Supersize New Zealand:

A Collection of Essays on how to Improve New Zealand's Public Policy

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Introduction

Luke Malpass

In April 2008, the CIS ran an event in Auckland titled 'Supersize New Zealand.' Speakers David Skilling (then CEO of the New Zealand Institute), Don Brash (former Governor of the Reserve Bank of New Zealand), Andrew Little (Secretary General of the EPMU, now also President of the Labour Party), and Phil Rennie (former CIS Policy Analyst) discussed their ideas for improving the performance of the New Zealand economy.

Following that event, a series of papers were commissioned to comment on how New Zealand could improve its economic performance. How can we 'supersize' New Zealand? Which policy prescriptions should be taken to help increase the performance of the economy and the well-being of all New Zealanders?

The papers that follow were all requested separately and not collaborated upon, but all share remarkably similar themes, and offer similar policy prescriptions. Smaller government, less regulation, more predictable regulation, less government spending (and making sure of the quality of that spend). Indeed, as the title of Roger Kerr's article suggests, 'institutions and policies matter most for prosperity.'

A lot can happen in a year

New Zealand's political and economic situation has changed substantially since the original articles were written. A new National-led government has been elected, ending nine years of Labour-led government. This event was met by jubilation by some and despair by others. One apparently Labour supporter wailed on the 6 o'clock news that hapless voters 'don't know what they've done' in voting for either National or ACT. While that particular claim remains to be seen, the election was interesting in itself because the debate was framed not so much between those old and outdated terms of 'right' and 'left' but between those who were happy with increasing government expenditure and interference in many aspects of everyday life and those who were not.

This particular framing is relevant to the content of this collection of papers—all point to the fact that increasing regulation and the associated increase in expenditure, quite aside from being an often unnecessary nuisance, have acted as a significant handbrake on economic growth and prosperity.

The 2008 general election has heralded more than a change in government; it has also brought to a close a chapter in New Zealand's history of national prosperity and seeming invincibility. Our export-led economy had been selling products all over the world, our milk solids had reached record prices, and our dairy industry had grown enormously. Economic growth had been strong and sustained, the minimum wage had steadily risen, unemployment had been relatively low. This is now changing. The election coincided with rapidly deteriorating conditions, created in part by the global financial crisis and in part by the realisation that much of the prosperity in New Zealand has been illusory and funded by debt.

Long-term policies are important

It is often said that there are no short-term fixes to long-term problems. Current economic conditions (if they haven't already) are going to make this clear. Markets are not an abstract concept; various markets in New Zealand are not vague entities existing somewhere in the ether, operated and controlled by share-traders and politicians. They are an aggregation of all consumer behaviour. If people decide to save instead of spend, for example, it will be reflected in market demand for certain goods and services. This will in turn affect the whole economy.

Given these changes, the authors who have had time have updated their articles or written an addendum to them. The content of these addendums is not what one might expect on the surface—they are perhaps notable for their lack of exciting stimulus packages and grand government schemes to kick-start the economy, save jobs, or 'encourage green innovation.' The common thread weaving throughout this booklet, reinforced in the addendums, is that quality long-term policies that promote productivity and growth are the only policies that truly increase income and national economic well-being. As Matt Nolan points out, it is all about increasing the size of the economic pie. Short-term demand management is no substitute for prudent, long-term predictability and high quality regulatory frameworks. Even if fiscal stimulus and various government guarantees were desirable actions in themselves, free of moral hazard, they simply do not work.

All of the papers that follow use this motif. Government intervention in markets has little efficacy precisely because markets cannot be 'controlled' with levers of state. Governments have neither the knowledge nor the ability to direct what essentially amounts to an aggregation of individual choices, decisions and behaviours. Where the government has waded in, as these papers suggest, it has only succeeded in perverting incentives, socialising undesirable behaviours, and wasting money.

Bear in mind while reading that the original scripts were written early last year in very different political and economic circumstances. The topics covered in this volume vary from housing to productivity to welfare reform, and all are asking the same question: How can we construct the best policy for New Zealand in this area?

This collection is a contribution to the ongoing public policy debate in New Zealand. The country faces substantial challenges ahead. Government debt is mounting. Tax revenues are forecast to drop by $NZ 1 billion. If no substantial policy changes are made, gross government debt is set to rise to 33.1 per cent of GDP in 2012–13 and up to 57 per cent in 2022–23.

Now as ever, regardless of what happens in the short term, long-term policy considerations must be at the forefront of our thinking.

Luke Malpass
Policy Analyst
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Sydney
March 2009

Setting the Scene: New Zealand's Challenge

Gareth Morgan

Politicians constantly seek a grand but simple solution to the problems facing their nation, maybe a silver bullet. But when it comes to New Zealand's current economic problems, there just is no silver bullet that will reverse the humiliating slump the country has engineered to secure its position in the lower half of OECD real per capita incomes—21st out of 30 as it happens. And the consequences of that performance continue to haunt efforts to change—particularly in the export of skills to Australia where living standards are firmly set at 12th out of the 30 within the OECD league tables.

Helen Clark made a big deal of how she would lift New Zealand out of the compost and into the top half of the league tables but, sadly, the cynicism and short termism of political ambition meant she was unlikely to match the rhetoric with deeds. In fact, her government has overseen an era of investment skewed heavily towards residential property at the expense of a balanced spread of risk-taking across the range of New Zealand's portfolio of income-earning endeavours. Exports, for example, have been dealt the disciplining hand of a rising real exchange right through Labour's term as the central bank has been left in sole charge of trying to counter the inflationary consequences from a low productivity economy that was determined to get rich by steering investment monies into an orgy of property speculation. The subsequent high real interest rates have served as a magnet for offshore lenders—to the point that we now have the bizarre combination of a record high terms-of-trade partnered with a record deficit on the balance of payments current account.

The global theme of the 1990s has been the emergence of structural imbalances between the surplus and deficit economies. And nowhere is the disjoint more stark than in New Zealand where we have accumulated a massive overseas debt, all in the name of the great property dream. It is a disaster ready to descend on us.

Could the government have done things differently? After all, the property boom has been a global phenomenon, and New Zealand has become one of the three most over-valued property markets in the world. But to expect our government to have single-handedly stood in the way of that may well have been wishful thinking. What could it have done? Perhaps the property orgy was inevitable—given the history of high nominal interest rates, the reality that New Zealanders have never experienced a significant fall in house prices, and the sad lack of sufficiently respectable investment alternatives in the financial sector thanks to inadequate safeguards of the public interest by regulators. Our Wild West financial sector has burnt a lot of hard-earned lifetime savings of ordinary New Zealanders. So property, the allure of which is enhanced even further thanks to a tax break, has become the en masse investment destination for Kiwis and, of course, to that extent, it has been a self-indulgence. Combined with new records of gearing, thanks to the global liquidity flood, New Zealanders have achieved the most expensive, lowest quality per dollar housing in the world.

