Answering the $64,000 Question

Closing the income gap with Australia by 2025

First report of the 2025 Taskforce

2025 TASKFORCE

November 2009

978-0-478-33096-0 (Print) 978-0-478-33097-7 (Online)

New Zealand Government

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First Report and Recommendations 2025 Taskforce

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ISBN: 978-0-478-33096-0 (Print) 978-0-478-33097-7 (Online)

Persistent URL is http://purl.oclc.org/nzt/r-1252

"Our vision is to close the gap with Australia by 2025."

Hon John Key, Prime Minister[1].

"There is a major task to be done to arrest New Zealand's continuing decline. But it will be difficult to succeed given how far the country has slipped, and its consequent economic, particularly structural, and other difficulties. Success will require a full-blooded unqualified commitment, based on an astute, strategic, and well executed approach, linked with unequivocal political leadership."

Excerpt from a submission from
Kerry McDonald to the 2025 Taskforce

1 Quoted in *Sunday Star Times*, 8 November 2009.

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Executive summary

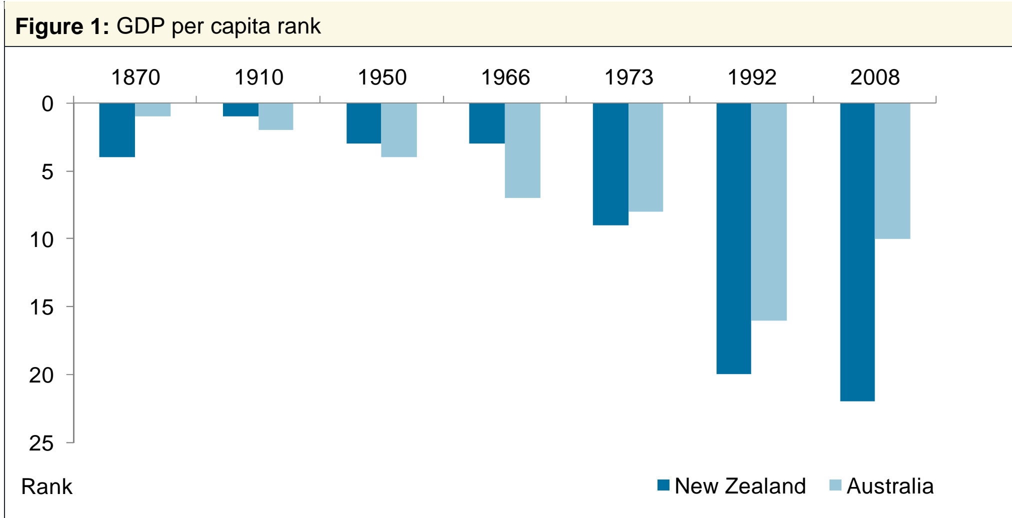
Over the last four decades, living standards in New Zealand have fallen far behind those in Australia. The gap is large. Measured in terms of real Gross Domestic Product (GDP), average Australian incomes are around 35 percent higher than those in New Zealand. For a family of four, that gap is worth around $64,000 a year. The gap matters. Being poorer means those of us living here have fewer choices than our peers in Australia do. And more and more of our friends and families have chosen to leave New Zealand for the better opportunities, higher incomes, and richer range of choices abroad – a net 260,000 New Zealanders have left in the last 10 years alone, mostly to Australia.

The Prime Minister has articulated his vision of closing the gap with Australia by 2025. We share that vision. New Zealand has vast potential: strong institutions, hardworking and creative people, a degree of trust and integrity second to none in the world, and abundant natural resources. So of course the gap can be closed. But it won't close of its own accord. And if nothing is done the gap could get worse, with increasingly serious long-term implications for our country's future. Starting from here, closing the gap will require far-reaching policy reforms. That will take bold courageous leadership over at least the next decade.

The 2025 Taskforce has been established to help answer New Zealand's $64,000 question: what can and should be done to reverse the slide? Following an extensive discussion of various factors that help shed light on the New Zealand story, this report culminates in a wide-ranging set of recommendations. We hope they will stimulate extensive public debate. Policy reform along these lines would give us every chance of meeting the 2025 goal.

High living standards in New Zealand in the past were no flash in the pan. For 100 years, incomes in New Zealand – and Australia – were among the very highest in the world. But from the second half of the 1960s, a marked deterioration began to become increasingly apparent. Today, once-poor Asian countries such as Korea and Taiwan are moving ahead of us, and recently the first of the former Communist countries of eastern Europe passed us.

Figure 1: GDP per capita rank



Source: Maddison for 1870-1970, constant prices, 1991 Int. GK$, OECD for 1971-, US$, constant prices, constant PPPs, reference year 2000

Why is the income gap to Australia, and other advanced countries, so large? New Zealand's small size doesn't explain very much. Nor does the Australian mining industry. Nor does the pattern of ownership of the housing stock. Our monetary policy is run just the same as in other similar countries and our exchange rate is not obviously more volatile than those in many other developed countries. Of course, New Zealand is a long way from world markets, but our distance hasn't changed, we can't do anything about it, and it should not be an insuperable obstacle: Australia continues to show that. Given the opportunity, New Zealand firms and entrepreneurs will take on the world's markets with as much drive and commitment as businesses anywhere else in the world.

The critical long-term issue for economic success is getting the "rules of the game" right. Excellent policies and institutions create an environment in which people find it attractive to make the most of their talents and resources, building for the future and providing for themselves and their families. Such frameworks mean that firms – whether owned by New Zealanders or by foreign investors – find it rewarding to innovate and to invest here, in new products, new markets, and new and better ways of doing things. For the most part, firms and individuals don't have different interests: we all need strong competitive businesses in New Zealand, and successful businesses are built substantially on the skills and talents of their people and the savings accumulated over time by people here and abroad.

Our assessment is that New Zealand simply has not consistently made the effort to get and keep these policy frameworks and institutions right. New Zealand has made serious economic policy mistakes for decades. The full adverse impact of the protectionist regime put in place in the 1930s and of measures such as producer board monopolies was masked for a long time by the high commodity prices of the post World War Two period. But the costs were substantial. Of course, we can't blame the mistakes of the 1930s for the problems of today, but we've gone on making policy choices that have repeatedly undermined our chances of turning things around. Periods of good policies, strongly oriented towards improving New Zealand's economic performance, have been offset by much longer periods in which policies have headed in the wrong direction, or simply gone nowhere.

Government spending as a share of GDP is much larger than it was when we were much further up the international league tables (and is well above government spending in Australia). As we've become relatively poorer, New Zealand extended the welfare system in ways that allow an increasingly large proportion of the working age population to opt out of working, fully financially supported by the state. That is a large cost, both to the government directly and in terms of wasted talent and skills. We've hugely increased public subsidies to tertiary education, even though the private returns to a good education have never been better. And we've gone on providing a very generous universal pension that leaves many people quite rationally concluding that there is no particular reason to save for themselves.

The New Zealand economy is much more open and competitive, internationally and domestically, than it was. Almost every country's economy has opened up. The reforms of the 1980s and early 1990s represented a very significant step forward. But liberalisation and reform are not some sort of one-off exercise. While we have stood still in some areas, and made serious reversals in others over the last decade, most other countries have continued to improve their regulatory systems. On internationally comparable measures, we now typically score no better than the middle of the pack.

To close the income gap with Australia, our per capita GDP growth rate over the next 16 years will need to be twice what it was over the last 16 years. But the actual choices that New Zealand governments have made continue to go directly counter to what is required to close the gap. Over the last decade, New Zealand has:

- Increased effective marginal tax rates (quite materially in many cases),
- Increased government subsidies and concessions in a range of areas,
- Increased direct state ownership in business, and
- Imposed heavier regulation on the labour market (one of the very few countries to do so).

In addition, the problems of planning legislation, and the mindsets of the local authorities and officials involved in the administration of that legislation, have become increasingly apparent and increasingly constraining.

The huge increase in government spending since around 2005, reversing much of the fall achieved over the previous decade, has been particularly stark and troubling. From the year ending June 2004 to Budget projections for 2009/10, annual core Crown operating expenses will have risen by 60 percent (or $32 billion). Expressed as a share of GDP, operating spending rose from around 29 percent in 2004 and 2005 to around 36 percent now. A small proportion of the increase in that ratio is mechanical: GDP itself temporarily fell during the recession. But at least five percentage points of the increase was simply new spending. That means core government operating spending is around $9 billion per annum higher than it would have been if government spending had just kept pace with the underlying growth in the economy itself.

The economic case for much of the new spending was particularly poor: two egregious examples were the move to make student loans free of interest (costing more than $500 million per annum) and the trebling (to now in excess of $1 billion per annum) of subsidies for early childhood education and day-care. There are no apparent economic benefits from either substantial subsidy, the benefits of which are heavily concentrated on the taxpaying middle classes. Increasing spending on that scale meant passing up the opportunity for tax cuts that would have improved our long-term performance. Taxes adversely affect people's choices to work, invest, and save, so without a clear economic rationale such spending leaves the country as a whole poorer. Sharply rising government spending also squeezed out private sector activity, in part by pushing up the exchange rate.

It is all but impossible that New Zealand's per capita economic growth can be doubled – which is what achieving the 2025 goal means – with government spending as large as it is now. Unfortunately, the Government's fiscal strategy announced in this year's Budget in practice largely ratified the rise in the size of government spending, offering no specific plans to reverse the increase to any meaningful extent.

Overall, the pattern of policymaking over the last decade defies the well-established international evidence about what works. So it is no real surprise that New Zealand is not doing better. The overall policy environment here is not much better than those in the various other advanced countries that also languish near the bottom of the group of longstanding OECD countries, and our distance does count against us (even if less than it did 100 years ago).

In its recent review of New Zealand, the OECD recommended policy reforms that in many cases are quite similar to those in our Report. The OECD explicitly highlighted that if we want to overcome any disadvantages of distance we need policy frameworks that are consistently among the best in the world. If we are serious about closing the gap to Australia, we shall certainly need such policies. We still have best practice policy in some areas, but that was truer 15 years ago than it is today. Across the whole spectrum of policies that affect the climate for economic performance, we are far from being good enough.

In particular, governments appear to continue to remain confused about what they can and must bring to the table if our economic performance is to be transformed. Governments just don't have the knowledge, the expertise, or the incentives to be picking winners, or tilting the playing field this way or that.

There are lots of exciting opportunities for New Zealand business. New technologies, new products, new markets beckon each year. Competitive markets have proven the best vehicle for realizing these gains. What markets do best is to encourage innovation, reward success and weed out failures. By doing that, markets help to ensure the best possible use of scarce resources: translated, that means we get the most out of what we have, both now and in the future.

It is critical to re-establish the mindset that markets, not governments, create wealth best. The tendency to look to government assistance (tax concessions, regulatory and legislative protections, direct state investment) to particular firms and sectors, as if getting that right offers the answer to our economic underperformance, must be successfully fought. We have tried these sorts of initiatives for decades in New Zealand – and much more so again in the last decade – with outcomes ranging from mediocre at best to disastrous at worst. We see little reason to expect different results this time around.

Governments must start doing government excellently, not playing at business. There is more than enough work to do focusing on securing substantial improvements in things only governments can fix (tax systems, welfare systems, core public services, better regulation). Government choices have a vital role in economic success, but that role is not attempting to apply some superior wisdom – of the sort that goes beyond human capabilities – to identifying especially promising sectors or industries, and using taxpayers' money to back such views without effective accountability or discipline.

There is much that can be done relatively readily. The key elements of the Taskforce's approach are:

- Significantly cutting government spending and tax rates.
- Finding better, more effective, ways of ensuring the delivery of services the government does fund.
- Substantially improving the rigour with which government spending proposals are evaluated.
- Substantially improving, across the board, the quality of economic regulation.
- Getting government out of the ownership of business assets.

Take just one example of the scale of what can be done. If government operating spending as a share of GDP could be reduced back to the level that prevailed as recently as 2004 and 2005, the deficit would be closed and there would be scope for deep tax cuts. That would open up a range of far-reaching options that could make a huge difference to our economic performance. For

example, for an annual cost of $7 billion the top personal tax rate, the company tax rate, and the trust rate could all be aligned at 20 percent. But there are alternative approaches: for example, the same resources could be used to fund the sort of dual rate system adopted in a number of European countries, in which the tax rate on capital incomes could be set much lower than labour tax rates.

If, over time, we could reduce government spending still further as a share of GDP, even more substantial cuts in income tax rates would become possible. We know that a well-structured tax system, with low income tax rates, can make a powerful difference in the long run. Tax changes will be even more powerful as part of an overall strategy designed to get much better value from the resources we already have and to substantially improve the regulatory climate in ways that mean that people and firms are keen to innovate and invest for the future.

If we fail to act, or are seduced by strategies that have been proved, over and over again, to have failed, there are substantial risks. For example, New Zealand's firms, farms, and households are very heavily indebted, our foreign debt is at levels that prompt serious questions from credit rating agencies, and much of our growth in the last decade has been in the form of a debt-fuelled consumption binge. There is a real risk that thirty years of increasing domestic and external indebtedness will eventually catch up with us. If that happens, the income gap with Australia could widen further.

We are recommending very substantial changes in the way we do things in New Zealand. We don't make these recommendations, consistent with meeting the 2025 goal, out of some technocratic fixation with particular economic statistics. GDP isn't an end in itself. Higher incomes create better opportunities and more choices across a huge range of dimensions: more health care, better education, a cleaner environment. Better outcomes in these areas aren't just fortunate by-products. New Zealanders expect better health and education, and better roads: what we are proposing will, if implemented, deliver that.

There is a pervasive myth that economic reform of the sort proposed here is about benefiting the rich. That is simply wrong. The rich have options the rest of us don't have and, in fact, are the least adversely affected by New Zealand's relative economic decline. This is a programme to improve substantially the lot of the ordinary New Zealander. We all have a huge stake in its adoption, but none more so than the least skilled, least able, least mobile among us. New Zealanders care about those people.

Serious reform on the scale recommended in this report, to achieve the 2025 goal, is the work of many years. But the first steps need to be taken now – time is short, and early steps will help convince individuals and firms, here and abroad, that real change is coming. By next year's Budget, we would expect that the Government should be in a position to outline the comprehensive approach it plans to take to achieve the 2025 goal.

Getting to the 2025 goal will involve hard choices. There is apparently a sense that far-reaching economic reform means electoral suicide. That hasn't been so here or abroad. It is a standing reproach to successive governments over the last 15 years that so little has been done to tackle the problems. New Zealanders aspire to something better than we have experienced in the last 35 years. Courageous and visionary political leadership is the central element that could give us every chance of delivering on that aspiration and achieving the 2025 goal.

Recommendations

Government spending

General

1. Government operating spending (as measured by core Crown operating expenses) as a share of GDP should be reduced by 2012/13 to 29 percent, the same share as in 2004 and 2005.
2. Beyond 2012/13, government spending as a share of GDP should be reduced materially further. To achieve this, the level of core Crown operating expenses per person should be capped in real terms.
3. The Public Finance Act should be amended to require the Minister of Finance to specify publicly a medium-term target for core Crown operating expenses, either in real per capita terms or as a share of GDP. In each Fiscal Strategy Report, the Minister of Finance should be required to report publicly on steps being taken to ensure that that goal is met.
4. The Government should undertake an in-depth examination of the scope for further institutional changes to strengthen long-term spending discipline. Examples of such institutions could include a Taxpayer Bill of Rights and/or an independent Fiscal Advisory Council.
5. Expert taskforces should be established to scrutinise each major area of government spending, with a view to proposing more effective models for delivering those services that the public sector will continue to fund.
6. Processes for evaluating government spending should be materially strengthened, including greater use of rigorous and transparent cost-benefit analysis for both new spending proposals and periodic reviews of the value that is being obtained from existing spending programmes. Enhancing the quality and rigour of such analysis should be a key priority for the Treasury.

Specific

7. Ambitious welfare reform measures should be undertaken as a matter of priority to reduce the very large number of people of working age currently receiving welfare benefits.
8. Early steps should be taken to lower the actual and prospective costs (as a share of GDP) of New Zealand Superannuation. The eligibility age should be increased progressively, with increases linked to ongoing improvements in life expectancy, and for some years payments should be indexed to the CPI rather than to after-tax wages.
9. Remaining KiwiSaver subsidies should be abolished.
10. Health:
    a. A funder-provider model should be reintroduced in the hospital sector, allowing much greater private sector involvement in the provision of taxpayer-funded services.
    b. Universal (unrelated to income or health status) subsidies for doctors' visits should be abolished.
    c. Subsidies for prescription pharmaceuticals should be substantially reduced, with those in generally good health and not on low incomes paying the full price up to a cap.

11. Education:
    a. The substantial increases in subsidies since 2005 for early childhood education and day-care should be reversed.
    b. A funder-provider model should be adopted for the school sector, allowing new providers to enter, with all-up per student funding equivalent to that for existing state schools.
    c. In the meantime, governance and accountability structures in the school sector need to be reformed to provide better incentives for stronger performance and greater accountability for teachers, principals and schools.
    d. Government-imposed fee caps on university fees should be abolished.
    e. Market-based interest rates should be reintroduced for student loans.
    f. Governance of the public tertiary sector should be reformed, including exploring the rationalisation of the non-university sector and the establishment of universities as independent foundations.
    g. A full review should be undertaken to identify, and recommend reform of, those areas in which various government education agencies (Tertiary Education Commission, Education Review Office, Ministry of Education) have become overly prescriptive, and to explore other, less intrusive, monitoring and accountability options to achieve policy ends that pass a cost-benefit test.

Taxation

12. Average tax rates should be substantially reduced, as ambitious expenditure restraint permits. Cutting core Crown expenses to 29 percent of GDP would, for example, allow the maximum personal tax rate, and the company and trust tax rates, all to be reduced to 20 percent.
13. Serious reforms should be undertaken to reduce the high effective marginal tax rates facing many middle income taxpayers with dependent children as a result of the abatement provisions of the Working for Families tax credit scheme.
14. Reductions in average tax rates should be achieved by reducing income taxes, and doing so having regard both to the importance of administrative simplicity and minimisation of tax avoidance on the one hand, and to the evidence that taxes on capital income can be particularly detrimental to economic performance on the other.

Government assets

15. All businesses owned by central government which are operating in markets where competition is actual or feasible should be sold.
16. Local governments should be strongly encouraged to sell their trading enterprises.
17. To strengthen governance while businesses remain in public ownership, an independent Crown Commercial Appointments Commission should be established, to be responsible for making recommendations to Ministers for Board positions on all Crown commercial enterprises and for vetting and publishing suitability assessments of all appointees to such boards.

18. The New Zealand Superannuation Fund should be wound up and its assets used to reduce gross government debt.
19. Congestion charging should be introduced in central Auckland and in any other cities where a cost-benefit analysis supports doing so. Full road-user charging, differentiated by place and time of road use, should be introduced as it becomes economically efficient to do so.
20. Rigorous and transparent cost-benefit analyses should restored to the prime place in guiding decisions on all public capital spending, including infrastructure spending. All such cost-benefit analyses for projects involving the outlay of more than $50 million should be formally reviewed by Treasury.
21. Mining:
    a. A governance framework should be put in place to facilitate the best economic use of those mineral resources in which the Crown has a direct ownership interest (under both land and sea).
    b. Mining developments on or under sensitive Crown land should generally be permitted provided that they pass a full cost-benefit analysis.
    c. Development of mineral resources should be undertaken by private operators, with the Crown securing its financial interest through appropriate royalty-type arrangements.

