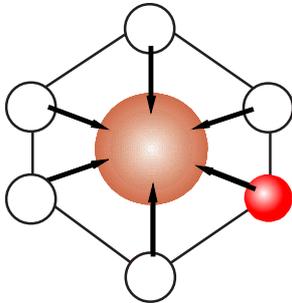


A COMPETITIVE PRIVATE SECTOR



Effective resource use comes down to the quality of our decisions

Microeconomic reform has improved efficiency – there is scope for further gains

Any economy has limited resources with which to generate income: limited numbers of people and machines, limited land and infrastructure. In any economy, it is important that these resources are used as effectively as possible. Our size and location make this particularly the case for New Zealand.

Effective resource use – and economic success – comes down to the quality of the vast number of complex decisions made every day by New Zealanders at home and at work, whether they're the owners of a corner dairy deciding which brand of beans to put on the shelf, a small manufacturer deciding whether to relocate overseas, or a major corporate deciding which markets to enter and which services to sell.

These decisions determine the level of wages, the number of jobs, the price and quality of goods on our market, the quality of much of our infrastructure and the quality of our lives. They are not made in a vacuum. A huge range of factors – from the international outlook to the weather, from skills policy to the macroeconomic environment – come to bear on them. And since the weather is by and large beyond human control, economic success will depend on government and households and businesses getting their stuff right.

In the last two decades, government has tried to get its stuff right by improving the environment for decision making. The tax system has been simplified. There is competition in bus, ferry and air services. A range of key state-owned infrastructure and commercial operations have been commercialised and, in some cases, privatised. Regulations that hampered many industries have been removed.

The results have generally been good. The corporatised and privatised entities are more efficient. Prices have fallen in sectors such as air travel, telecommunications, ports, shipping and postal services, and the quality of service has improved.

More recently, in the primary sector, producer board reform has been aimed at improving incentives, ensuring efficient use of the industry's capital and giving farmers and processors room to respond quickly to market signals.

Business performance has picked up. The process is dynamic – new businesses often replace old, some sectors grow whilst others decline. In some cases adaptation takes time because previous investment decisions are not easily reversed and because it takes time for people to develop new skills. This

evolution is most visible in the closures of larger plants. The start-ups and emerging enterprises are less obvious. But there is increasing evidence of ongoing improvement and increased dynamism in New Zealand businesses and a shift in their nature. For society as a whole, it is the improvement over time that matters.

Competitive improvement is a dynamic story

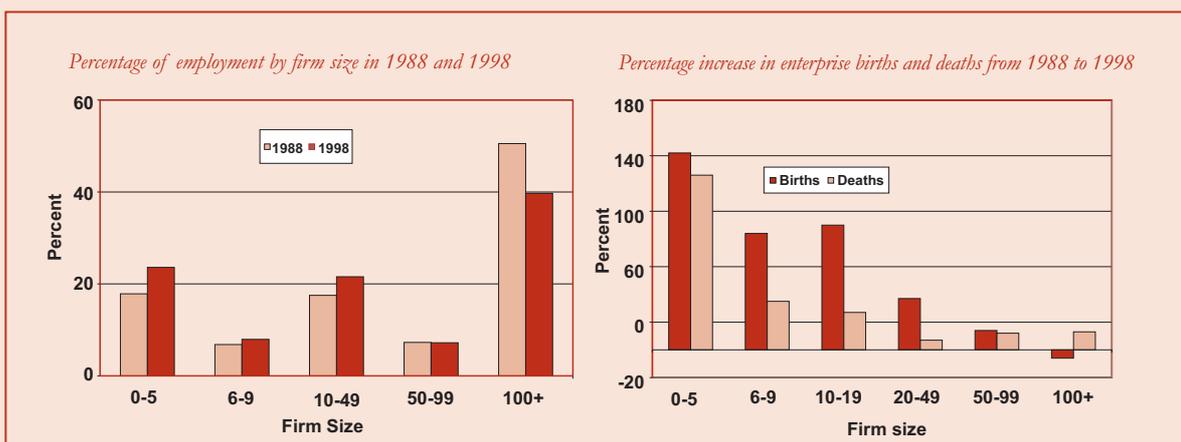
Anecdotal evidence of this dynamism includes the expansion and deepening of venture capital markets, the emergence of high technology incubators, increased net firm creation, more graduates, high export growth in manufacturing and other non-traditional sectors, and strong employment growth.