And then along came the tightening of the global financial sector—an inevitable consequence of global imbalances and leverage. New Zealanders are—like possums blinded by headlights—set to be bowled flat by a reversal of the easy money mortgage market.

So starting further behind the eight ball now rather than when Helen Clark declared her aim was to deliver a top half OECD economic performance, what on earth can a government do? What was it that the Clark government, through sheer ideology and focus on the short term, got so wrong?

Productivity is where it starts and ends. Government policy has to emphasise first and foremost in its priorities those policies that assist New Zealanders raise their incomes. Handouts certainly don’t do that, and the blind ideology that leads a government to obstinately resist giving any consideration to its excessive tax-take and instead seek favour from the electorate from a plethora of targeted benefits and grand schemes—in the case of the Clark-Cullen cartel, to fund public health services and public savings blueprints—ideological icons of the 'democratic socialist'—has produced a policy funk.

In his latest budget, Michael Cullen had to borrow to pre-fund the state pension (New Zealand Superannuation) for future retirees in order to avoid taxpayers having to borrow at that time to support the elderly. This must be the epitome of ideology gone mad.

So what do we do from here? Scarce investment monies must be directed to areas of the greatest net national benefit, which requires that government remove impediments, to ensure that markets can function efficiently and price signals can accurately reflect New Zealanders' preferences. This means we have to:

(a) ensure that compliance costs are minimal per gain in public benefit—the standard test of any regulation of tax impost

(b) ensure that markets have free and fair entry and exit

(c) subject all government expenditure to the fundamental test that net social benefit is improved over and above all other alternatives and, in the absence of that proof, eliminate such spending.

So there is no silver bullet, no big idea that will enable New Zealand to claw its way back from the slide of poor governance and political expediency. Rather, only through satisfying a suite of commonsense tests will government regulation, spending and taxation not frustrate the private sector in allocating its scarce resources in a manner consistent with maximisation of living standards.

And there's the rub. Such governance provides little opportunity for political grandstanding, for monuments to political greatness. Basically we just need a government that quietly gets on with putting in place good governance structures and making sound day-to-day decisions. For example, a good tax system would not require constant tinkering or politicking about which party can offer the biggest tax cut. It should be robust over time and not subject to fiscal drag. But what would our politics be without the pork-barrelling and the campaigns that play to the myopia of voters?

It may well be that governments work best when they are headed by people without self-aggrandisement, but the type of person interested in seeking office invariably is inflicted with an above-average interest in self-promotion. From a political perspective, how do you set up institutional incentives that promote the adoption and adherence to sound policies? In times of crisis, it seems that societies, by sheer necessity, promote such competent and selfless leaders—either because these people get drawn to the top at such times or because the situation forces the people already in charge to have their ideology take a back seat. Our issue at present is that we do not have a crisis and, to be frank, nor is one likely anytime soon. Yet our poor relative performance is corrosive and increases the probability of a real humdinger in maybe a decade or two.

Perversely when that happens, people will look back at this time as a kind of 'Golden Era' rather than as the time when we took the wrong fork in the road.

Institutions and Policies Matter Most for Prosperity

Roger Kerr

Lessons in the recent past about what makes for a prosperous world have never been clearer—sound institutions and policies. New Zealand ignores these lessons at its peril.

Nobel Prize-winning economist Douglass North says institutions are the constraints that structure human interaction. Institutions are formal (rules, laws and constitutions) and informal (norms of behaviour, conventions, and self-imposed codes of conduct). Together, they define the incentive structure of societies and economies.

The International Monetary Fund's April 2003 *World Economic Outlook* found that three-quarters of the variation in average per capita income around the world could be explained by differences in institutional quality.

Specifically, countries that changed their governments without disruption, limited the power of executive government, respected the rule of law and property rights, and enjoyed low regulatory burdens and an efficient public sector, were likely to be prosperous.

Another study by Richard Roll and John Talbott[1] found that as much as 85 per cent of the international variation in per capita income can be explained by the institutions and policies countries adopt.

The study found that once the proper legal, economic and political environment had been created, government activism should be avoided—a finding as old as Adam Smith's insights in *The Wealth of Nations*.

By contrast, this literature suggests that factors such as population size, distance from markets, endowment of natural resources, the ratio of trade to GDP, and cultural differences are at most minor determinants of a nation's prosperity.

Of course institutions are not everything; policies matter too. Barbados and Jamaica are two countries that inherited similar (British) institutions, but Barbados has outperformed Jamaica with superior policies.

Institutional quality improved greatly in New Zealand with the reforms initiated by the Labour government that came to office in 1984 and carried on by the National government of the early 1990s.

Landmark changes included 'economic constitutions' in the form of the *Reserve Bank of New Zealand Act 1989* and the *Fiscal Responsibility Act 1994*, which constrained executive government in its monetary and fiscal operations respectively.

To these could be added the *State-Owned Enterprises Act 1986*, the *State Sector Act 1988*, and the *Public Finance Act 1989*, which introduced better discipline into public sector operations, reduced barriers to international trade and capital flows, and liberalised regulatory frameworks for many internal markets.

These changes ushered in a remarkable period of productivity and economic growth, lower inflation, fiscal consolidation, and falling unemployment relative to New Zealand's performance in earlier decades. Apart from a brief interruption during the Asian economic crisis, this prosperity lasted until around the middle of the current decade.

Institutional quality began to deteriorate with the introduction of the mixed-member proportional voting system in the 1996 general election. Proportional systems make the removal of governments from office more difficult, and research indicates they are associated with higher levels of government expenditure and more protracted and compromised policy-making.

While New Zealand has retained many sound institutions, including the British common law, there was further deterioration in institutional quality after the Labour-led government was elected in 1999. In general, there was a move away from principles of limited government towards an open-ended vision (most memorably encapsulated in Prime Minister Helen Clark's statement, 'The government's role is whatever the government defines it to be').

