feature article

New Zealand's Flawed Growth Strategy

Roger Kerr

The government is committed to raising the country's growth rate, but this will not happen while public spending and taxation remain high.

The New Zealand government's top priority in this parliamentary term is to raise New Zealand's economic growth rate. Last month's Speech from the Throne (the address by the Governor General at the opening of parliament) stated unequivocally that the government: '. . . sees its most important task as building the conditions for increasing New Zealand's long term sustainable rate of economic growth'.[1]

The government has set a goal of returning New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings. The minister of finance has said that the next couple of years will show if New Zealand is on the right track.[2]

Becoming a high income economy is a goal that deserves total support. It is the only effective solution to many of the country's economic and social problems. The government deserves credit for committing itself to a very specific goal and holding itself accountable for getting New Zealand on to a much higher growth path over the next couple of years. Its credibility will rest on whether medium-term projections for economic growth after two terms in office are consistent with its top priority goal.

Can it be done?

A useful Treasury paper last year looked at how fast the economy would have to grow to bring New Zealand's real gross domestic product (GDP) per capita up to at least the median GDP per capita for OECD members.[3] Using reasonable assumptions it found that real GDP per capita growth of between 4.6% and 7.4% a year would need to be sustained for 10 years to achieve that goal. Currently the government's projections are for annual growth rates to fall away to just over 2% after the middle of this decade. The projections are for growth of real GDP, not per capita GDP, but as population growth is expected to fall to zero by that time the two growth rates converge.

Climbing back up the OECD ladder is not an impossible task. In the decade 1992-2001, New Zealand's real GDP grew by 3.1% a year on average. This was above the OECD average, almost twice the growth rate achieved by Germany and nearly three times that of Japan. Nevertheless, the Treasury calculations indicate that the projected long-term per capita growth rate of a bit over 2% a year would need to double to over 4% on a sustained basis to achieve the government's goal.

Doubling the economy's growth rate will require major changes. Economic research indicates that most of the international variation in income per capita—perhaps as much as 85%—can be explained by the institutions and policies countries adopt.[4] That is good news. It means that factors such as New Zealand's size and geography do not seriously limit potential income. But it also means that all institutions and policies need to be assessed in terms of their effect on growth. Every proposal before Cabinet and every bill before parliament needs to be judged on the basis of whether it is consistent with the government's priority of growth. Those that

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fail the test, such as the proposal to ratify the Kyoto Protocol, must be reviewed.

There are a lot of measures that would increase New Zealand's economic growth rate, and a coherent and consistent overall programme is essential. Some, however, are more important than others. Recently, the Nobel laureate in economics Milton Friedman was asked to nominate three policy changes that would do most to increase economic growth in the United States. His priorities were free trade, a competitive education system and cuts in government spending.[5] To date, the New Zealand government has moved in the opposite direction in all three areas: it has frozen tariffs, extended regulation and central control of education, and raised the long-term objective for central government spending from 30% to 35% of GDP.

Size matters

Last year the New Zealand Business Roundtable published a study by an Australian economic consultant, Winton Bates, entitled *How Much Government? The Effects of High Government Spending on Economic Performance.* The aim of the study was to survey modern research on whether high levels of public spending—and hence taxation, since most government spending has to be financed by taxation—harms economic growth.

In a famous exchange of views in the 1940s, John Maynard Keynes agreed with fellow economist Colin Clark that the maximum spending and tax burden an economy could sustain was about 25% of GDP. This was roughly the level reached in many advanced countries by the 1960s, but its effects on economic performance took time to show up. Twenty years ago, studies on the relationship between spending and growth tended to be equivocal. Bates's review of more recent research pointed to a clear negative relationship between the size of government and growth.