Regulation

General

22. A Regulatory Responsibility Bill should be enacted, based on the draft proposed in the recent report of the Regulatory Responsibility Taskforce.
23. Property rights should be added to the list of rights specified in the Bill of Rights Act.
24. Substantially improving the quality of regulatory impact analysis being undertaken before legislation is introduced and/or government regulatory powers are extended should be treated as a matter of high priority by Ministers and central government agencies. Such analysis should be an integral part of all policy development and review processes, to ensure that the full costs and benefits, to all sectors, are appropriately and rigorously factored into government decision-making.
25. An independent Productivity Commission should be established as a centre of microeconomic and regulatory analytical expertise. The Commission should be authorised (and resourced) to undertake reviews of matters referred to it by Ministers, and of issues it identifies as requiring further in-depth analysis and research.

Specific

26. A high quality independent taskforce should be constituted as a matter of urgency to review resource management law from first principles, including identifying the policy goals that should be served by such legislation and assessing the best ways of achieving those goals.

27. When determining the zoning of land for residential purposes, local authorities should be required by statute to take explicit account of any differences between the price of residential-zoned undeveloped land and the price of other undeveloped land in similar areas. These differences should be reported on by local authorities each year, with a strong presumption that scarcity of zoned land, as reflected primarily in price differences, should prompt action to increase the supply of residential land.
28. A system of tradable water rights should be established urgently.
29. Labour market:
    a. Labour law should be amended to strengthen the freedom of negotiation between workers and their employers, including, for example, streamlining provisions governing dismissal of workers, and putting less emphasis on procedural matters.
    b. Statutory provisions allowing enforceable mutually-agreed probationary periods for new employees should be extended, from the current maximum of 90 days for those working for small firms to a maximum of 12 months for employees of firms of any size.
    c. For employees earning in excess of $100,000 per annum, employment relations should be governed by the standard provisions of contract law rather than by the Employment Relations Act.
    d. The youth minimum wage should be reinstated as a matter of urgency, and minimum wage rates should be reduced to the same ratio to average wages that prevailed in 1999.
30. Immediate notice should be given that from 1 January 2011 all remaining tariffs will be removed.
31. Foreign investment restrictions should be further reviewed, starting with a strong predisposition that a much more liberal regime should be introduced.
32. Emissions trading legislation and any future emissions reduction targets the Government adopts should be independently monitored and periodically reviewed. Such reviews should focus on monitoring the economic impact of any carbon abatement goals, and the impact of chosen abatement regimes (here and abroad) on prospects for achieving the 2025 goal.
33. A review of the Commerce Act should be undertaken, with a focus on restoring the primacy of economic efficiency considerations and long-term consumer interests in the design and conduct of competition policy.
34. The Government should strongly encourage the transformation of Fonterra into a conventional company structure with fully-traded outside capital, using any appropriate instruments at its disposal.
35. Zespri's monopoly on the export of kiwifruit to markets outside Australia should be removed.

Background and introduction

Following last year's General Election, in the Confidence and Supply Agreement between their two parties signed on 16 November 2008, the leaders of National and ACT noted that they shared "aspirations for greater prosperity for New Zealanders, and see Australia as a benchmark. They have agreed on the concrete goal of closing the income gap with Australia by 2025".

The agreement went on to provide for the "establishment of a high quality advisory group to investigate the reasons for the recent decline in New Zealand's productivity performance, identify superior institutions and policies in Australia and other more successful countries, and make credible recommendations on the steps needed to fulfil National's and ACT's aspirations." The 2025 Taskforce has been established to serve as that advisory group, and was given the mandate of providing an initial report by 30 November 2009.

The terms of reference for the Taskforce are as follows:

> The purpose of the 2025 Taskforce is to provide the Government with credible recommendations to close the income gap with Australia by 2025, noting that this will require a sustained lift in New Zealand's productivity growth rate from its current level to around 3% a year or more. The Taskforce will provide its advice through an initial report that:
>
> - Reviews New Zealand's poor productivity performance, and monitors the productivity gap versus Australia
> - Identifies the causes of New Zealand's poor productivity performance and any barriers to improved productivity
> - Provides recommendations to create new or improve existing New Zealand institutions that could have an impact on productivity
> - Provides advice on policies and other measures to close the income gap with Australia by 2025

Taskforce members were appointed in mid-August, and began to meet in September.

A 1962 Monetary and Economic Council report was one of the first official documents to identify a productivity problem for New Zealand, raising questions about New Zealand's continuing ability to match living standards in comparable countries. The National Development Conference in the late 1960s highlighted similar issues. In subsequent decades there has been a growing awareness that our living standards have been drifting further behind those of countries we typically compare ourselves with.

Successive governments have talked of ambitious economic growth targets. In the early 1990s, senior figures in the then government talked of a 3.5 to 5 percent annual growth target. In the late 1990s, the then Prime Minister, the Rt Hon Jenny Shipley, articulated a goal of an annual rate of economic growth over the medium term of 5 percent. The Rt Hon Helen Clark, Prime Minister in the last Government, set a goal of lifting New Zealand incomes to the top half of the Organisation for Economic Cooperation and Development (OECD) group of countries within 10 years.

The continued failure to put in place policies and institutions that would enable us to make progress towards closing the large income gaps should stand as a reproach to successive governments over many years. On this occasion, however, the Government has both set a goal and then established a group to monitor its performance in pursuit of that goal. We take that as a sign of a serious commitment to doing what it takes to close the gap.

Closing the income gap with Australia by 2025 is, quite appropriately, an ambitious goal. Per capita economic growth rates have been pretty good in the last 15 years or so – as good as the average OECD country, although not as good as Australia. But Australian incomes are now 35 percent higher than our own. Matching Australian incomes by 2025 will mean roughly doubling the per capita growth rate we've already achieved, not just for a single year, but on average for the whole of the next 16 years. That won't be easy, and a year has already passed since the target was announced.

No one can credibly claim that the 2025 goal can be achieved without major changes in the way we are doing things. But New Zealanders are as hardworking and resourceful as any. And they do wish to improve their circumstances. The number who have left permanently prove that beyond any doubt. Given the right environment, our children and grandchildren will not have to leave to secure the living standards available in the wealthier countries of the OECD.

We firmly believe that New Zealand living standards can, once again, match those of other advanced economies and of Australia in particular. But goals and targets, aspirations and beliefs, are one thing. Making it happen is quite another.

To make it happen, substantial reforms are required on a wide range of fronts. Small changes simply will not be enough. Economic policymaking needs to be consistently focused on fostering a climate in which households and firms are more inclined to save and invest, to build for the future and to use scarce resources together in the most efficient possible way.

The 2025 Taskforce has no power, but we have the ability to contribute to informed public debate about the nature of the goal, the options for achieving it, and the progress (or lack of it) being made towards the goal. We commend Ministers on their willingness to establish a group such as this and we hope that our reports will be part of a process which means that, this time, significant and sustained action is taken to put New Zealand back among the countries with the best living standards in the world.

The Taskforce will offer recommendations on practical policy initiatives and institutional reforms that, together, could transform the outlook for New Zealand and enable us to catch Australia by 2025. Taskforce members come from a variety of backgrounds. We hope that the common ground we have reached on the sorts of policies and institutions that are likely to be required will help to influence public and political opinion.

The Taskforce has been set up for a three year term. In our next two reports, in addition to any further analysis and recommendations we provide (and there are a number of areas we would like to explore in more depth), we will be assessing progress. That assessment is likely to take the form of analysis of the policy initiatives undertaken in the intervening period, and of any early signs in the economic data of the impact of those measures. In this report, we strongly urge the establishment of a permanent, properly-resourced, Productivity Commission by 2012. Such a Commission would have a wide-ranging role, but we would expect that it would, among other things, help carry forward the task of analysis and independent advice on the sort of microeconomic reform required to carry New Zealand towards the 2025 goal.

We have prepared this initial report in a rather short period of time. In doing so, we have been greatly helped by presentations from experts in a number of fields, and by submissions received from a wide range of individuals and institutions. The names of those from whom submissions were received are listed in Appendix One. A number of the presentations and most of the submissions are available on the Taskforce's website (www.2025taskforce.govt.nz).

We also record our appreciation to The Treasury, which has provided staff to act as the secretariat to the Taskforce.

Part I − Understanding the problem

Why aim to match Australia by 2025?

Why do economic growth and productivity matter?

Each person's life has many dimensions. And each one of us values some things more than other things. So where do economic growth and productivity fit into the mix? Why should they be things that matter to governments?

Economic growth – however it is measured – is not much of an end in itself. And it isn't for governments to determine what the ultimate goals of their citizens should be.

Perhaps some people measure success in life by how high their income is, perhaps especially by how high it is relative to other people: for them, money is a way of "keeping score". And perhaps there is, for some, a sense that achieving a higher level of per capita GDP than other comparable countries might provide some sense of validation or achievement – akin perhaps to league tables published at the time of every Olympic Games.

The country's population is growing. To employ a growing population even at today's incomes means the total size of the economy needs to keep increasing. But the main focus of this report is not on the total size of the economy, but on the ability of the economy to generate higher income per head of population. Indeed, that is what productivity is about.

Most people, whether or not they fully appreciate it, value economic growth, and the ability of the economy to generate more, mainly for the choices that growth enables them to make.

Those choices might be exercised in the form of consuming more or better things – bigger houses, better quality food, designer clothes, more toys for the children. It might take the form of more exotic holidays, or early retirement. Or it might be better health – countries with higher incomes typically produce better health outcomes, and can afford technologies and treatments not generally available in poorer countries. Or it might be better education, or stronger defence forces. Or it might be improving the physical environment. Once one gets beyond primitive communities, it is quite clear that wealthier countries devote more of their wealth and income to mitigating and reducing pollution than poorer countries do. The contrast between pollution in China and that in the United States or Western Europe is striking – as is that between London 50 years ago and London today.

The gains from greater productivity are not typically taken exclusively in the form of higher GDP and increased material living standards. For example, most people use the economy's much greater productive potential to work shorter hours than their ancestors did 100 years ago. They take longer holidays. They vote for governments that establish higher environmental standards, to improve the physical environment. People do all that in New Zealand, and those in other developed countries do so too.

Economic growth and incomes should matter to New Zealand governments not for their own sake, but because they matter to citizens, who want to be able to have the choices here that our peers in other countries do. At present, we mostly do not have anything like the same range of choices. That is what being poorer means.

Why focus on Australia?

Political leaders may have had many different reasons for articulating the goal in terms of closing the gap to Australia. We believe that it is useful to have done so, not because matching Australia should be the end in itself, but because that target is, for now, a very useful proxy and benchmark for the things we really care about. It is a useful benchmark for several reasons.

First, Australia is the high-income English-speaking country to which the average New Zealander can most readily migrate. People respond to incentives and opportunities. The prospect of a better life was what attracted most of those who came to this country from the United Kingdom in the 19th century – at a time when the barriers of distance and information were so much greater than they are today. Almost all of us would need no more than a passport to follow the more than 500,000 (net) who have already left to begin a new life in Australia.

Second, Australia is also the country in which it is easiest to see and feel the differences in living standards (and to analyse the institutional and policy differences). A large proportion of New Zealanders now have friends or relatives living in Australia. Australia is a favoured holiday destination for New Zealanders – over 700,000 leisure trips were made by New Zealanders to Australia last year alone. And the many cultural similarities – from parliamentary democracy and English legal systems to shared passions and rivalries in sport – help bring the differences home starkly. The brand names on the goods in the shops are similar; indeed many retail chains and service providers are the same on both sides of the Tasman. For a family living in the suburbs of Auckland, it is simply much easier to envisage what one might gain from moving to the suburbs of Melbourne than from moving to, say, Dusseldorf or Vienna, two European cities often rated as offering among the best living standards in the world.

Thirdly of course, Australia itself is one of the higher income advanced countries. Australian incomes aren't as high[2] as those in countries such as Norway, Luxembourg, and the United States. But Australian incomes and living standards have consistently, through all the stages of its economic development and over 150 years, been in the top half of the OECD group of countries. There have been periods of slippage, but they have been able to be reversed.

Practical New Zealanders seem to relate best to the concrete and tangible. Provided Australia continues to succeed, its sustained strong track record and its proximity help provide a very tangible benchmark against which to assess our own economy's progress and the quality of policymaking in New Zealand.

[2] And productivity per hour worked in particular is not as high.

Of course, Australia's policy environment, while better than our own in some respects, is far from ideal. As just one example, the Australian Productivity Commission has recently highlighted the extraordinarily generous government assistance provided to the Australian car industry during the recent recession; questionable assistance to an industry that itself is probably only viable because of government subsidies and protection.

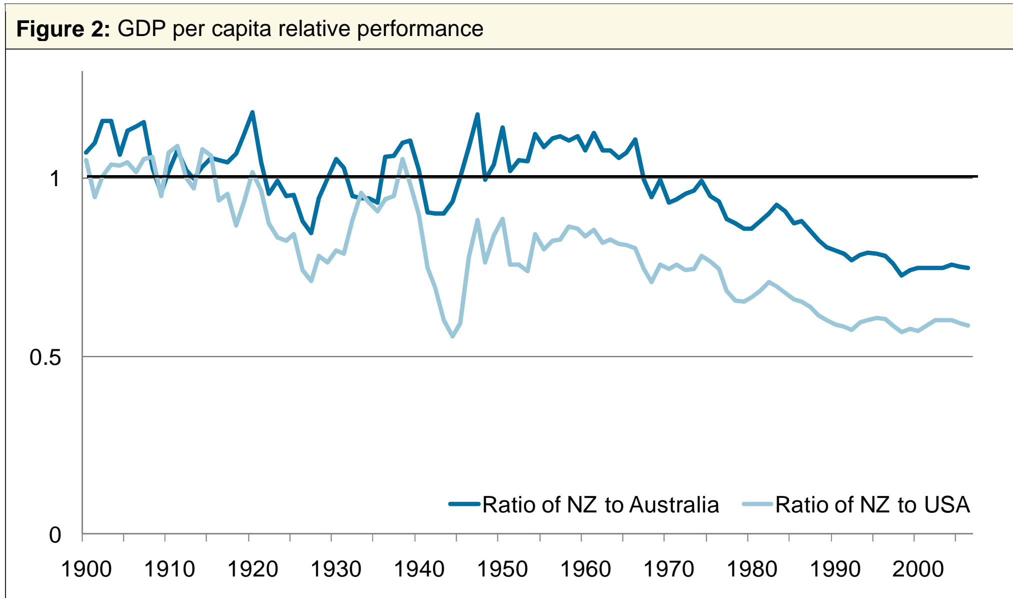
In future, something unexpected could happen and the Australian policy environment could deteriorate sufficiently that the living standards of its people fall away relative to those in other advanced economies. There would be nothing remotely attractive about having closed the gap to Australia that way – as our largest trading partner and largest source of inward foreign investment, Australia's success matters greatly to us.

Living standards in New Zealand and Australia

Whatever way one looks at the issue, New Zealand incomes and living standards are very substantially below those in Australia.

It wasn't always so. For most of the time since at least 1870, our living standards appear to have been quite similar to those of the typical Australian – sometimes a little better, and sometimes a little worse. And when our measured incomes were similar there was no sustained net flow of people across the Tasman in either direction. Both New Zealand and Australia were for a long time about equally successful in achieving living standards for their people that were among the best anywhere in the world. Both New Zealand and Australia began dropping down the international league tables in the 1960s.

Figure 2: GDP per capita relative performance



Source: Maddison for 1900-1970, constant prices, 1991 Int. GK$, OECD for 1971-, US$, constant prices, constant PPPs, reference year 2000

With the benefit of hindsight, it is clear now that our living standards began to drop below Australia's from the late 1960s. In the twenty years after World War Two, our terms of trade had been strong. They fell away sharply after 1966, which brought into sharper relief the consequences of longstanding protectionist policies that were adversely affecting the ability of the economy to generate strong economic growth over the longer-term. At no time since the mid 1970s have New Zealand incomes and living standards even come close to those in Australia, on any measure. And there has been no sustained period since the mid 1970s when New Zealand incomes have risen relative to those in Australia.

Extensive economic reforms undertaken from the early 1980s to the early 1990s led to a substantial improvement in New Zealand's relative economic performance[3]. When compared with the OECD group of countries as a whole, New Zealand's income gap has not widened further since the early 1990s, although the gap to Australia has widened a little further. The gap to Australia, and to the rest of the developed world, is large and should be deeply troubling.

The official economic statistics tell us about the gap in living standards, and so do the specific differences in what New Zealanders and Australians have that are set out in Box 1.

The other way to get a sense of the difference is to look at the choices people make. People don't respond to differences in national accounts statistics, but to their perceptions of opportunities for themselves and their families. In recent decades, too many of our people have concluded that there are better economic opportunities for themselves and their children in other countries, notably Australia. For each person who has already left, many others tell pollsters that they are tempted by the option.

Box 1: What do Australians get with their higher incomes?

Digging down to look at what people in the two countries actually consume can give a more tangible sense of the differences between New Zealand and Australian material living standards. Again, what is important in different climates varies, and tastes differ. But comparing living standards in New Zealand and Australia is easier than in most pairs of countries because the tastes and expectations are broadly similar.

These data are sometimes less reliable than the national accounts. Sometimes they are not compiled by national statistical agencies but by industry bodies. Even when statistical agencies are involved, things aren't always measured exactly the same way in different countries. There is no single decisive fact. This box simply illustrates that across a very wide range of things that different people value or like to consume, the typical New Zealander has less than the typical Australian.

Starting with where we live: the average size of a new Australian house or apartment built in 2007 was 212 square metres. In New Zealand, the comparable average was 193 square metres.

Or what we drive: Australians have 619 cars per 1000 people, while New Zealanders have 560.

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[3] Australia undertook significant, although less extensive, reforms during the same period.

New Zealanders work more to earn our lower incomes: 887 hours a year are worked per head of population, as compared with 864 hours per head in Australia.

Australians live longer: 81.1 years, compared with 80.2 years in New Zealand.

Fewer people in Australia (111 per 100,000 people) die of heart disease each year than do in New Zealand (127 per 100,000 people).

Many fewer people die on the roads there: 7.8 each year per 100,000 people in Australia, 10.1 each year in New Zealand.

Australians have more televisions (505 per 1000 people) than New Zealanders do (477 per 1000 people).

And there are more broadband subscribers (10.3 per 100 people, compared with 8.1 per 100 in New Zealand).

There are more cinemas per million people in Australia (92.4) than in New Zealand (82.2).

And more mobile phones too (906 per thousand people versus New Zealand's 861 per thousand).

Australians drink more than New Zealanders: both alcohol (9.8 litres per capita versus 8.9 litres) and fruit juice (34.4 litres per capita versus 24.8).

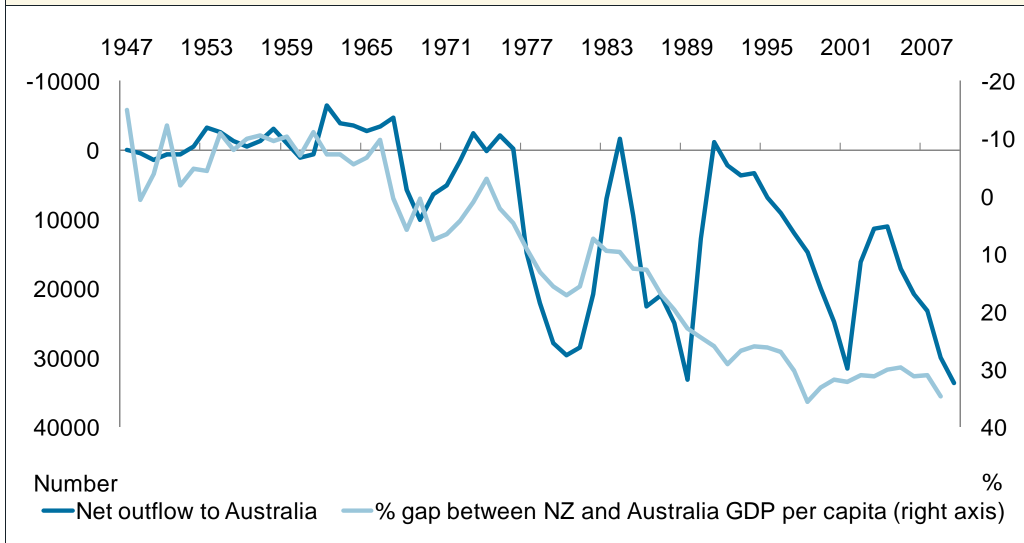
This isn't comprehensive by any means – that is why we have national income accounts. And there are some measures on which New Zealanders have more than Australians. Australia has 34.9 McDonalds outlets per million people, but New Zealand has 36.9 per million.

