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Why is Australia So Much Richer than New Zealand?

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- Australians are a third richer than New Zealanders. Per capita GDP (adjusted for purchasing power parity) is NZ$48,000 in Australia compared to just NZ$36,400 in New Zealand.
- This difference is remarkable given that the two countries enjoyed the same level of income for most of the twentieth century. From the 1970s onwards, both countries were hit by economic shocks, recession, bad policy, and painful reforms, yet Australia has pulled through this period in much better shape than New Zealand.
- Reforms have seen New Zealand's growth greatly improve since the 1990s, but not fast enough to catch up with Australia. The income gap is stubborn and shows no sign of closing.
- Geographic isolation and a small population are important factors in New Zealand's underperformance compared to the rest of the world, but Australia suffers similar conditions and has overcome them more successfully. Australia has not moved closer to the rest of the world over the last thirty years, and nor has New Zealand moved further away.
- The resource boom's impact on Australian growth is often overrated. New Zealand's commodities have also enjoyed record returns, and its exports make up a greater proportion of GDP than do Australia's. In any event, natural resources are no guarantee of growth.
- The big difference between the countries is labour productivity. Australian workers produce a third more wealth for every hour worked, largely because they have more capital (machinery and technology) to work with.
- New Zealand firms have invested less in capital than their Australian counterparts, but not because of a lack of savings or finance. Instead, the major challenge for New Zealand seems to be a lack of profitable investment opportunities.
- Government policy has a major role to play in creating a healthy environment for growth and investment. International surveys show little difference between the two countries in terms of red tape and regulation, but the direction of policy is just as important as the static picture. Ad hoc government interference in areas such as energy, telecommunications, and asset sales has greatly increased investor uncertainty in New Zealand.
- Tax is a major area of difference between the two countries. Australia is a much lower taxing country, especially in terms of income tax. This affects incentives to work, save, and invest.
- Prosperity does not come by accident. Australia has a stronger political consensus around policies for growth, which contributes to investor confidence. In contrast, New Zealand halted most major reform in 1993, and has increased tax and regulation since 2000.

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Introduction

New Zealand and Australia are remarkably similar countries. Both are isolated, sparsely populated former British colonies with a shared history and culture. The structure of the two economies is also similar. Since 1983, both countries have introduced free-market reforms and opened their borders to each other in trade and migration.

Yet for all these similarities, there is one major difference: the level of wealth. Australians enjoy per capita GDP of NZ$48,000, which is 32% higher than New Zealand's NZ$36,400.[1] Put simply, Australians are nearly a third richer than their New Zealand cousins.

On a world scale, the latest OECD rankings for income per capita (adjusted for purchasing power parity) have Australia in thirteenth place and New Zealand near the bottom in twenty-second place.[2]

The relative placing of the two nations is reflected in differing wage levels across a variety of professions. Research by the New Zealand Institute for Economic Research (NZIER) shows the wage differences for similar jobs in Auckland and Sydney (table 1).[3]

The large income gap between Australia and New Zealand is a relatively new phenomenon, because the two countries have historically been amongst the wealthiest nations in the world.

Table 1: Comparative wages in Auckland and Sydney

	Auckland (NZ$)	Sydney (NZ$)
Dump truck operator	45,000–60,000	73,000–84,000
Leading hand (construction, building)	45,000–55,000	58,000–84,000
Senior qualified accountant	90,000–150,000	147,000–211,000
Senior doctor	113,500–163,500	150,000–203,000

Of course, money isn't everything, and doesn't guarantee happiness in life. So why is there such concern about this gap?

Firstly, in an open world economy New Zealand is losing large numbers of skilled people though emigration. In the year that ended in September 2007, over 40,000 New Zealanders permanently departed to Australia (an average of 769 a week).[4] Many of these people are highly educated; the OECD estimates that 24.2% of New Zealanders with a tertiary education are living overseas, compared to just 2.5% of Australians with tertiary qualifications.[5]

Secondly, wealth provides the means to tackle other concerns, such as social and environmental problems. In healthcare, for example, Australia is able to fund a wider range of cancer drugs and provide vaccinations against cervical cancer.[6] Australia outperforms New Zealand on a wide range of social indicators, including life expectancy, infant mortality, income inequality, and suicide rates.[7] On the UN's Human Development Index, Australia is in third place, while New Zealand is ranked twentieth.[8]

Background: How did we get here?

The large income gap between Australia and New Zealand is a relatively new phenomenon, because the two countries have historically been amongst the wealthiest nations in the world. In 1970 Australia ranked seventh in the OECD for GDP per capita, and New Zealand was almost equal, in ninth place.[9]

The 1970s were a tough time for the world economy, which suffered oil shocks and recession. For New Zealand, another shock came in 1973, when the UK joined the European Economic Community. This meant the end of guaranteed access to the UK market for New Zealand's agricultural exports. By 1980, New Zealand's GDP per capita had slumped to just 78% of the OECD average.[10]

As a smaller and less diversified economy than Australia, New Zealand was hit harder by these economic shocks. The New Zealand government's response also helps explain why it fell so far behind over this period. From 1975 to 1984, the Muldoon government

increased protectionism through export subsidies, import controls, high progressive taxation, price and wage controls, and large government debt. An enormous public works program known as 'Think Big' was intended to make New Zealand self-sufficient in energy but was an expensive disaster.

