Focusing on Growth

Summary Report of the 2025 Taskforce

Background

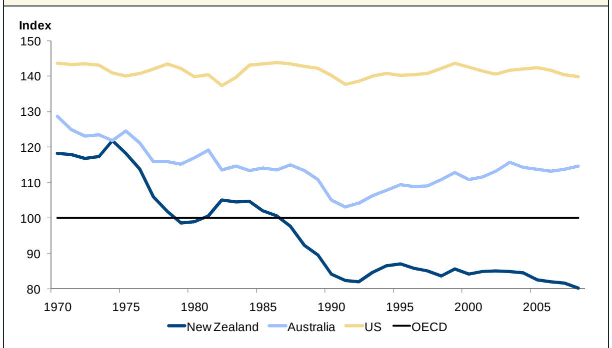
The 2025 Taskforce was set up in 2009 to provide recommendations to the Government on how to close the income gap with Australia by 2025.

The Taskforce's first report in 2009 concluded that far-reaching policy changes would be required to close the gap. The Taskforce stands by the specific recommendations made in that report. We have used this second report to more fully articulate the context and framework for those recommendations. It stresses the urgent need for public policy to become focused on creating an environment conducive to strong sustained economic growth that will benefit all New Zealanders.

The income gap between Australia and New Zealand

Since the mid 1970s, per capita incomes in New Zealand have fallen substantially relative to those in Australia and the OECD average, although the rate of decline was slowed notably by the extensive reforms of the late 1980s and early 1990s. In our first report, we estimated that Australian incomes were 35 percent higher than in New Zealand. Australia proved more resilient than New Zealand in the recent global recession, and the OECD projects that the income gap could increase to 42 percent by 2025. To close the gap by 2025, New Zealand will need to grow slightly more than two percent per annum faster on average than Australia.

Figure 1: GDP per capita relative to the OECD, 1970 - 2008



Source: OECD, OECD = 100, current prices and PPPs

There are two reasons why closing the income gap with Australia matters. First, our real incomes affect our material standard of living. People in Australia and most other advanced countries can afford better houses, better healthcare, higher levels of funding for education and more expensive investments in environmental protection.

Second, we need to ensure that there are opportunities for our people to realise their potential in New Zealand. The income gap will encourage more New Zealanders to join the hundreds of thousands who have already emigrated, mostly to Australia. Based on current projections of the income gap and its impact on emigration, a net 412,000 New Zealanders could leave New Zealand over the next 15 years. That is almost one in every ten people living in New Zealand today, and equivalent to the entire population of the Wellington region. The skills and enterprise of these emigrants would be a huge loss to the New Zealand economy, especially given that taxpayers would have spent perhaps $30 billion educating and providing medical care for them. Immigrants may reduce the impact, but they are not a perfect substitute for the rapid loss of so many people born and raised in New Zealand.

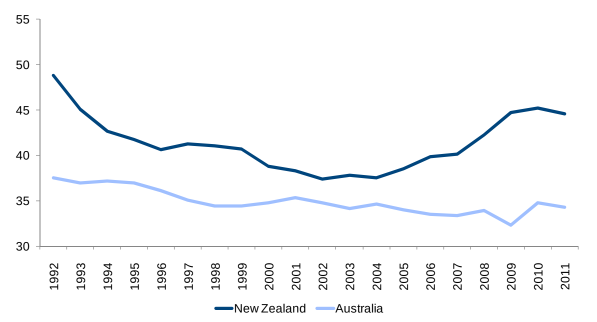
To catch Australia over the next 15 years, New Zealand's income is likely to need to grow at slightly more than two percent per capita faster than Australia on average. That is a formidable challenge, which requires policies that are much superior to those in Australia in their focus on growth. This challenge can only be met by ambitious and far-reaching reforms along the lines recommended in our first report. Over the last two years, the Government has taken some steps that are likely to have improved our growth prospects and some that are likely to detract from them. It is also investigating growth-enhancing policy change in other areas. But on balance, New Zealand is still a long way from having the kind of policies needed to have any chance of closing the gap with Australia by 2025, or even of making serious progress towards that goal.

To close the gap with Australia, governments need to consistently make choices that will increase economic growth. This focus on growth will mean government building a structured analysis of the implications for economic growth into every major policy decision that it makes, and benchmarking all proposals on the best and most growth-enhancing practices of the most successful countries. The Treasury and the new Productivity Commission should be required to advise Government on this and to facilitate better-informed public debate.