Source: Most of these data were obtained via www.nationmaster.com on various dates in November 2009.

Each individual has different reasons for moving country, but the vast majority of those who have left for Australia have gone since the mid 1970s, when the gap between New Zealand and Australian living standards began to more obviously widen. Before then, people still moved across the Tasman, both ways, but the net flows were usually small and were not consistently in one direction for very long. By contrast, in the last decade alone, a **net** 260,000 more New Zealand citizens have left than have come home again: the overwhelming majority of that net outflow has been to Australia[4]. For a country of a little over 4 million people, that is a huge loss.

[4] The data indicate that the net outflow of New Zealanders to Australia shares broadly the characteristics of the New Zealand population, but that the net loss of New Zealanders to other countries tends to be disproportionately higher skilled.

Figure 3: Net migration and the income gap

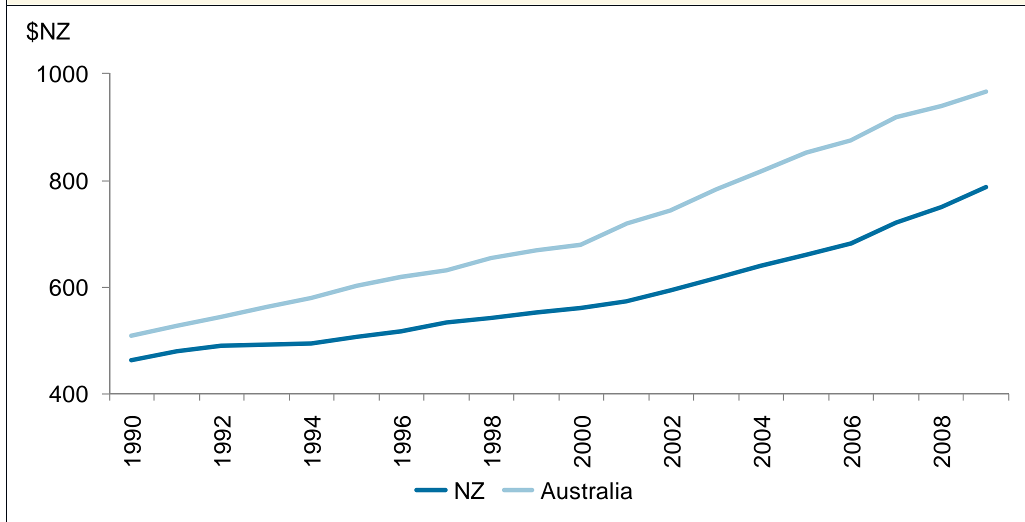


Source: Statistics NZ, GDP per capita from Maddison for 1947-1970, constant prices, 1991 Int. GK$, OECD for 1971-, US$, constant prices, constant PPPs, reference year 2000

Net outflows of our people, on the scale we have now been seeing for decades, are a telling indication of policy and political failure. When people abandon their home country on that scale it is a sign that something is deeply wrong – whether in Ireland from the 1950s to the 1980s, or New Zealand since the 1970s. It makes closing the gap urgent.

Sometimes it can be difficult to give the person in the street a strong sense of what the large gap in living standards between New Zealand and Australia actually means. Numbers can be abstract, perhaps never more so than international national accounts statistics. Moreover, for many people life in New Zealand is good, and our material living standards have increased enormously – in the last decade alone, real wages have increased substantially and overall living standards of the average New Zealander (at least as proxied by real GDP per capita) have increased by 21 percent. But that outcome, good as it was, left us a little further behind Australia than we were ten years earlier.

Figure 4: Average weekly earnings – total, gross, all employees, current PPPs



Source: Statistics NZ, Australian Bureau of Statistics, OECD

There are several ways to look at the issue. On the one hand, we can compare the things New Zealanders consume with the things Australians consume. Across a huge array of such measures, New Zealanders consistently have "less stuff". We have less stuff even though, on average, New Zealanders choose to spend a higher proportion of our incomes than our Australian peers do. Tastes differ, and the things each of us puts priority on differ, but almost regardless of what one values, New Zealand incomes don't enable us to purchase as much as Australian incomes do.

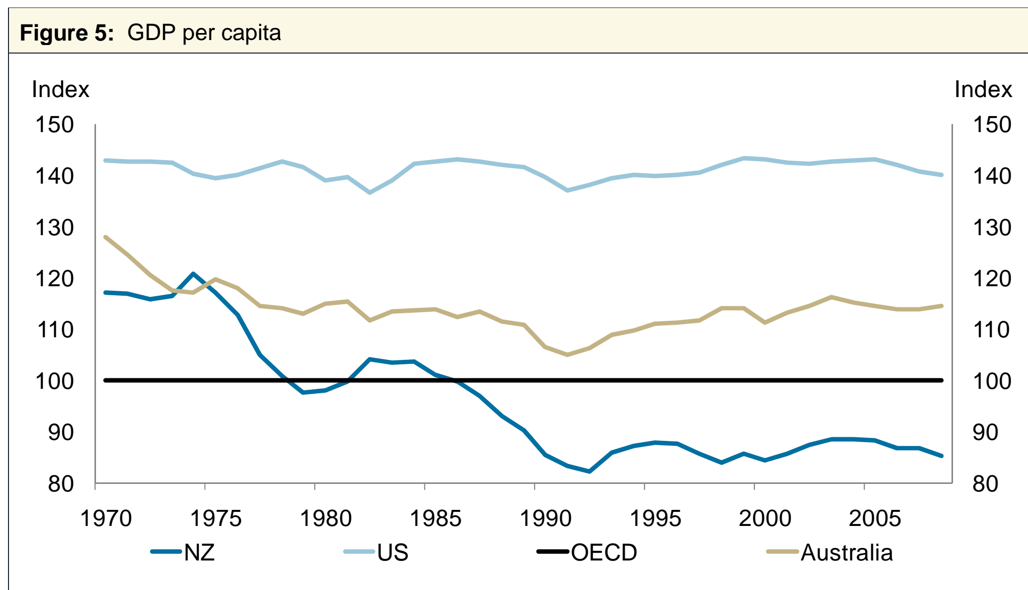
It isn't just a matter of physical goods or private sector services, but of public services – be they good quality roads, or schools, or armed forces, or hospitals. It is increasingly difficult to have first world public services, and the outcomes people expect from them, on New Zealand incomes, at least without an ever-increasing burden of taxes which in turn would impede future growth prospects. For example, our lower incomes don't stretch far enough to support the steadily increasing flow of new drugs and new medical technologies that richer countries can afford. And because our incomes (and, hence, the tax base) are lower than those elsewhere, we have to use more of those limited incomes to pay skilled and mobile people enough to stay in, or move to, New Zealand.

In making the shift to Australia, those who leave don't face serious trade-offs. They can earn higher incomes, have more physical goods, and enjoy holidays that are at least as long. But they also have good beaches and parks, and a physical environment that is protected. Their choices are enlarged by leaving their own country. For an increasing number of New Zealanders who stay behind, it means facing up to having their relatives – often children and grandchildren – growing up far away, mostly in Australia, as citizens of a different land.

Measuring and monitoring the income gap

This report focuses on the policies and institutions governments can put in place to create the best climate for sustainable long-term economic growth in New Zealand. From among the various statistical measures of the difference in the performance of the New Zealand and Australian economies, the Taskforce has concluded that our primary benchmark should be the gap between New Zealand and Australian real GDP per capita, as reported by the OECD in purchasing power parity (PPP) terms. Real GDP per capita last year was 35 percent higher in Australia than in New Zealand[5]. On that measure, an average New Zealand family of four is worse off than their Australian counterparts by around $64,000 per annum[6].

Figure 5: GDP per capita



Source: OECD, OECD = 100, at constant 2000 PPPs and constant prices

Other measures each have advantages and disadvantages, but each shows a large difference in Australia's favour. As a measure of living standards, differences in real Gross National Disposable Income (RGNDI) might be preferable, but there are data limitations, and in any case RGNDI measures are thrown around by fluctuations in the terms of trade. Changes in the terms of trade affect real living standards, but as both New Zealand and Australia are commodity exporters the two countries both have quite volatile terms of trade. Moreover, governments have next to no influence on the terms of trade. We want to focus attention mostly on measures of economic performance that are more directly amenable to the impact of policy reforms. Sustained improvements in the terms of trade (more so than in Australia) would be a welcome windfall gain – but not something that can be counted on.

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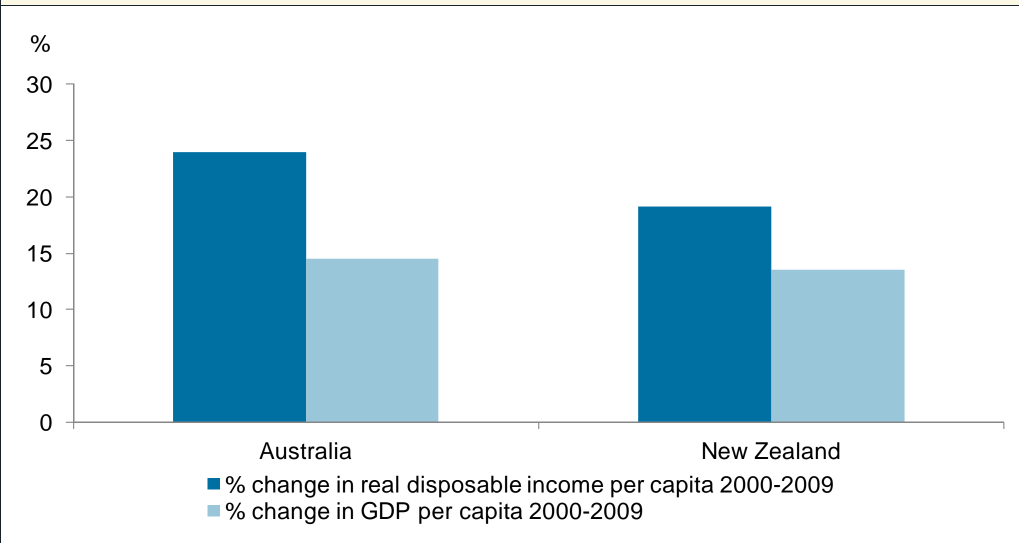
[5] In 2008, nominal GDP per capita, in PPP terms, was 45 percent higher in Australia than in New Zealand. That larger difference reflects the impact of the extremely high terms of trade in Australia in 2008.

[6] Of course, not all of this difference is in the direct consumption and savings of households. Around a third of all income is currently taken in taxes, to finance various public services.

Figure 6: Effects of changing terms of trade



Source: Statistics NZ (note: real disposable income per capita - gross), Australian Bureau of Statistics (note: real disposable income per capita - net)

We will also report on developments in the other measures of income and living standards. But we will take little comfort if, say, the Australian minerals boom were to reverse over the next few years (which would narrow the RGNDI gap between the two countries), or even if our own dairy prices were to double again temporarily (also narrowing the RGNDI gap). In the long-run, better policy frameworks and economic institutions will provide the right environment for enduringly closing the gap with Australia.

Box 2: Formal measures of living standards

There are significant statistical challenges in attempting to measure living standards, both over time within a country, and between countries.

The most commonly quoted measure of economic performance, real Gross Domestic Product (GDP), is an approximate measure of the value of all the goods and services produced in a country, adjusting for the effect of changes in the general level of prices.

In developed countries, real GDP is measured relatively well but not perfectly. All countries struggle to measure the "volume" of output in service sectors. And where the "black economy" is larger, the measurement difficulties are more serious. However, even if GDP were perfectly measured, it would not be a fully satisfactory guide to living standards.

For example, the state of the physical environment isn't captured at all. And the implications of shifts between whether household services are undertaken within the market or within the family are ignored. If a person marries his or her housekeeper, GDP will fall even though well-being might reasonably be assumed to have risen. These things tend not to matter much from year to year (the underlying patterns of behaviour don't change much in the very short-term) but they can complicate comparisons between countries, or even within countries over long periods of time.

In addition:

- Some of the value of what is produced in New Zealand does not accrue to New Zealanders. The most important element of this is the income earned on foreign investment in New Zealand. In many developed countries, this issue is not hugely important. But it is a significant issue for both New Zealand and Australia. Both countries are highly dependent on foreign debt and equity capital, New Zealand materially more so than Australia. To measure the incomes accruing to New Zealand residents, statisticians deduct from GDP that portion of what is produced in New Zealand that accrues to foreign residents, and add back what New Zealand residents earn from overseas. The resulting measure is known as Gross National Income (GNI). At present, in New Zealand, GNI is around 7 percent lower than GDP.
- Real GDP or real GNI are measures of real **gross** income. But as any owner of plant and machinery, or of a house or commercial building, knows, physical assets deteriorate over time. Provision needs to be made to repair and eventually replace those assets, and the amount of that provision is not available to consume without undermining citizens' real future consumption possibilities. Statisticians subtract an estimate of the substantial annual depreciation of the physical capital stock to derive Net Domestic Product (NDP) and Net National income (NNI) measures. These measures are not widely quoted, probably for two reasons: they are less well-measured and the differences between the annual growth rates of net and gross measures are usually small.
- Measures of real domestic product and national income (gross or net) do not capture the direct impact on a country's living standards of changes in the terms of trade. If the prices of the goods and services we export rise (relative to those of the goods we import), the overall purchasing power of New Zealanders rises. As a nation we are better off, but this is not captured in the real GDP or real GNI measures. Statistics New Zealand makes an allowance for the value of terms of trade changes in a series called real Gross National Disposable Income (RGNDI). The terms of trade adjustment can make a big difference at times, especially for countries that are heavily reliant on the export of commodities. In both New Zealand and Australia, the rise in the terms of trade meant that living standards rose by more than GDP did over the last decade.

Comparisons of living standards across countries get more awkward still because of different price levels, fluctuating exchange rates, and different spending patterns. The OECD produces the most useful international comparisons, reporting (with a lag) the real value of GDP in each of its member countries expressed in a common currency, translated using what is known as "purchasing power parity" exchange rates. If we simply translated GDP figures at current exchange rates, the measured value of our GDP would be high relative to that in other countries when our exchange rate is temporarily very high. But that will mean little in terms of living standards, as much of what we consume is not traded internationally. The PPP numbers attempt to look through these fluctuations to get a more comparable measure of how many real goods and services incomes in each member country will actually purchase.

Year-to-year comparisons of growth rates across countries are relatively easy to do consistently and reliably. Measuring absolute differences in living standards in a fully reliably way is more difficult. Differences in tastes and preferences, and even in the climate, shape what people actually consume and bedevil formal comparisons of living standards. To take just one trivial example, many more air conditioners are likely to be used in Brisbane than in Dunedin, but more will be spent on heating in Dunedin than in Brisbane. And in a more extreme climate, more of one's income has to be used for both heating and cooling to achieve the same degree of well-being the resident of a temperate climate might enjoy. And how does one value easy access to the beach and the outdoors, such as one might have in Christchurch, with easy access to great museums, art galleries and newspapers that one might have in London?

Understanding the reasons for the income gap

Reaching a better understanding of why New Zealand incomes and material living standards are now so much lower than those in Australia is important. It is important in its own right: as humans and citizens we strive to understand our situation better. But it is also important because understanding how we got here can go some way to help narrow down the debate around the range of options that might help close the gap. If, for example, things have been tried repeatedly in the past and haven't made much positive difference, they are unlikely to be part of the solution now either. There are three, slightly separate, dimensions to the question:

- Why did the income gaps open in the first place?
- Why are they as large as they are now?
- Why are the income gaps showing no sign of closing?

Those who have attempted to answer these questions have proposed a range of explanations and highlighted a variety of issues and perspectives. This part of our report is devoted to reviewing some of the possible elements of the story: some featuring prominently in public debate, others not so much. A few of the possible explanations seem to us best thought of as pure myth. Many others may be part of the overall story of New Zealand's ongoing underperformance. Some may have more to do with how the gap got so large; others may be more relevant to the question of what now holds New Zealand back from improving its position.

In some important areas, getting the story straight has been made considerably more difficult by the serious weaknesses in New Zealand's statistical data. This is not, in any respect, a criticism of Statistics New Zealand. We understand that they do an admirable job for the most part, operating with the very limited resources available to them and within the priorities set by successive governments. We have appreciated their assistance with our work. This Taskforce is also not, by any means, the first to raise concerns about the adequacy of the resources that have been devoted to economic statistics[7]. Serious well-informed economic analysis, especially around the sort of deep-seated and longstanding issues that need to be grappled with if the 2025 goal is to be achieved, requires good economic and financial data. New Zealand's data collections need to be materially improved, possibly by reprioritization of existing resources but perhaps too by an increase in total resources devoted to this area.

Before proceeding further, it is worth reiterating one of the central insights of the substantial international literature on what makes rich countries rich and poor countries poor.

[7] For example, in its submission to the 2007 Finance and Expenditure Committee Inquiry into monetary policy the Reserve Bank concluded a discussion of the weaknesses in New Zealand statistical collections noting that "meeting the realistic expectations of users seems unlikely to be able to be done adequately without the provision of material additional resources."

The importance of institutions

The international literature[8] is clear that the biggest difference between rich countries and poor countries is not their natural resources or their terms of trade, or their size or location, but the quality of their institutions. In this context, institutions can be thought of as the over-arching "rules of the game", both formal and informal, that provide the framework against which subsequent government and private sector decisions and choices are made. Institutions include features that we often taken for granted: well-defined and respected private property rights, ability to trade within and across borders, effective enforcement of contracts in a well-functioning and honest legal system, personal security, a high degree of social trust and so on. Without arrangements like these, which allow markets to play their pivotal role, it is very difficult for entrepreneurs to flourish or, therefore, for a country or community to achieve sustainably high levels of wealth and income.

At its starkest, the point is illustrated very simply: the Congo and Australia both have substantial endowments of natural resources, but the Congo has almost none of the institutions that would encourage firms or individuals to invest (whether in human or physical capital) and to take advantage of the natural endowments of its land or people. Alternatively, consider the case of North Korea and South Korea. These two countries started in 1950 with almost identical geography, people, climate and cultural legacy, and with GDP per head itself almost identically low. One country nurtured institutions that protect property rights and encourage innovation and enterprise, and has now just achieved higher income per head than New Zealand. North Korea, by contrast, is now one of poorest and most miserable nations on earth.

Institutions – the rules of the game – matter a lot. They are the biggest difference between rich countries and poor countries. And partly because institutions are important, countries that are rich tend to stay rich, and those that are poor stay poor: institutions (formal ones and the implicit societal norms that are such an important part of the mix) tend to change slowly. It is against that standard that New Zealand's decline is so marked. Other than Argentina and Uruguay, probably no advanced country has tumbled further down the international league tables in the last 100 years.

In many respects, both New Zealand and Australia have long had among the best institutions in the world – and have been fortunate heirs to institutions and traditions that transformed the world. In international surveys and comparative studies, New Zealand consistently scores better on the quality of its institutions than it does on overall material living standards. Indeed, on many indicators of institutional quality New Zealand performs extremely well. Just recently, Transparency International ranked New Zealand as the least corrupt country in the world, and a new Legatum Institute study, while highlighting the many institutional similarities between Australia and New Zealand, also highlighted the higher degree of social trust prevailing in New Zealand[9]. The

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8 See, for example, Daron Acemoglu, Simon Johnson and James Robinson, *Institutions as the Fundamental Cause of Long-Run Growth*, NBER Working Paper No. 10481, May 2004.

