limit on the period during which an able-bodied individual could claim benefits from the state? Could we, perhaps, gradually raise the age at which people become eligible for New Zealand Superannuation, reflecting the gradual increase in life expectancy and improved health among the elderly?

Clearly, there would be huge benefits not just to economic growth but also to social cohesion if we were able to achieve a radical reduction in the number of those dependent on income transfers from the state.

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Increasing productivity

Even more important than increasing the proportion of the population who produce goods and services in the market economy is increasing productivity. Ultimately, it is productivity—output per person—which mainly determines the standard of living, and it is clear that increasing GDP per capita by 3.6% p.a. means at least trebling the rate of productivity improvement which New Zealand has achieved in recent years (not much above 1%).

Improving productivity involves a whole host of things that can be loosely grouped under three headings—improving human capital, improving physical capital, and improving technology.

Improving human capital

To improve our human capital, we urgently need to improve the quality of our education system. That is, 'improve the quality of our education system' rather than increase the resources devoted to our education system. We might need to increase the resources devoted to education, but we already spend a higher fraction of our national income on government support for education than the majority of other developed countries. Despite this, international surveys of educational achievement suggest that we are not getting educational outcomes consistent with this high level of expenditure.

It must be a source of grave concern that so many of the people coming out of our high schools have only the most rudimentary idea of how to write grammatical English; and that while Singapore, South Korea, Taiwan, and Hong Kong occupied the top four places for mathematics in the Third International Maths and Science Study, New Zealand ranked only 21st (out of the 38 countries in the study).[6]

It cannot be good for our economic growth, or for the employment prospects of many of our young people, that, according to an OECD report released in April 1998, nearly half of the workforce in New Zealand cannot read well enough to work effectively in the modern economy.[7] It must be a matter for particular concern that 70% of Maori New Zealanders, and about three-quarters of Pacific Island New Zealanders, are functioning 'below the level of competence in literacy required to effectively meet the demands of everyday life'.[8]

Improvements in pre-school, primary, and secondary education are crucial for our long term growth, and for the long-term social cohesion of our society—probably more so than are improvements in tertiary education. Indeed, it may well be that improvements in these pre-tertiary areas are the fundamental prerequisites for improving the quality of tertiary education in New Zealand.

But although there can be little doubt that improving our human capital by securing improved educational outcomes would contribute to New Zealand's long-term growth, the higher-growth dividend from improved educational outcomes would almost certainly accrue well into the future, not within the next few years, or possibly even within the next decade. Indeed, it is sobering to reflect that some of the countries which have had particularly good economic growth in recent years, such as Australia and the United States, have literacy levels not significantly higher than New Zealand's. It may well be that better educational outcomes would be more important in ensuring that more of our people have access to higher paid jobs, and thus in assisting social harmony, than in assisting economic growth directly.

Improving physical capital

One obvious way of increasing the output per person employed is to give people more physical capital to work with, not just plant and machinery but also roads and other infrastructure. Of course, more physical capital is of no use whatsoever if it is the wrong sort of physical capital, and that points towards the huge importance of 'getting the signals right'—that is, ensuring that investment takes place in areas which maximise the goods and services produced by that capital. As the Japanese have discovered in recent years, all the investment in the world will not encourage growth if the extra capital produces few of the goods and services that people actually want.

We now have most of the signals right—businesses are no longer encouraged by high levels of protection to invest in industries where New Zealand will never be internationally competitive; the financial sector is free of the regulation (and the irrational exuberance that immediately followed the removal of that regulation) which used to distort the allocation of resources; and the misallocation caused by the interaction of inflation and the tax system is also now a thing of the past.

Businesses find the compliance costs of many public sector rules and regulations a significant obstacle to more investment.

Under these circumstances, what might we do to encourage investment in *more* physical capital?

At the very least, we need to seek and destroy those obstacles to investment which are within our own control. There is little doubt, for example, that businesses, especially small and medium-sized businesses, find the compliance costs of many public sector rules and regulations a significant obstacle to more investment. The recent report of the Ministerial Panel on Business Compliance Costs highlighted these issues, and noted that complying with a multiplicity of rules and regulations stifled the ability of businesses 'to expand, innovate and compete'. Businesses saw the biggest single problem as the way in which the Resource Management Act was being implemented, and described dealing with that legislation as being 'cumbersome, costly and complex'. It should not take two years to get all the approvals needed to set up an early child-care facility for only 30 children, or ministerial intervention to cut through the red-tape involved in setting up a boat-building yard.