Changing the balance between the public sector and the private sector

Since 2004, New Zealand general government outlays as a proportion of GDP have grown very rapidly. New Zealand governments have spent a larger share of GDP than their Australian counterparts for decades, but that gap has widened markedly in the last seven years. This spending increase has contributed little to core government functions. Much of the increased spending is "tax churn" collected from and returned to middle-income earners in the form of universal provisions such as interest-free student loans, early childhood subsidies, KiwiSaver subsidies, and subsidised visits to the doctor.

Figure 2: General government outlays (percent of GDP)



Source: OECD

Government taxation and spending is not just a costless transfer from one part of society to others. Firms and individuals respond to taxes by working, saving and investing less than they would have otherwise. Those "deadweight" costs can be very substantial. The recent Henry review in Australia noted that the deadweight costs are highest for corporate income tax, at perhaps 40c in every dollar. Even GST, a relatively efficient tax with lower deadweight costs than some other taxes, has materially adverse effects on economic activity.

To avoid the deadweight costs of high taxation, government needs to be much more focused on efficient provision of public goods and support for those genuinely in need, rather than creating spending programmes that largely benefit the same middle-income families who pay taxes. In markets where a high proportion of the services are provided by, or assets are owned by, the public sector, the competitive pressure that drives productivity growth and innovation will be reduced or entirely absent. By reducing the scope for private sector investment and provision of services, and reducing the share of the private sector in the economy as a whole, these public sector activities are a barrier to higher growth rates.

Our statement in last year's report that smaller government was critical to closing the gap was considered contentious. We stand by that statement as an important component of the broader range of policy changes set out in our recommendations needed to generate higher growth. Some rich countries do have larger public sectors than New Zealand, but their rates of growth are typically modest. Our reading of the economic literature and the historical evidence suggests that closing an income gap of the size New Zealand faces, and reversing our decades of relative decline, cannot be done with government spending at more than 40 percent of GDP as it is in New Zealand at present. A focus on removing unproductive government spending which does not improve economic and social outcomes, and on cutting the most inefficient taxes as a result, will have a substantial positive impact on growth.

The Government's Budget strategy envisages gradually reducing the size of government over the coming decade to 2004/05 levels. However, no specific decisions that would deliver such an outcome have been announced. A much greater sense of urgency and ambition will be needed to remove the policy initiatives and regulations that inhibit economic growth. In the medium term, New Zealand will need to consider ways of imposing greater fiscal discipline to ensure we can surpass Australia's relatively small share of government spending in GDP and the relative stability of that share of spending over time. Options include a taxpayers' bill of rights and an independent fiscal council.

The sharp increase in New Zealand government spending since 2004 has created our largest structural primary budget deficit in decades.[1] Because this deficit is structural, it can only be eliminated by serious policy choices.

It seems likely that over the past two years large government deficits have kept interest rates and the real exchange rate higher than they otherwise would have been. This is preventing much-needed rebalancing of our economy that would result in much greater production in internationally competitive sectors. New Zealand's net foreign liabilities are now so high that it would be imprudent to assume they can sustainably be increased further. A credible, well-signalled, early return to fiscal surpluses through reduced spending will be vital to putting the economy on a more competitive global footing.

There have been no major state asset sales in New Zealand since 1999, which has put New Zealand out of line with practice in other advanced and emerging countries. Not only has the government retained ownership of many trading enterprises, but both past and present governments have increased state holdings of business assets (airlines, rail, broadband, banking).

The case for state asset sales is different from the 1980s and 90s, when reducing public debt and eliminating gross inefficiency drove decisions. Today the debate needs to address the potential lost contribution to economic performance resulting from these firms operating under public sector constraints, without market incentives and disciplines. State-owned enterprises and other major Crown trading enterprises could potentially contribute much more to the economy if they were wholly or partially privatised, including through initial offerings to the New Zealand public.

Public-private partnerships (PPPs) are widely and successfully used overseas, including in Australia, to engage private capital and expertise in infrastructure development or other public purposes. There have been few PPPs in New Zealand, but there are areas where much wider use of them would be appropriate. We have the advantage of being able to learn from the experiences – successes and failures – of other countries to more fully capture the benefits PPPs can offer.