Notable instances of institutional change included:

- the widening of the Reserve Bank's inflation target to 1–3 per cent in the Policy Targets Agreement in 2002, and the apparent abandonment by the Reserve Bank of the legislated goal of price stability
- the *Local Government Act 2002*, which expanded the purposes of local government and gave councils a 'power of general competence'
- an erosion of respect for property rights in cases such as Timberlands,[2] the foreshore and seabed, public access to private land, Telecom unbundling, shared fisheries proposals, and Kyoto forests, and opposition to a proposal to include the protection of private property rights in the NZ *Bill of Rights Act*
- the replacement of the internationally respected Privy Council by a NZ Supreme Court
- the undermining of the capacity and independence of the public service through political interference, and the weakening of the Westminster system as ministers routinely attacked government departments rather than defending them
- the passage of the *Electoral Finance Act*, which had a chilling effect on free political speech
- disrespect for the rule of law in the intervention to block the bid by Canadian interests for a shareholding in Auckland International Airport
- a massive increase in regulatory burdens; renationalisation of industries; an expanded, wasteful and inefficient public sector; and entrenched inflation and inflationary expectations.

Major barriers to prosperity such as the *Resource Management Act* were not reformed, while further costly regulation such as ambitious climate change measures were passed into law.

These changes to institutions and policies had predictable outcomes. After maintaining its momentum for some years on the back of the earlier reforms (and favourable external circumstances), the economy stalled with low productivity growth, higher inflation, large current account deficits, and the projected disappearance of fiscal surpluses.

New Zealand was in recession by early 2008, well before it was hit by the international financial crisis, and the outlook for growth in real incomes is mediocre. The Labour government's goal of restoring New Zealand to the top half of the OECD income ladder was never in sight, and income gaps with Australia look set to widen.

Reversing these trends requires reversing the deterioration in institutional quality and policies, and building on the earlier improvements. There is no reason why New Zealand cannot match Australian per capita income levels over the next 15 years or so with outstanding economic management.

Action would be needed across a broad front, and would need to be maintained consistently, not in an erratic fashion.

Rather than revisit issues already mentioned, let me single out two proposals I think would have material benefits.

First, a tax and expenditure limit should be introduced into the *Fiscal Responsibility Act* (now part of the *Public Finance Act*) which, for all its virtues, has not effectively disciplined public spending. In line with legislation in place in a number of US states, it could take the form of a rule limiting spending growth to population growth plus inflation, unless a government obtained support for higher increases in a referendum. The National-led government elected in November 2008 has agreed to introduce a bill containing such provisions for select committee consideration.[3]

Second, a further 'economic constitution' should be put in place to discipline regulatory interventions. This should spell out in statute sound regulatory principles and require compensation for regulatory takings, along the lines of the *Public Works Act*. A task force is to be established to carry forward the deliberations of a select committee in the last parliament on a proposed *Regulatory Responsibility Act*.[4]

Overall, better institutions and policies, with government limited to its proper role of ensuring the provision of genuine public goods and a safety net, which promote greater economic freedom and provide maximum scope for entrepreneurial endeavour in the private sector, must be the foundation of any program to achieve greater prosperity for New Zealand.

Endnotes

1 Richard Roll, 'Quality Institutions Key for Development,' *Perspectives* No. 25 (Wellington: New Zealand Business Roundtable, September 2002), www.nzbr.org.nz/documents/perspectives/perspectives/issue25.pdf (Accessed 9 March 2009).

2 Timberlands, a state-owned forestry company, was directed by the government to breach contracts to supply native timber to existing customers.

3 For more detail, see Bryce Wilkinson, *Restraining Leviathan*: *A Review of the Fiscal Responsibility Act 1994* (Wellington: New Zealand Business Roundtable, November 2004), www.nzbr.org.nz/documents/publications/publications-2004/restraining_leviathan.pdf (Accessed 9 March 2009).

4 For further detail, see Bryce Wilkinson, *Constraining Government Regulation*, discussion paper (Wellington: New Zealand Business Roundtable, November 2004), www.nzbr.org.nz/documents/publications/publications-2001/constraining_govt.pdf (Accessed 9 March 2009).

Big Ideas to Super-Size New Zealand's Economy

Don Brash

In a 12-minute speech, there is little time to dwell on the obvious that:

- a gap has emerged between living standards in New Zealand and those in countries to which New Zealanders can readily move;
- this gap has become markedly larger over the last seven or eight years, particularly against countries such as Australia, in large part because our trend growth in labour productivity has roughly halved as compared with the trend growth in the 1990s;
- as a result, we are seeing an increasing number of New Zealanders leave the country permanently;
- we are increasingly unable to afford the good things of life that richer countries take for granted, such as a proper course of Herceptin for treating breast cancer;
- we are increasingly dependent on migrants to fill the gaps left by departing New Zealanders so that, for example, we now have the highest percentage of foreign-trained doctors in the developed world with one New Zealand doctor leaving the country every week; and
- even the government, when it is being completely honest, acknowledges that there is not the slightest chance of reaching the top half of the OECD by 2010, as was their original objective, or even of achieving the 4 per cent trend growth which Michael Cullen said was his immediate aim in his 2002 Budget.

I think most people in this room also accept that simply cutting income tax rates, or making marginal changes in income tax thresholds, to leave a few more dollars in the pocket of the average wage earner will make no fundamental difference to this dismal picture. At the same time, pushing companies to pay Australian wages despite New Zealand's much lower productivity per person is just plain dopey—unless the advocates of this course of action want to discourage employment by those companies.

Having spent four and a half years in Parliament, I suspect that the leadership of both our major political parties understand all this rather well. The problem is not their lack of understanding but one of explaining what needs to be done to an electorate with a rather short time horizon and a very poor understanding of what needs to be done.

All my proposals on what needs to be done would, I believe, have a materially beneficial effect on improving our living standards. The proposals are grouped under two main headings—macro and micro, though I admit the distinction is a bit artificial.

I will not be discussing issues relating to climate change or the measures that might be taken to reduce carbon emissions. This is partly because I suspect that David Skilling will touch on those issues in his speech and partly because I remain somewhat sceptical about the impact of human activity on climate, and suspect that within five years, many others will have come to share my scepticism. But let me just say in passing that there isn't the slightest doubt that achieving big reductions in greenhouse gas emissions of the kind that both major political parties have committed to will almost inevitably have profoundly negative implications for our standard of living.

One other comment by way of introduction. I make no apology for the fact that none of the proposals I put forward today is brand new in the sense that nobody has advocated them previously. Unfortunately, achieving higher living standards involves doing a whole lot of things that may not be understood by the general public, but that are now widely understood by policy-makers.