A comment by Professor James Gwartney, a leading researcher on economic growth, quoted in the study, received a lot of attention. Gwartney wrote:

> . . . New Zealand is still a big government welfare state. Government spending [central pus local government] continues at nearly 40 percent of GDP, a figure much too high for maximum growth. I do not know of any country that has sustained per capita income growth of 4 percent or more with that level of government spending.[6]

One critic of this statement is the minister of finance, Michael Cullen. In an election debate on 23 July 2002

Table 1. OECD countries that achieved annual average growth in real GDP per capita of at least 4% a year for 5, 7 or 10 years consecutively

Achieved Growth	*Ireland*	*Korea*	*Luxembourg*	*Finland*	*Portugal*	*Spain*	*Mexico*	*Japan*
Over five years in a row	1985-1990	1985-1990	1985-1990		1985-1990	1985-1990		1985-1990
	1986-1991	1986-1991	1986-1991		1986-1991	1986-1991		1986-1991
	1987-1992	1987-1992	1987-1992		1987-1992			
	1988-1993	1988-1993	1988-1993					
		1989-1994						
	1990-1995	1990-1995						
	1991-1996	1991-1996						
	1992-1997	1992-1997	1992-1997					
	1993-1998			1993-1998				
	1994-1999		1994-1999	1994-1999				
	1995-2000		1995-2000	1995-2000			1995-2000	
Over seven years in a row	1985-1992	1985-1992	1985-1992		1985-1992			
	1986--1993	1986--1993	1986--1993		1986-1993			
	1987-1994	1987-1994	1987-1994					
	1988-1995	1988-1995	1988-1995					
	1989-1996	1989-1996						
	1990-1997	1990-1997	1990-1997					
	1991-1998		1991-1998					
	1992-1999	1992-1999	1992-1999					
	1993-2000	1993-2000	1993-2000	1993-2000				
Over ten years in a row	1985-1995	1985-1995	1985-1995					
	1986-1996	1986-1996	1986-1996					
	1987-1997	1987-1997	1987-1997					
	1988-1998	1988-1998	1988-1998					
	1989-1999	1989-1999						
	1990-2000	1990-2000	1990-2000					

he claimed it 'is simply wrong'. He also stated that the view that 'cutting taxes leads to higher economic growth is simply not true'. Dr Cullen's rebuttal appears to be based on a memorandum from his advisor, Peter Harris, whose analysis makes the following assumptions:

- that the focus is on the economic performance of OECD member countries;
- that the relevant rate of growth is that of GDP per capita; and
- that the appropriate measure of the level of spending is the OECD's ratio of general government outlays, which includes local government, to GDP.

Mr Harris's paper acknowledges that instances of 4% per capita growth over an extended period of time 'are not that common'. Nevertheless, he identified four countries (Finland, Ireland, Korea and Luxembourg) that were 'of interest' in having achieved that rate of growth for five years or more since 1985. He wrote that, of these, one (Korea) had a small government and the other three 'had governments that spent in excess of the "forty percent" level'.

As table 1 opposite shows, Mr Harris's statement that these four countries achieved 4% per capita growth for five years or more is correct. However, five years is too short a period to establish 'sustained' growth. Professor Gwartney's comment on this point is as follows:

> Clearly, growth during a five-year time period is often a misleading indicator of long-term sustainable growth. Finland illustrates this point. While Finland achieved 4% growth during the five-year period following 1994, real GDP fell by approximately 10% during the four years prior to 1994. Thus, Finland's strong growth during the five years following 1994 was primarily the result of recovery from a very deep recession. It did not represent long-term sustainable growth. At least a 10 year period is needed to avoid the bias introduced by cyclical factors.[7]

Moreover, the debate is in the context of lifting New Zealand's level of real GDP per capita to at least the median for OECD members. As the Treasury paper showed, New Zealand's real GDP per capita would need to grow by at least 4.6% a year for 10 years to achieve the government's goal. Thus 10 years is a more relevant period to use.

When the growth objective is extended to 10 years, only three OECD countries (Ireland, Korea and Luxembourg) achieved it, as the table shows. The average ratio of government spending to GDP of two of these three countries was well below 40%. Between 1985 and 2000, Korea's spending ratio peaked at 23.3% in 1999. Ireland's spending to GDP ratio was almost 51% in 1985. It subsequently declined to be under 40% in 1989 and was under that level for all but four years (1991 to 1994) up to 2000. In 2000 it was 29%. As Professor Gwartney has observed:

> With its entry into the EEC, Ireland liberalized its trade policies during the 1980s. It also shifted to a more stable monetary policy. After decades of expanding government, tax increases and budget deficits, the bond market virtually forced Ireland to reduce its spending in 1987. The cut was followed by a period of restraint on the growth of government. Eventually, tax rates were lowered. This combination of policies—trade openness, monetary stability, smaller government, and lower taxes—transformed Ireland into a high-growth economy during the 1990s.[8]

Public spending at New Zealand's level is inconsistent with the government's goals for sustained growth.