Welfare, health, schools and superannuation

There is much scope to reform welfare, health, schools and superannuation to achieve better outcomes while, in many cases, also reducing government spending and taxes. This can be done by focusing government funding on the necessary parts of the social welfare net, reducing the churn of taxation and benefits for middle-income families, and changing the balance between private and public sector provision and the funding of those services.

In welfare, there needs to be a strong focus on eligibility criteria and return to work, where possible, for every form of benefit while ensuring that ongoing support is available for those genuinely in need. This may be helped by lowering effective marginal tax rates to make it more attractive to choose work rather than welfare, as well as by introducing time limits on benefits when work capacity is established, and well-targeted support for education and training.

In health, New Zealand should look to more private provision of facilities and delivery of services, following the trend established in the United Kingdom and other European countries. The Government should establish a Health Taskforce to examine world-leading health models and the lessons they offer New Zealand.

The Government should provide much stronger encouragement to independent schools and remove restrictions such as the lack of performance pay and school zoning that inhibit performance improvements in the state school system.

New Zealand should lift the age of eligibility for New Zealand Superannuation beyond 65, as Australia, the United Kingdom, the United States and other countries are doing, and also draw a clear link between life expectancy improvements and future increases in the eligibility age. Lengthening the typical working life by two years would itself represent a material contribution to closing the per capita income gap with Australia.

[1] The structural deficit is the deficit that will remain when the impact of the current recession has ended.

Investment in infrastructure, research, and tertiary education

High-quality infrastructure investment will be needed to meet the 2025 target, and government has an important role in getting the climate right for that to occur. The government can have a direct role in infrastructure projects that cannot efficiently be provided by the private sector, but it is imperative that rigorous, transparent cost-benefit analysis be done on all projects, using modern techniques of analysing the optimal timing of investment. And while transparency is vital, decisions on whether or not to proceed with such projects need to be made in the light of the results of the cost-benefit analysis. Projects that do not meet such a test waste scarce public resources.

An unusually large share of total New Zealand research and development (R and D) spending is funded by government, including public funding of research in Crown Research Institutes and tertiary education institutions. Much international evidence from empirical studies indicates that only private R and D spending has a direct impact on growth, because it is initiated by firms in response to their own perceptions of profit opportunities. This suggests that government funding of R and D should not be increased.

In a high performing New Zealand economy, more private research and development spending would take place without specific government support. That means we need an overall policy framework where more firms want to spend their own money on R and D, not more public subsidies to firms to somehow compensate for other weaknesses in the New Zealand business environment. The research and tertiary education sector is too heavily micro-managed towards "official visions" of New Zealand's economic development path. Public research funding should once again be fully contestable, and roadblocks to improved governance and consolidation of entities in the research and tertiary education sector should be removed.

Reducing regulation

Improving economic growth means removing or reshaping regulation that is limiting the scope for technological change and entrepreneurship. Despite the far-reaching reforms in the 1980s and 1990s, New Zealand once again has too much low-quality regulation, creating barriers to economic growth in a number of key markets and sectors. This creates the potential for material income gains from regulatory reform. The New Zealand Productivity Commission, if properly resourced, should have a useful role in evaluating reform options and obstacles in the regulatory area, and highlighting examples of best practice from around the world. In our first report we commended the concept of a Regulatory Responsibility Bill. We remain of that view.

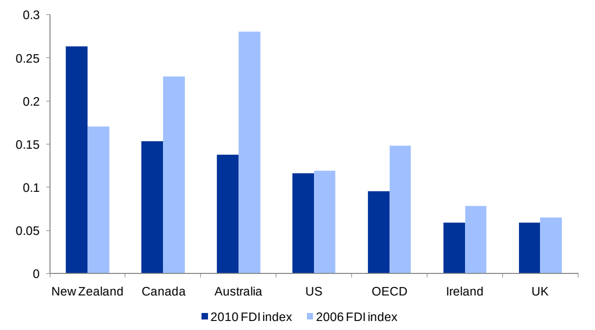
Specific regulatory issues that need to be addressed include the following:

- The *Resource Management Act* should urgently be subject to further and more fundamental review to bring it back to its original intent as an effects-based, broadly permissive law. Change to the Act to date has been insufficient. The reform process must result in a much more responsive supply of new land for housing when demand increases to end the current situation in New Zealand where houses, relative to incomes, are among the most expensive in the world.
- New Zealand's *labour market* flexibility reduced substantially over the last decade, particularly with the minimum wage being raised to the second highest level in the OECD relative to median incomes. Abolition of the *youth minimum wage* has had a seriously adverse impact on youth unemployment, and it should be reinstated urgently.
- A regulatory regime is needed around *hazardous substances,* and *new and genetically modified organisms*, but New Zealand's is overly restrictive, requiring specific approval for even low-risk work. It is out of step with regimes in Australia, Europe and the USA, and is diverting valuable research to Australia and elsewhere.