Macro proposals

1) **Improve the education system.** By this, I don't mean throwing vast amounts of additional money at university students. Yes, tertiary education is important for our future, but I strongly suspect that the quality of our pre-school, primary and secondary education is of even

more fundamental importance to the productivity of our work force. Far too many New Zealanders are barely literate and barely numerate, and they will never be highly productive in an economy increasingly dependent on employees being both literate and numerate. Does this require more government spending on education? Probably not: government spending on education already makes up a higher percentage of our GDP than in most other developed countries. What we need is better trained teachers and a remuneration system that differentiates between good teachers and those who should be in another career. That almost certainly implies giving parents more choice about where their children are schooled.

2) **Change the welfare system so that it encourages people back into the workforce.** On the face of it, participation in the paid workforce is already fairly high by developed country standards. But it's also true that despite employers up and down the land being desperate to hire staff, the number of working age adults who still depend on the state for their primary source of income is well in excess of 250,000. Many of these dependents are allegedly sick or injured, although why the number of those sick and injured should have increased by 50 per cent since 2000 is frankly beyond me—the increase strongly suggests that there has been significant migration from the mildly work-tested Unemployment Benefit to the un-work-tested Sickness and Invalids Benefit. Many others are on the Domestic Purposes Benefit, where the eligibility criteria allow uneducated teenagers to make a lifestyle choice in favour of single parenthood—to their own huge detriment and to the detriment of their children. The current welfare system not only involves very substantial fiscal costs but also discourages too many people from entering the workforce, with social as well as economic costs.

3) **Hold government spending at present levels, per capita, in real terms.** This hardly sounds like an ambitious target. It implies a steady *increase* in government spending in nominal terms, both because of inflation and because of population growth. It simply means holding current levels of real spending on a per capita basis. If the population increases, or if prices increase, then government spending goes up to compensate. But achieving such a goal would

involve stopping the substantial *growth* in real government spending per capita which the present government plans to do. The 2008 Budget Policy Statement projects an increase in inflation-adjusted government spending per capita of more than 28 per cent, or some $9,000 per household between 2004 and 2012. That is a truly massive increase in government spending per capita in real terms, and seems impossible to justify other than in crudely political terms. If, instead, real government spending could be held at current levels, on a per capita basis, the scope to provide tax reductions which would give the private sector more space to grow would be very considerable indeed.

4) **Constrain the growth in government regulation.** The Australian Productivity Commission estimates that complying with regulations in that country costs 4 per cent of GDP, or about A$40 billion. And that is the cost of *complying* with regulations. Unquantified, and probably unquantifiable, is the almost certainly much greater cost imposed by regulations that simply stop investment occurring altogether. In recent years, there has been an explosion in the quantity of legislation and regulation that people and companies have to comply with, most of it enacted with the utmost of good intentions. When I was Governor of the Reserve Bank, I made the decision to impose on the banks a disclosure regime designed to ensure that they behave prudently to minimise their risk of getting into difficulty. My intention was to use public disclosure to put pressure on bank managers and directors to operate in sensible ways. I don't resile from that decision. But having been a director of a bank myself now for much of last year, I realise that the system I initiated has created very large compliance costs. It's overkill. For large banks, the quarterly disclosure statement is around 100 pages—no doubt ideal material for insomniacs but a huge barrier to reading and engagement by normal members of the public, or even dedicated financial journalists. Most of the information needed by the public is available in 3–4 pages in the Key Information Summary which banks are also obliged to publish. There would be considerable merit in some form of legislation that created a quality and cost benefit hurdle that all new legislation and regulation would have to clear

before coming into effect with the objective of minimising the cost of regulation.

5) **Give the Reserve Bank an additional instrument to moderate inflationary pressures.** Everybody in the export sector, and indeed everybody competing with imports, knows about the acute problems caused by big swings in the exchange rate, caused in part by financial markets' perceptions of what the Reserve Bank is likely to do with the Official Cash Rate. I'm not talking about the day-to-day or week-to-week volatility of the exchange rate. There are plenty of market mechanisms available to protect against those short-term fluctuations. The real problem is caused by the 5–7 year swings. No exporter, wondering whether to make an investment, can cover the exchange risk for, say, the next seven years. There is virtually no market for seven-year forward contracts, and even if there were, exporters wouldn't know with confidence the value of their exports seven years into the future, or the currency in which they would be denominated. So when the NZ dollar increases in value from less than US39 cents in late 2000 to nearly US80 cents today, many exporters struggle to stay afloat and many more are forced to scale back their businesses. Many swear to focus more on the domestic market in future. And yet we need to increase our exports, as David Skilling may well point out. I believe the Reserve Bank best serves New Zealanders, both socially and economically, by keeping prices stable, but I have come to the conclusion that using only the Official Cash Rate (OCR) to do that puts far too much pressure on exporters and those competing with imports because of the effect of OCR on the exchange rate. As I have indicated elsewhere, I would favour giving the Reserve Bank a constrained authority to vary the excise tax on fuel—increasing it when there's a need to restrain overall spending because of strong inflationary pressures, and reducing it when there's a need to stimulate overall spending when inflationary pressures are very weak. This should lead to smaller swings in the exchange rate and less variability in interest rates—to the benefit of homeowners, exporters, and those competing with imports as well.

Micro proposals

6) **Flatten the income tax scale and limit the maximum tax payable to $1 million.** Most of the current discussion about tax cuts seems to be about letting people keep more of their own money, and that in itself is entirely desirable. But the relevance of tax to long-term living standards mainly relates to the marginal tax that people pay on the next dollar of earned income. Having a beneficiary face an effective marginal tax rate of 80 cents in the dollar is no way to encourage him, or her, to get off a benefit and into the work force. Having a tradesman face an effective marginal tax rate of more than 50 per cent, after taking into account income tax and Working for Families abatement, is no way to encourage him to work harder, or expand his business. Those incentives would be significantly better if the effective marginal tax rate were much lower. Fewer tax rates would also greatly simplify compliance with the tax system. There is a real danger in this election year of foregoing large amounts of tax revenue as part of a vote-buying tax auction while leaving the basic structure of the tax system, and the high effective marginal tax rates, substantially untouched. That would be an enormous wasted opportunity, though I understand only too well the political obstacles to a more rational tax system. I can already hear the taunts of Labour Party politicians if John Key proposes flattening the tax scale, even though that might well be one of the best contributions he could make to help *low-paid* New Zealanders.