9 The comparison between New Zealand and Australia is effectively illustrated in a graph at this link http://www.prosperity.com/prosperiscope.aspx?sel=NZ,AS&year=2009&index=prosperity

surveys can't capture all aspects of the institutions that matter in particular societies, but these are extremely strong foundations for renewed prosperity.

Good institutions must not be taken for granted. But if the institutions of society ultimately determine that society's economic success, they aren't the only factor. That is especially so when the challenge is (as it is for this Taskforce) to focus on lifting one advanced country's economic performance relative to those of other advanced economies.

Policy choices and the nature of specific government interventions matter too. The distinction between institutions and policies can be, at the margin, a somewhat artificial one. Here, policies refer to measures and choices taken by governments within a strong and well-governed market environment.

Explaining New Zealand's sustained economic underperformance is no small task. The ready-made explanations that explain the severe underperformance of, say, Argentina, North Korea, or the Eastern European countries during the Communist era are less helpful in telling the New Zealand story. There is no single easy "silver bullet" explanation, either for the relative decline over 35-40 years, or for the now-persistent failure to close the gap.

Some possible factors

Distance

New Zealand is among the most geographically remote countries in the world – probably further from world markets than any other country. We always have been.

It seems quite likely that distance matters for income levels. Formal research[10] provides some support for that. It costs more to get goods to market from further away, which leaves less of the value of those goods and services for the sellers. It also costs more – in all sorts of ways – to develop new markets when one is a long way away from those potential markets.

But as a Taskforce we are not persuaded that distance can explain much about New Zealand's overall economic performance in the last century. New Zealand is one of the most remote countries in the world. So is Australia. And New Zealand certainly has not got further from world markets in the years since the income gap began to become obvious.

If transport costs seem high now, they are as nothing to what they were. Even 100 years ago, three of the highest income nations on earth were New Zealand, Australia, and Argentina, all weeks by ship from any of their major markets, and with communications links slow and/or expensive when compared with today's free (at the margin) email and very cheap telephone calls.

[10] Boulhol, H. and A. De Serres, "Have developed countries escaped the curse of distance?", OECD Economics Department Working Papers. No. 610, 2008

And if world markets are still far away, recall that in the first half of the twentieth century, when New Zealand was still one of the richest nations on earth, New Zealand's exports overwhelmingly went to the United Kingdom, which is almost as far away as one could get. By contrast, today's large markets in the United States, China, Japan, Australia and the rest of east Asia are far closer, and easier and cheaper to get to, than they have ever been.

There are counter arguments in the literature. Some emphasise the apparently growing importance of personal relationships that may matter more for trade in services, or tailored design products, than perhaps they would for, say, trade in bales of wool. And cross-border trade in components is clearly becoming much more important than it was.

Our distance might make it hard for us ever again to have the very highest incomes in the OECD, but we remain unpersuaded that distance can explain much about our income gap to Australia. Australia is almost as distant as New Zealand from world markets. As just one other example, Hawaii is also likely to suffer from any tyranny of distance – it is among the most remote states of the United States but certainly not among the poorest[11]. A multi-national firm that is based in the United States and doing its design there, assembling in China, drawing components from across Asia, and shipping and marketing to the world is a reality: each link in that chain deals with distances that are huge by historical standards.

In the end, it is not hard to believe that if New Zealand – everything else unchanged – could be physically relocated to an equally temperate zone near the North Atlantic coast, our incomes would be a little higher. The same goes for Australia. But, of course, physical relocation isn't an option. Distance is what it is, given the limitations of transportation and communications technology. If we want to generate first world living standards here, for ourselves and our children, we simply have to find ways to overcome any disadvantages of distance by being better or smarter in other areas.

Size

With a population of a little over 4 million, New Zealand is not a large country, and is materially smaller than Australia. But New Zealand is not among the smallest nations in the world, and even among the group of developed countries there is nothing unique about our size: countries such as Norway, Denmark, Finland, Singapore, Slovakia, Slovenia, and Ireland have similar populations, and Cyprus, Iceland, Luxembourg, and Malta are materially smaller. Most of these countries have incomes at least as high as New Zealand's. And there is no sign that over time small countries are getting poorer relative to large ones.

Size might matter for various reasons. At a trivial level, the per capita cost of maintaining the apparatus of a state (embassies, head of state, parliament etc) tends to be less for large countries than for small. Countries that are sparsely settled (including both New Zealand and Australia) may have to spend more, per capita, on physical infrastructure than more closely settled countries. And in any potential military conflict, size is clearly an advantage – but that has rarely, if ever, been much of an issue for New Zealand.

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[11] Personal income per capita in Hawaii was 18th highest among the 50 states in 2007. http://www.census.gov/compendia/statab/ranks/rank29.html

The smaller size of the home market may be a more important factor. A highly successful innovative new firm starting out will more quickly reach the limits of its home market in a smaller country (such as New Zealand) than in a large country (such as, say, the United Kingdom). If there are – barriers to moving into exporting – and there seem to be some – the small size of the home market might hold an economy back somewhat. In some cases, of course, innovative firms based in small countries simply respond by looking to develop foreign markets immediately. How much weight should be put on all this partly depends on the nature of the barriers and hurdles. Some barriers of size don't affect New Zealand as much as other small countries: we share a common language and similar legal systems with two of the most important world economies (the United States and the United Kingdom) in a way that some other small developed countries, eg Slovenia or Iceland, do not. And many large countries are nowhere near as homogeneous as they may appear superficially: a West Virginia company will also face hurdles, and material costs, to breaking into the California market.

International trade is the normal way to counteract any disadvantages of being small. Small countries typically trade more than big ones – thus, the value added by exports and imports is a more important part of the New Zealand economy than it is for Australia, than it is for the United States or the United Kingdom or Japan. Of course, that means formal trade barriers put up by other countries are a cost to being small: they restrict foreign trade in a way that doesn't apply to domestic trade. Trade barriers – tariffs and the like – have been dropping steadily in recent decades, although more so generally for manufactured products than for agricultural products. For New Zealand, the loss of unrestricted market access to the United Kingdom in the 1970s probably had real economic costs, sustained for some considerable time. But the long-term trend still appears to be back towards something approaching free trade in goods and services.

There are other possible barriers to being small that haven't gone away: New Zealand has an independent exchange rate where, say, Finland or Malta (both part of the euro area) no longer do. Exchange rate issues are covered separately later.

Public choices may tell us something about the economic importance of size. In recent decades, there has been a strong and consistent trend towards the emergence of new and smaller countries, presumably chosen by voters assessing where their own best interests lie. By contrast, there have been very few examples of two countries merging.

Even if New Zealand's small size matters more than we think, it is simply not going to change very materially in any period relevant to the current adult population or, more particularly, to the 2025 goal. If, somehow, New Zealand's population quadrupled in the next 30 years, New Zealand would still be no more than a moderate-sized country, and smaller than Australia is today. And the transition to such a new larger size would itself be enormously disruptive, entailing some combination of very much higher birth rates and very much higher immigration rates.

For now, there are simply too many prosperous small countries in the world for us to attach very much importance to our small size as an explanation for our current low ranking among OECD countries, let alone as a constraint on our future potential.

Commodity economies

Some accept that Australia is as distant from world markets as New Zealand, and is also not heavily populated (indeed, can be thought of as a grouping of small economies scattered across a whole continent), but suggest that the real difference is minerals – Australia seen as a veritable mine of coal, gold, iron ore, gas and so on. When mineral prices have risen as much as they have in the last few years, the argument has an obvious superficial appeal. Others attribute our failure to the fact that New Zealand is still a "commodity economy".

How should we think about these issues?

From a global perspective, what is striking about both New Zealand and Australia is the unusually high proportion of the total exports of both countries that is commodity products. As Australia is a successful high income country, and New Zealand has been much less successful, and as over long periods of time the terms of trade of the two countries have behaved quite similarly, it is unlikely that simple commodity dependence explains very much.

Turning to the specific role of minerals, many high income countries have next-to-no mineral resources: these include Singapore, Taiwan, Japan, Denmark, Ireland, and Austria. And in many countries abundant mineral or hydrocarbon natural resources have come to be seen as something of a "curse", undermining good policies and institutions, and deferring necessary structural adjustment. Australia, of course, appears to have coped with, and utilized, its mineral earnings quite well.

Even the importance of minerals in Australia can be overstated. Australia's mineral and related exports were growing very rapidly (as a share of total exports and of GDP) from the 1960s, at least 20 years before Australia reversed its own fall down the OECD income per capita rankings. Minerals were already around 35 percent of total Australian exports by the mid 1970s (equal in nominal terms to around 5 percent of Australia's GDP in 1970 compared with 13 percent at the peak of the commodity price boom last year).

In passing we note the brute reality that for most of the second half of the twentieth century the real prices of industrial commodities were falling. That trend has been interrupted this decade – years after Australia's economic performance had begun to improve markedly – but it is an open question whether that reversal will prove enduring. In the very long run, digging up the earth to produce raw commodities, with ever-lower mineral grades, is not obviously a guaranteed route to sustained high national wealth for a rapidly growing population. Policies are likely to matter much more.

It is also worth noting one of Australia's particular disadvantages. Australia is a very dry country with an often rather hostile climate. Much of its wealth in its first 150 years was built on "the sheep's back", but the potential for agricultural and pastoral industries has turned out to be much less in the long run than it first appeared: scarce water and a changing climate in a sense meant that Australia had to rely less on farming and more on some other tradable sector. Mining is the most important of those.

Turning back to New Zealand, it is not always appreciated, perhaps especially by New Zealanders, just how well endowed with natural resources New Zealand is[12]. We have a climate almost ideally suited to grassland farming and, for example, productivity growth in the dairy sector has been faster than in most other sectors of the economy in the last 20 years. There is abundant scope for innovation, new technologies, and smart products in these commodity-based industries.

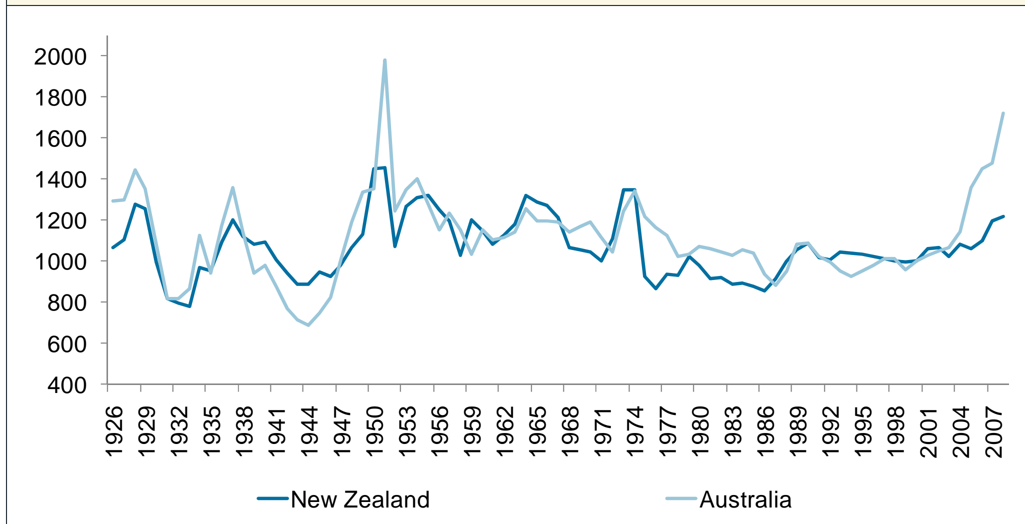
New Zealand also has among the largest resources anywhere of renewable fresh water[13], which is increasingly becoming one of the world's scarcest resources. On the seas, we already have a huge exclusive economic zone (fourth largest in the world and, of a size, per capita, unparalleled by any country other than some small island states in the Pacific) that is rich in fish (a well-managed sustainable resource) and mineral resources. Even on or under the land, indications are that New Zealand's mineral and hydrocarbon resources could be, for the physical size of the country, at least as large as Australia's – rich in iron sands, lignite and other minerals, and in geothermal energy potential. New Zealand may well have made it more difficult to explore and develop its resources than Australia did, but if so those are regulatory and asset management issues, not ones of underlying economic potential.

Mineral earnings have clearly been a huge part of Australia's sense of prosperity and national mood this decade. When the prices of the goods one's country sells rise so dramatically, that does markedly boost incomes and purchasing power. And although Australia's exports are a much smaller share of its economy than New Zealand's are of ours, their terms of trade have risen more than ours did. But all that is this decade's story, and this decade isn't when the big differences between New Zealand and Australia developed. We didn't close the income gaps to the rest of the OECD either – even though they are net importers of the commodities New Zealand and Australia sell, and hence "penalized" by the higher commodity prices.

[12] World Bank estimates of natural resources (including pasture land) per capita are at the following link: http://go.worldbank.org/RRCQLBZMX0

[13] According to the 2009 World Development Indicators only four countries have more per capita (Canada, Norway, Papua New Guinea, Gabon), and no high or even middle income country uses such a small proportion of the fresh water it has.

Figure 7: Terms of trade



Source: Statistics NZ, Reserve Bank of Australia, Australian Bureau of Statistics, Footnote: Both series scaled to equal 1000 in the year 2000

Investment in houses

There appears to be a widespread belief that, in some sense, New Zealanders invest "too much" in housing, and that this is one of the sources of our longstanding economic problems. It is not clear what sort of theory of economic growth, implicit or explicit, motivates this belief. The claim does not stand up to scrutiny.

One problem that bedevils the discussion is the two quite distinct uses of the term "invest". In colloquial parlance, buying a residential rental property is thought of as purchase of an "investment property" (and the seller has presumably "disinvested"). To an economist, only the construction of a new house (or other asset) is investment.

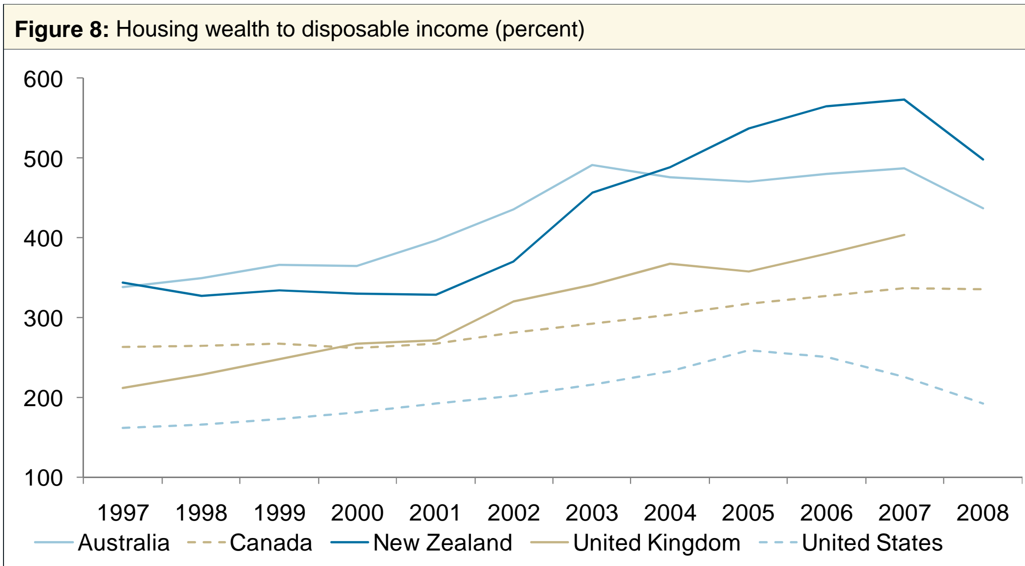
Taking the economist's perspective first, comparable international data are readily available on residential building activity. Over the period 1970 to 2006, 5.1 percent of New Zealand's GDP was used for building and altering houses ("residential investment"), a little below the median OECD country at 5.9 percent. That has been so even though our population – the most important factor ultimately influencing demand for housing – grew more rapidly than the OECD average. Australia's population was also growing rapidly, and 6.2 percent of its GDP was used for residential investment over the 1970 to 2006 period. Much the same picture holds if one splits the period in half, and looks only at the post-liberalisation period since the early 1990s.

New Zealanders have devoted a slightly smaller share of GDP to building and altering houses than Australians have. But our incomes are much lower than theirs. That means the real dollar value of resources devoted to building the housing stock in New Zealand has been consistently much less than that in Australia. As a result, our houses are, on average, smaller and less well-appointed. That is one of the consequences of being poorer. But if there is a hint of causation about overall economic underperformance it probably runs in the other direction to the conventional wisdom: very high house prices may indicate that New Zealand (and Australia for that matter) devotes fewer real

resources to building new houses than would, in some sense, be desirable. Costly regulatory barriers help account for this underinvestment.

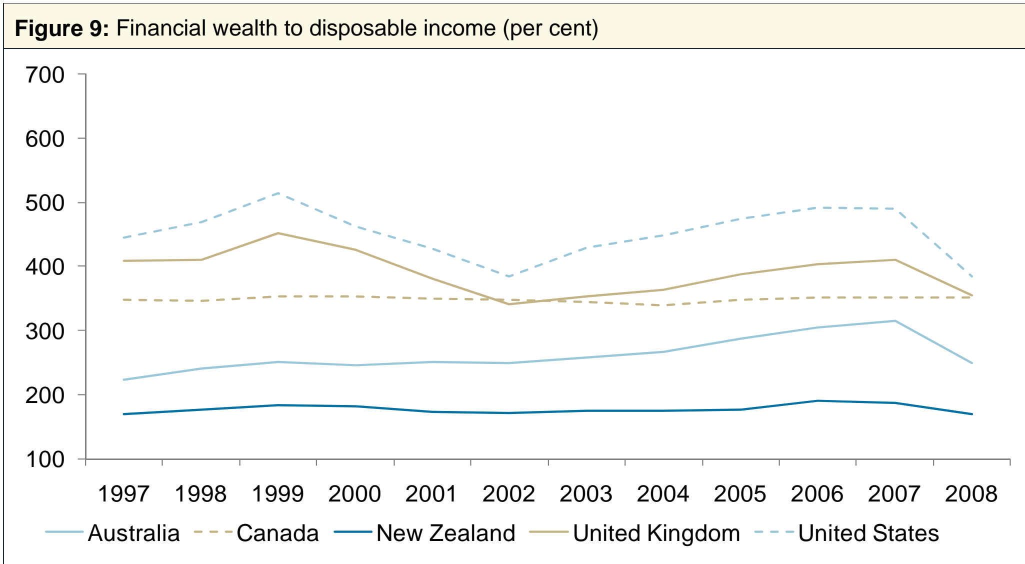
But what about "investment" in colloquial parlance? Good international data are hard to come by, but it is generally accepted that the value of houses owned by households as a share of their total assets, or of household sector net worth, or relative to household income or GDP is currently larger in New Zealand than in other OECD countries.

Figure 8: Housing wealth to disposable income (percent)



Source: Data provided by IMF staff

Figure 9: Financial wealth to disposable income (per cent)



Source: Data provided by IMF staff

We have already noted that the physical housing stock in New Zealand itself is not unusually large. So how are these two sets of observations reconciled?

First, house prices in New Zealand are currently very high (indeed, relative to incomes, houses in New Zealand and Australia are among the most costly in the world). Current house prices appear unlikely to be sustainable in the long run, but when house prices are very high, unsurprisingly they show up as an unusually large ratio to total "wealth" or income[14].