And a range of studies point to a steady and continuing improvement in the performance of New Zealand firms and managers over the last decade (although these have also highlighted scope for further improvements).

Despite the range and complexity of daily decisions, the preconditions for good decisions are relatively simple:

- clear motivation or incentives
- access to inputs such as staff, raw materials, capital
- high quality rules of conduct, or laws, to ensure that interactions with customers and other businesses run smoothly

New (and improved) kids on the block



A key feature of business dynamics over the past 10 years has been the increase in business entry and exit.

The increased level of business dynamics is seen as a positive by most commentators. An illustration of the benefits of dynamism comes from a study of Chile. Using firm level data, Levinsohn and Petrin find that much of the measured increase in industry productivity is due to replacement of old less productive firms with new more efficient firms.

Levinsohn J and Petrin A, "When Industries Become More Productive, Do Firms? Investigating Productivity Dynamics", NBER working Paper 6893, 1999.

- good information on the business environment.

How can governments help families and businesses make the best possible decisions? To some extent, governments around the world have different answers to that question, but there is agreement on the need to meet these preconditions and, in particular, to provide quality ground rules in areas like health, safety, the environment, and anti-competitive behaviour.

These ground rules are key to maintaining a competitive and dynamic private sector. High quality means stable, predictable and consistent. But it also means appropriate and flexible: too many or too rigid controls can stop people using their resources as effectively as they otherwise would, reducing the scope for innovation and creativity.

*High quality regulations are
stable and consistent,
appropriate and flexible*

Governments frequently face trade-offs between policy goals. In some cases, economic objectives will conflict with environmental or social objectives. Social and environmental objectives can also be at odds. There is frequently no obvious 'right' answer – high quality can also mean opting for a solution likely to endure. Public concern over biotechnology is a good example; where Government must weigh up the clear potential benefits against the perceived and documented risks. The tensions are real and potentially costly: perceptions and promotions of New Zealand as clean and green may be incompatible with becoming a value-adding, food-producing knowledge economy.

Taxing trade-offs

Tax is often cited as a culprit when business compliance costs are up for discussion. Keeping those costs down while still collecting revenue involves several trade-offs. For instance, deducting PAYE from wages and salaries is a low cost and effective way of collecting taxes, but these costs are borne by employers in the first instance. They are increased when the PAYE system is used to collect child support obligations and student loan repayments, and disburse family assistance. Again these are low-cost solutions, but they impose costs on business.

Businesses also face compliance costs in meeting their company tax obligations. While these could and should be reduced, for small businesses in particular, simplifying the tax system will usually involve revenue losses and these can be large.

There are not only trade-offs to be made between economic and environmental objectives or economic and social objectives but also between economic objectives. The trick in this instance is developing a low-cost tax system that still meets its primary objective – collecting revenue.

Climate change policy is another case in point. As a signatory to the Kyoto Protocol, New Zealand has agreed to limit greenhouse gas emissions in the period 2008-2012 to the level they were at in 1990. The economic costs will be minimised if the Government gives well in advance clear, consistent and credible signals on what it intends to do.

On balance the current regulatory regime for managing such conflicts has been designed relatively well.

*There is scope for improving
the light-handed regulatory
approach*

But there are a small number of specific areas where regulatory design could be improved. Particular concerns have been raised about the light-handed regulatory approach covering utilities and natural monopolies.

New Zealand's light-handed approach preserves strong incentives for firms to invest sensibly and to be innovative and dynamic. The telecommunications market provides a good example: significant investment in new technology has led to a high quality communications system. In contrast, more formal price control regulatory regimes give governments more control over natural monopolies' prices and profits but reduce the motivation of firms to behave dynamically and can distort investment decisions.

There is some scope for improving the light-handed approach. In telecommunications, it looks as if better regulatory guidelines on number portability and interconnection would increase competition.

There is more scope for improving the practical application of regulation. Examples include: inconsistent application of the Resource Management Act (RMA), and, in the case of the Hazardous Substances and New Organisms (HSNO) Act, a decision-making process that is too slow and has insufficient regard for the commercial sensitivity of information. Similarly, the detailed implementation of the preferred tradeable permits scheme under our climate change obligations will be crucial in efficiently achieving environmental objectives.