   There would also be merit in adopting another of the recommendations of the government's own Tax Review Committee in 2001, namely limiting the amount of tax paid by any one individual in one financial year. The Review Committee recommended a limit of $1 million. Adopting such a limit would be politically difficult because so much of our current debate on tax is based on crude envy, but it would certainly make sense economically. Very few New Zealanders, if any, pay an annual income tax of more than $1 million; such an amount is more than sufficient to cover the costs imposed by any one taxpayer on the rest of society; and adopting such an approach would almost certainly be revenue positive by attracting back to New Zealand a number of expatriate

Kiwis who have gone abroad to more 'tax-friendly' jurisdictions, as well as attracting wealthy Americans, Europeans and Asians. Quite apart from the revenue *gain* from such a measure, the increase in entrepreneurial dynamism from such an influx of successful business people would be a substantial gain.

7) **Fix the Resource Management Act (RMA) and HSNO Act.** I rather strongly suspect that the *RMA* does more to inhibit New Zealand's economic growth than any other single piece of legislation. It makes getting consent to undertake almost any kind of investment an incredibly expensive, risky and time-consuming process. I think it was Transit New Zealand that pointed out some years ago that getting approval to build a major road in New Zealand can take seven years, as compared with seven days in Singapore. Nobody thinks that we can cut our approval times from seven years to seven days any time soon, but seven years is ridiculous. The Forest Industries Council pointed out two or three years ago that at that time 21 major wood-processing plants were under construction in Australia but none at all in New Zealand, and the Council laid most of the blame on the *RMA*. Nobody in this room wants to destroy our natural environment, but without a major re-write of the *RMA* we have very little chance of again achieving Australian living standards.

   The *HSNO Act* also is a major impediment to investment, especially in our vital agricultural and horticultural industries. It has had a major impact on slowing the introduction of new plant varieties.

8) **Remedy our serious deficit in roading infrastructure, and price road usage correctly.** For all the talk about public transport and the benefits of improving our rail network, the evidence is overwhelming that rail systems rarely pay their way while roading infrastructure has a substantial payoff in terms of economic growth. New Zealand almost certainly has a serious deficit in roading infrastructure, not only in major metropolitan areas such as Auckland but also in many North Island rural areas. I say 'almost certainly' because one of the things we can't be sure of is the *extent* of that deficit in a situation where we continue to allow people to treat roads as free at point of use. Of course, motorists contribute to the cost of roads

through petrol excise tax, but that tax is the same no matter when or where roads are used. Motorists also contribute to the extent that they are ratepayers, but the amount of rates paid bears absolutely no relationship to when or where roads are used, or even whether roads are used at all. When I argue for pricing road usage by some form of electronic tolling—with tolls varying depending on when the roads are used—most people say such a move would be politically impossible. I don't agree: I strongly suspect that people would accept electronic road pricing if told that petrol prices would drop by 30 or 40 cents per litre, with a 25 per cent drop in their local council rates. Of course, some people would end up paying more under such a system just as some people would end up paying less, but everybody would benefit by a marked reduction in traffic congestion.

9) **Allow easier dismissal of unsatisfactory employees, especially in the first three months.** Yes, I know, this is a hardy annual on the agenda of all business lobby groups, but that surely doesn't invalidate it. On the contrary, the fact that every business lobby group, and every business person I've ever met, and the government's own Small Business Advisory Group make this point shows how widely felt this concern is. New Zealand is now the *only* developed country that effectively prevents employers taking on a new staff member on a probationary basis. When the current intense pressures in the labour market abate, there can be little doubt that the people most disadvantaged by the absence of a probationary period will be the poorly educated, ethnic minorities, recent immigrants, and those with a criminal conviction in their past—the very people our society should be trying to help. Making it difficult and expensive to lay off unsatisfactory staff, or staff no longer needed because of a change in the business environment, is not only disadvantageous to the poorest in our community, it also increases risk for those contemplating investment and reduces our growth potential.

10) **Free up more land for housing.** It is increasingly being recognised that the main reason that houses in New Zealand have become severely unaffordable—with the median house price in our major cities some six times the median household income—is that local and regional governments have imposed tight restrictions on the

availability of residential land through their zoning rules. Of course, this has had serious *social* consequences, with more and more young New Zealanders finding it impossible to buy their first home. But it has almost certainly had profound *economic* consequences as well, driving a huge increase in consumer spending from the perceived increase in the 'wealth' of homeowners, leading in turn to a large balance of payments deficit, a heavy dependence on the savings of foreigners, an undesirably high exchange rate (the consequence of the Reserve Bank's having to lean against the inflationary pressures generated directly and indirectly by the rise in house prices), and a diversion of a high proportion of available savings into building ourselves more and more lavish houses—much of it on money borrowed from foreigners. Politically, this problem can't be solved overnight, but solve it we must.

So there you have it: Don Brash's 10-point plan to increase our living standards! None of it is politically impossible, but implementing the plan would take courage because the pay-off would not be instantaneous. But there would be a pay-off. Young New Zealanders would still want to go overseas to see the world, as they have always done. The difference this plan would make is that a high proportion of them would want to come back home.

Addendum

Looking back on the speech I made early last year, there's not a word I'd want to change. Yes, it's now clear that the world has entered a financial and economic crisis that is vastly more serious than seemed likely in early 2008. And yes, it is now clear that New Zealand itself has been in recession for more than a year.

But it is also clear that some of the policies I criticised last year have put us in a situation that is even more serious than I realised at that time.

For example, I argued for holding the level of government spending in real terms per capita—not cutting government spending, not even cutting it in real terms, just holding it steady in real terms per capita, so that nominal spending would continue to increase as a result of inflation and population growth. Alas, the last government continued to expand its spending strongly, with the result that core government spending was projected in the latest Budget Policy Statement to rise from 31.7 per cent of GDP in fiscal year 2008 to 35.5 per cent in fiscal year 2010. This massive increase in just two years is equivalent to an increase in government spending of $7.25 billion per annum. Without that splurge in government spending, the fiscal position would have been vastly more comfortable.

Or look again at the effects of the restrictive zoning of residential land, not only in New Zealand but also in other English-speaking countries such as the United States, the United Kingdom, and Australia. In all three of those countries and in New Zealand, the restrictive zoning of residential land facilitated an enormous increase in the price of housing. That in turn encouraged the mistaken belief, a belief held by both borrowers and the banks that lent to them, that house prices *always* go up. Given the almost universal acceptance of this belief—most people seemed to assume that the long-term decline in real estate prices in Japan and Germany was somehow a special case—it seemed entirely prudent for borrowers to borrow against the increased value of their homes and for banks to lend against that increased value.