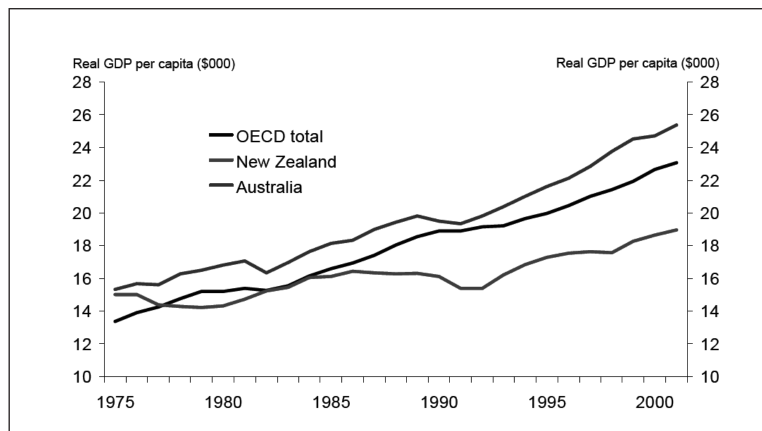
A radical change in direction came in 1984, as the fourth Labour government began introducing free-market policies. Subsidies and tariffs were scrapped, the dollar was devalued and then floated, and the public service was radically restructured. Many government departments were turned into corporate bodies and privatised, and monetary policy was devolved to an independent Reserve Bank with strict inflation targets. Taxes were lowered, flattened, and diversified. After 1990, the National government continued reform in the areas Labour avoided, by cutting social spending and deregulating the labour market.

The economic theory of 'convergence' suggests that over time, wealthy countries will end up at around the same level of income, as technology and ideas spill over. Clearly, this isn't happening across the Tasman Sea.

Australia carried out similar reforms, but at a slower pace, throughout the 1980s and 1990s. Arguably, their reform was less abrupt and painful, because Australia didn't have as many bad policies to fix as New Zealand did. For example, a legacy of high public debt and spending meant that by 1990, tax revenue made up 37% of GDP in New Zealand compared to an equivalent figure of 28% in Australia.[11]

Figure 1 shows how badly New Zealand performed from the late 1970s onwards. By 1992, its real GDP per capita was barely above what it was in 1974.

Figure 1: New Zealand, Australian, and total OECD GDP 1975–2002 ($US)



Source: Allan Bollard, OECD[12]

Since the reform period, New Zealand's economic performance has greatly improved, with an average growth rate of 3.4% from 1992 to 2005 compared to 3.75% in Australia over the same period.[13] Yet, this improvement has been nowhere near fast enough to close the gap.

Economic shocks and bad policy decisions can explain how New Zealand fell behind Australia in the first place, but why does the gap remain, and why is it so stubborn? The economic theory of 'convergence' suggests that over time, wealthy countries will end up at around the same level of income, as technology and ideas spill over. Clearly, this isn't happening across the Tasman Sea.

The most common reasons offered for New Zealand's relative underperformance include:

- Geographic isolation and small population
- Lack of natural resources
- Lower labour productivity, which is in turn driven by a lower capital/labour ratio
- Low household savings
- The economic environment, which includes tax and regulation

This rest of this paper looks at these issues in depth, and considers what policies are most likely to boost New Zealand's growth.

The tyranny of distance (and size)

New Zealand is one of the most isolated countries in the world. Its nearest neighbour, Australia, is three hours away by plane, while the big markets of Europe and Asia are even more expensive and difficult to reach. At the same time, its small population is spread over two long, skinny islands the size of the British Isles. No other country in the world has comparable attributes.

Distance matters because exporters have to pay to transport their goods—even if that cost has fallen in recent decades. It also makes it harder for exporters to develop knowledge of foreign markets and build relationships with the necessary people. In contrast, it is much less of a challenge for an entrepreneur in Hong Kong or Belgium to expand into Asia or Europe.

This is why the New Zealand Treasury acknowledges that distance has a negative effect on trade and the international flow of capital, people, goods, services, and technology to and from New Zealand.[14] The International Monetary Fund (IMF), the NZIER, and both the Australian and New Zealand treasuries all agree that distance has a negative effect on growth rates.[15] The IMF estimates that New Zealand's 'geographic isolation' accounts for approximately half its underperformance in relation to other OECD nations.[16]

Population size matters, too, because of the economies of scale and larger markets it can provide. Major companies are more likely to set up in Sydney than in Timaru because they can reach more customers, hire skilled employees, and work with other companies and service providers there. New Zealand's market of 4.2 million people simply doesn't allow for as much depth and development as does Australia's population of around 20.9 million.