*The cost of poor quality
regulation can be far reaching*

The cost of poor quality, badly implemented regulation can be far reaching. Governments must ensure regulations are stable, predictable and consistent. Striking the right balance between tradeoffs while encouraging innovation and effort are also key.

Industry policy

The question then, is whether helping businesses and households to make better decisions goes further than providing the necessary conditions and frameworks for a strong private sector.

Industry policy which signals direction may help, but the costs of getting it wrong are high

Internationally, 'going further', by providing more assistance to firms, frequently includes policies aimed at helping industry to develop and find its competitive advantage, such as venture capital, export credit guarantees, research and development (R&D) subsidies or tax breaks, promotion of clusters/industry groups. Less common are development banks, procurement policies, and ongoing central government ownership of commercial entities. 'Going further' can also mean the government develops a strategic view of the best way for the economy to develop, pushing industry along this development path.

The potential costs and benefits of such policies need to be very carefully considered and managed.

Benefits are said to come from signalling and encouraging a preferred direction for economic development, either by improving the stock of knowledge individuals hold when making decisions, or more simply by ensuring those decisions reflect the more comprehensive analysis carried out by the government.

The costs come from government getting it wrong, and therefore diverting resources and activity to less efficient sectors of the economy. Calls for assistance will come from firms with poor prospects as well as from upcoming firms. The direct economic costs (such as from levying the required taxation) and administrative costs (such as protecting against tax avoidance when R&D tax breaks are offered) can also be substantial.

The challenge will be to develop policies that minimise those costs and distortions.

Avoiding initiatives that attempt to encourage the economy to develop along a particular development path, in favour of policies aimed at helping industry in general to develop its competitive advantage, is perhaps the key way to do this.

Working closely with the private sector to develop a consensus on the best way to provide such assistance will also minimise potential costs.

Best practice

Many countries pursue direct industry policies. Their experience shows policies designed to help firms find their competitive advantage (such as government provision of venture capital or seed capital funding) carry lower risks than policies that try to shape the economy's development path (such as promoting the development of the biotechnology industry).

Experience also suggests a range of generic 'best practice' guidelines to minimise the potential costs. These include:

*Clarifying objectives and
working in partnership*

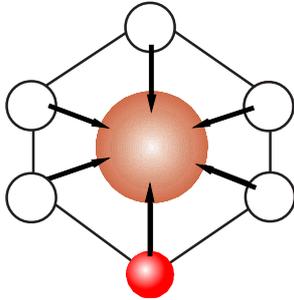
- working in partnership with private sector providers rather than creating totally government owned and operated entities (e.g. Greenstone fund for providing venture capital)
- keeping the government at arms-length from day-to-day management
- paying close attention to ensuring that the entities involved have the necessary skills/capability to undertake the required functions
- requiring co-funding from the private sector to match government expenditure (e.g. Finland determines its public R&D spend on the basis of the aggregate level of private sector expenditure)
- focussing on helping firms to operate within an existing market rather than taking over the market itself (e.g. rather than providing venture capital directly, providing assistance for firms to develop their ideas to a level where they can sensibly seek private sector venture capital)
- providing assistance in as neutral a way as possible (e.g. subsidising all tertiary students to the same extent rather than favouring particular subjects)
- focussing on providing transitional or temporary assistance
- ensuring government has the necessary information to monitor performance, and to decide when and how to withdraw
- if a greater level of intervention is required, intervening through purchase rather than ownership
- minimizing fiscal risk through making the Crown a preferred creditor and/or capping its annual expenditure.

Next steps

- consider the progress of the Commerce Amendment Bill (currently at the select committee stage)
- clarify light-handed regime as it applies to telecommunications and electricity sectors
- consider options for improving the regulatory regime applying to the telecommunications and electricity sectors
- consider options for improving the implementation of regulation (e.g. RMA national guidelines, reducing HSNO timeframes)
- implement tax simplification measures as set out in *Less Taxing Tax*

- consider how to proceed in areas where there are currently opportunities to improve the quality of investment – particularly producer boards and roading
- clarify objectives for industry policy and design of supporting institutional arrangements.