And so we saw in all those English-speaking countries a deeply-entrenched tendency to spend more than was earned, with people borrowing the difference from the thrifty savers in other countries, some of them much poorer than the countries whose citizens were doing the borrowing. Nowhere has that profligacy been more pronounced than in New Zealand. As a result, we now have a higher ratio of net external liabilities to GDP (above 90 per cent) than any other developed country except Iceland.

I very well recall John Pitchford in Australia and Milton Friedman in the United States arguing that, provided the government's accounts are in surplus and the exchange rate is floating, a balance of payments deficit should be no concern of policymakers. Their argument was that, with the public sector in surplus, any overall *national* deficit reflected in the balance of payments by definition means that it is the private sector that is choosing to spend more than its income. And they argued that policymakers should not interfere with those private sector choices.

Eventually, either private sector borrowers will decide that they have taken on enough debt, or their creditors will make that decision for them—either way, the overspending (and so the balance of payments deficit) comes to an end, probably through some combination of a lower exchange rate and higher interest rates as foreign savers become less willing to lend.

I have a lot of sympathy with that view. But it presupposes that the adjustment from *over*spending one's income to spending *within* one's income will happen rather smoothly. The present situation suggests that it doesn't always happen that way. With a sufficiently abrupt shock to general confidence, many borrowers choose to cut back on their borrowing, and lenders simultaneously become much less enthusiastic about lending. Asset prices fall sharply, and we see a general contraction in activity.

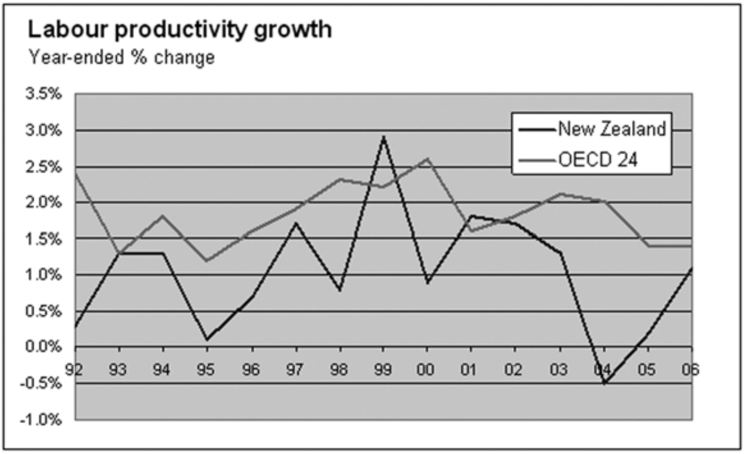
The new NZ government faces the difficult task of dealing simultaneously with the short-term crisis in confidence, the longer-term crisis of our slow growth rate relative to the countries to which New Zealanders can readily move, and our continued heavy reliance on the savings of foreigners. Beyond the short-term adjustment phase, continuing the 'borrow and spend' policies of recent years is no longer a viable option given the gloom in international credit markets.

The Great Spending Trade-off

Matt Nolan

The fundamental issue for increasing the size of the 'economic pie' is productivity. The more productive a nation is, the more it can create with its scarce resources.

In New Zealand, our labour productivity growth has run at a lower rate compared to the average of OECD countries over the last 15 years.



One of the main contributing factors to New Zealand's poor productivity performance over the last 20 years has been the lacklustre growth in capital intensity levels. Firms have been unwilling to invest in capital for a number of reasons, including regulatory and economic uncertainty. However, as identified by Treasury,[1] one of the most pressing issues has been the high cost of capital.

Many people believe that inflation targeting is the root of the high cost of capital, with interest rates in New Zealand consistently at high levels relative to the rest of the OECD. Although high interest rates are a problem, the solution is not abandoning inflation targeting.

The 'average' real interest rate set by the Reserve Bank can be shifted around for a number of reasons, namely:

- time preference of firms and households
- condition of international credit markets and distance from capital markets
- changes to a nation's endowment of resources
- fiscal policy.

We cannot control the international economic environment; we cannot exogenously create a greater endowment of resources; and we should not try to control the preferences of individuals and households. But, as a nation, we can try to control the level of government spending.

Since 1999, nominal government consumption and investment have risen by 71.6 per cent—significantly more than the 60.3 per cent increase recorded among the private sector components of national expenditure. As a percentage of GDP, government spending on consumption and investment has risen from 21.8 per cent to 23.5 per cent over the past eight years—and given the current spending path of government, it appears it will grow further.

But, how does this hold up interest rates?

Of course, this raises the question why does greater government spending increase interest rates? There are three main channels through which government spending can push up interest rates by increasing structural inflationary pressures.

First, government spending tends to be on less 'productive' items than private spending, and even when it is not, the government does not set wages and costs in response to efficient prices signals but, instead, in response to budgetary pressures.

In the current environment, where tax revenues are constantly surprised on the upside, there is less pressure for government departments to keep costs down—thereby leading to more spending for the same level of output, which is inflationary.

Second, there is the impact on the labour market. As mentioned above, a reduction in fiscal discipline leads to higher wages in the public sector. As public and private sector firms compete for the same labour, higher wages in government put pressure on firms—increasing cost pressures.

Third, when the government taxes and spends income, all that income is spent. However, if that income had been left in the private sector, part of it would have been split between the firm and the employees.

The firm's component could be used to invest or paid out as a dividend. As a part of the dividend would be saved, both these actions would involve less inflationary pressure than straight government consumption—and government investment.

The employee would have spent part of this income and saved part—so it would be less inflationary than government consumption.

An additional way the government can increase inflationary pressures is by changing the way it sources revenue. For example, Finance Minister Michael Cullen has gradually increased the progressivity of the tax system. By making a tax scale more progressive, a society is shifting funds from those who save (thereby leading to investment) to those who consume.

Overall, the way the government raises revenue and the amount of revenue the government raises influence inflationary pressures in the economy.

Then why don't we just cut spending?

Contrary to the belief held by Cullen, there is a trade-off between efficiency and equity. While our finance minister is willing to ignore this trade-off in order to increase the level of 'equity' in the economy (which appears to have more to do with equality than fairness), we cannot be so rash as to ignore that such a trade-off does exist.

Society, for whatever reason, is willing to pay to achieve certain social standards. However, the broader society may not be aware that when achieving some of these equity goals through programs such as working for families, we are not only paying more than the tax cost of setting up the scheme but also facing higher interest rates on the money we borrow. Furthermore, as interest rates are higher, incentive for firms to invest will be lower—leading to an overall smaller economic pie.

