Closing the Gaps –
Between Current Economic Policy and the Needs of Producers

Kerry McDonald
Company director; Chairman of Oceana Gold Limited

AUSIMM, Auckland
14 November, 2005

Several recent years of fortuitous circumstances have allowed New Zealanders a mirage of economic robustness and prosperity, when the reality is an economy with low incomes, low productivity and major structural weaknesses.
New Zealand's economic problems are serious and they need to be resolved if New Zealand is to have a prosperous future, comparable to Australia's and of other First World countries.

Resolution requires a fundamental shift in policy, towards building international competitiveness and economic capability and efficiency, with less debilitating regulation and intervention.
Productivity, competitiveness, exports and savings must be top priorities. Serious, complementary tax reform is also needed.

My perspective for making these comments is that of tradable goods producers and, particularly, of New Zealand's largest gold producer and exporter, Oceana Gold. It reflects 16 years at the NZ Institute of Economic research, 25 in the Australasian mining and mineral processing sector and 15 as a company director in a range of industries in Australia and New Zealand.

It is relevant that Australia is New Zealand's largest export market, by a substantial margin and, in 2004/5, gold was New Zealand's second largest export to Australia, 17% ahead of next-ranked timber, 60% ahead of cheese, more than twice refrigerators and freezers, and some three times wine and carpets. Gold is consistently in the top three exports to Australia. It has a substantial potential to increase its contribution to New Zealand's future.

My first speech on the New Zealand economy was in the early 1970s. The "big picture" is that since then New Zealand has steadily gone backwards, compared to Australia and the rest of the OECD. There have been some years of good growth but these have tended to highlight New Zealand's fundamental economic weaknesses.

This contrasts with the long held vision of becoming a high productivity, high income country, but the determination has been lacking for the tough task of turning vision into reality.

It is now a serious question, whether New Zealand's politics under MMP, reflecting its low productivity, the prevalence of low incomes, for many low tax payments and low savings, and the orientation to government expenditure rather than participation in risk taking in productive activity, will accommodate an effective policy response, particularly to improve business competitiveness and export performance.

These comments are rather critical but then improvement comes from trying to improve what is wrong, not what is right.

New Zealand is, still, a small, export-dependent economy and society. Export earnings (broadly defined) per capita are a key determinant of economic living standards, along with the rate of growth in productivity. Unfortunately, New Zealand's long term performance in both has been poor, well behind Australia's and the OECD average:

	Australia	**USA**	**New Zealand**	**OECD**
Increase 1960 – 1999:				
Real GDP/ employee % (productivity)	97	83	39	158
Exports/capita %	490	550	220	540

Source: OECD

Reflecting this, New Zealand now ranks 22nd in the OECD with an average GDP/capita of US$23,200; Australia ranks 10th with an average of US$30,100. This is a key indicator of living standards.

It is surprising that that there has not been a much more focussed and effective policy response to this sustained poor performance.
If productivity and exports are so important why don't we hear more about them; why weren't they centre stage in the recent election campaign? Why do we hear so much about sustainable development, but not about the vital economic component of it.

Since 2000, New Zealand has enjoyed an unusual period of high economic growth, of the order of 4% per annum. This reflected an unusual coincidence of external factors:

- the terms of trade have averaged 1035 since 2000; only one single year has been higher since 1988.
- net inward migration has been very high since 2000, peaking at over 40,000pa; since 1970 the previous highest year was 28,500.

These strong growth stimuli were reinforced by strong growth in household debt, the household debt to income ratio rising to 143%, from 100% in 2000 - it was less than 60% in 1990.

In the same period house prices rose by nearly 80% and a lot of the debt was secured against increased equity in houses and used to finance increased consumption.

This period of high growth had a number of consequences that highlighted its unsustainability and the economy's basic weaknesses:

- the Current Account deficit is now 8% of GDP, which is very high and clearly unsustainable. 5% is considered to be high.
- national and household savings rates continue to decline and are now negative – Households at negative 12%, one of the lowest rates in the OECD.

- New Zealand's external obligations continue to rise and are now $164 billion and 110% of GDP – amongst the highest (worst) in the OECD. The cost of servicing these obligations is now an important is issue.

There are other areas of concern, including:

- in the last 2 years labour productivity growth (RBNZ) averaged a low 1% per annum.
- changes in employment-related legislation have reinforced the role of unions, at the expense of employers and the development of performance and productivity based labour arrangements.

- New Zealand's inability to grow its exports on a competitive basis and at a sufficient rate is a critical weakness. In spite of its high export dependence, New Zealand's exports per capita are now below the OECD average. Poor export performance is the main cause of New Zealand's slow growth (NZIER).

- The State Sector has a critical role, in terms of both quality of policy and stewardship of resources. In June, 2002 the State Sector Standards Board highlighted "areas of significant concern in the State Sector which continue to require serious attention". These included:

  + quality of leadership
  + quality and effective use of performance management systems
  + weak orientation to whole of government
  + emphasis on outputs rather than outcomes
  + and so on.

While there has been good progress in some respects, overall there has been inadequate focus on improvement; and ministers have been insufficiently committed and demanding

This is simply not good enough, is relatively easy to deal with, given the single oversight of Cabinet and the Central Agencies and needs urgent attention. The failures reported regularly in the media in some parts of the State Sector add weight to this urgency.
Its not a good look when the Police decide one in five crimes will be ignored, including commercial burglaries!