We may also need to look at whether there are deficiencies in our national infrastructure which are acting as a deterrent to investment. Do we, for example, need to improve the transport infrastructure in some parts of the country—perhaps in some of the areas where forests are reaching maturity by upgrading road systems, perhaps in Auckland by completing the originally-planned motorway system and by introducing more appropriate congestion charges?

Could we do more to encourage investment by expanding the size of the market? If the small size and isolation of the New Zealand market discourage investment in New Zealand, should we be doing more to encourage those with the skills and attitudes which can assist our growth to immigrate to New Zealand?

Should we more vigorously seek economic integration into a much larger market? We have made a great deal of progress through our free trade arrangement with Australia, and the bilateral free trade arrangements with Singapore, and potentially Hong Kong and other countries in the region, are to be welcomed. But if we really want to encourage investment in New Zealand for a much larger market, perhaps we should be devoting every effort to negotiating a free trade arrangement and greater economic integration with the United States also. There can be little doubt that one of the major reasons for the recent economic success of both Ireland and Finland is their membership of the European Union. Closer economic integration with the United States would not make New Zealand any closer physically to California, but it would carry potentially enormous economic benefits.

The time may have arrived when we need to give serious consideration to the pros and cons of alternative currency arrangements.[9] Far be it from me to advocate the abolition of the Reserve Bank of New Zealand! Any decision to abandon the New Zealand dollar in favour of some other currency is finally a political decision, not a decision for central bankers. Whether there would be a net economic benefit in adopting some other currency arrangement is uncertain, but if we are to have a no-holds-barred discussion on how to improve New Zealand's economic performance, one of the issues that should be looked at is this.

Another matter relevant to how we might encourage more investment in physical capital is the tax regime. Do we need a substantial change in the tax structure to encourage investment in New Zealand by New Zealanders, by immigrants, and by foreign companies? And if so, what might that change look like? This would probably involve a significant reduction in the corporate tax rate (it is disturbing that New Zealand's corporate tax rate is now the highest in the Asian region). The rate of company tax is rarely the only factor determining the location of a new investment, and indeed it is not often even the dominant factor. But it is a relevant factor, and is one of the issues to look at if we are serious about encouraging more investment in New Zealand.

Improving technology

Finally, how might we increase the growth rate of productivity, or of GDP per capita, by further increasing the rate at which we adopt new technology from abroad, and develop new technology of our own? Roger Ferguson, Vice Chairman of the Federal Reserve Board, cites research done by US Federal Reserve economists which suggests that 'the consolidated influences of information technology investments account for about two-thirds of the acceleration in (US) productivity since 1995'.[10] And there can be little doubt that a radical improvement in New Zealand's productivity growth rate will require a more rapid adoption of new technology than has been the case in recent years.

It is disturbing that New Zealand's corporate tax rate is now the highest in the Asian region.

To some extent, we would see more rapid adoption of new technology if we saw more investment in human and physical capital. The three things often go together. But there are some things we probably need to do to encourage this.

To begin with, we should at least try to ensure that there are no obstacles to the development and adoption of new technology. In particular, we need to ensure that our regulatory framework does not close off developments in biotechnology, an area where we have the potential to be world leaders. This does not, of course, mean that there should be no restrictions whatsoever on experiments in this area, but it does mean that we should remember that every restriction has a cost as well as a potential benefit, and sometimes the cost can be very substantial.

Do we need to go further, by providing positive incentives to undertake research and development in New Zealand? Recent OECD data suggest that Australian businesses spend about double what New Zealand businesses spend, relative to GDP, on research and development, while those in Ireland spend about three times as much, those in Finland spend about six times as much, and those in Sweden spend about nine times as much. Even allowing for some over-statement arising from businesses having an incentive to re-classify expenditure as R & D where there are tax benefits from doing so, New Zealand businesses seem to be spending substantially less on R & D than do businesses in other successful economies.[11]

Do we need to take steps to encourage the adoption of new technology by encouraging a more entrepreneurial, more risk-taking culture? At a minimum we may need to try to make entrepreneurs feel more loved! We also need to foster an understanding of financial matters, and an interest in business activities, in our schools, through programmes such as those run by the Enterprise New Zealand Trust.