New Zealand's small population also means that a firm there will reach its limit in terms of domestic growth fairly quickly, and will then have to export or merge with a larger company to expand further. This situation also drives many New Zealanders overseas to take advantage of the extra career opportunities and higher salaries available in larger countries like Australia, the USA, and the UK.

Both countries face similar challenges, yet Australia has overcome them more successfully. All of this leaves New Zealand looking for alternative explanations for its poor performance.

These factors could explain, to some extent, New Zealand's underperformance when compared with the rest of the world. But do they impact more heavily on New Zealand than on Australia? It seems unlikely that a few hours less flying time to the world's major markets would make a significant difference to a nation's economic performance, and New Zealand actually exports more as a percentage of GDP than Australia (more on this later).

Does Australia's population of 20.9 million give it a significant advantage over New Zealand? It is hard to find evidence to support this. It does give Australia two major cities (Sydney and Melbourne), but much of the country's population is spread over a vast distance. For example, Perth is further from Sydney than Auckland is.

Importantly, Australia and New Zealand enjoyed similar incomes until the 1970s. Is it possible that the impact of size and distance has somehow intensified in the last thirty years? This doesn't seem credible, given the large improvements in technology and increases in trade volume over this period. The cost of transport (by air and sea) has dramatically dropped, and the internet and cheap phone calls make communication far easier. New Zealanders are arguably the world's best travellers, with anywhere from five hundred thousand to a million expatriates scattered around the globe contributing to a faster-than-ever flow of ideas and technology to the country's shores. [17]

Over the last thirty years, New Zealand hasn't moved further away from the world, and Australia hasn't moved any closer. 'Gravity modelling' by economists suggests that New Zealand has done slightly worse than would have been expected, given the distance, while Australia has done slightly better.[18] Both countries face similar challenges, yet Australia has overcome them more successfully. All of this leaves New Zealand looking for alternative explanations for its poor performance.

Natural resources: Is Australia the 'lucky country'?

Another common explanation for Australia's recent growth has been luck, in the form of its abundant natural resources. Booms in the Chinese and Indian economies have seen demand and prices rise for Australian coal, natural gas, gold, and minerals. Does this make Australia's prosperity inevitable, given that it is literally sitting on a goldmine?

This explanation is unconvincing, because Australia's level of exports is still relatively low. Exports make up just 21% of Australia's GDP, compared to 29% of New Zealand's.[19] In addition, New Zealand has experienced a similar boom in commodity prices, with rising demand for agricultural products and record payouts for farmers.[20] Just like Australia, New Zealand's commodity prices have doubled since 2002.[21]

But are Australia's exports more valuable than New Zealand's? Detailed modelling by the NZIER has found little advantage for Australia:

> These results were rather surprising. We had expected to show that Australian exports had performed better than New Zealand's exports due to their commodity mix being more directed in favour of faster-growing sectors … this has not been the case.
>
> More importantly, our analysis shows that Australia's strong economic growth cannot be attributed to the performance of its external sector. It suggests that domestic demand has been a key driver behind Australia's success.[22]

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The last point is important, because many commentators question just how important the resources boom has been for Australian growth. The New Zealand Treasury notes that 'net exports have made very little contribution to growth, with negative contributions to growth in Australia from net exports since 2002.'[23]

John Edwards, HSBC's chief economist for Australia and New Zealand, also agrees that exports have 'made only a minor contribution.' He argues that 'neither China nor the commodities boom has been central to Australia's economic performance in the first decade of the 21st century. They may well matter a great deal in the next five years, but they haven't mattered much in the last five.'[24]

Even if natural resources were driving Australia's growth, many economists question whether it is healthy to become dependent on this for too long. The danger is that it may lower the international competitiveness of the manufacturing sector by raising the exchange rate (a phenomenon known as 'Dutch disease') and encourage underinvestment in education and competitiveness.

In any event, possession of natural resources is no guarantee of growth. Africa has an abundance of natural resources, yet continues to struggle, while prosperous countries like Switzerland and Singapore have almost no natural resources. The most important factor is how a country uses its resources and its people.

Are Australians smarter? Do they work harder?

To answer these questions, we need to look at the two basic components of economic growth: labour utilisation and labour productivity.

In plain English, labour utilisation is the number of people working (and the hours they put in) while labour productivity is the effectiveness of that work (how much 'stuff' each worker produces for every hour worked).