Second, in New Zealand the private rental stock is mostly owned by the household sector directly. That isn't always so in other countries. Some of the difference may reflect the physical nature of the housing stock. In countries where apartment living is more common, it is quite normal for large rental properties to be owned by listed corporate entities. In New Zealand, detached houses, or small blocks of 3-4 flats, have long been the normal form of private rental property, and these sorts of properties are often more naturally owned by individuals (including those who are happy to use their home handyman skills to maintain rental properties). It is also possible that the tax treatment of rental property in New Zealand and Australia is a little more neutral between individuals and corporate holders than it is in some other countries. In particular, in New Zealand and Australia operating losses on rental properties can be offset against the owner's other income (in the same way that a corporate offsets losses on one activity against income from another). Operating losses on highly-leveraged rental properties are quite common near the peak of a housing cycle: at those peaks, rental yields (the main source of income) tend to be very low, and interest rates (the largest outgoing) tend to be very high.

Thirdly, private savings rates in New Zealand ("savings" in the economist's sense of earned income not spent on consumption goods and services, as distinct from gains from asset revaluations) have been lower than in many other developed countries (including Australia) for many years. Relatively low savings rates over long periods of time mean that total household wealth is small in New Zealand. In turn that means that even though our housing stock isn't unusually large, there simply isn't much "left over" to hold in financial assets after the population's housing demands (themselves quite normal by international standards) have been met. This is also true, although to a lesser extent, of Australia.

Rental property performs a vital economic and social function. Such properties have to be owned by someone. It is not obvious that, for example, reshuffling the ownership of the existing rental stock – so that houses were owned by corporates and households owned shares in house-owning companies – would make any material difference to anything relevant to closing the income gap.

At a policy level, the one important difference between the New Zealand and Australian housing markets is that Australia levies a capital gains tax on investment properties. We discuss tax issues later in the report. Here we simply note that the presence of a capital gains tax on investment property has not immunized Australia from very large swings in house prices: on most measures, Australia's cycles have been quite similar to those in New Zealand.

[14] Of course, higher house prices do not create real wealth from the perspective of the economy as a whole: the gain achieved by an elderly homeowner selling an overvalued house to move into a rest home is exactly offset by the additional cost facing the young couple buying the same house as they move from renting into home ownership.

In summary:

- House prices are currently very high relative to incomes. If anything, that is a strong indication that there are too few houses, not too many.
- Over a long period, New Zealand households appear to have saved only a modest proportion of their low incomes. That means overall household wealth is quite low, and the total is dominated by (currently) overvalued housing stock.
- Someone has to own the stock of rental houses. In New Zealand, households tend to do so directly. It is not obvious that anything material rests on the question of which private sector party – households, New Zealand firms, or foreign investors – owns the bulk of the rental stock.

Past reform programmes

It is occasionally claimed that our economic problems relate to the reforms of the 1980s and early 1990s. The income gap between New Zealand on the one hand, and Australia and the rest of the OECD on the other hand, opened materially further in the 1985 to 1992 period. Some critics – generally those skeptical of the merits of a market-based economy – stop at that point: they simply note that the income gap widened further during this period, and has more or less stabilized since the pace of reform slowed markedly. Others, generally more supportive of an open and competitive economy, highlight issues around the way in which reforms were undertaken, and in particular around the sequencing of the reforms. They contrast the approach adopted in New Zealand with the somewhat more gradual and incremental approach to reform adopted in Australia in the 1980s and early 1990s.

We see little or no merit in the argument. It is not surprising that the income gap widened further during the accelerated period of macroeconomic adjustment and structural reform in New Zealand. Those measures were needed to control large fiscal deficits, to bring ballooning debt under control, to lower markedly an inflation rate that had averaged among the highest in the OECD, and to create the conditions encouraging resources (capital and labour) to move out of uncompetitive industries. Of course, in some ideal world, and especially with the benefit of 20/20 hindsight, reforms – on both sides of the Tasman – would have been conducted a little differently. In some areas, the reforms in New Zealand were measurably superior – for example, the design of our GST and our fisheries management regime[15]. In others, no doubt Australia did better. But no serious economist is arguing for a return to the sort of high inflation New Zealand experienced, to the high protective barriers that made cars or clothes for the children hugely expensive, to the absurdity of assembling Japanese televisions in New Zealand, to a 66 percent maximum personal income tax rate, or to some of the most inefficient transport systems in the world.

[15] And anyone who has had to find a taxi in central Sydney in peak hours is surely grateful for the deregulated New Zealand taxi market.

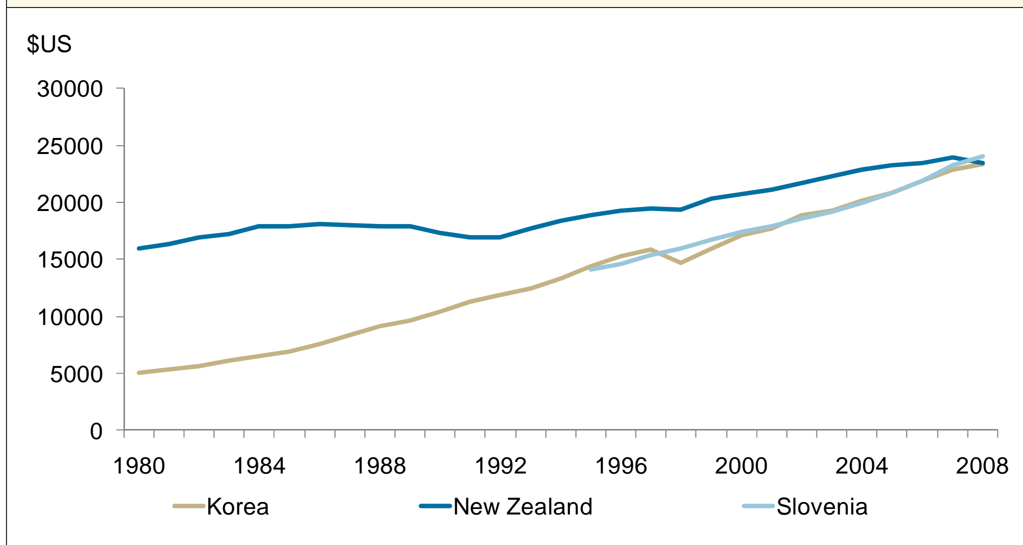
The serious deterioration in New Zealand's economic performance relative to Australia and the rest of the OECD started from the mid-late 1960s and accelerated between the mid 1970s and the early 1990s. The New Zealand reform and macroeconomic stabilization programme proved to be sufficient that the gap between our incomes and those of other developed countries has not widened materially since the early 1990s.

New Zealand's period of rapid reforms had largely come to an end by 1992. That was 17 years ago. Many of the reforms took place at least 25 years ago. Nations have rebounded from the economic effects of serious wars faster than that. With hindsight, some of the changes could no doubt have been done differently. But they were widely lauded by leading international commentators, and they delivered New Zealand a model of economic policy that was widely regarded as then being among the best in the world. Our economic policies and institutions were by then at least on a par with, and in many respects well ahead of, the structures in place in Australia at the time. It is simply not credible to suggest that any weaknesses in the way a twenty year old reform programme might have been conducted can be blamed for us failing, even now, to make any progress towards closing the income gap to Australia or the rest of the OECD.

The same can probably also be said for many of the important policy mistakes of New Zealand's past. In many important dimensions, we shut down competition in many parts of our economy in the late 1930s and, in particular, made it much harder than it should have been for new firms to develop niches in international markets. Even after World War Two, it took the following 40 years to reverse this stance and, ever so slowly, unwind the controls and re-open ourselves to the world. Capital was used very inefficiently throughout that period, and New Zealand firms failed to adapt quickly to the challenges of operating globally. Add in the effects of periods of subsidization of our largest industries in the late 1970s and early 1980s, of the rapid increase in the size of government spending, and of the sheer waste of resources associated with the Think Big period. In many respects it is a story about a country that did everything possible, for a long period of time, to hamstring its long-term growth potential and to reward rent-seeking behavior – building a business by obtaining favours from governments in one form or another – rather than private innovation and the efficient allocation of resources. The impact of longstanding producer board monopolies, in discouraging the sort of innovation that intense competition tends to give rise to, may still be having a material influence.

Most of those mistakes are decades-old now (we return later to discuss some more recent ones). Other countries have transformed their economic performance in the intervening generation: we've done no better than hold our own. Slovenia laboured under Communist rule for 40 years and only became independent in mid-1991, just as New Zealand's reform efforts were about to wane. Within the last few years it became the first former Communist country to have per capita incomes higher than those in New Zealand. Slovakia – another former Soviet bloc country, and a byword in European backwardness in the early 1990s – only began significant and extensive economic reform in 1998 and already has output per hour worked almost equal to that in New Zealand (having achieved roughly 5 percent annual per capita economic growth throughout the last decade).

Figure 10: GDP per capita: Slovenia, South Korea and New Zealand



Source: OECD, US$, constant prices, constant PPPs, reference year 2000

Skills and human capital

The size of the workforce, and the level and quality of "human capital" – the skills and aptitudes each of us acquire through work, training, education and experience – are important parts of any story of wealth accumulation and improving living standards.

It seems unlikely that deficiencies in this area can explain much about why our incomes lag so far behind those in Australia and elsewhere in the OECD. There are no direct measures of human capital, but data indicate that the share of the New Zealand population with a tertiary qualification is now among the highest in the OECD (having increased markedly in recent decades). Skill shortages were a common theme in business surveys this decade – but that is to be expected when demand is running well ahead of the economy's underlying productive capacity. It is well known that New Zealanders in employment work long hours by international standards: across the population as a whole, hours worked per head of population in New Zealand averaged 887 in 2008, higher than in either the United States (852) or Australia (864), and well above the figure for the OECD countries as a whole (805).

Investment and the physical capital stock

Most economic output requires not just human capital, but physical capital too. All else being equal – which it never is – a higher rate of investment will tend to lift GDP and average output per worker, provided that investment is primarily undertaken by private businesses pursuing opportunities in shareholders' best interests. It is not just, or even primarily, about adding more of the same machines or software. New investment is one of the key channels through which the gains from innovations that lift the overall level of (multi-factor) productivity are realised. So it is not that investment is a *cause* of growth, but that a high level of investment in a particular economy, all else equal, is a reflection of the large number of profitable opportunities firms believe can be tapped.

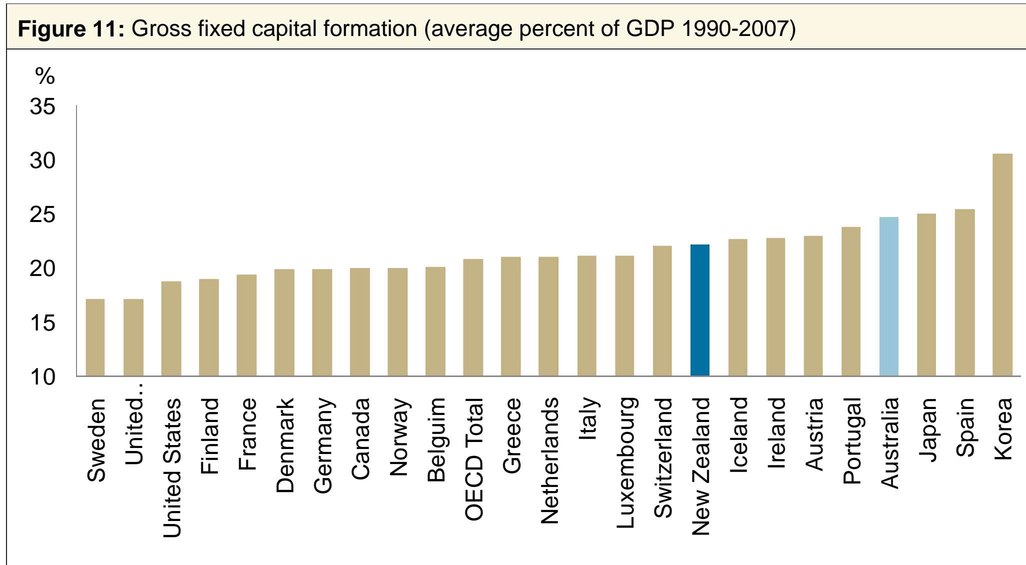
The amount of investment firms and households undertake will be influenced by a wide range of things, including:

- The (pre-tax) cost of capital
- The rate of growth of the population or the workforce
- The tax regime
- The general business regulatory environment
- The nature of the sector where profit opportunities exist
- Actual and perceived profits
- Availability of finance

Many of these factors overlap. In most circumstances, it is the combination that matters.

The best available, internationally comparable, measure of new investment is real Gross Fixed Capital Formation (GFCF), as recorded in individual countries' national accounts and reported by the OECD. Ideally, we would like to also be able to focus on changes in the stock of capital per worker. Capital stock estimates are difficult, and quite dependent on assumptions, in any country. This is a particular example of an area where data difficulties compound the problem in New Zealand.

Figure 11: Gross fixed capital formation (average percent of GDP 1990-2007)



Source: OECD

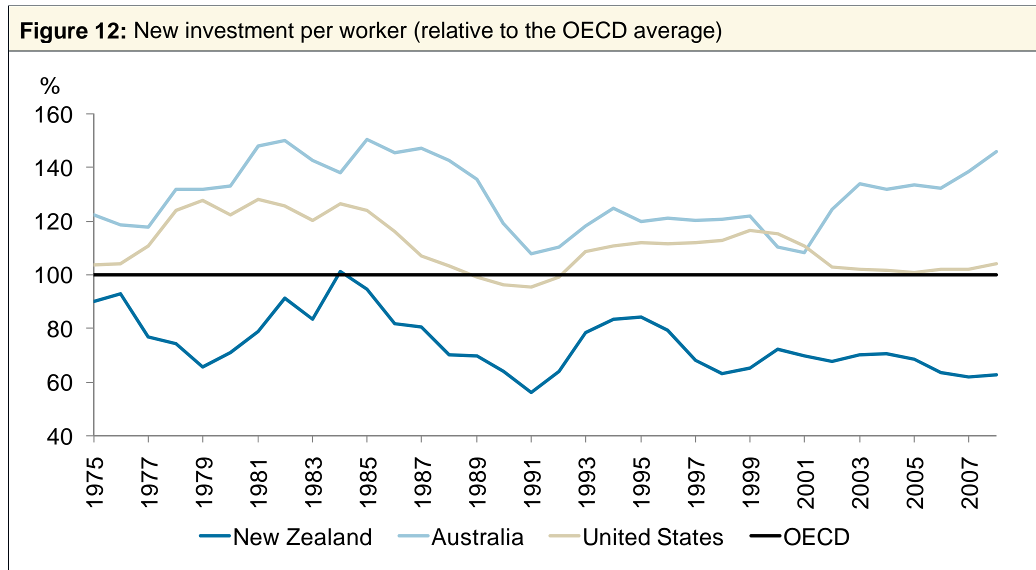
Over recent decades, New Zealand's investment (GFCF) as a share of GDP has been around that of the average longstanding[16] OECD country (since 1970, 24 percent of GDP, as compared with the OECD average of 23.7 percent). In Australia, 27 percent of a much larger GDP was invested during that period.

[16] Longstanding OECD countries in this report are the 24 countries that had joined the OECD by 1973 (mostly European, but including the United States, Canada, Japan, Australia and New Zealand). From the 1990s onwards Mexico, South Korea and a group of former Soviet-bloc countries joined the OECD.

For the period since 1990, the picture has been much the same: investment was 21.1 percent of GDP in New Zealand, 24.2 percent in Australia, and 21 percent in the average longstanding OECD country.

However, New Zealand's GDP per capita is so much less than that in the average OECD country, let alone Australia: to get the same real dollar value of investment spending per worker in New Zealand as in other countries the total share of GDP accounted for by investment would have to be materially **higher** than in other countries. In fact, the OECD calculates that over the last 15 years for every $100 of non-residential investment spending per worker in the OECD as a whole, New Zealand firms spent only $70. Firms operating in Australia, by contrast, have been spending around $120.

Figure 12: New investment per worker (relative to the OECD average)



Source: OECD

Note: Non-residential gross fixed capital formation per worker at current prices and current PPPs (OECD = 100).

Of course, the capital requirements of the industries an economy specialises in affect investment needs. Consider two high income OECD countries: Australia and the United Kingdom. The mining sector is very important in Australia, and that sector and associated infrastructure tend to be quite capital intensive. Australia devotes a relatively large share of its GDP to investment. On the other hand, the United Kingdom devotes a relatively small share of its GDP to investment, probably in part reflecting its specialisation in financial and business services, high value-added sectors which tend to require much more human capital than physical capital.

The rate at which the population and workforce are growing also influences the required rate of investment. A faster growing population will tend to require, over time, a larger flow of new houses. An economy with a growing workforce needs not only the increase in the capital stock per existing worker implied by new innovations and opportunities, but also enough capital to equip each new worker. Thus, we would expect that in an economy with a faster growing population the ratio of investment to GDP would be higher than in an equally successful economy with a static population.

Between 1990 and 2007, New Zealand's population grew by 25.9 percent, a little faster than Australia's, and faster than any longstanding OECD country other than Turkey[17].

To recapitulate, firms operating in New Zealand invest, on average, very little per worker relative to other countries. The impact is compounded by the fact that New Zealand's labour force is increasing faster than those of most OECD countries, so more additions to the capital stock are required each year just to sustain current levels of output per head. We cannot – and governments should not – attempt to anticipate which sectors New Zealand firms might develop particular strengths in. But it is hard not to conclude that for New Zealand to have matched Australian levels of income would have involved much higher investment to GDP ratios over a sustained period. In that sense, the low rate of investment per head has been a proximate cause of our economic underperformance, a reflection of the perceived lack of profitable opportunities in New Zealand. By contrast, for example, Korea and Slovakia – two poorer but very fast-growing OECD countries – have since 1990 had the highest ratios of investment to GDP of any of the OECD countries.

The important question then is why more investment projects have not been undertaken over the last 15-20 years. There is no suggestion that firms have not made rational choices, so the focus of analysis probably needs to be on opportunities. Specifically, why did firms operating here, or which might have considered operating or expanding here, either not find or not take up sufficient profitable opportunities that would have resulted in a level of investment that would have been more consistent with closing the income gap.

Entrepreneurial drive

One answer sometimes suggested is that perhaps New Zealanders lack the entrepreneurial drive of Australians, or those of other wealthy countries. This one simply does not ring true. On the one hand, Australia has no long-established tradition of enterprise that would mark its business people, scientists, and other innovators out from those of New Zealand and other OECD countries. The Australian economy was, for a considerable time, sheltered behind protective barriers almost as high as those in New Zealand[18]. Even today, Australian companies scarcely take on the world in record numbers: exports as a share of GDP are only around 21 percent, compared with around 29 percent in New Zealand (and non-commodity exports make up a substantially larger share of New Zealand's GDP than they do Australia's[19]). The rate at which new firms are founded in New Zealand appears to be quite high: we know that 60,000 new businesses are started each year[20]. And we have only to point to the success of New Zealand companies such as Rakon, Icebreaker, Xero, Buckleys, Navman, Gallaghers Tait Electronics, Fisher and Paykel Healthcare,

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[17] In the United Kingdom, by contrast, the population increased by only 7.3 percent over the 1990-2007 period. With low population growth and a concentration in the human capital intensive financial sector, the UK's ratio of investment to GDP averaged only 17.1 percent.

[18] As just one example, the Australian Wheat Board export monopoly was only ended in 2007.

[19] Over the last decade, exports of non-commodity goods and services have made up around 16 percent of New Zealand's GDP and around 9 percent of Australia's GDP.

[20] In Australia, around 335,000 businesses were started in 2006/07, a very similar rate (per capita) to that in New Zealand.

Emerald Foods, Weta Workshop, and Jade. There are not enough of those companies, and they have not yet grown large enough, but there is little to suggest that New Zealanders are not at least as willing as Australians to seize opportunities and make the most of them – in business as in yachting, rugby, medical research and other fields.