We need to consider whether the personal income tax structure provides appropriate encouragement to entrepreneurial New Zealanders to stay in New Zealand, and encouragement to entrepreneurial potential New Zealanders to come here. Our top rate of personal income tax is not particularly high by the standards of other developed countries, but it cuts in at a level of income below that in many countries and our tax system allows relatively few deductions. Compared with the rapidly growing economies of Hong Kong and Singapore, our top rate of personal income tax is very high.

Perhaps we also need to think of some more innovative moves in the tax area. The United Kingdom attracts many entrepreneurial people from all over the world to live and work in that country by exempting from UK tax all income generated outside the UK for people not born in the UK. Switzerland effectively 'negotiates' the tax to be paid by wealthy foreigners who want to live in Switzerland. It may be no accident that many entrepreneurial New Zealanders have moved to these countries in recent years.

Another idea was suggested in the discussion paper issued by the McLeod Committee recently, namely establishing a maximum amount of income tax to be paid by any individual during the course of a year. The McLeod Committee suggested that that might be $1 million.[12] Even a maximum of $500,000 per annum would be more than enough to cover 10 times over the cost of public services likely to be used by a person paying that much tax, but would be a level of tax which would seem very attractive to many expatriate New Zealanders and other entrepreneurial people in the US, Europe and Asia, from whom we are currently collecting no tax revenue at all.

It is highly likely that establishing such a maximum would actually generate significantly more tax revenue for the New Zealand government than the present tax structure does. It would offend traditional New Zealand values to waive income tax once $500,000 had been paid, but what if very few current New Zealand residents pay more than $500,000 in tax each year? And if such a regime encouraged 1,000 entrepreneurs to come to New Zealand and the government were to gain, say, an extra $500 million a year in tax revenue to finance more early-childhood education and tax incentives for research and development, who amongst us would be worse off? Indeed, the likelihood is that such an injection of entrepreneurial drive might well play a major role in changing the rate at which New Zealand business adopted new technology, and so in improving the growth in New Zealand productivity.

Conclusion

New Zealand has some huge advantages in terms of economic growth—macroeconomic stability, a substantial measure of consensus on economic policy across the political spectrum, a competent and corruption-free judiciary and bureaucracy, an English-speaking population. After some decades of growing substantially more slowly than other developed countries, we have recently picked up our growth performance and during the 1990s achieved per capita growth at a rate closely similar to average growth in other OECD countries. There are, therefore, plenty of reasons to be optimistic. Getting back to around the middle of the OECD pack in terms of GDP per capita within a decade—indeed, even within two decades—will still be a major challenge. Fortunately, our history suggests that we thrive on challenges.

Endnotes

1 'Climbing the OECD Ladder: What Does New Zealand Have To Do?', a memo written by Grant Scobie and Peter Mawson to Alan Bollard (New Zealand Treasury: 4 April 2001).

2 As above.

3 Speech to the annual conference of the New Zealand Association of Economists (Christchurch: 28 June 2001).

4 Scobie and Mawson, 'Climbing the OECD Ladder'.

5 Towards Higher Living Standards for New Zealanders: Briefing to the Incoming Government 1999, The Treasury.

6 IEA Third International Mathematics and Science Study, 1998-1999.

7 Human Capital Investment: an International Comparison (OECD, 1998).

8 *Adult Literacy in New Zealand* (Ministry of Education, 1998).

9 For a full discussion, see D. Brash, 'United We Stand? The Pros and Cons of Currency Union', *Policy* 16:3 (Spring 2000), 15-18.

10 'The Productivity Experience of the United States: Past, Present and Future', a speech at the US Embassy in The Hague (14 June 2001).

11 A New Economy? The Changing Role of Innovation and Information Technology in Growth (OECD, 2000), 29.

12 *Tax Review: Issues Paper* (June 2001).