New Zealand has a good record of labour utilisation. Its labour force participation rate of 68.3% compares favourably to 65% in Australia, and people work a similar number of hours in the two countries.[25]

Laziness, therefore, is certainly not a reason for New Zealand falling behind. The crucial difference is in labour productivity. Australians don't necessarily work harder than New Zealanders, but they do work more effectively. Every hour of work they do produces an extra 37% of output.[26]

Labour productivity is the key to economic growth, and it is widely accepted that lower productivity is the key reason why New Zealand lags behind Australia. As economist Paul Krugman notes,

> Productivity isn't everything, but in the long run, it is almost everything. A country's ability to raise its standard of living over time depends almost entirely on its ability to raise its output per worker.[27]

New Zealand's labour productivity has actually grown slightly faster than Australia's over last fourteen years, but nowhere near fast enough to close the gap.[28] Why does this anomaly persist?

It is certainly not because Australians are more intelligent or better educated than New Zealanders. Comparisons made by the OECD show little difference in student competence or in the education level of the general population.[29]

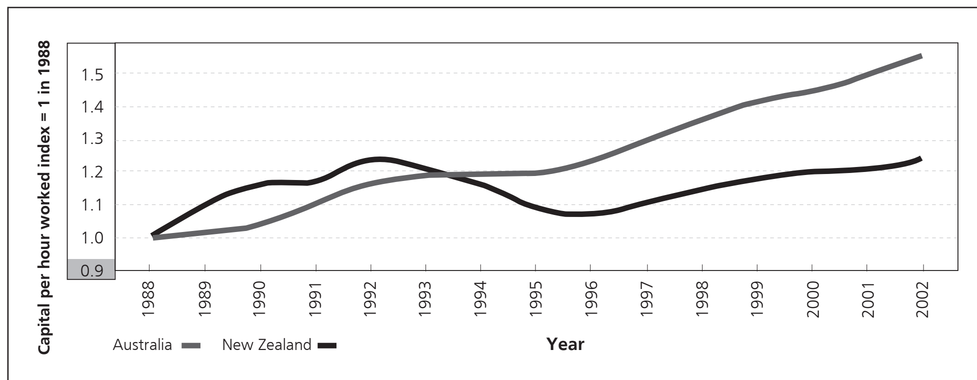
To discover the cause of the anomaly, we can look more closely at labour productivity and break it down into its two main components.

Multi-factor productivity is a measure of how efficiently workers use their capital (such as machinery, technology, equipment, and tools). New Zealand has matched Australia in this over the last fifteen years, but a major missing link appears to be the second component of labour productivity—the *labour/capital ratio*, which is a measure of the amount of capital available for workers to use. [30]

New Zealand's level of capital per hour worked was the same in 2002 as it was in 1991, a period in which other OECD countries invested heavily in new technologies. The graph below (figure 2) clearly shows how Australia has increased its capital to labour ratio:

There is no magic level that firms should be investing at, because large-scale capital-building programs can be disasters ... if there is no real need or market for the resulting products.

Figure 2: Capital per hour worked, 1988–2002



Source: Ministry of Economic Development[31]

According to the New Zealand treasury and the IMF, this lack of 'capital intensity' explains 70% of the difference in output per hour worked between Australia and New Zealand.[32]

A capital problem

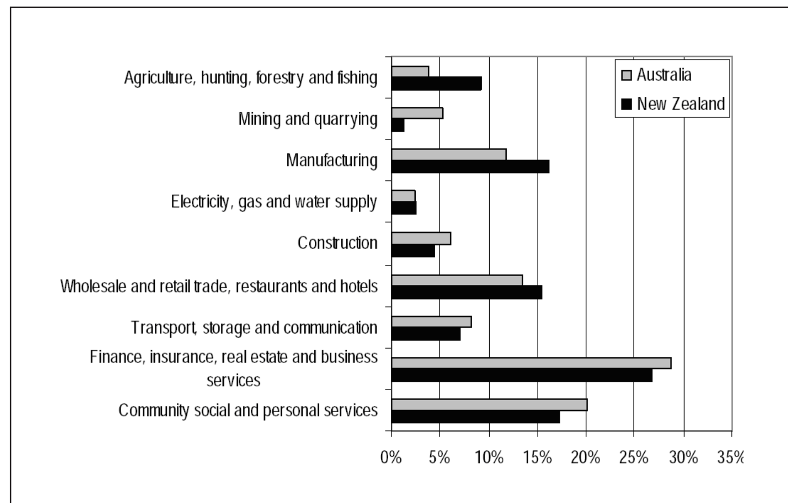
This raises an obvious question: why have New Zealand firms not invested as much in new tools and technology for their workers to use?

Of course, there is nothing wrong with having less capital. There is no magic level that firms should be investing at, because large-scale capital-building programs can be disasters (as Think Big was) if there is no real need or market for the resulting products. However, given the contribution the labour/capital ratio has made to Australia's growth, it is worth investigating further why there has been less investment in New Zealand.

Could it be that the composition of Australia's economy is significantly different to that of New Zealand's, with more emphasis on industries such as mining that require a higher level of capital? The OECD and NZIER have considered this, and the graph

in figure 3 shows little difference. While mining is more important to Australia, this is matched by New Zealand's greater reliance on manufacturing.

