NEW ZEALAND'S POLITICAL ECONOMY: Ineffective Policies, Lost Opportunities, Miserable Results & Serious Risks

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New Zealand's economic performance has been unacceptably weak, mainly because of ineffective policies. A more strategic and effective approach is essential to mitigate the continuing decline into relative poverty, mediocrity and ineffectiveness and build a sustainable future. Policy risk and economic sustainability are now major issues for directors.

TREASURY ADVICE TO INCOMING GOVERNMENT

Treasury's advice in 1999 was:

- long term growth in production and incomes is the foundation upon which higher living standards are built
- The economy is poised for long term growth, it is on the upswing; the challenge is to strengthen the growth path.
- the best contribution the Government can make is to sustain an environment that helps individuals and businesses to make good decisions.
- There is scope for improving regulation and gains to be made from greater public sector effectiveness.

Its 2005 advice was:

There are three key challenges:

- enhancing productivity growth
- maintaining fiscal stability
- lifting the performance of the State Sector.

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Some previous speeches are relevant: www.strategicvalue.co.nz, especially: Slip Sliding Away – A Critical View of New Zealand's Economic Performance, NZ Institute of Economic Research AGM, 2000; and The Critical Role of Leadership in the New Zealand Public Sector – Why the Sector is Failing to Perform to its Potential, Public Sector Conference, Feb 2007.

The main policy challenge was to enhance productivity.

The briefing emphasised the need for a sound business environment, one that encouraged enterprise and innovation, where firms seek out profitable new opportunities and well-performing and productive firms prosper.

In 2008 there is no evidence of an effective policy response to Treasury's well founded advice.

The consequences and implications of this are outlined below.

CONTEXT

The Global economy has enjoyed a sustained period of buoyancy, boosted by surging growth in developing economies, excess liquidity, low interest rates, the mispricing of risk and a pervasive sense of complacency. Developing economies emerged strongly, providing goods, markets and increased competition - and shifting the balance of economic power.
But, aspects of the buoyancy made it unsustainable. Widespread performance failures amongst US and EU regulators, rating agencies and financial institutions led to serious, ongoing problems and the outlook now is much more challenging and uncertain.
New Zealand too enjoyed faster economic growth, rising asset values and a sense of increased wealth and prosperity but key economic indicators continued to deteriorate along with the strength and structure of the economy and policy was largely ineffective in addressing the critical economic issues - particularly productivity, and competitiveness. Many New Zealanders seemed to expect that economic trends were always positive and became seriously exposed to adverse events.
The main policy focus now is climate change and emissions trading, but the critical economic problems entail high risks for New Zealand, in a more challenging economic environment.

KEY PERFORMANCE INDICATORS

1. The Government's Assessment

An NZIER analysis of the Government's recent report Economic Development Indicators 2007 concludes: the 24 underlying determinants of New Zealand's living standards are "heavily clustered" in the "low" and "deteriorating" performance ratings. Twelve were rated low, 10 medium and 2 high. In addition 13 were deteriorating, 2 steady and 9 improving.

Productivity is "low and deteriorating" and its growth has been at or below benchmark countries since 1980. New Zealand was also "low and deteriorating" in savings, international trade, outward foreign direct investment, management skills, exchange rate, balance of payments and net foreign assets. The tax system was "deteriorating" as the rest of the world has been steadily reducing tax rates and New Zealand's share of total taxes from personal and corporate income is high! That is a woeful picture.

2. GDP

New Zealand's has declined from being a "high" income to a "lower middle" income country. Its GDP per capita remains low and slow-growing by OECD standards and below all Australian states except Tasmania. A brief growth surge in the early 2000s closed the gap with Australia slightly - to

77% in 2005, but, between 2004 and 2007 Australia's real GDP growth rate was 23% higher and 2006-2007 94% higher than New Zealand's. The high growth came at a high cost and moving into the top half of the OECD in GDP / capita remains implausible.

3. Exports

Slow growth in exports and a weak portfolio of export goods and services were major causes of persistent, large and unsustainable current account deficits: over 6% of GDP in 2000 and 9% in 2007, in spite of strong terms of trade. New Zealand's exports are below 30% of GDP compared to the OECD average of over 40% and New Zealand suffers from a high dependence – 65%, on low value, simply transformed land based exports. Its share of high tech exports is only about 5% compared to the OECD average of nearer 35% and its service exports are no better: 60% is from tourism compared to the OECD average of nearer 20%. Also its exports are unduly energy and emissions intensive – one of the highest levels in the OECD.