Sometimes it is also claimed that successful New Zealand business people are too willing to cash up too soon, and enjoy the fruits of success (the boat, bach, and BMW) rather than continuing to build their businesses up. We have not encountered any systematic evidence to support this claim. Everywhere in the world, some people build businesses, and then cash up to enjoy the fruits – from successful merchants or industrialists retiring from Manchester to build elegant country houses in the 19th century, to businessmen selling up to go into politics. Some will be talented creators, but not natural managers of large enterprises. Some will have owed their success as much to good fortune as to innate skill: for them, selling up and crystallizing the gains is likely to be a very prudent step. Others will simply put a higher value on other things in life than making more money. In any society – especially one New Zealand's size – there are likely to be only a relatively few highly successful highly-driven entrepreneurs.

The high cost of capital in New Zealand may be an issue here. In some cases it is easier and more rewarding to sell a successful New Zealand firm, as a whole, to overseas purchasers (who have a lower cost of capital) than to list the firm in New Zealand, with the founder retaining a substantial stake and ongoing involvement. Even if there is something to this point, it says nothing about the drive or enterprise of those who have built businesses in New Zealand.

Cost of capital

Firms borrowing in New Zealand dollars clearly face higher borrowing costs than firms borrowing in the currencies of most other OECD countries. New Zealand's real short-term and long-term interest rates have consistently averaged higher than those in the United States and Australia. Even if New Zealand firms borrowed in foreign currencies, most would prudently want to convert the exposure back to New Zealand dollars (and, hence, would in effect be paying New Zealand dollar interest rates). Borrowing costs affect investment behaviour. All else equal, for any given set of apparently profitable business opportunities the higher the real borrowing costs are the lower the rate of investment is likely to be.

The cost of equity is also affected. For a New Zealand saver considering the choice between investing in debt and equity instruments, the high (average) New Zealand interest rates are relevant to his or her calculation. For any equally risky projects in, say, New Zealand and the United Kingdom, the total return a New Zealand domestic equity investor will be looking for will be higher than a United Kingdom investor will be looking for. Other things being equal, fewer projects will obtain equity finance in New Zealand.

Largely for that reason, a high proportion of New Zealand firms that do grow are eventually purchased by foreign investors. Foreign investors tend to be willing to settle for a lower rate of return than New Zealand investors would be, and hence are willing to pay a higher price for the New Zealand business (because they face a lower cost of capital than New Zealand investors do).

The overall pre-tax cost of capital – a combination of debt and equity – is higher, and is widely considered to be higher, for New Zealand investors and firms than for those in other advanced OECD countries.

Of course, New Zealand firms and investors are not the only ones who can respond to investment opportunities in New Zealand. Foreign investment is, to a considerable extent, a substitute for domestic-owned investment. And New Zealand has a high level of inward foreign investment (relative to the size of our economy)[21], although also one of the more restrictive regulatory environments among OECD countries for foreign investment. But most of the physical capital stock is owned by New Zealanders not foreigners, and most businesses starting out are owned and developed by New Zealand entrepreneurs not foreigners.

Were foreign capital fully mobile, and foreign debt and equity investment fully substitutable for domestic debt and equity, there would be no sustained differences in real interest rates between countries. But it is well-established that there are such differences – equally creditworthy borrowers face materially lower borrowing costs, persistently through time, in the currencies of Japan, Singapore or Switzerland, than they do in the United States dollar, or in the Australian dollar. And borrowers in all those countries typically face lower costs of finance than do borrowers in New Zealand. It is, therefore, hard not to conclude that the higher overall cost of debt and equity in New Zealand is part of what has held back the rate of investment in New Zealand, all else equal.[22] Other factors may have reduced the number of profitable business opportunities (before financing costs), but some that would have been profitable at, say, US or European interest rates would simply not have taken place in New Zealand because of the cost of capital here.

[21] The OECD reports that the stock of inward foreign direct investment in New Zealand was equal to 59 percent of GDP in 2006, compared with 32 percent in Australia. Net inward foreign investment was around 48 percent of GDP in New Zealand, and 3 percent in Australia.

[22] It is sometimes argued that the high interest rates are, in some sense, imposed on us by jittery foreign creditors, who look at New Zealand's large external debt and penalise us accordingly, and hence really reflect greater risk. There is not much evidence to support this line of reasoning. Of particular importance, the gap between our interest rates and those abroad has been high for a long time, and yet New Zealanders (firms, households and farmers) have continued to increase their indebtedness as rapidly as anyone in the world throughout the entire period. The story of New Zealand doesn't appear to be one of a recalcitrant borrower penalised by its bank manager and slowly deleveraging. Rather, credit has been quite readily available, and for some reason New Zealanders have been willing to pay a premium price to continue to increase their indebtedness rapidly – and not, as per the discussion earlier, to finance unusually high investment spending.

Domestic savings

New Zealand's national savings rate – the share of each year's GDP not consumed – has averaged 17 percent since 1990. That is among the lower national savings rates in OECD countries. Australia's national savings rate has averaged 20 percent of GDP over the same period – also a little below the savings rate in the average OECD country. But there is quite a range of advanced country experiences. For example, national savings rates in the United States and the United Kingdom (averaging around 15.5 percent) have been lower than those in New Zealand. However, because US and UK incomes are so much higher than those in New Zealand the real dollars saved per person are still lower than here than in the US and the UK.

Domestic savings can matter to future New Zealand living standards in at least two ways.

The first is uncontroversial. For any given amount of investment in the New Zealand economy, a lower (than otherwise) level of savings by New Zealanders means a smaller proportion (than otherwise) of the capital stock in New Zealand is owned by New Zealanders. Savings, once invested, generate additional income for the saver. If a greater proportion of the return on capital is paid to foreigners (because they provided the capital), our future incomes (GNI) will be lower relative to the total value of production in New Zealand (GDP). But provided the level of investment in New Zealand is not affected, the wage rates firms in New Zealand can support also won't be affected.

But if a lower rate of domestic savings did adversely affect the level of investment occurring in New Zealand then both GNI and GDP would be lower – there would be less activity taking place in New Zealand. A lower rate of investment, all else equal, would lower the wage rates that firms operating domestically could pay.

There are two possible channels. One argument sometimes made for why domestic and foreign investment might not be full substitutes in practice is that distance and unfamiliarity with New Zealand mean that foreign equity capital will be less likely to find its way to profitable domestic investment opportunities. How much weight should be given to this argument? Intermediaries exist to overcome those sorts of barriers. It is no doubt true that an individual saver in California looking for equity investment opportunities is unlikely to become aware of the growing high-tech company in Christchurch that needs equity capital. But there is less reason why an investment fund responding to profitable opportunities in New Zealand (and perhaps other similar countries) should not do so fairly effectively. At the very early start-up stage, some entrepreneurs are financed primarily by the savings of family and friends, and it is less likely that foreign investment can fill all those opportunities.

Probably more important is the likely connection between national savings and domestic interest rates. All else equal, a country with a high desired savings rate, relative to the investment opportunities firms see in that country, will tend to have lower domestic interest rates[23]. The central bank of such a country will need to set interest rates lower than elsewhere to maintain price stability: Singapore, Switzerland, and Japan are good examples of such countries. And a country with low desired savings relative to the investment opportunities firms see in that country will tend to have a relatively higher interest rate structure. On the one hand, that higher interest rate structure will encourage more savings than otherwise, and on the other hand it will also deter some investment projects that would otherwise have been considered. So the important stylised fact in New Zealand is not so much that our actual savings rate is low relative to the actual investment rate. Rather it is that if the same (real) interest rate applied in New Zealand as in the average OECD country, our savings rates would be materially lower and investment rates would be higher than in the average OECD country. In such a world, low desired savings raise domestic interest rates somewhat, and so constrain domestic investment.

Again, proximate causes are different from fundamental causes.

National savings can be analysed as the sum of public saving (what the government saves) and private savings. Over most of the last 15 years, New Zealand's public savings rate was among the highest in the OECD. For the time being that has changed: the rapid expansion in government spending and the unfunded tax cuts undertaken in the last five years mean that New Zealand now faces a reasonably extended period of operating deficits.

Private saving and consumption choices are just that: private. The government is not directly responsible for those choices. However, government policies can affect those choices, consciously or inadvertently, and can influence households to save less than they otherwise would do. Government surpluses themselves can encourage the private sector to save less – they have less reason to worry about the risk of future tax increases

At least two broad classes of specific government policies are also likely to influence private savings choices, even if the government's own books are balanced:

- Welfare policies. Government-provided retirement incomes are likely to materially influence incentives for the private sector to save. Generous state assistance for tertiary education, state-funded health services, and social welfare benefits are also likely to have somewhat similar effects. The New Zealand welfare system is more generous than the systems in Australia and the United States and our universal non-contributory New Zealand Superannuation is among the most generous anywhere in the developed world.

[23] Across the advanced world as a whole, countries with low rates of national savings tend to have somewhat higher real long term government bond interest rates, all else equal.

- Tax policies. Taxing both the income earned on capital (eg interest) as well as the labour income that first generated the income that was saved is widely regarded as, in effect, double-taxing savings and hence potentially quite costly. New Zealand obtains a relatively high proportion of its tax revenue from the taxation of capital (as does Australia), and until recently had a comprehensive approach to income tax, in which all domestic income earned on savings was taxed at the individual's maximum marginal personal tax rate. That is very unusual internationally[24]. Taxation of income on capital would be expected to adversely affect both domestic investment and domestic private savings.

Australia also typically has had among the highest real interest rates among OECD countries. In Australia's case, it is plausible that desired rates of investment at any given domestic interest rate may be a significant part of what underpins the relatively high neutral level of interest rates. Over recent decades, on average, a consistently larger share of Australia's GDP has been devoted to investment than any other longstanding OECD country. That is consistent in part with the fact that Australia has had among the most rapid population growth in the OECD and with the rather capital intensive nature of the mining sector.

Monetary policy and the inflation target

Over the entire post-liberalisation period, New Zealand's real interest rates (short and long term) have averaged well above those in other OECD countries, including Australia. New Zealand interest rates affect the cost of capital (debt and equity) to New Zealand firms, and are likely to affect economic performance adversely. Various critics have suggested that something in the New Zealand monetary policy regime, or the specification of our inflation target, is to blame. We have not seen any evidence to support such a claim.

The Official Cash Rate (OCR) very directly and substantially influences short-term interest rates and also materially affects longer-term New Zealand interest rates[25]. The OCR is set and adjusted by the Reserve Bank with the aim of achieving and maintaining the inflation target agreed with the government. But it is the savings and investment preferences of New Zealand firms and households that ultimately determine where the Reserve Bank needs to set the OCR to keep inflation in line with the medium-term target.

There seem to be three possible strands to the criticism:

- It is sometimes suggested that the inflation target is out of line with international norms or with what is desirable for New Zealand. In fact, the current inflation target (1 to 3 percent annual inflation on average over the medium term) is quite conventional by international standards: a

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[24] In most other advanced countries, substantial social security taxes exist and are levied on labour income but not on capital income. In New Zealand, the social welfare system is funded from general taxation and, at a personal level, capital and labour income are taxed at the same rates.

[25] Longer-term interest move quite closely day-to-day with those in the United States and Australia. However, over time, the absolute level of, say, two-to-five year interest rates in New Zealand is mainly influenced by expectations of where New Zealand's Official Cash Rate will be set in future.

little higher than the target in the euro area, a little lower than that in Australia, and very similar to the targets in the United Kingdom and Canada.

- Even if the target itself is conventional, it is possible that the Reserve Bank might have been running policy too tightly in pursuit of the target. However, over very long periods (including when the Chairman of this Taskforce was Governor), the inflation rate has consistently averaged above the midpoint of the successive target ranges. If anything, some might think that the record suggests monetary policy has been a little too loose on average. It certainly provides no reason to think that monetary policy has been too tight, in a way that could account for the surprisingly high level of real interest rates that has prevailed in New Zealand.
- It has also been argued at times that the Reserve Bank is either excessively reactive or too slow to react. If that were so, it might, at the margin, have undermined our economic performance. The Reserve Bank has published research which suggests that it conducts monetary policy (adjusts interest rates in response to new information) in a way that is very similar to its peers in a number of other similar countries, including Australia[26]. We are not aware that anyone has contested the results of that research. The Reserve Bank of New Zealand no doubt misjudges the data from time to time. So do its peers abroad. On occasion, it acts too soon or too late. So do its peers abroad.

Any explanation of why New Zealand real interest rates have consistently been high by international standards should focus on those factors that influence the supply of and demand for credit, not on the agent (the Reserve Bank) that adjusts the lever (the OCR) to keep the two in balance. It needs to be better appreciated that the average level of real interest rates in this economy, on average over long periods of time, is *not* set by the Reserve Bank.

The Taskforce strongly endorses the current statutory framework for monetary policy and its focus on price stability. In the last decade alone, the framework has been independently reviewed by both a leading international expert (Professor Lars Svensson) commissioned by the previous Government and, more recently, by Parliament's Finance and Expenditure Committee. Both those reviews concluded that the New Zealand monetary policy framework was consistent with best international practice.

We discuss exchange rate issues, and the merits (or otherwise) of possible alternative exchange rate regimes, later in this report. To anticipate, we see no reason to think that a materially different specification of the inflation target, or any feasible supplementary tools, would be likely to make any material or systematic difference to the size of the fluctuations in the real exchange rate. This is not some statement of blind dogmatism: it reflects the experience of countries as diverse as Japan, the United States, Australia, Canada, Sweden, Norway and Korea[27]. Each of these countries does things a little differently, and they have all had very substantial variability in their real and nominal exchange rates.

[26] See, for example, the paper "How similar is monetary policy in New Zealand, Australia, and the United States?" provided as part of the Reserve Bank's submission to the 2007 inquiry into monetary policy undertaken by Parliament's Finance and Expenditure Committee . The paper is available at http://www.rbnz.govt.nz/monpol/about/3074316.html

[27] Of these countries, both Japan and Korea have at times undertaken extremely heavy exchange rate intervention.

Since the Reserve Bank of New Zealand Act was passed in 1989 there have been several changes made by successive governments to the way the inflation target has been specified. The midpoint of the target range has been increased twice, and the accountability procedures have been articulated in more flexible terms. In each case, the advocates for change appear to have argued that such change was important to help improve New Zealand's economic performance and to respond to big swings in the exchange rate. In each case, they were wrong. Each change has probably provided a little short-run relief and no long term gains, simply leaving New Zealand with the cost of a higher inflation rate. Because even firms now expect inflation will average around 2.5 percent over the medium term, we now have some additional distortions and economic costs that we would not have if the inflation rate was lower.

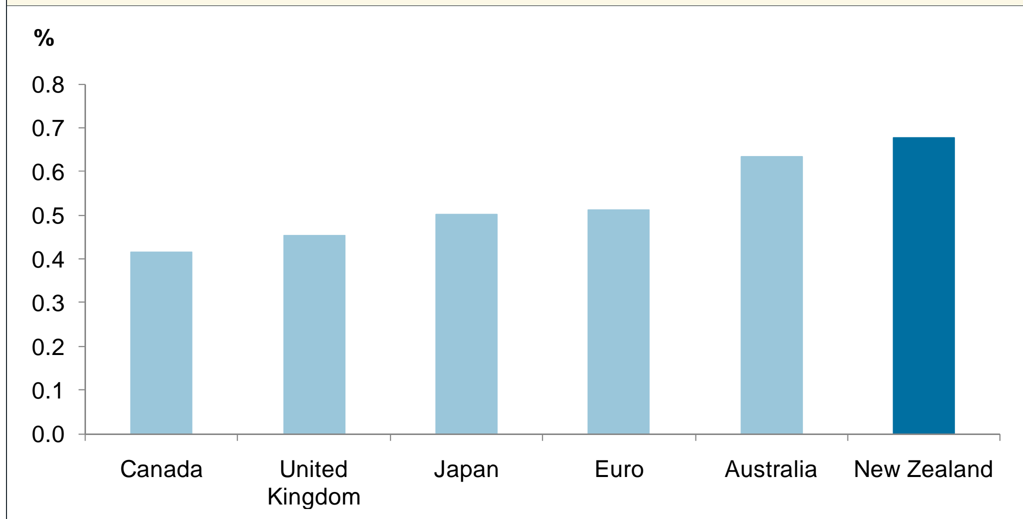
There is no evidence that changes in the inflation target have made any difference in improving economic performance. That is no surprise. Monetary policy made its contribution to improving our prospects back in the late 1980s and early 1990s when corrosive high inflation was excised from the system. New Zealand's approach to monetary policy management and inflation targeting has been widely imitated and admired abroad. Foreign observers are often surprised by the extent to which the monetary policy regime in New Zealand has repeatedly been an issue in political campaigns, in a way not seen in any other comparable country. They now do things our way in Australia, Canada, and the United Kingdom. We should take some quiet pride in that, and get on with focusing on the real issues relevant to our economic underperformance. Attacking symptoms is time and effort not spent on addressing the real problems.

Exchange rate variability and trade performance

Since 1985, New Zealand's currency has been freely traded in international markets. Our exchange rate is floating, as are the currencies of most developed countries: Norway, Sweden, Canada, Australia, the United Kingdom, Japan, South Korea, the euro area as a whole, and the United States. There are other ways of managing the exchange rate, and we discuss some of those below, but it is important to recognise that most developed countries – and the advanced commodity exporters among them – have exactly our sort of system.

Floating exchange rates tend to be quite volatile. Fluctuations in the exchange rate can usually be explained after the event, but all floating exchange rates are more variable than changes in the underlying economic fundamentals appear to warrant. That variability is both short-term (minute to minute, day to day, even month to month) and over the full course of the cycle.

Figure 13: Exchange rate volatility
(average absolute daily change against US dollar Jan 2000-Oct 2009)



Sources: Reserve Bank of New Zealand, Datastream

The short-term volatility of the New Zealand dollar is now quite high. The Australian dollar is also quite highly volatile over short terms. The Australian dollar and the New Zealand dollar move quite closely together much of the time, so short-term volatility in that currency pair (a very important one for many New Zealand exporters and importers) is very low by international standards. But against other currencies, buying insurance against the short-term volatility in both the New Zealand dollar (NZD) and the Australian dollar (AUD) is quite expensive, a little more so for the NZD than for the AUD[28].

International evidence suggests that short-term exchange rate fluctuations matter more than might be expected. When countries moved to adopt the euro, the volume of trade between those countries, particularly intra-industry trade, increased noticeably, even when individual pairs of countries had previously had exchange rates that fluctuated only very slightly. That is consistent with the evidence that much more trade takes place within countries than across international borders, even when the physical distances involved are similar.

But there is probably less disquiet about the very short-term volatility in the exchange rate than about the size of the year-to-year swings, and the amplitude of the full exchange rate cycles. Those issues have been particularly prominent this year, when our currency – and many others – has fluctuated through an enormous range, as sentiment on the world economy and attitudes to risky assets have waned and waxed. This year has been unusual, although even this year the New Zealand exchange rate has not been at either record highs or record lows.