Figure 3: Percentage of total value added by industry



Source: OECD, NZIER[33]

While relying on overseas savings may not be a perfect substitute for domestic savings, there is little evidence that New Zealand firms are hampered by either the availability or cost of finance.

The New Zealand Institute argues that the country's low level of saving is the culprit, as it forces entrepreneurs and firms to borrow money from overseas lenders, who charge higher interest rates. It would therefore be understandable that New Zealanders invest less. David Skilling argues that 'One of the best documented results in economics is the persistent correlation between domestic savings and domestic investment.'[34]

This argument explains why the idea of compulsory super is gaining momentum in New Zealand, not necessarily to fund retirement needs, but to increase domestic investment. NZX CEO Mark Weldon argues this is the reason why Australia has done so well over the last decade. 'Nine [percent] every day out of every person's wages [in Australia] goes into superannuation and that promotes savings and it promotes investment, and that's what we need here.'[35]

But is a lack of access to investment money really holding back New Zealand firms? This seems strange when there is a glut of global savings, particularly from Asia. The Reserve Bank of New Zealand notes 'We are currently seeing a phenomenon where considerable private equity is roving the world looking for investment opportunities.'[36]

A recent study by the New Zealand Treasury considered this issue and concluded that while relying on overseas savings may not be a perfect substitute for domestic savings, there is little evidence that New Zealand firms are hampered by either the availability or cost of finance. The OECD agrees 'there is little evidence that New Zealand businesses are systemically constrained by lack of access to finance.'[37]

There is plenty of further evidence to support this conclusion. New Zealand's long-term real interest rates are similar to Australia's.[38] The real cost of 'equity capital' (money borrowed to invest) is harder to calculate, but a study by Victoria University professor Martin Lally in 2000 found there was no difference in the real cost of borrowing in New Zealand and Australia.[39]

Even if there was a difference, there is debate over how much the cost of capital actually affects investment and GDP growth.[40] A recent paper by the NZIER disputes the relationship between savings and investment, arguing that increased saving is a result of growth rather than the other way around. The paper also points out that in any event, New Zealand's national (as opposed to household) savings level has not changed in recent years.[41]

All of this indicates that the lower capital ratio in New Zealand is not due to a lack of finance or savings, but to a lack of investment opportunities. For most New Zealand firms and investors, the returns are either too low compared to investments that could be

made overseas, or not worth the risk. Further evidence of this comes from the Government Superannuation Fund's decision to invest most of its money overseas.

Another explanation for New Zealand's lower capital intensity could be the lower relative cost of labour. Australia has a more rigid, unionised system of industrial relations than New Zealand, with a high minimum wage and national awards that set pay levels. This makes it expensive to hire staff, and therefore more rewarding to invest in capital. This is reflected in Australia's higher unemployment rate of 4.8%; clearly, many of its workers are being priced out of the labour market.

The relative cost of labour is also reflected in New Zealand's recent growth, which to a large extent has been driven by an increase in the number of workers. Since 1991, an extra 600,000 jobs have been created, representing a 45% increase in the number of people employed.[42] Once again, there is nothing wrong with this; in a proper free market, firms would be expected to invest in labour when it is available, and switch to capital when labour becomes too expensive.

However, a recent study by the New Zealand Treasury suggests that even when taking relative prices into account and adjusting for the different types of industry, New Zealand firms are *still* slow to respond to changes in the relative price of capital: 'the responsiveness in New Zealand is about one half that of Australia.'[43] Once again, this further supports the idea that a lack of investment opportunities is the major problem.

History may play a role here, in that Think Big used up large amounts of capital in non-productive areas. But are there greater impediments to investment and/or greater uncertainty about outcomes in New Zealand that make investors nervous? The following sections will consider this possibility.

The playing field

Economists agree that one of the most important determinants for growth is the environment in which the economy operates. How easy is it to set up a business and to hire staff? How much red tape and bureaucracy is there to deal with? How high are taxes, and how stable is government policy?

According to the OECD, creating an environment that facilitates growth should be one of the most important priorities for governments:

> Of course, no government can make productivity growth happen; the best it can do is to identify and remove obstacles to growth and provide an economic environment in which firms and individuals can flourish.[44]

Roger Kerr agrees, arguing that 'the quality of a country's institutions and policies largely determines its long-run economic performance.'[45]

Improving the policy environment has been a goal of economic reform in New Zealand since 1984, with deregulation, privatisation, trade liberalisation, and tax cuts. Yet these reforms haven't been enough for New Zealand to catch up with Australia, prompting the OECD to ponder 'the mystery … why a country that seems close to best practice in most of the policies that are regarded as the key drivers of growth is nevertheless just an average performer.'[46]

Improving the policy environment has been a goal of economic reform in New Zealand since 1984, with deregulation, privatisation, trade liberalisation, and tax cuts. Yet these reforms haven't been enough for New Zealand to catch up with Australia.