4. Net Foreign Liabilities

The large current account deficits caused rapid growth in net foreign liabilities as the excess foreign exchange spending - the deficit - was covered by foreign capital borrowed by or invested in New Zealand. The deficit was about $4bn in 1999 and $13bn in 2007, when net foreign liabilities had increased to $140bn and New Zealand is now vulnerable to the willingness of overseas investors to fund this net liability position (*RBNZ, Nov 2007)*. The annual cost of servicing the net foreign liabilities rose sharply from $5bn to $11.5bn and from 17% to 25% of total exports, which is a serious exposure.

5. Households

From 2000 to 2007 household borrowing increased from about $5bn to $19bn; household debt interest payments increased from about 7% to 14% of disposable income; and household savings fell sharply, to about minus 10%. In spite of the buoyant economy and low unemployment, spending on social welfare increased from about $13bn in 2001 to about $17bn in 2007 and the average New Zealand family was no better off in 2001 than in 1981 *(AU Study).* Low incomes make households vulnerable and dependent on government subsidies. Australian wages are now about 40% above New Zealands.

6. Productivity

New Zealand's low productivity is a national disaster. New Zealanders work amongst the longest hours in the OECD but for comparatively meagre rewards because of their low productivity. It is a critical issue. It undermines competitiveness and limits incomes, living standards and New Zealand's capacity to do things – defence, environmental protection, science, justice, health, education, etc. Between 1990 and 2004 labour productivity increased by 1% p.a. - ranked 26 out of 30 countries in the OECD. Between 2000 and 2007 New Zealand's total productivity grew only 0.4% per annum compared with 2.3% per annum from 1992 to 2000. New Zealand's increase in tax and regulation since 2000 strongly correlates with poor productivity *(CIS).*

7. Investment

Business investment in New Zealand is only about 10% of GDP compared with 16% in Australia. "The big difference between Australia and New Zealand is labour productivity". (Rennie, CIS, Dec, 2007). Per hour worked, Australians produce about a third more wealth, because they have more capital to work with. New Zealand's level of capital per hour worked was the same in 2002 as in 1991 whereas Australia's had increased by 35% - and the gap is widening rapidly (MED). According to Treasury and the IMF, New Zealand's lack of capital intensity explains 70% of the difference in output per hour between the countries. This raises serious questions about New Zealand's tax and investment-related policies.

8. Government Expenditure & Taxation

There have been substantial increases in Government spending in recent years, 46% 2002-2007 compared to the GDP increase of 42%, contributing to inflationary pressures.

Between 1988 and 2007 total taxation increased from 31% to 35% of GDP. The largest increase, of 50%, was between 2002 and 2007 when personal income tax increased 36% - but corporate tax by 101%, nearly three times faster than the growth in GDP.

The company tax share of the tax base increased from 13.8% to 18.7% while the personal tax share fell from 46% to 42% and the indirect tax share from 42% to 37%. These trends are significant in term of New Zealand's competitiveness along with the too-weak incentives to save and for businesses to invest. 14% of personal income tax payers now pay about 65% of all personal income taxes, including the unpublished impact of *Working for Families*. Government current expenditure is about $13,000 per capita per annum but only about 20% of personal income tax payers pay enough income tax and GST to match this level of expenditure. That some 80% are subsidised has important implications as the politics of policy design favour increased expenditure ahead of tax cuts.

9. Other

As a percentage of GDP New Zealand's R&D spend is half the OECD average and its investment in "knowledge" less than half.

New Zealand's outward Foreign Direct Investment is only about 10% of GDP, whereas Developed Economies average more than 25%.

KEY ISSUES

1. The Politics of Economic Policy

The elected politicians in Government determine economic policy. Since 1999 few have had much experience of business but the Labour members have a strong orientation to a political model which determines policy priorities and processes. The model prefers strong centralisation, control and managed outcomes, rather than delegation, debate and public processes of policy discovery and regulation rather than market-based processes. As Prime Minister Clark declared after the 1999 election "the hands off days are gone" and "leaving outcomes to the market… won't work and never did for New Zealand".