INCREASING SKILLS AND PARTICIPATION



*Skills are a key determinant
of incomes and living
standards*

That individuals and economies go nowhere without the right skills has become something of an article of faith, at the core of careers advice for sixth formers as well as much talk about the Knowledge Economy.

So why does increasing skills and labour market participation matter?

There is evidence that paid work is key to people's sense of well being. And, at a broader level, it is arguable that a well-educated society confers other social, environmental and political benefits.

More prosaically, we know that skills are a key determinant of individuals' incomes and living standards. Ultimately it is the way we apply our skills – our creativity, or technical knowledge, our social skills, ability to make decisions, manage and market – that will influence our incomes and quality of life.

Looking around the world, we know that, in developed economies, the era of low skilled workers earning relatively high incomes has passed. For most people, income levels are tied to participation in the labour market – and this participation is one of the main ways people maintain and upgrade their skills.

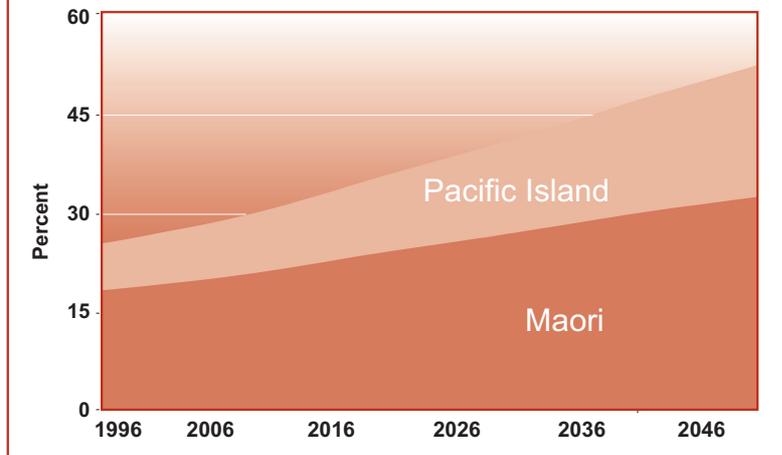
We know that higher incomes generally come from higher productivity. We also know that, at least to some extent, skills acquired at school are linked to productivity in jobs. No policy maker, though, can promise that particular skills or more skills will generate higher levels of growth – which makes designing programmes that enhance skills development without competing with or detracting from other goals particularly challenging.

New Zealand and overseas trends

*Growing margins for higher
skills*

The last 15 years have seen growing margins paid for higher skills and, increasingly, the exclusion from the paid workforce of those who don't have such skills. This is one of the factors involved in growing income disparities throughout the developed world – suggesting some tension between upskilling the workforce and other policy goals.

Employment in the services sector has expanded while those holding down low-skilled jobs in the tradeables sector are increasingly finding themselves in an international labour market – as the recent closure of Bendon's local plants illustrates. Although we can't predict the mix or level of skills that will be required in the future, we can reasonably assume continued rapid change.

*The changing face of New Zealand schools**Maori and Pacific Island secondary school pupils as a percentage of total secondary school population to 2051*

Retraining, skill updates and frequent changes in jobs will increasingly be a feature of New Zealanders' working lives – a wide variety of training options across the whole spectrum of skills will be needed to meet that demand.

New Zealand also faces the challenge of a growing demographic bulge from historically lower achieving groups. A disproportionate number of Maori and Pacific Islanders leave schools without qualifications and work in low skill jobs.

Over the next two decades, Maori and

Pacific Islanders will increasingly form a larger proportion of the working age population. Their continued low achievement may prove a constraint on growth.

Formal skills

Growing rolls in the upper secondary and tertiary sectors are clear evidence that people are responding to the demand for, and margins paid for, higher skills.

That said, evidence suggests that New Zealand youth are emerging from formal education less competent in foundation skills than their counterparts in similarly developed countries. While average performance in reading is good, we do not perform as well on other dimensions of literacy. Performance in science and maths is mediocre.

That doesn't tell the whole story. In literacy, instead of being tightly clustered around the middle, there is a wide range of achievement, from the very poor to the very good. In maths and science there is a wide difference in performance according to ethnicity.