This comment has been seized on by critics of the free market. Columnist Chris Trotter says New Zealand is 'like the poor girl who comes to the skinny dipping party,' but 'we're the only one who's naked. Everyone else is on the side of the bank with their cameras going click, click, click.'[47] David Skilling from the New Zealand Institute argues that good policy settings are 'necessary but not sufficient' for high growth. 'There is a growing sense in New Zealand that more is needed. It is increasingly difficult to sustain an argument that the major factor holding New Zealand back is the absence of sufficiently aggressive policy reform.'[48]

How radical were New Zealand's reforms, and how does the policy environment compare with Australia today? The major international studies paint a mixed picture:

- The World Bank's annual listing of the easiest countries in which to do business rank New Zealand second (behind Singapore) with Australia in ninth place.[49]
- New Zealand ranks third on the Fraser Institute's Index of Economic Freedom, compared to Australia at ninth.[50]
- The Heritage Foundation/Wall Street Journal's Index of Economic Freedom ranks Australia in third place with New Zealand in fifth.[51]
- The IMD's Competitiveness Scorecard for 2007 ranks Australia in twelfth place and New Zealand at nineteenth.[52]
- The World Economic Forum's Global Competitiveness Report puts Australia in nineteenth place and New Zealand at twenty-fourth.[53]

The *direction* of policy is just as important as its current state, because changes to taxation and regulation send messages to the world that shape perceptions about how business-friendly a country is.

New Zealand businesses have disputed some of these studies, in particular the World Bank report. According to Business New Zealand, this survey 'does not cover compliance with tax, resource management or environment law, which are key issues for New Zealand companies.' Instead, they say the report is 'heavily influenced by its ranking on "ease of getting credit".'[54]

Policy direction

While these studies show little difference between the countries, it is important to remember they paint a static picture. The *direction* of policy is just as important as its current state, because changes to taxation and regulation send messages to the world that shape perceptions about how business-friendly a country is.

Compared with Australia, New Zealand's implementation of reform has been stop-start and inconsistent. Almost all of the major reforms happened before 1993, in the periods when Ruth Richardson and Roger Douglas controlled the Treasury. The rest of the 1990s (once the mixed member proportional [MMP] electoral system was introduced) saw only relatively minor reforms.

The 1999 election brought an end to reform and a change in direction, as Prime Minister Helen Clark declared 'the hands off days have gone,' and that 'leaving outcomes to the market … won't work and never did work for New Zealand.'[55] The fundamental policies brought about by free-market reform remain in place (such as independent monetary policy, a balanced budget, and free trade) but many other areas have been re-regulated. Tax rates have increased, competition has been removed from personal injury insurance, and there is increased regulation of the labour market. A new economic development agency (New Zealand Trade and Enterprise) has flirted with 'picking winners' through industry grants and regional development.

According to New Zealand business groups, the government has introduced two thousand new regulations since 1999, with the biggest sources of complaints from business being the Holidays Act, the ACC, the Employment Relations Act, and the Kiwisaver scheme.[56]

Meanwhile, the reform path in Australia has proceeded more smoothly, perhaps because there were no financial crises such as those confronted by incoming New Zealand governments in 1984 and 1990. Australia has been slower to adopt some reforms (such as GST and industrial relations reform) but there have not been the major leaps, stops, and reversals that have occurred in New Zealand. This predictability is important, because firms don't like surprises. Frequent major policy changes make it harder to plan and invest for the future.

Of course, none of this is to say that things are perfect in Australia, where business groups also complain regularly about the level of red tape they face. But the Australian government has taken more proactive measures, with the Banks Taskforce in 2005 presenting the government with 178 recommendations on how to reduce the regulatory burden on business. In addition, the Productivity Commission, created in 1998, now conducts an annual review of red tape in different sectors of the economy, and regularly reviews the results of government spending.

A crucial factor not covered by the international surveys on the ease of doing business is industry-specific regulation, where governments bring in new rules or conditions for specific companies or industries. According to business groups and the NZIER, there have been 'several very public instances in recent years of political intervention in the regulatory process or the market that determines the returns available to investors.'[57] Examples include:

- *Telecom*. The government announced last year it will force the company to 'unbundle' the local loop to provide better broadband internet access. Telecom's share value dropped by NZ$1.1 billion following the announcement.[58]
- *Energy*. The government has taken a 'hands-on' approach to major energy projects, increasing uncertainty about future supply. The recently released energy strategy has attracted strong criticism from employers, business groups, and chambers of commerce, who warn of chaos and uncertainty for investors.
- *Assets*. Air New Zealand, personal injury insurance, and the national rail track have all been re-nationalised. Possible investment by Singapore Airlines into Air New Zealand was rejected, and the government also voiced its disapproval of the sale of shares in Auckland Airport to Dubai International.
- *Climate change*. New Zealand signed the Kyoto treaty with the government claiming a net benefit from carbon trading, but a recalculation showed a deficit of NZ$600 million instead. Long negotiations over a possible carbon tax were abandoned, and a new scheme of emissions trading was unveiled in 2007 instead.
- *Industrial relations.* Changes to the Holidays Act and other employment law changes have driven up the costs of labour without any corresponding gain in labour productivity.