That leaves Luxembourg. It appears to be a marginal case. According to the OECD data, its spending ratio was above 40% between 1990 and 1997 (peaking at 44% in 1992 and 1993), 40% in 1998 and 1999, and 39% in 2000. The OECD data also show Luxembourg sustaining just over 4% growth for 10 years in a row. However, as Professor Gwartney has commented:

> While Luxembourg may have achieved real growth of 4 percent during the 1990s, how relevant is it to the issue of whether high levels of government expenditures generally retard growth? Luxembourg has a population of 439,000 and an area of 3,000 square kilometres. It is more comparable to a modest sized city. For various reasons, small geographic areas often experience rapid growth.[9]

There seems to be some question marks over the OECD data for Luxembourg for both expenditure and GDP. But even if we accept Luxembourg as a marginal case, the upshot of the debate is that the experience of 25 of the 26 OECD countries suggests public spending at New Zealand's level is inconsistent with the government's goals for sustained growth. Dr Cullen has also acknowledged that New Zealand's policies need to be better than other countries' to offset its natural disadvantages if it is to match their performance. It would therefore be reckless to base policy on a marginal

case: as Nobel laureate George Stigler has noted: '. . . we must base public policy not upon signal triumphs or scandalous failures but upon the regular, average performance of the policy.'

Big government harms growth

Dr Cullen claims that there is no evidence that lower government spending and taxing is likely to lead to higher growth.

Economic analysis suggests that up to some point government spending on public goods and services such as defence, law and order, and public health, and on appropriate regulation, contributes to growth. However, as the ratio of government spending to GDP increases beyond the optimum level, additional spending depresses growth for the following reasons:

- As government grows relative to the market sector, the returns to government activity diminish. The larger the government, the greater is its involvement in activities it does poorly.
- More government means higher taxes. As taxes take more earnings from citizens, the incentive to invest, develop resources and engage in productive activities declines.
- Compared to the market sector, government is less innovative and less responsive to change. Growth is a discovery process. In the market sector, entrepreneurs have strong incentives to discover new and improved technologies, introduce better methods of doing things, and exploit opportunities that were previously overlooked. Also, they are in a position to act quickly as new opportunities arise. In government, the nature of the political process lengthens the time required to modify bad choices (such as ending ineffective programmes) and adjust to changing circumstances. As the size of government expands, the sphere of innovative behaviour shrinks.
- As government grows, it becomes more heavily involved in redistributing income and in regulatory activism. Redistribution blunts incentives for wealth creation. It also induces people to spend more time seeking favours from the government and less time producing goods and services for consumers.

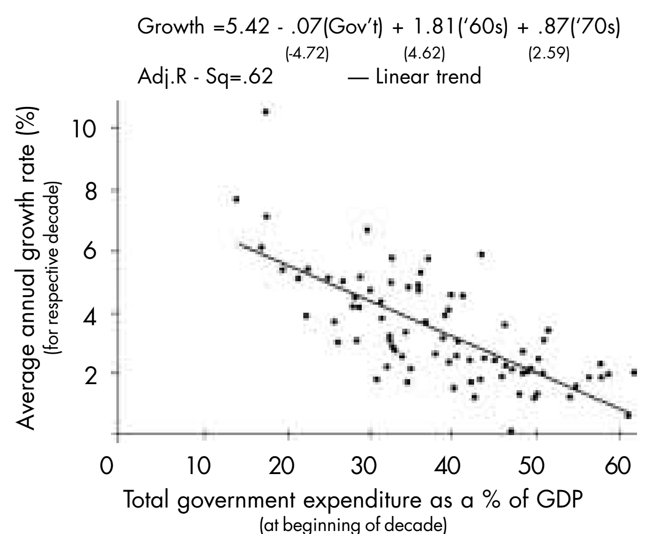
In contrast to Dr Cullen's claim, the *Report of the Joint Economic Committee, Congress of the United States, on the 1999 Economic Report of the President* contains an empirical analysis which showed that the rate of economic growth declines as government spending increases. The relationship is plotted in figure 1.