Foreign direct investment

New Zealand has depended heavily on foreign direct investment since the beginning of European settlement. According to the OECD, New Zealand now has one of the most restrictive FDI regimes. Recent announcements will have accentuated this trend, but have been formulated without informed public debate about the costs and benefits of foreign ownership, or a clear public understanding about the negative impact that restrictions on foreign investment have on New Zealand's economic performance.

Figure 3: Index of FDI restrictiveness by country, 2006 and 2010



Source: OECD

Note: On the vertical-axis, numbers are between 0 (open) and 1 (closed)

The Taskforce can see no national economic benefit in the current level of restrictions on foreign investment in New Zealand. To close the income gap with Australia, New Zealand must create a stronger presumption for acceptance of foreign investment, subject to the same regulatory provisions as domestic investors.

Industry policy

Active industry policy may have helped some developing Asian economies that had a clear comparative advantage but faced institutional or infrastructural barriers to development. There is no evidence that this approach works in a developed economy like New Zealand. The record of governments "picking winners" or "tilting the playing field" towards sectors or individual firms is extremely poor, in New Zealand and everywhere else.

Far too much emphasis has been placed on searching for clever new government initiatives that will directly drive higher growth rates. At their core, those policies reflect the idea that choosing some potentially high growth sectors for special government support will allow us to overcome the costs created by poor policy choices. A much more effective strategy is to directly address the barriers to expanded activity across the whole economy: high taxation and government spending, government ownership, regulation, and investment and service provision that inhibits private sector activity. The contemporary global economy is complex, but the fundamental sources of economic growth have not changed. Government policy should focus on minimising the barriers to the productivity improvements, innovation and private investment that are the sources of economic growth rather than on searching for new ways to identify the appropriate recipients of subsidies.

Conclusion

The public policy changes we recommend will require strong political leadership and an ability to convey a vision of what New Zealand can once again achieve. It will also require an unwavering focus on the private sector as the driver of productivity, sustainable job creation and growth. By minimising the barriers to growth-enhancing private sector activity, government will make us all better off, even if we do not achieve the growth rates required to close the gap with Australia by 2025.

We do not have to settle for the crumbs from Australia's table. But changing course requires an active and sustained focus on the policy options outlined in this and our earlier report. New Zealand must create a policy environment that is more conducive to private sector investment, and where every part of the private sector finds it attractive to play its part in generating growth and higher per capita incomes. And since our growth rates must be materially higher than those in Australia to close the gap, New Zealand will need to emulate and surpass the best of Australian policies that minimise the barriers to economic growth.

Overall conclusions of the report

The findings of the Taskforce set out in the full report may be briefly summarised as follows:

1. The income gap between Australia and New Zealand is very large. In our first report we estimated it to be 35 percent. Based on OECD projections, by 2025 the income gap will have risen to 42 percent. To close the gap by 2025 New Zealand will need to grow by slightly more than 2 percent per annum per capita faster than Australia for the next 15 years.

2. Closing the income gap matters. Our average real incomes affect our material standard of living; they determine the quality of the houses, healthcare, education and environmental protection that we can afford. The income gap could also result in the emigration of over 400,000 New Zealanders during the next 15 years. The skills and enterprise of these emigrants would be a huge loss to the New Zealand economy, especially given that taxpayers would have spent perhaps $30 billion educating and providing medical care for them.

3. There is no reason why the income gap between Australian and New Zealand cannot be narrowed. New Zealand possesses most of the natural advantages and disadvantages that Australia has, including good economic and social institutions, abundant natural resources, hard working, and creative and increasingly well-educated people, and is strongly integrated into trade with countries with higher growth rates.

4. We can close the gap without economic and social upheaval. Many of the changes required are already in place in Australia and other developed economies, although to grow much faster than Australia our policies will have to be materially more growth-friendly. To have the choice to introduce change incrementally, substantial changes in public policy must be implemented very soon.