It is a serious question, whether there is a political constituency now for addressing these difficult issues or, if not, the likelihood of decisive leadership in the needed direction?

New Zealand is a low income country, according to the OECD.
Reflecting this most people don't pay much tax, are net beneficiaries of government expenditure and the Household sector, currently ,doesn't save.

The 3% of individual tax payers with the highest incomes pay about 25% of all personal income tax. The top 10% pay about 45%.
At the other end of the scale, 56% of tax payers pay only 14% of personal income tax.

Average central government expenditure per taxpayer is about $13,000pa. A personal income of $38,500 generates direct and indirect (specifically GST) taxes of about $13,000.

About 670,000 tax payers had incomes above this level; but 2.4 million had incomes below this level. These numbers are approximate.

So, there are a lot of voters in the community that are likely to be more interested in increased government expenditure than lower taxes and who are unlikely to have any incentive to support policies that reduce the burden and disincentive of taxation and increase the competitiveness of producers generally and exporters in particular.

On the other hand, it is clear that the policy framework, including taxation, is a disincentive to investing in a higher level of exports. Tax relief has been ruled out yet 98.9% of respondents to the NZ Herald Boardroom Survey pre-election said taxes should be reduced and 92% that the tax system should be changed to encourage higher savings and more business investment.

Meanwhile, we seek more open trading arrangements with China and others, which is good, but without putting in place the policies that will allow New Zealand businesses, and tradable goods producers in particular, to compete. Most businesses having been adapting to China's emergence for some years, increasingly sourcing components from there, relocating there or to another more competitive location or sourcing from there rather than local producers. It is a logical and important economic process.

But China, in particular, poses a fierce competitive challenge to New Zealand, especially its manufacturers and processors. Its labour market cost structure and productivity are now a major competitive influence in New Zealand. We must deal with it by productivity and competitiveness, not regulatory intervention, in the New Zealand Labour Market.

The following quote from Bill Buckley (Buckley Systems, in Management, Nov 2005) on competing with China is relevant:
"Its doomsday for New Zealand engineering. This is something I've got to compete against when I've got to employ people here with more rights in this Company than I do. The whole outlook of our Government just makes it impossible for us to make a living anymore." And so on. If you know the Company and its successes, its worth reading in full. Its from the coal face as it were.

Without an effective policy response the implications for New Zealand could be very sobering. On the other hand, with a more astute policy response there is a better outlook.
And with a Current Account deficit at 8% of GDP and increasing restriction of competitive forces in the labour market, were are starting off under water – and still moving at half speed towards developing a single economic market and Common Border with Australia.

Now, more specifically on the mining and mineral processing sector.

Producers are exposed to a whole range of risks and policy has a substantial influence on the nature and extent of those risks. But much of the electorate has no direct interest or understanding of these issues – they have no skin in the game, but a major influence on policy.

Positive tax changes look problematic and expenditure growth is oriented to consumers, not producers. The example of forestry is sobering; where adverse or indifferent policies – expropriation of carbon sink values, energy reforms, electricity transmission, roading, Treaty settlements, etc, in the face of a strong NZD and some difficult markets, really knocked the sector.

The Resource Management Act continues to be an unduly expensive impediment to investment and development, with little prospect of real improvement. Project developers face an often inefficient, cumbersome and costly process, even if they do support the Act's objectives. Many project opponents will have no interest in or perceived exposure to the wider economic consequences of good projects being delayed or stopped.

Energy is important for most new investments but is now problematic. It is difficult/impossible to get satisfactory long term supply arrangements to support major projects, in the face of the likely gas and electricity shortages.
Lines companies, an essential element, are cost plus prices setters, risk averse and not exposed to competition.
Energy sector policies have been poor since the 1980s and there are few grounds for optimism now.

Telecommunications policies seem more designed to protect the incumbent than to facilitate the development of a competitive, world class infrastructure.

Kyoto Protocol policy was poorly designed and implementation has been problematic – OceanaGold was the first company to sign an agreement through the full process. How should we regard that agreement now? What will the Government do? More risk and uncertainty – and we went into the process in good faith to manage and mitigate risk.

The sector has an excellent export growth potential but the administration of the RMA is a major issue, as is the impact of government generally, which often increases risk for the developer, but then requires full indemnity for its own risk, in spite of the benefits it will gain.

I could go on!

Conclusion:

New Zealand faces serious economic problems, that are unlikely to be remedied without decisive Government action to create a more competitive economy and a sustained improvement in exports per capita and productivity.

Effective leadership is needed as politics favour more of the same – increasing tax revenue - on the present basis, and other revenues, expenditure oriented to Households not producers and an orientation to achieving social objectives, even where they reduce competitiveness, rather than driving economic performance.

The serious distortions in the economy, particularly the external deficit, high level of external obligations and low saving rate, as well as the increasing burden of taxation on a shrinking proportion of workers and personal tax payers, justifies urgency.

The gold mining industry has the potential for substantial expansion and greater contribution to the economy and exports.
Material improvements in the policy environment are likely to give a good payback, in national net benefit terms.