Hopefully, this point can be raised in this year's election—then the voting public can tell the government whether they would prefer greater levels of growth or further increases in equality.

ADDENDUM

Since I wrote the previous article, a lot has changed in the economic environment. Commodity prices have tumbled, unemployment has begun to rise, the general outlook for the economy has soured, and a National-led government is in power.

In the current environment, policy makers have decided that inflation is not the problem; instead, we need to turn our eyes to the more immediate issues of falling production and rising unemployment. Even so, the importance of productivity and the idea of controlling government spending and improving institutional structure remain as important as ever. As we discussed in the previous article, inflation is but a symptom of the structural imbalances in the domestic economy—the disease does not disappear simply because the symptoms have temporarily abated.

Often when a crisis occurs, there is a clamour to 'do something.' Suddenly it becomes all right to throw fiscal discipline out of the window, while the quality of spending becomes a secondary issue for politicians. However, if anything, the issue of the quality of spending is more important in times of economic hardship.

Contrary to popular belief, getting people to dig a hole and fill it back up does not create value in society. The idea that paying people to do nothing will improve outcomes is based on the notion that, in some indirect way, giving money to people to do nothing will in turn create work for people who can create value. Why not cut out the intermediary and focus solely on the creation of wealth?

In New Zealand, our labour market has not yet given up the ghost—with 4.6 per cent unemployment in December 2008, the labour market actually remains on the tight side of neutral (which is estimated to be 5 per cent). However, with forecasters now expecting unemployment to head well over 7 per cent, there is scope for good government policies to make a difference without having to compromise the long-term capacity of the New Zealand economy.

What are sensible policies that the government can undertake in such an environment?

- Allow spending growth to continue to rise at the same level the government would in the absence of a temporary crisis (although where this level sits is a matter of debate)
- Re-target spending: Take spending from 'wasteful' areas and put it to work in areas of the economy with a greater social return
- If the budget allows, then bring forward infrastructure spending: The more of government's planned infrastructure spending that can be implemented during a recession the better—as the cost of building will be lower
- Try to recognise any structural shocks: If some industries are facing a permanent decline in competitiveness, let them shrink—but try to provide education and re-training initiatives to get the employees back into the workforce
- If the credit market remains frozen, there is the potential for government to temporarily fund retail loans through banks—and ensure that otherwise efficient businesses can maintain cash flow.

These policies may not even be necessary, given that the unemployment situation in New Zealand remains much stronger than it is in many other developed countries (e.g. the United States). However, any policy introduced by the government to deal with the crisis must at least be in society's long-term interest.

A timely, targeted and sensible response by government is both consistent with the short- and long-term requirements of the New Zealand economy—let's hope that the National-led government remembers this at a time when the political pressure to 'do something' is mounting.

Endnotes

1 Max Dupuy and James Beard, 'Investment, Productivity and the Cost of Capital: Understanding New Zealand's "Capital Shallowness,"' New Zealand Treasury Productivity Paper TPRP 08/03 (Wellington: The Treasury, 2008).

Super-sizing New Zealand's economy

Phil Rennie

I've spent the last few years at the CIS reading, writing and thinking about economic policy. In this time, certain themes kept popping up, and tonight I've narrowed them down to five ideas I want to put out there on how we could super-size our economy.

My first point is that size matters—size of government, that is. The entire public sector (which includes universities, schools and state-owned enterprises) now makes up 45 per cent of the GDP. That's nearly a half of all wealth created in New Zealand in the control of its bureaucrats and politicians.

That figure is higher than it was under Muldoon, and it's much higher than in Australia, where the equivalent figure is 35 per cent.

As the other speakers have said tonight, productivity is the key. But just remember that our official measurements of productivity only apply to the private sector; we don't actually measure the public sector—the other half of the economy—in the same way.

What that means is the value we get from the public sector is hugely important to our economic performance. If we're going talk about big ideas tonight, then we can't ignore this issue.

The evidence of value is not great, though. Government spending is now $20 billion a year higher than it was in 2000, yet most measurements of social progress have hardly changed. Social parameters such as life expectancy, hospital outputs, literacy and numeracy, violent crime, suicide, poverty, and inequality are largely unchanged. That's a poor return when you consider the one-third increase in government spending in real terms.

So how can we get better value? Here are a few ideas.

First, the goals and outcomes of every new policy must be established in advance. The worst policy mistakes happen when the problems are not defined early on.

Second, the policies must be reviewed every few years to see whether they are actually working. Too often, we launch new programs or funding injections but soon forget about them. We can learn a lot from the United Kingdom and Australia where outside agencies conduct vigorous reviews.

Third, we should use sunset clauses. If the set goals of a policy aren't achieved within a certain timeframe, funding must be stopped automatically. There's no reason why funding for failed policies should continue without checks and balances.

My second theme tonight is tax. I know this is almost a cliché these days but it is a very important factor in the policy debate. New Zealand is now the highest taxing English-speaking nation in the OECD, and again much higher than Australia.

Lower tax makes a difference, not just because it means more money in the pocket, but because of how it influences behaviour. Lower tax makes it more rewarding to invest, to save, to start working, to employ people, even to move to New Zealand in the first place.

All around the world, the countries that have cut taxes and have lower tax burdens have been growing much faster and enjoying greater prosperity than those who increase taxes. It's not a perfect correlation, but it's a pretty strong one.

So how much should we cut taxes by, if we really wanted to? Well, in this year's budget we have an operating balance of $2 billion plus $3 billion for new spending. If we used the $5 billion, we could have two low flat-income rates of 15 per cent and 25 per cent, and that's without cutting a single dollar of spending.

If you wanted to be really serious, and a bit more radical, you could scrap Working for Families, interest-free student loans, and the Kiwisaver incentives. Most of those policies are middle-class welfare anyway, in that the benefits go to people who paid the tax in the first place.

Scrapping these policies leaves a flat tax rate of 15 per cent, again without cutting any other spending. So it's not a crazy idea; it is a totally achievable goal if we want it—and if we have the political willpower and courage.

That kind of cut would be a real turbo-boost to the economy. Just imagine what a boost to incomes that would be, how much investment it would encourage, and the kind of headlines it would generate around the world.

Imagine how much simpler our tax system would be and how much less red tape there would be. Imagine being able to sack half of IRD and putting thousands of tax lawyers and accountants out of business. That has to be a good thing for the country! They could spend their time actually doing productive things instead, rather than helping people dodge the law.