The political consequence of the Lange reforms put off limits the policies required to lift productivity, competitiveness, exports, progress towards the Single Economic Market with Australia and real tax reforms. Free trade agreements can create trade opportunities but exports depend on profitable risk taking by business in a competitive economy and the critical policy link of export competitiveness is noticeably missing and is not being addressed. This policy approach is also encouraged by a lack of empathy with business and lack of acceptance of the critical importance of these policies for New Zealand's future, when weighed in the political balance.

The current emphasis on world-leading climate change policies, in spite of their weak analytic foundation and high risk to the economy, is in sharp contrast to the approach to New Zealand's fundamental economic problems. Climate change is a critical issue but more measured, progressive and better designed policies would be in New Zealand's best interest.

There is an endless stream of new regulations and obligations affecting business, increasing cost, complexity and inefficiency and undermining competitiveness, profitability and the incentive to invest. Productivity remains low and compensating additional spending and regulations simply paper over the cracks. It would be different if "economic transformation" was achieving any significant gains – but it isn't - and the large proportion of net beneficiaries of government expenditure reinforces the preference for increased regulation and government spending and the reluctance to rely on markets.

With hindsight the Government's abandonment of the Knowledge Wave, which was strongly supported by the Private Sector and aimed at a constructive working partnership with Government to improve New Zealand's performance, was a strong and unequivocal signal to business, which was not fully understood at the time.

Fundamentally, the political system has been ineffective in improving the lot of New Zealanders, because it focuses on the wrong things. It is also inefficient because it does what it does poorly.

2. Policy and MMP

MMP has been unhelpful for economic policy. With more parties and multi party coalition governments, each party leverages its positions to implement its policies, which are typically social or environmental and not for a stronger economy. The lack of political focus and action on serious economic issues underlines the problem, as does the preference for increased government spending over fiscal prudence and tax reform.

3. Policy Risk

Policy risk is now a serious impediment to investment and financing decisions in New Zealand because of the lack of strategy, emphasis on short term political objectives and poor policy design, implementation and management. There are numerous examples of poor policy and a deep sense that Government – political and official, doesn't understand business or empathise with it and that policy will be oriented to political objectives, with less concern about the impact on business and the economy. Recent examples include: the failure to progress the Single Economic Market with Australia; the disastrous Kyoto policies, which also decimated the Forestry Sector; energy policy, which has no regard for competitiveness; electricity supply security and prices; the numerous costly and inefficient regulations affecting business; the steep rise in company tax receipts and the long delay and then limited business tax reforms; and the apparent lack of concern or positive response to the loss of businesses offshore".

Any investment now using energy or causing emissions, or employing staff, for example, have a high degree of policy risk.

4. Government

Central Government accounts for about a third of all economic activity in New Zealand so its efficiency and effectiveness has a major impact. Unfortunately, in recent years "... there have been substantial increases in Government spending*......)" (RBNZ, MPS, Dec 07)* and "despite ongoing surpluses in the government's operating balance, fiscal policy is contributing to inflationary pressure" *(RBNZ, Oct 07 OCR).* The increases in government spending, on top of a buoyant private sector, "crowded out" the private sector, in the labour market for example, and put upward pressure on inflation, interest rates and the exchange rate.

The performance of the State Sector is a major issue. In spite of modest improvements, there are numerous examples of weak leadership and management, systemic and other failures, lack of training and development and ineffective performance management. Examples of performance failures are too numerous to recount, but include:

- The large increase in core areas of social spending, from $28bn to $39bn in 5 years for uncertain benefits. "While this social spending is essential, it seems to have contributed very little to our social progress." *(What Does it Profit Us, A State of the Nation Report from the Salvation Army, Feb 2008).* The Health and Disability Commissioner and Treasury have also questioned the benefits from the substantial increase in spending.

- The 2006 report on the Ministry of Health and the Health Sector demonstrated a complete failure of organisation and leadership and a 2004 Treasury report concluded productivity had fallen 7.7% in three years.

- The President of the Law Commission, Sir Geoffrey Palmer says New Zealand's laws are "a frightful mess" and are often put together without thinking about their wider impact.