Whatever the supposed merits of these moves—and most have been hotly contested—they are likely to have increased uncertainty for investors. The NZIER says the new rules for energy and telecommunications 'are difficult to understand, especially for foreign investors, and unlikely to appear stable.' This is critically important to New Zealand's economic growth because

> Investors, whether domestic or foreign, will invest in New Zealand only if they are confident that subsequent political decisions will not deprive them of the risk-adjusted return … They can easily invest elsewhere.[59]

By comparison, Australian political leaders share a broader consensus on policies for growth. During the recent election campaign, Labor leader Kevin Rudd—now Australia's prime minister—boasted in television advertisements that he is an 'economic conservative.' He argues 'Australia's economic good times are built on the legacy of reform of the Hawke and Keating Labor Governments,'[60] and that 'if you cease reforming this economy, you start to strangle long-term productivity growth. We don't intend to do that.'[61]

Meanwhile, Helen Clark dismisses similar reforms in New Zealand as 'failed policies of the past.'[62]

Arguably, the clear sense of direction in Australia—persisting even through a change of government—contributes to the bullishness of the economy. Various surveys consistently show higher levels of consumer, business, and investment confidence in Australia.[63]

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A taxing question

Perhaps the biggest contrast between the countries is the level of tax and spending. The most recent comparable year from OECD figures is 2005, in which Australians paid 31% of GDP in tax compared to New Zealand's 38%. New Zealand is now the highest-taxed non-European nation, and the highest-taxed English-speaking nation in the OECD.[64]

Clearly, this level of taxation will have an impact on economic growth, because it transfers money away from the entrepreneurial sector and makes investing, employing,

and working less rewarding. In an earlier CIS Issue Analysis, *Why Tax Cuts Are Good for Growth,* I outlined these arguments in greater depth, and the New Zealand Business Roundtable has recently estimated that the total deadweight cost of tax (the lost potential wealth) is around NZ$20 billion a year in New Zealand.[65]

The size of government is important to growth, because the public sector's use of resources is likely to be less productive. Statistics New Zealand doesn't measure the productivity of government sector, but in the CIS Issue Analysis *New Zealand's Spending Binge*, I outlined serious concerns over the efficiency and effectiveness of government spending in New Zealand.[66]

Government spending on 'non-traded' goods and services (domestic goods for which there is little competition) also contributes strongly to inflationary pressures. Electricity, hospital services, tertiary education, and local rates have all been key drivers in pushing up inflation, which is why the Reserve Bank has been so concerned about government spending.[67]

For individual earners, there is a large difference between the two countries' income tax rates. Once the next phase of Australian tax cuts is implemented by the new Labor government, a New Zealand worker on NZ$46,000 (the average wage) will be paying twice as much income tax as he or she would be on the equivalent salary in Australia.[68]

Combined with already higher wages in Australia, this tax package will make emigration from New Zealand even more rewarding. This is bad news for New Zealand employers, who are already struggling with skills shortages. Employers rank this the number one obstacle to growth, closely followed by tax and red tape.[69]

Once again, the trend is important. New Zealand's level of tax as a percentage of GDP has been increasing since 2000, while Australia's has been declining thanks to five successive years of tax cuts.[70] Australia's new Labor government plans to continue cutting taxes until 2010, which will further increase the gap between the two countries.

Once again, there is a strong difference between the Australian Labor Party and and the Labour Party of New Zealand. Kevin Rudd says he is 'committed to keeping taxes as low as possible to attract investment and reward enterprise.'[71] Meanwhile, Helen Clark has announced that her government will introduce tax cuts in 2008, but only after seven years of dismissing the impact of tax on the economy.

The size of government is important to growth, because the public sector's use of resources is likely to be less productive.

The New Zealand Business Council for Sustainable Development admires the Australian approach of providing a long term plan for cutting taxes.

> In Australia there is an understanding that tax policies do not come with rock-solid guarantees and are subject to economic performance. However, Australia looks at a final destination, and New Zealand should learn from this … Having a goal will help attract both [*sic*] talent, business and revenue.[72]

Summary

The key to wealth is productivity, and Australian workers are more productive because they have more capital to work with. New Zealand firms have invested less than their Australian counterparts, despite the costs and returns being similar (or better). As the NZIER notes, this 'suggests that there may be bottlenecks preventing greater capital investment from occurring.'[73]

A nation's policy environment plays an important role in facilitating growth, and in this respect, there are important differences in direction between New Zealand and Australia. New Zealand's increase in tax and regulation since 2000 strongly correlates with declining productivity. According to Statistics New Zealand, labour productivity growth since 2000 has averaged just 1.4%, compared with 3.2% for the 1990s.[74]

To some extent, this is explained by the increase in the labour participation rate, since the last workers to be hired are usually the least skilled and productive. Yet the drop is still remarkable; multi-factor productivity growth has averaged just 0.7% since 2000, and capital productivity has actually declined by 0.1% over the same period.[75]

A myth persists in some quarters that New Zealand is a laboratory for free-market reform, and that it has done all it can to create a level playing field. The reality is that our major reforms are now considered orthodox around the world. If we want to increase our growth, we need to do more, as Australia has consciously chosen to do.