If you think this is all too radical so far, then look at what Kevin Rudd is doing in Australia. He's actually cutting wasteful government spending by $10 billion over the next four years, and giving big tax cuts. So arguably he's more radical than I am, and he is a *Labor* Prime Minister!

My third point is about regulation and red tape. Again it's almost a cliché, but again there's a good reason why we keep hearing about them—because they are so important. Every extra cost we impose on employers and business is a handbrake on growth, employment and investment.

On most international comparisons, we actually do OK for ease of doing business, but that shouldn't be an excuse for not doing more. We shouldn't pat ourselves on the back and say, 'oh well, at least were not as bad as Kazakhstan.' We can always do better.

So what exactly can we do? First, commit to certainty and stability. Every time the government changes its mind without warning or consultation, it creates massive uncertainty in the minds of investors, both local and overseas, and it makes them nervous about committing to this country.

Auckland airport is of course the most obvious recent example of this. Energy policy and climate change have also been very unpredictable.

Second, make it harder for governments to pass new regulations. This is what Rodney Hide is trying to do with his private members bill, whereby governments would have to explain the cost and benefits of every proposed new regulation and then have a review after five years.

And once again, we could do worse than look at what Kevin Rudd is doing—he has appointed a Minister of Deregulation with the sole job of removing red-tape.

So that's tax, spending and regulation I've covered. My fourth point is probably going to be the least popular idea, and it's about re-prioritising our education spending.

We have an enormous number of tertiary students—nearly half a million enrolled in 900 different institutes.

I worry that we actually have far too many young people sitting on their bums, especially at university, who don't really need to be there, who aren't really enjoying their study and won't get a job directly out of it, and who are only there because they're following their mates and/or what their parents told them to do.

At the same time we have a shortage of workers in so many different areas, especially the trades and engineering jobs.

So I think there is a serious mismatch going on, and we're wasting a huge amount of time, money and human capital. Just to give you a couple of examples, more than half of all law graduates don't end up practising law. They do something else, and I'm one of them. In fact, the completion rates for all tertiary students in New Zealand are not flash either.

University isn't for everyone, and we need to consider having higher entrance standards and probably higher fees to make students take it more seriously, to consider the real cost of study rather than just using it as form of glorified babysitting.

For those talented and smart young people who really should be at university, I'd be happy to have more scholarships and support for living costs to get them there. But when we subsidise fees by 75 per cent, we are seriously warping people's decision-making. Interest-free student loans only make that worse.

I think we need to frontload our education spending so that we spend more at the early levels, including primary and pre-school, where it can make a real difference and has much more of a public benefit.

For a change, my fifth and last point may not be that controversial. It's about the need to improve the basic financial literacy of New Zealanders and being smarter about spending money.

There is a lot of disturbing evidence that suggests New Zealanders are not too savvy when it comes to managing money. A number of surveys show New Zealand lagging behind other countries when it comes to understanding basic concepts such as compound interest and the benefits of paying off debt.

I don't believe we necessarily have a savings problem in New Zealand, but it's *how* we save and *how* we invest that is questionable at times. A lot of people seem to have an aversion to the stock market, and those who do invest often prefer to do it themselves rather than get professional advice. And it seems that many people may have put all their eggs into the property basket.

As a nation, we spend billions of dollars every year on pokie machines and loans from dodgy finance companies, mostly by people who can least afford it.

This kind of problem is tough for the government to solve on its own, and I don't have a magic solution. But there are some good initiatives happening; financial literacy was introduced in the school curriculum last year, and public awareness campaigns are being launched this year by public and private groups.

So those are my five ideas:

- put the brake on public spending, and get better value from what we do spend
- introduce a flat tax rate of 15 per cent
- declare a jihad on red tape
- spend less on universities and more on early education
- get smarter with managing money.

All these policies can be instrumental in super-sizing New Zealand's economy.

ADDENDUM

In the 12 months since I gave the speech, super-sizing New Zealand's economy has become a hopelessly optimistic goal; limiting the damage over the next couple years is the best we can hope for.

The most obvious change to my plans is due to the massive deterioration in the government accounts. For the last decade, Michael

Cullen had the luxury of bonus tax revenue filling his coffers every year, to the extent that his biggest problem was what to do with it all. His successor, Bill English, must be fuming; a year ago it looked as if the multi-billion dollar surpluses would continue, but instead the country is now facing a decade of deficits.

This puts a huge straitjacket on the government and makes tax cuts much harder to fund. My original article makes it sound easy—just use the surplus and redirect new spending, but neither option is possible now. The money is all gone.

I guess this really illustrates the tragedy of missed opportunities over the last decade. With just a little more discipline on spending, we could have funded massive tax reforms and ensured families and businesses were much better prepared for this recession. It was an opportunity that may not occur again for a generation.

Tax cuts are still essential though, even more so as the credit crunch begins to bite. Now more than ever, we need entrepreneurs to take risks, employ people, and keep the wheels of the economy churning.

So how do we afford tax cuts? One tool the new government will adopt is to increase borrowing to pay for infrastructure, rather than paying for it all in one go. This is a sensible move and standard practice around the world because for major projects such as roads and hospitals, it is only fair that the costs are spread over time. Future generations will use and enjoy those things so it is reasonable to defer some of the costs onto them.

Inevitably though, the level of public spending will have to be tackled. The New Zealand economy has become enormously overbalanced towards the public sector, which still makes up around 45 per cent of the economy. We need to shift the balance back towards the private sector, which actually creates wealth and jobs and opportunities.

It will take political courage to do this, but in terms of political capital there will never be a better time for would-be reformers. For a start, National has been elected with a strong public mandate to rein in spending. And the credit crunch has changed perceptions and behaviours; people are becoming more frugal with their money, cutting back on luxuries, and prioritising spending, and they quite rightly expect government to do the same.

Research has shown that when times are good, voters favour higher spending on social services. Perhaps the reverse is true—that when money is short, voters will appreciate a government with discipline.

One target for review should be the Cullen Fund, which receives around $2 billion a year. This might be OK in a time of heavy surpluses, but I'm not sure we should be borrowing money to save, especially when the markets are in such turmoil.

Other sectors, such as education and especially health, need to focus on improving productivity rather than more funding. Government social spending has nearly doubled over the last 10 years but the results—in both outputs and outcomes—have been hugely disappointing. There is enormous scope for improvement in services here.

The other recommendations I made about regulation, education, and financial literacy are still relevant, perhaps even more so than 12 months ago.