The study found that a 10 percentage point increase in the size of government as a share of GDP reduces the long-term annual growth rate of real GDP by 0.7%.[10] On this basis, the New Zealand government's decision to increase the long-term objective for government spending from 30% to 35% of GDP knocked perhaps one third of a percentage point off New Zealand's potential growth rate. These findings are consistent with others reported by Winton Bates.

More recent evidence comes from a comparison of the economic performance of American states. A study found that during the 1990s the 10 states with the highest tax burden grew at half the rate of the 10 states with the lowest taxes. Personal income grew by 40% in the low-tax states but only by 25% in the high-tax states. Job growth was 28% in the low-tax states but only 13% in the high-tax states.[11] I know of no study that shows the opposite relationship, namely that higher taxes, beyond prudent funding of public goods, leads to faster growth.

It is therefore extraordinary that Dr Cullen remains in denial in the face of such evidence. Following the spending reductions of the early 1990s, the New Zealand economy grew by nearly 4% a year in the five years to 1996 (the more consistent overall policy framework, and possibly cyclical factors, also played a part in this expansion). Subsequent increases in spending dampened the growth rate. On the tax side, there is abundant evidence that lower taxes encourage work, saving and investment, and increase economic

Figure 1. Economic growth declines as size of government increases, 1960-1998



Sources: Derived from *OCED Historical Statistics*: 1960-1994 and *OECD Economic Outlook*, June 1999. This analysis is based upon 84 observations (21 OECD countries for which data was available times four decades).

growth. A Treasury study advised that 'The case for reducing taxes remains strong because . . . even small increases in economic growth will lead to substantial improvements in living standards in the long term'.[12] Mary Harney, Ireland's deputy prime minister and leader of the free-market Progressive Democrats, has stated that 'low taxes are the central reason for Ireland's economic success'.[13]

Smaller government, richer people

Dr Cullen has long been an admirer of Germany; he has commended what he calls the 'Rhenish model'. Germany should be an object lesson for New Zealand, but for the opposite reasons. Germany is one of Europe's biggest welfare states, and its average annual growth rate in the decade to 2001 was 1.5%. In the 2002 World Competitiveness Report ratings, Germany ranked 47th out of 49 major countries for flexibility and adaptability. Germany's deep-seated malaise, including a bottom rung in the European Union for unemployment, goes well beyond the problems in the East. The former free-market miracle has long since lost its way; its average income level is now below Australia and only just in the top half of the OECD, and its ranking is likely to fall further.

Arguments for shrinking the size of government are often met by the response: 'What programmes do you propose to cut?'. This has it exactly backwards. No less an impeccable source than President John F. Kennedy argued correctly when he said: 'It is a paradoxical truth that tax rates are too high today and tax revenues are too low—and the soundest way to raise revenues in the long run is to cut rates now.'

Ireland's experience in reducing its spending ratio from over 50% of GDP in the 1980s to around 30% today bears this out. Its rapid economic growth has allowed large increases in government spending on services such as health and education. Winton Bates's study pointed out that if New Zealand's real GDP were to grow by 3% a year and spending were held constant in real terms—not cut at all—the spending ratio would fall by 5 percentage points over five years. In practice, there is ample scope to achieve expenditure reductions in New Zealand by cutting wasteful and badly targeted programmes.

More generally, the historical picture is clear. The rich countries in the world today got rich with relatively small government. Prior to World War I, government spending in the United States, Sweden and Japan was about 10% of GDP or less, and the average for advanced countries was about 13%. Even in the so-called 'golden age' of the 1950s and 1960s, public expenditure in most countries (including New Zealand) was only in the 20-30% range. Big government in the developed world is really a post-1960s phenomenon. It was associated with a much poorer economic performance in the 1970s and 1980s. The exceptions during this period were the fast-growing Asian countries, which all had small governments. From the 1980s, most OECD countries have moved to policies involving greater economic freedom, including falls in their public expenditure to GDP ratios since the early 1990s. The main exception is Japan, where government spending rose from under 20% of GDP in 1970 to nearly 40% today, and which is in deep economic trouble.

Conclusion

The empirical record shows that it is highly unlikely that New Zealand can achieve the kind of growth rate targeted by the government with total government spending equal to 40% of the economy. Without a lower objective for the central government spending ratio, and tighter disciplines on local government, its growth strategy is simply not credible. Many other moves towards greater economic freedom would be needed as well.

Endnotes

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6 Personal communication from James Gwartney to Winton Bates (January 2001).
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