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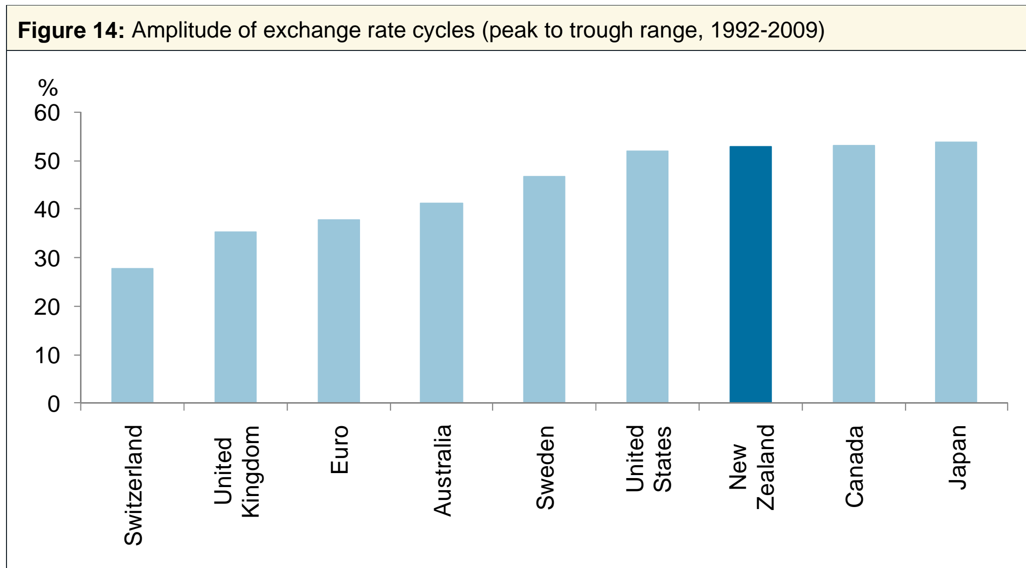
[28] Our short-term exchange rate variability was not always so high. In the 1990s, movements in the exchange rate were factored directly into the day-to-day management of monetary policy. As a result, the exchange rate was less variable over very short terms, but short-term interest rates were more volatile. There are choices about how to manage monetary conditions, but the current New Zealand model is entirely conventional internationally.

There is no unique way of measuring effective average exchange rates for countries. However, the Bank of England compiles a useful set of exchange rate indices for various developed countries, including New Zealand, calculated on a consistent basis. The graph below shows the range, from low to high, within which the (floating) currencies of various developed countries have fluctuated since 1992[29]. Over that specific period, the New Zealand dollar – at least on this measure – has been one of the more variable currencies: but even over that whole 17 year period, our trough to peak range was almost exactly the same as those for the United States, Canada, and Japan. The currencies of even the largest and most advanced economies can and do move through very large ranges.

Figure 14: Amplitude of exchange rate cycles (peak to trough range, 1992-2009)



Source: Bank of England, effective exchange rates.

The ranking of countries in this sort of comparison can change quite quickly. There have not been very many cycles in each country's exchange rate in the times since exchange rates were floated – 3 or 4 in New Zealand's case. Australia and the United Kingdom have experienced slightly smaller – but still large – exchange rate cycles than New Zealand has over that period. But there is no obvious reason to think that will be so in future. There is also no simple pattern: smaller countries don't seem to have larger cycles, and neither do commodity producers. Countries that have actively intervened in their exchange markets (Japan for example) do not seem to have had smaller cycles than those which did not.

[29] 1992 is chosen because from around then all the countries shown had floating exchange rates and reasonably low and stable inflation rates.

In such a small and short sample, specific idiosyncratic events explain a lot. For example, in New Zealand the very large increase in government spending after 2005, funded by reducing budget surpluses, will have materially exacerbated the exchange rate cycle. The additional spending, and resulting pressure on resources, prompted the Reserve Bank to raise interest rates, in turn exacerbating the upward pressure on the exchange rate, undermining the competitive position of tradables sector firms[30,31].

Do real exchange rate fluctuations matter? Intuitively it seems that they should – that the range of fluctuations is sufficiently large, and uncertain, that it must surely affect decisions to go into exporting, decisions on plant location etc, and that the uncertainty must mean that a higher than normal proportion of those decisions will prove, with hindsight, to have been wrong. Exports themselves aren't in any sense "better" than other production, but experience tends to show that fast growing countries achieve that fast growth through channels that involve faster than normal growth in exports, simply because the rest of the world is where the big pool of customers is.

In principle, there is some reason to think that exchange rate fluctuations could matter more for New Zealand than for exporters in many other advanced countries. New Zealand has few very large exporters like Air New Zealand. Its more typical exporter is an individual family farm (Fonterra is essentially just a tolling operation, passing all its net revenues back to farmer suppliers), a motel owner or an adventure tourism operator. None of these operators has much natural diversification. By contrast, Australian exports are much more heavily dominated by multi-national mining companies. Such companies, with operations (and costs) on several continents and in several currencies, have considerable in-built diversification against the impact of fluctuations in the Australian dollar.

Hedging instruments are, of course, readily available from banks for a range of terms. But hedging a relatively volatile currency is not a costless option. Either a firm pays a large upfront premium (for an option, akin to an insurance policy), or has to have the borrowing capacity and credit lines to absorb the at-times very large mark-to-market fluctuations in the value of forward foreign exchange contracts. To absorb the sorts of large fluctuations seen in currencies such as the New Zealand dollar would encourage firms to have more equity and less debt than they would otherwise need. There is a general perception that a higher proportion of equity finance raises a firm's overall cost of capital.

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[30] But it is worth highlighting that, whether or not our exchange rate was floating, these sorts of spending increases would have induced substantial pressure on the real exchange rate. In a floating system, the pressure is apparent in a rise in the nominal exchange rate. But in a fixed exchange rate system, the effects show through in high wage and price inflation, which undermines firms' international competitive position in quite as potent a manner. The experiences of Spain and Hong Kong, with firmly fixed nominal exchange rates but sustained periods of large real exchange rate overvaluations, are salutary.

[31] One recent empirical paper highlighting the link between increasing government consumption spending and the over-valuation of the real exchange rate is V. Galatsyn and P. Lane, The Composition of Government Spending and the Real Exchange rate", *Journal of Money, Credit and Banking, Vol 41, No 6, (September 2009)*

New Zealand's rate of export growth has been quite modest over quite long periods of time. But New Zealand is not unique by any means. Australia, the United States, the United Kingdom, and Canada have also all recorded only relatively modest growth in export volumes (as a share of GDP) in the decade prior to the recent recession[32].

Meaningful international comparisons are not as easy as they seem. Export statistics record the total value of the goods or services exported. Those exports often include substantial imported inputs. Cross-border trade in components for manufactured goods has grown extremely rapidly in the last 20 years as trade barriers have fallen. Both the exports of the components and then the total value of the final product show up in respective countries' official export statistics[33].

This rapid growth in trade in components is not a particularly important factor for either New Zealand or Australia. Most of our exports aren't manufactured, and using more imported components is much less easy when the distances between countries are large than it is between countries such as Belgium, France and Germany. Measures of the value-added domestically from exporting are more meaningful. In countries where trade in imported inputs has grown rapidly, value-added will have grown much less rapidly than the headline figures for gross trade. It is difficult to get good consistent reliable data through time, and this is an area where more up-to-date work would be valuable, but it is not obvious that New Zealand's value-added export performance in the last 10-15 years has been materially different from that in other developed countries[34]. But that performance hasn't been good enough to contribute to even begin to close the income gap. Exporting looks much like the rest of the New Zealand economy, and the same factors that would improve the overall business environment (discussed in the following chapters) are likely also to be what matter in terms of lifting the overall export performance.

The economics literature has had a surprising degree of difficulty in isolating the economic impact of exchange rate movements. There is a variety of reasons for that including, in particular, the fact that the exchange rate does not move in isolation from everything else that is going on in economies and financial markets, here and abroad. At one level – but not a terribly helpful one – it is clear that if a less variable exchange rate could descend from heaven, achieved without changing anything else, the overall performance of our economy (and those of other countries with quite variable exchange rates) would be improved. Later in the report we outline why we do not consider that such options are open to New Zealand policymakers.

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[32] Exports as a share of GDP in the three years prior to the current recession (2005 to 2007), compared with the same series for 1995 to 1997.

[33] Consider two firms operating respectively in France and Belgium. Initially they source all their material inputs locally and export all their output. Then, still making the same final output, each moves to source its material inputs from firms a few miles away in the other country, before exporting the finished product as before. That change in business practice will be recorded as a significant increase in the total exports of both countries, but the real economic gain (the rise in GDP) would be small.

[34] Evidence for the period to 2001 is presented in Black, M, M Vink and B White (2003) 'An evaluation of the contribution of exports to economic growth', paper presented to the New Zealand Association of Economists' Conference, June 2003.

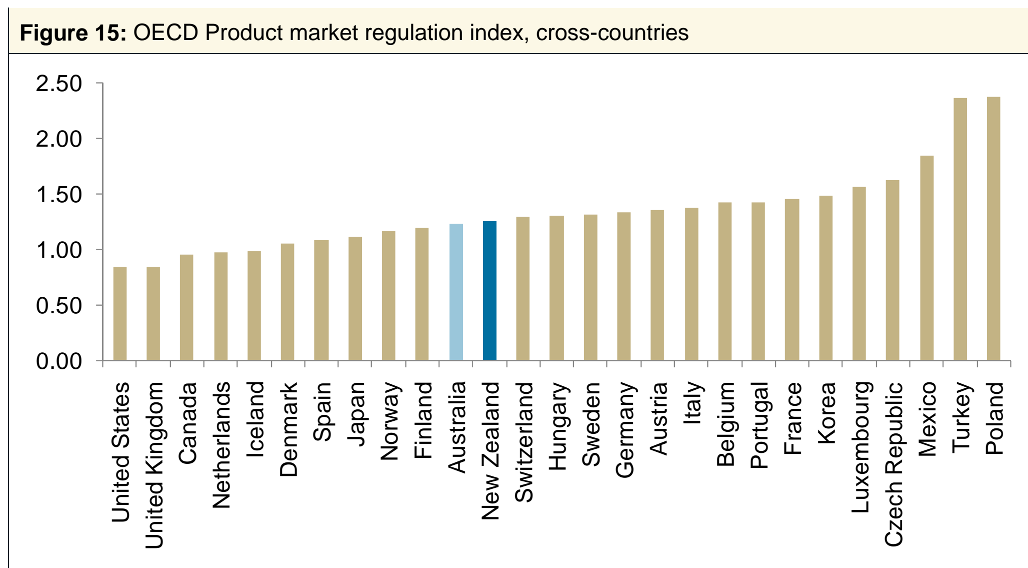
Business regulatory environment

The regulatory environment facing business will usually be a significant influence on the willingness of firms, domestic and foreign, to invest in a country. In trying to understand why the level of business investment has not been higher, and has not been at levels consistent with beginning to close the income gaps with other developed countries, the state of the regulatory environment is an obvious candidate.

New Zealand undertook extensive regulatory reform and liberalisation, of world-leading quality in many areas, in the decade or so from the early 1980s. A much higher reliance on competition and market forces, rather than government fiat, helped create, on this dimension, a favourable business environment. Deregulation encompassed labour market liberalisation, abolition of import licensing, substantial reductions in tariffs, the introduction of competition to network industry sectors, and so on. It also involved the government consciously pulling back from attempting to "pick winners" – sectors or strategies or firms.

But since the mid 1990s, there has been a real loss of reform momentum, and material steps backwards in some areas. Most other OECD countries have continued to improve. The OECD calculates detailed index measures of regulatory structures across countries. On the best known of those measures – that for product market regulation – New Zealand is now rated not much better than the middle of the pack, well behind countries with the best regulatory environments, the United States, the United Kingdom and Canada. Those three countries are very different in many respects – size of government and welfare system among those differences – but they highlight that good, empowering, regulatory environments for business can be created in all sorts of different countries. In respect of labour market regulation, New Zealand was the only OECD country to materially increase the extent of regulation of the labour market this decade.

Figure 15: OECD Product market regulation index, cross-countries



Source: OECD, Product Market Regulation Database

For a country starting out with whatever handicaps distance and size might impose, and already lagging badly in terms of the incomes its citizens are able to generate, this gap between our regulatory standards and international best practice is likely to have made a material difference.

There has been little sustained reform since the early-mid 1990s, in a period when most of the rest of the OECD has continued to liberalise markets. There were tax cuts in the mid-1990s, but then the maximum marginal tax rate was raised in 2000 adding significant complexity to the tax system and, by not adequately enforcing boundaries between different types of income, undermining its integrity. Competition was introduced for the provision of insurance for work injuries in 1999: this modest reform was then fully reversed by a new government in 2000. Gradual foreign trade liberalisation has continued, both in the form of unilateral tariff reductions and through various free trade agreements. However, the 1990s legislation that would have seen all tariffs lifted by 2006 was repealed, and more slippage has occurred this year with the decision to delay any further unilateral tariff reductions until 2015.

Successive changes to employment law and to the Holidays Act, and substantial increases in minimum wages (including shifting young people from the previous youth minimum wage onto the much higher adult minimum wage), have undermined the flexibility and effective functioning of the labour market. The passage of legislation to allow Fonterra to form, and especially to do so without proper market disciplines and transformation into a conventional company structure, will almost certainly be seen by history in the same light.

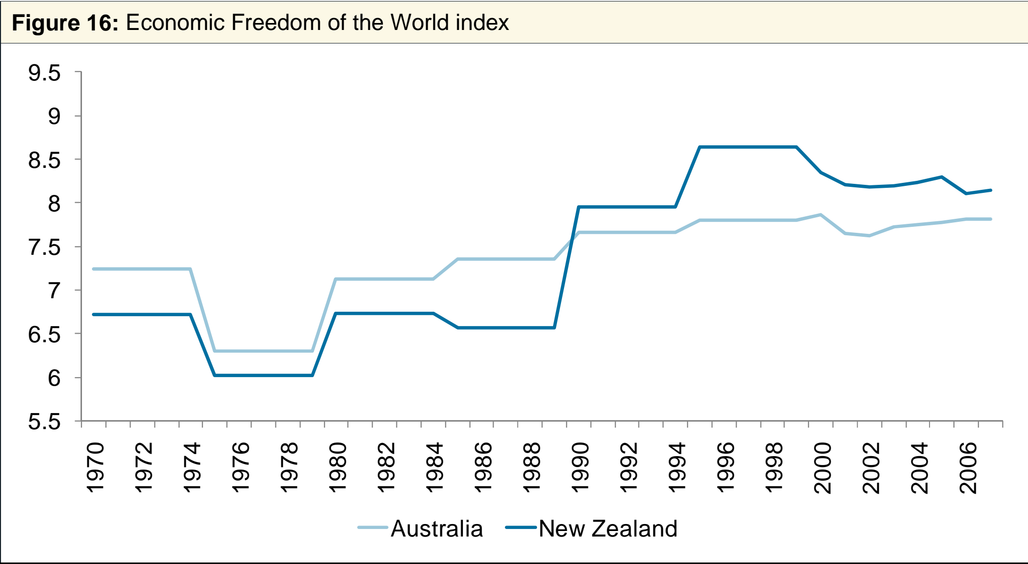
There have been no material state asset sales since 1999, and indeed the government has actually increased its overall ownership of business assets, as the dominant shareholder in Air New Zealand, founder and owner of Kiwibank, and owner of KiwiRail and the rail track. And the constraints imposed by the Resource Management Act, and the associated “smart growth” approaches increasingly favoured by those administering the Act, appear to have become increasingly binding and costly, for all sorts of investment, including the supply of new housing.

In addition, there has been an increasing number of examples of the use of incentives or subsidies to encourage behaviours considered desirable by governments. KiwiSaver subsidies, research and development tax credits, and grants, loans and tax credits for various favoured or apparently promising industries, all tend to discourage the most efficient and productive allocation of resources. At best, they appear to respond to symptoms rather than underlying policy weaknesses and constraints.

This story is consistent with the results of many surveys of international economic performance and the business environment that show slippage in our relative (and sometimes absolute) position. On many of these measures we still do at least as well as Australia. In most areas Australia has policy frameworks that are quite good, but are typically well short of world best practice.

Even in the last year the record has been mixed. To take just one example, allowing probationary periods for new employees in small firms was a modest step in the right direction. But it was difficult to see the case for a large increase in the already-high minimum wage in the middle of a recession, with substantial job losses taking place.

Figure 16: Economic Freedom of the World index



Source: Fraser Institute

In addition to increasing concerns around the application of the Resource Management Act, there have been other indications that our institutions may provide insufficient protection for the rights of private property owners. Two prominent examples in recent years include moves taken by the previous Government quite directly to prevent shareholders in the Auckland airport company selling their shares to a foreign investment fund, and moves to alter the regulatory structure in the telecommunications sector in a way that deprived shareholders of a very substantial portion of the value of their shares without compensation.

Reasonable people may differ on the appropriate regulatory structure for the telecommunications sector. The point here is not the substance of the policy choice, but that such regulatory action, especially when taken without providing compensation to affected parties for their losses, creates substantial uncertainty, and may seriously undermine the willingness of domestic and foreign savers to invest in building businesses in New Zealand. Media reports suggesting officials had recently been considering options that might force Telecom and other companies to make core infrastructure available to local fibre companies, and that the relevant Minister refused to rule out such an intervention, raise similar concerns about whether the lessons of the previous intervention have been fully absorbed. Land cannot be taken under the Public Works Act without compensation, and we think that the adverse impact of other regulatory or legislative initiatives that remove or reduce some private property right needs to be taken considerably more seriously.

We have also noted a sense that the overall regulatory environment is subject to too much uncertainty, with too much chopping and changing of policy regimes. We have heard senior business figures, including executives of companies operating around the world, commenting that in some respects the choice between proposed regulatory regimes matters less than greater stability and certainty. Our impression is that in recent years the uncertainty around telecommunications regulation, electricity regulation, water rights, emissions trading, forestry conversions and, in the dairy industry, effluent disposal cannot have helped encourage a favourable climate for business investment. Getting policy frameworks right matters, and innovation is

important in the regulatory area, but in making changes there needs to be some balance struck between the benefits from improving the policy regime on the one hand, and the benefits of certainty and predictability for firms on the other. Comprehensive cost-benefit analyses and rigorous regulatory impact assessments would help.

The Resource Management Act is a specific example of a piece of legislation that appears to have acted as a barrier to New Zealand realising its full potential, slowing both investment and productivity growth. Allowing such a wide range of objectors, and not requiring either objectors or the determining authorities to give material weight to the costs to others of the stances they are taking, comes at considerable cost to the entire economy. The long-running case in Auckland, in which one supermarket chain was able to prevent a competitor opening a new store for 17 years, should stand as a national disgrace. Recent changes to the Resource Management Act have made a start on reducing some of the costs and delays but there are material questions as to how much of an improvement those changes will make, and suggestions that in some areas the changes actually represent a step backwards.

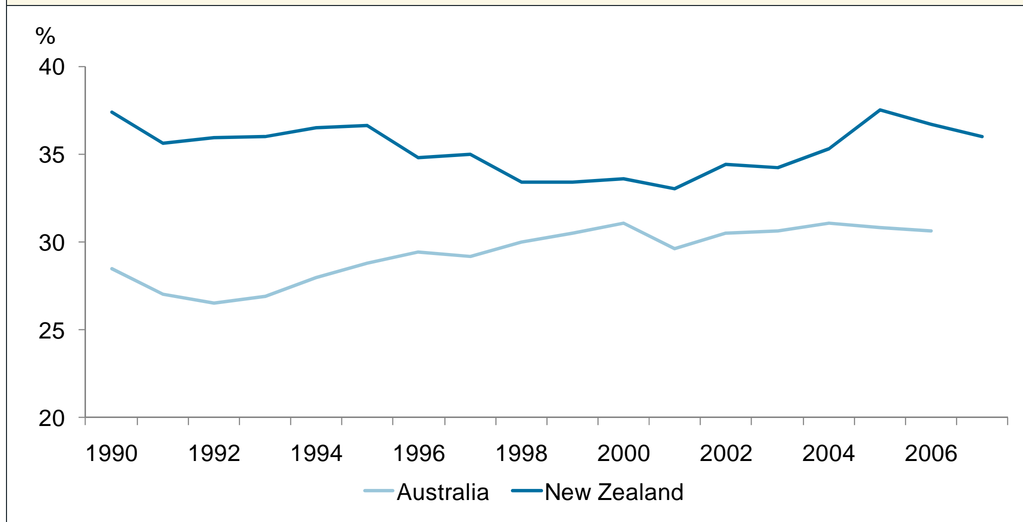
Similar issues arise with processes under which new biological organisms and plant cultivars are allowed into New Zealand, and with policy on the scope for allowing genetic modification in agriculture. These are sectors in which New Zealand seems to have, at present, its greatest comparative advantage and yet regulatory structures appear to stand in the way of innovation, and the application here of foreign innovations. It has been suggested that permission would be refused if it was proposed today to introduce to New Zealand the plant material from which the kiwifruit industry subsequently developed. If that is a fair characterisation of the constraints in place it is deeply troubling.