5. Closing the gap requires unwavering focus on growth-promoting public policy. Strong political leadership will be needed to ensure a consistent policy focus on allowing the private sector to drive productivity, sustainable employment creation and growth. Unless this happens, those of us who remain in New Zealand will find ourselves spending an increasing portion of our incomes travelling to Australia or other countries to visit our wealthier brothers and sisters, children and grandchildren.

To close the gap with Australia, New Zealand must achieve a major increase in productivity (output per worker). Increases in productivity and the private capital investment normally associated with it, are very strongly influenced by policy choices. Too frequently, governments make policy choices that are inconsistent with a focus on growth and prosperity. To generate higher levels of growth, governments must consider the implications for productivity and capital investment of every decision they make and every new regulation they enact. They must explain to the public why a decision that will inhibit economic growth is inconsistent with the national interest and why private interest lobbying for alternative approaches must be rebuffed.

To facilitate this focus on growth, the Government should establish processes to ensure that all new policies, initiatives and legislation are assessed against a requirement that they contribute to the objective of raising economic growth. It should also seek out and remove policies that inhibit growth wherever they may be found, and should ensure that the Treasury and the Productivity Commission provide expert and timely advice to Government on this issue as well as promoting better-informed public debate.

This focus on growth will mean:

1. Lower levels of government spending and lower rates of taxation, consistent with rapid return to a structural fiscal surplus that will allow the real exchange rate to fall, encouraging a rebalancing of output back to the tradables sector and a reduction in private borrowing from offshore. The immediate and achievable target should be to quickly return core Crown operating expenses back to the proportion of GDP achieved in 2005 – 29 percent.

2. A comprehensive review of the boundary between the private sector and the public sector that will reduce government involvement in commercial activities that can be better provided by competing private firms, put the capital, expertise and innovation of the private sector to work for public purposes, provide middle-income families with wider choice in return for the opportunity to pay a larger share of the cost of education and health costs, and focus on providing New Zealanders with productive employment rather than benefits.

3. Introducing more robust analysis of the business case for major public investment projects, particularly through the adoption of best practice private sector methodologies.

4. Focusing on policies that create an environment within which the private sector finds it attractive to invest in R and D rather than increasing publicly-funded research, and improving the return from existing public investment by reducing micro-management of research and tertiary education, reforming and simplifying governance, maximising the contestability of funding and removing barriers to the efficient evolution of the system.

5. Undertaking fundamental reviews of the regulations that are most obviously barriers to increasing productivity and innovation, reducing costs, and encouraging private investment. Priority should be given to a more fundamental review of the RMA to bring it back to its original intent as an effects-based, broadly permissive law, increasing labour market flexibility and reinstating the youth minimum wage, and reducing the costs of the regulatory regime relating to hazardous substances and new organisms.

6. Creating a more positive environment for foreign direct investment, including removing the uncertainty that exists because of recent decisions, statements, and changes to the overseas investment regulations.

7. Institutionalising better processes for vetting the quality of government spending and regulation, for example, through a taxpayers' bill of rights or independent fiscal council in respect of government spending and a Regulatory Responsibility Act in respect of regulation.

The vulnerability created by New Zealand's structural fiscal deficit and level of external indebtedness creates severe limits on policy flexibility. But the Taskforce is convinced that only by making New Zealand a more attractive environment for private sector investment and innovation, and by providing stronger incentives for every part of the private sector to play its part in generating that growth, will our growth rates and our per capita incomes increase by comparison with those in Australia.

Far too much effort over too many decades has been spent on the search for clever new government initiatives that will drive higher rates of growth and create greater prosperity in New Zealand. At their core, those policies reflect the idea that we can overcome the disincentives for business investment and growth in New Zealand created by high tax rates and regulation by choosing some potentially high-growth sectors of the economy to benefit from special government support. Governments consistently back losers rather than winners and find it difficult to exit poorly performing investments.

Moreover, there is ample evidence that active industry policy poses substantial political and institutional risks, including capture by private interests, and investment of taxpayer funds in projects that reduce efficiency for long periods (the Think Big policies of the early 1980s being one of New Zealand's best modern examples). But most importantly, active industry policy is a second or third best response to barriers to private sector investment and risk taking. Globalisation and the complexity of the contemporary global economic environment have not changed the fundamental sources of economic growth. The first-best policy response is to address directly the tax rates and the regulatory constraints that discourage higher productivity, innovation and private investment across the whole economy.

The fundamental point is that to grow much faster than Australia we will need policies which are materially more growth-friendly than those in Australia, and at this stage we are a long way from having such policies.

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