- The criticism by Hodder and others of the inability of the Justice system to provide a soundly based, reliable service at a reasonable cost for commercial litigants.

And so on! The need for action to improve performance is great.

5. Learning and Improvement

Successful organisations are typically "learning organisations" in which lessons learned support continuous improvement. Successful nations also reflect this process. The improvements mean increased productivity - more/better outcomes per unit of input – labour hour, unit of energy or water for the benefit of all. While some State Sector organisations have this characteristic the problems outlined in this paper, to a significant extent, reflect a lack of learning and improvement, including at the national level.

Several studies highlight the weak state of management in New Zealand generally "plateaued at what can best be described as a level of mediocrity" (NZIM Management Capability Index,, Management, June 2006); NZIM has called for a concerted, nationally directed programme to lift performance, but the Ministry of Economic Development Project Collaboration "appears to have dropped off the agenda of political priorities" (Management, Jun 2006).
Multinational companies in New Zealand traditionally gave many New Zealanders high quality training and experience but this has fallen off sharply and there has been a hollowing out of business, including senior Senior Executive opportunities, which is also constraining the supply of potential company directors. This all makes learning difficult. and low productivity and wages will make it increasingly difficult to attract and retain good, learning talent.

6. Tax Policy

Post 2000 tax reforms, should have reduced the burden of taxes on companies and individuals, as an investment in New Zealand's economic performance. Instead the opposite occurred, reducing competitiveness, profitability, the incentive to invest and the rewards to individuals for their work.

The Government's approach to taxation (and economic reform generally) is reflected in its approach to taxing the offshore activities of New Zealand companies. An assessment by KPMG tax partners: the Government accepted that after 20 years reform was needed and stated that "... the Government's commitment to economic transformation is at the heart of this package".
However, the proposed reforms don't match the talk. Apart from an active business exemption "the rest of the proposals are compliance focussed rules, almost entirely aimed at ensuring New Zealand's tax base is not eroded". The result of the reforms make it more, not less difficult for New Zealand companies to grow offshore and increase compliance costs.

This is also a good example of the Law Commissions concern – a poorly judged policy response on a specific issue, without due regard to the bigger picture.

7. Comparison with Australia

With higher productivity, Australian salaries average some 40% higher. Low paid workers, on $30,000 per annum pay 37% less tax there. At $100,000 per annum tax is 10% lower now but will be 22% lower in 5 years, with announced tax reductions *(Deloitte's).* Not only is New Zealand falling seriously behind, it is not engaging effectively to progress the economic relationship and loosing too many capable people to Australia.

SUMMARY & CONCLUSIONS

Handicapped by poor economic policies, New Zealand is being marginalised by a globalising, rapidly developing world. Productivity is low and slow-growing - limiting incomes, international competitiveness and living standards. Weak international competitiveness is limiting exports. Major causes are inadequate investment in productive capital and excessive regulation.

Low incomes lead to high benefits, subsidies and vulnerability. Weak exports mean rapidly rising net foreign liabilities and servicing costs. The result is a vulnerable economy and household sector and a shrinking ability as a nation to be significant and make a difference.

Policy ineffectiveness is a critical issue. Policy is too often politically oriented rather than strategic, mistrustful of markets, undermined by MMP and poorly designed, implemented and managed - and policy risk is now a serious problem. Centralised and controlled policy processes inhibit constructive engagement and debate and learning - in organisations and nationally.

Instead of tax reforms and other policies to improve productivity and competitiveness, the burden of tax on business actually increased sharply between 2000 and 2007, regulation and government costs also increased and rising Government expenditure was inflationary, pushing up interest rates and the exchange rate, discouraging investment and exports and crowding out the private sector. Without competitiveness trade agreements are of limited value!

New Zealand's tax base, the engine of the political model of intervention and subsidies, is being exposed by the weak economic fundamentals and increasingly propped up by regulation.

The high proportion of households subsidised by government means that politics favour increased spending and subsidies rather than economic reform. Consequently the fundamental problems continue and the added regulations threaten the capacity of the legal system - a frightful mess - and are extra baggage for businesses trying to compete and for the now small proportion of the community who pay significant personal income tax.

This is not a path to an economically, environmentally or socially sustainable future.