There is an extended and persistent tail of underachievement at school

More disturbingly there is an extended and persistent tail of underachievement. One in five school leavers has no qualifications – a figure that hasn't shifted since 1990. This may become even more of a problem if these underachievers are clustered in the same geographic area and are of the same ethnicity. When disadvantaged groups are isolated intellectually, they become isolated socially, and this works against the acquisition of human capital among young people.

Where to?

Central government regulates, funds and provides most education services – particularly in the compulsory sector where people pick up the foundation skills that provide a platform for further learning. The sheer size of this role means government has a huge impact on the quality and responsiveness of provision.

Labour market signals should support skill acquisition

Government is slightly less involved in the choice and supply of further layers of skills. In a fast changing world that involvement should avoid muddling labour market signals. Those signals (and the skills demanded) change rapidly. If they are clear, students, workers and businesses can make informed choices about skills investment, and providers can respond quickly. Inevitably, though, it will take time for the mix and level of skills of the population to change.

Given the degree of change in the labour market and in job content, labour market regulation must support this ongoing adjustment and help people to acquire skills through participation. Competitive pressures now mean wages and conditions are much more closely linked to productivity.

There may be tensions between labour market policy and social assistance

There may well be tensions between goals in labour market policy and in social assistance – between judgements of income adequacy and incentives. A classic example here is the judgement to be made about the appropriate level for a minimum wage – set too high it may undermine other policy aims, protecting those already in work but putting up a new barrier to those out of work. Another is the balance to be struck in protecting employees from capricious dismissal while ensuring employers are not put off hiring new staff. Similar tradeoffs and judgements have to be made in designing a welfare system so as to address poverty while minimising any associated disincentives to participation in employment and learning.

Improving skills and educational outcomes

The causes of ‘success’ in education and more generally in life are complex and poorly understood. Empirical evidence suggests the quality of formal education accounts for something between 10 and 25 percent of the difference between individuals’ educational achievement. Innate ability is important, but so are home, cultural, community and work place factors. Policies to improve New Zealanders’ skills need to look beyond the school gate.

Our schools could be more effective

There is no blueprint on what makes a good school

That said, formal education is the factor that governments influence most directly and firmly. International comparisons suggest that our schools could be more effective. Empirical research suggests that it is not simply a matter of resourcing. We cannot be confident that further substantial increases in the level of resources for schools will lead to significantly better outcomes. A key focus must be on improving the effectiveness of schools. We know that schools matter, and that school management and the quality of teachers are important. But beyond some very high level prescriptions, there is no blueprint or consensus on what makes an effective school. This points to several needs. Governments and parents need good information about learning outcomes to provide a standard against which to measure school performance and student achievement. Teachers and communities need room for innovation, allowing for new types of programmes within schools and new types of institutions – particularly for weaker students. The regulatory regime currently makes this difficult.

At the tertiary level, investments in skills bring significant benefits to individuals and firms. It is important that the value and cost of those choices is clear. The challenge is to minimise barriers to access while ensuring that funding arrangements do not distort individuals' decisions about the skills in which they invest or where they obtain these.

Overall, a loan facility is the best way of managing this trade-off, and it is important not to confuse its objectives, which are about financing tertiary education, with separate objectives designed to provide subsidies for tertiary education. It also recognises wider equity concerns – on average, people who complete tertiary qualifications earn substantially more in their working lives than those who do not.

Have we got a deal for you

Using census data it is possible to calculate the rate of return from qualifications. The return to an individual is the extra lifetime (after-tax) income the qualification generates less fees paid and any income foregone while studying. Returns will differ by gender because of differences in expected income, and differences in income opportunities that are foregone while studying.

Estimates for 1998 Qualifications	Rate of return percentage	
	Male	Female
No qualification to School Cert.	16.8	36.9
School Cert. to UE	13.5	10.1
UE to Bachelor degree	9.2	7.1

Source: Sholeh Maani, "Private and Public Returns to Investments in Secondary and Higher Education in New Zealand Over Time: 1981-1996", Treasury Working Paper 99/2, 1999.

The move though to individuals bearing a greater share of the cost of their investment in tertiary education is a significant change in the role of government in New Zealand and as such is controversial.

Next steps

- refine governance arrangements to improve effectiveness of poorly performing schools
- improve information on the learning outcomes of individual students and individual schools
- consider objectives for tertiary education policy and associated institutional arrangements.