Australia's commitment to growth and free-market policies is why the OECD says the country has 'made its own luck,'[76] and why Australian Treasury economists agree that 'Australia's recent economic performance has not happened by accident. Rather it is the outcome of a concerted policy effort to lift the performance of the economy.'[77]

Australian Treasury Secretary Ken Henry told a New Zealand audience in 2003 that Australia is prospering because of 'good policies.' When asked 'What else?' he replied, 'Good policies.'[78]

All of this undermines the idea that New Zealand is still the 'naked girl at the party,' to use Chris Trotter's words. New Zealand may once have been in that situation, but not for long. Australia has overtaken it and has no intention of stopping for a cup of tea. As Martin Wolf writes in the *Financial Times*, New Zealand's reforms 'were radical only by the standard of New Zealand's incompetent past … It is simply wrong to describe such reforms as delivering a laissez-faire paradise. "Improved, but could do even better" would be a far more sensible assessment.'[79]

New Zealand's reforms 'were radical only by the standard of New Zealand's incompetent past ... It is simply wrong to describe such reforms as delivering a laissez-faire paradise.

Some policy ideas

Even if natural factors were the main explanation for Australia's success, there would be nothing governments could do about it. Policymakers need to focus on problems that they *can* fix.

Trying to force extra investment in capital (through compulsory super, for example) would not be an economic cure-all. Lack of available finance is not the problem for New Zealand firms; the problem is the absence of profitable investment opportunities. Forced investment for the sake of investing can be a disaster, as Think Big demonstrated.

The most sensible and realistic thing policymakers can do to increase New Zealand's growth is not to second-guess and control people's behaviour, but to make the environment for growth as fertile as possible.

The following ideas could all play an important part in boosting New Zealand's productivity and help close the gap with Australia:

- *Lower income taxes.* This is not the solution to all New Zealand's problems, but it is important, because lower tax encourages work, employment, investment, immigration, and savings. In *Why Tax Cuts Are Good for Growth*, I outlined this argument in greater depth, and the Treasury has told the government, 'studies strongly suggest that high marginal tax rates damage growth.'[80] Tax cuts are easily affordable thanks to a large budget surplus, and opinion polls show strong public support for such a move.
- *Cut the top rate of income tax*. Raising the top rate of tax to 39% for income over NZ$60,000 was symbolic, destructive, and completely unnecessary. This rate was originally intended to catch the top 5% of taxpayers, but it now applies to the top 14% (nearly half a million workers).[81] Removing this rate should be the first tax priority because it will have the strongest impact on growth. High-earning individuals are the entrepreneurs, savers, and employers in the economy, and usually respond strongly to any changes.[82]

  For those concerned about equity, it is worth noting that this top 14% of earners in the highest bracket currently pays 53% of all income tax, yet the removal of this top rate would still leave them carrying 51% of the burden.[83] It would also be a visible rejection of the 'tall poppy syndrome,' and send a clear message that success and hard work are valued. If New Zealand chooses as a nation to tax success, it shouldn't be surprised to have less of it.

- *Improve the quality of government spending*. The entire public sector (including universities and state-owned enterprises) makes up 43% of the economy, so clearly its performance will impact on productivity and on the economy as a whole.[84] Work by the Centre for Independent Studies has raised serious questions about the effectiveness and efficiency of recent spending, and the Treasury devoted an entire section of their post-election briefing to the government on this topic.[85]
- *Commit to light-handed regulation as much as possible*. Ad hoc government interference into the energy and telecommunications sectors, as well as uncertainty over climate change policy and asset sales, has shaken investor confidence. The advice of the NZIER should be followed: 'The regulatory regime must be simple, stable and free from political opportunism … In our view, New Zealand should abandon the industry-specific regulation developed since 2000 and return to the light-handed regulatory regime of the 1990s.'
- *Regulatory responsibility law*. Such a law, as proposed by ACT leader Rodney Hide, could help to constrain the growth of red tape. The bill would require the government to clearly explain the purpose of each new regulation, as well as its cost and what it will achieve. It would also involve regular reviews of the government's compliance with the law and the effectiveness of regulations. To some extent, the Productivity Commission in Australia serves this function.

These policies will not be silver bullets, and this is not a definitive list. Yet without these fundamentals, it will be difficult for New Zealand to ever close the gap with Australia.

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