The size of government

The regulatory environment matters, but the size of government – the level of spending and the taxes raised to finance that spending – can also have a significant bearing on economic performance.

The share of total GDP taken in taxes in 2007 was 36 percent – exactly the same share as in 1993, although higher than in the late 1990s. The tax take, as a share of GDP, has been consistently above that in Australia in the post-liberalisation period, and the gap has been widening over this decade. The tax take has averaged much higher than the level of spending, reflected in significant government operating surpluses over many years.

Figure 17: Total tax revenue (as percent of GDP)



Source: OECD

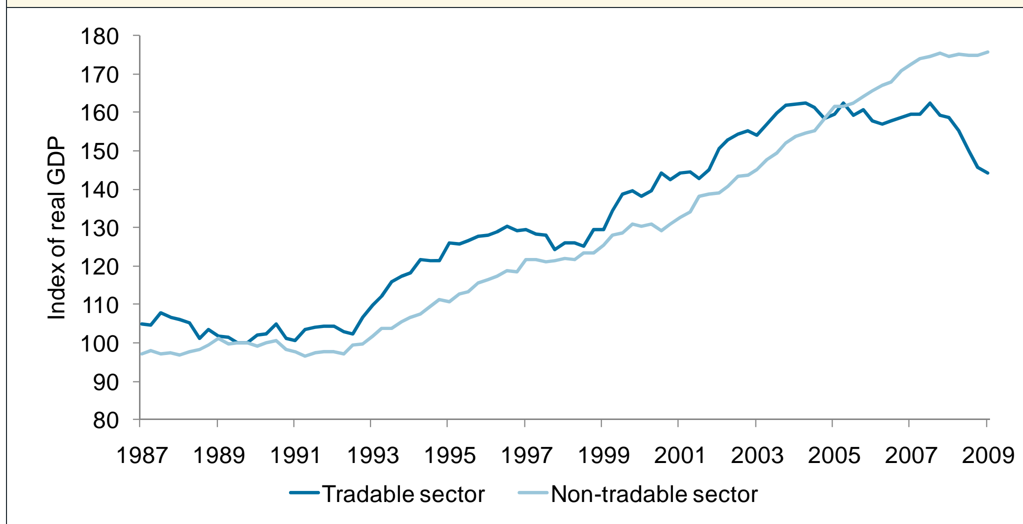
However, the surpluses were dissipated rapidly. Government spending has increased enormously in the last few years: the best measure is that core Crown operating expenses rose from around 29 percent of GDP only four to five years ago, to around 36 percent this financial year. That is equivalent to a very large share of all the additional income the economy generated during that period[35].

Transitions to a period of markedly higher government spending (when taxes are not being raised at the same time) put unusually intense pressures on the private sector – the ultimate source of sustained economic growth – during the period of the transition. As discussed earlier, such pressure show up in higher real interest and exchange rates. These effects aren't permanent, but the long run is a succession of short runs. Government spending was increased rapidly over a succession of years that contributed to a sustained period of overvaluation of the real exchange rate. Producers competing in international markets were placed under real, often unsustainable, pressure. Unsurprisingly there was little or no growth in New Zealand's tradables sector in the few years prior to the recession. That isn't in any sense the fault of the Reserve Bank, the monetary policy regime, or the exchange rate system. Instead, it is the logical and inevitable corollary of a decision by the state to spend more without anyone in the private sector wanting to spend less[36].

[35] Estimating empirically a "marginal propensity of the government to spend" is riddled with complexity, however, including around the position of the economy in the business cycle at two points in time, whether to use real or nominal measures and so on.

[36] The demand effects of tax cuts, without commensurate reductions in government spending, can have substantially similar effects on the exchange rate during the transition. Over the longer-term, once supply responses are taken into account, lowering taxes and raising spending have very different effects on growth and income prospects.

Figure 18: Tradable and non-tradable components of GDP



Source: Statistics NZ, Footnote: Index of real GDP, March 1990 quarter = 100

But there is also a much longer-term, more troubling, story too. In the early years of the twentieth century – one hundred years ago – total New Zealand government spending was less than 15 percent of GDP. And even as recently as the early-mid 1970s, New Zealand government spending was only around 25 percent of GDP.

Spending rose very substantially, up by around 15 percentage points of GDP, from the late 1970s. One of the biggest single factors contributing to this rise was the move to a very generous universal pension from age 60 in 1976.

International comparisons of government spending, and of the "size of government" more generally, are not entirely straightforward for a variety of reasons[37]. For cross-country comparative purposes, we have to work with the limited data that we do have – for OECD countries, general government outlays as a share of GDP. On a broad measure, encompassing both central and local government, government spending in the United States and Australia was around 38 percent in 1990. On the same measure at the same time, New Zealand general government spending in 1990 was just over 50 percent of GDP.

Very significant efforts were made in New Zealand to bring the growth of government spending under control: by 2002 general government outlays reached a trough of under 38 percent of GDP (at the time below the OECD average and only a little above the United States and Australia). Hard fiscal choices that had been made in the early 1990s were sustained by successive governments (in particular reaping the benefits of the gradual increase in the age of eligibility for New Zealand Superannuation). The loss of spending discipline in recent years means that the OECD now projects that general government outlays in New Zealand in 2010 will be 46 percent of GDP.

[37] Including issues around GST on government services, whether welfare benefits are taxed or not, the role of tax expenditures, and differences in "mandates" (if, for example, the government legislates that people must spend their own money on something, that has some significant similarities with the government spending itself).

Of course, it is not impossible to be a high income country and have a large share of GDP taken, and spent, by the government. To assert otherwise would simply fly in the face of the obvious facts.

But our situation isn't one of simply maintaining a high international ranking. Our focus is on identifying why we are so much poorer than other countries and how to turn that performance around. Evidence suggests that countries that increase the size of government as they decline economically will struggle to reverse the economic decline. Successful fast economic transformations – themselves relatively few in number – have multiple dimensions, but typically one part of the story is either a low or substantially shrinking size of the state[38].

The size of government spending may have mattered for economic performance in a variety of ways.

First, government spending needs to be paid for. Taxes fund the bulk of government spending. Almost all taxes reduce the rewards to effort: to work, to the accumulation of capital, to investment; all the issues touched on elsewhere in this chapter. Economists struggle to reach a clear consensus on how large each of these effects is, and which is more important, but the direction is clear. Throughout the period since the reforms of the 1980s and early 1990s, New Zealand's ratio of total general government revenue to GDP (around 43 percent) has been above that in the average OECD country (38 percent) and well above that in Australia in particular (35 percent).

Second, government spending is typically not subject to the same rigorous scrutiny that people and firms give to spending their own money. That means scarce resources are often not being used to their most productive ends. A higher share of government spending means a smaller share of all the economy's choices about how to use scarce resources are being robustly tested.

Third, some components of government spending themselves further undermine incentives, and hence the level of economic activity and aggregate incomes. Sometimes this is a matter of deliberate policy choice, but often enough it is probably an unintended, not fully appreciated, consequence. Relatively generous universal state pensions are one among many examples.

Finally, it should also be noted that the ratio of government spending to GDP in New Zealand has been one of the more variable in the OECD in the last couple of decades. The contrast with Australia is quite stark: since 1991 general government outlays in Australia have fluctuated in a range of 34 to 38 percent of GDP, while those in New Zealand have fluctuated – sharply down and then sharply back up – between 38 and 50 percent of GDP. That variability creates uncertainty about future tax rates and future income distributions. It also adds to the challenges the Reserve Bank faces in managing monetary policy.

Multi-factor productivity

In a mechanical sense, one can think of economic growth as arising through some combination of an increase in labour inputs, increases in capital inputs, and improvements in the efficiency with which those two inputs are combined. Getting the most out of the labour and capital together is

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[38] Countries such as Hong Kong and Singapore have had low government spending throughout. In other successful cases, notably Slovakia and Ireland, government spending was a large share of GDP at the start of the process but ongoing spending restraint was a part of the reform process, substantially shrinking the relative size of government spending through time.

what is known in the jargon as growth in multi-factor productivity. Multi-factor productivity (MFP) is hard to measure accurately. The measures that exist – both here and abroad – are more volatile than it is credible to suppose describes the real economy. Some of that relates to the difficulties touched on earlier in measuring the capital stock.

Over recent years, there has been an increasing tendency to focus cross-country comparative productivity analysis on performance in the sectors that are more readily measured, and where market prices enable a better calculation of the real value-added in a particular sector. Those sectors are also more responsive to changes in the regulatory and wider business environment. The performance of the state sector itself, the largest chunk of the "non-measured sector", is of vital importance to the overall well-being of the economy and the living standards our people can achieve, but it is subject, almost by definition, to a different set of influences.

Comparable data for the measured or market sectors of the New Zealand and Australian economies is available back to 1978. It is striking that over that thirty year period both labour productivity and multi-factor productivity in the measured sector grew very slightly faster in New Zealand than in Australia. Indeed, over a similar period, multi-factor productivity in New Zealand has also matched or exceeded that in the United States.

Table 1: Measured sector productivity growth

	Labour productivity growth annual average % change		Multifactor productivity growth annual average % change	
Period	New Zealand	Australia	New Zealand	Australia
1978 to 2008	2.1	2.0	1.1	1.0
1978 to 1984	1.6	1.6	0.9	0.5
1984 to 1991	2.8	2.1	0.6	1.5
1992 to 1999	2.2	3.0	1.8	2.0
1999 to 2008	1.6	2.0	0.9	0.8
since 1992	2.0	2.3	1.4	1.2

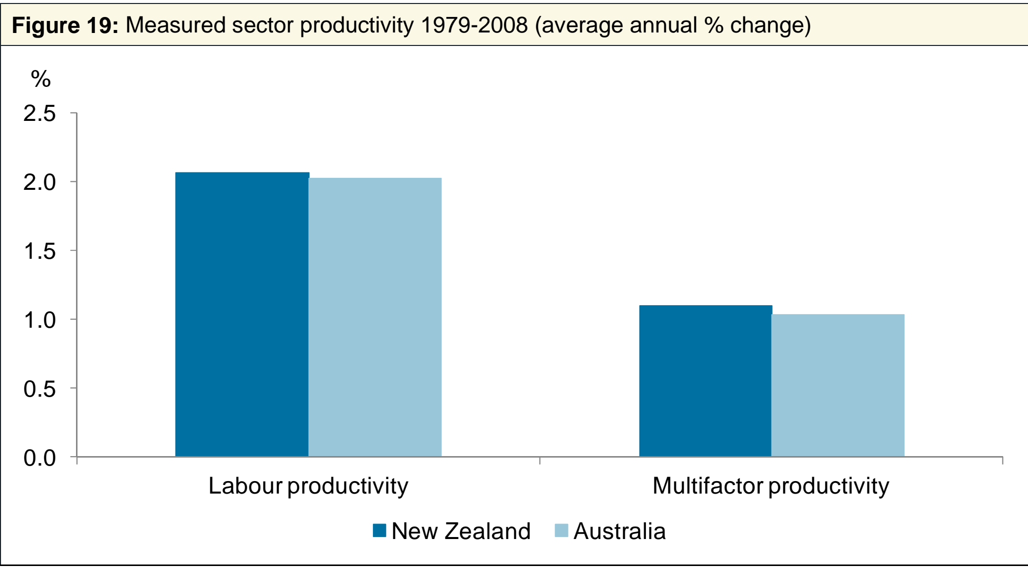
Source: Statistics NZ, Australian Bureau of Statistics

It is not surprising that over the first 20 years or so of the period, New Zealand's market sector productivity growth outstripped that of Australia: our economy had been even more heavily regulated and distorted than the Australian economy, and for a decade or so (beginning with some important steps in the early 1980s) the process of reform here was bold and far-reaching.

In both countries, growth rates for market sector MFP and labour productivity have fallen away quite markedly.[39] The fall in productivity growth rates in the two countries has been quite similar in scale, but even over the last decade, when the regulatory environment for business went somewhat backwards in New Zealand, multi-factor productivity growth in the New Zealand market sector has exceeded that in Australia.

[39] Indeed, in a recent paper Ben Dolman of the Australian Productivity Commission gathers market sector MFP data for 16 OECD countries. In the 1990s, NZ recorded the third fastest rate of growth (Australia 6th) and in this decade, NZ recorded the 8th fastest rate of growth (Australia 11th).

Figure 19: Measured sector productivity 1979-2008 (average annual % change)



Sources: Statistics New Zealand, Australian Bureau of Statistics.

There are reasons, unrelated to the economic policy framework, why MFP growth rates might have been expected to fall this decade. In both countries, investment as a share of GDP was above average – though more so in Australia than New Zealand. It takes time to realise the productivity gains from new investment (some projects themselves take years to put in place). In Australia, the severe and long-running drought also reduced the volume of output for any given amount of capital and labour input. In both countries, by the end of the period the unemployment rate was unusually low – but more so, and for longer, in New Zealand. An extremely low unemployment rate is a good thing, but it is natural that the last one percent of workers will tend to add less additional output than the first one percent of new workers (so MFP growth might reasonably have been expected to grow a bit more slowly than when, in the 1990s, in both countries the unemployment rate was falling from almost 11 percent).

Looking ahead, Australia may over the next few years reap more fully the MFP gains from the large investment in its mining sector in recent years. And it looks as though New Zealand has now resumed a process of regulatory liberalisation suggesting that the business climate could be more growth-friendly here than it has been in the last decade.

It seems clear that the regulatory position has worsened in New Zealand in recent years. Nonetheless, it is not obvious that New Zealand firms that do invest have been any less able to innovate and adapt than firms in other countries, including the United States. The constraint seems to relate to how many projects firms are willing to invest in, rather than their ability to use labour and capital well together in the projects that do go ahead. That is encouraging, of course, but the trends are still consistent with the overall income gap not getting any wider, rather than suggesting that any narrowing is likely.

Measuring productivity in the rest of the economy – the public sector – is a significant challenge in all countries. As far as we can tell, it is not being done overly well at present, either by statistical agencies, or by The Treasury. For much of central government, output in the national accounts is

measured simply on the basis of inputs – eg staff numbers (so no labour productivity growth or multi-factor productivity exists, by the statistical agency's definition). Different countries handle these measurement challenges in different ways – and those differences complicate cross-country comparisons.

The limited data tend to suggest that productivity performance in the New Zealand public sector – itself a larger share of the economy than the comparable sector in Australia – has been relatively poor, despite the far-reaching public sector reforms implemented from the late 1980s. An international study done in 2003[40] compared public sector efficiency across the longstanding OECD countries, and on that measure (which focused on the outcomes taxpayers should expect from public spending) New Zealand did not perform well. It is difficult to reach strong conclusions about public sector productivity, but the questions are real and important, given the large share of the economy's real resources directly managed by the public sector. They are much more profound than just cutting costs at the margin on existing government operations.

This whole area is one of those where it appears that more resources need to be made available to ensure that Statistics New Zealand is able to produce a full range of excellent, internationally consistent, data that would enable this Taskforce and other commentators and researchers to better understand New Zealand's economic performance.

[40] Afonso,A., L Schuknecht, and V Tanzi, *Public Sector Efficiency: An International Comparison*, European Central Bank Working Paper 242, July 2003.

Part II – Towards 2025

The Taskforce's story

For many decades, New Zealand had among the highest living standards in the developed world. Starting in the mid-late 1960s, the position deteriorated markedly. The extent of our decline is very marked by any standards.

The previous lengthy chapter discussed various factors that may help illuminate the landscape. In this, considerably briefer, chapter, we attempt to distill the analysis and present our view of what really matters and why, before turning to specific policy options. Understanding fully our decline will no doubt keep scholars occupied for decades. As policy advisers, we face the challenge of helping to do something now about reversing the decline. The data are too weak to test many of the propositions implicit in our story as fully as we would like. But we offer this interpretation with the benefit of our long cumulative experience and the insights garnered from both the numerous submissions and our own discussions. As policy advisers, our bias tends towards emphasising things that hold New Zealand back now, but this perspective is informed by our interpretation of the historical experience.

We hope we have dispelled some of the explanations others have advanced. We don't believe New Zealand's small size explains very much. Nor, taken over the long view, does the Australian mining industry. Nor does the pattern of ownership of the housing stock. The monetary policy regime is entirely conventional internationally. And, if the exchange rate variability can't have been helping, the exchange rate is not obviously more volatile than those in various other developed countries. Distance from world markets is likely to matter, but we can't do anything about it, and it should not be an insuperable obstacle – as Australia continues to show. Given the opportunity, New Zealand firms and entrepreneurs will take on world's markets with as much drive and commitment as businesses anywhere else in the world.

External assistance sometimes helps lift economic performance. For the smaller European countries that have transformed their economies in recent decades, access to the full EU market – and some fiscal transfers from Brussels – must have helped. But countries don't get wealthy and stay wealthy based on windfalls (which often end up doing at least as much harm as good), but through the relentless efforts of their own people. New Zealand simply has not consistently made the effort.

Going back decades, and at times still today, we have constrained the ability of private capital to find and develop the business opportunities that provide the basis for sustained wealth. For example, we've pursued the chimera of market power in commodity export markets at the expense of discouraging the innovation and discovery of fresh opportunities that competition tends to bring. Of course, market access issues have been an important constraint at times, but governments have too often aided and abetted a "but this one is different" approach, departing from the tried and tested lesson of the power of competitive markets. We made small size more of a constraint than it needed to be discouraging foreign trade and investment. It is extraordinary that a country so

dependent on foreign capital, and likely to need much more of it if it is to have a chance of catching Australia, still has one of the less liberal regulatory environments in the OECD for foreign direct investment. And we are still locking up some of our biggest businesses in state ownership, where the full potential of those businesses is most unlikely to be realised. What that potential is we don't know, but markets and the disciplines they bring are best placed to find out.

New Zealand's long and ongoing history of providing government assistance (tax favours, regulatory favours, and direct investment) to particular firms and sectors or to particular types of activities is too little appreciated. From producer board monopolies to a steel mill, from state-sponsored energy projects to forestry tax breaks, from export incentives to irrigation schemes, from film-making subsidies to repurchasing a rail network and an airline, to the questionable case for state commercial involvement in ultra-fast broadband the pattern is a fairly relentless one. Many of those interventions look disastrous and hard to understand with hindsight: all would have had eloquent champions in their day.

Far too much effort, over too many decades, has been spent sorting out and devising new clever initiatives, at best responding to the symptoms rather than to the underlying weaknesses in New Zealand's policy framework. KiwiSaver is perhaps one relatively recent example. In a successfully transformed New Zealand we'd almost certainly expect to see more private savings taking place. But if the energy and resource that has gone into devising and administering KiwiSaver had been put instead into using budget surpluses to cut taxes, and to making the case for overdue change in our overly generous pension system, the long-term results would almost certainly be superior to what we have now.

Too often we seem to have been incapable of recognising, or unwilling to recognise, the implications of choices we are making. In the period since our economic decline really set in, the government often has responded in ways that have actually weakened important incentives. Government spending is much larger (relative to the size of the economy) than it was when we were much further up the international league tables – and is well above Australia's. Maximum tax rates are lower than they were, although earlier avoidance opportunities mean the improvements in incentives are often less than they seem. The greater reliance on consumption taxes to finance government spending was a step in the right direction, but overall taxes, including those on savings, still remain materially higher than those in Australia.

And as we've become relatively poorer, we developed a welfare system that has allowed a much larger proportion of the working age population to opt out of the labour market, fully supported by the state. That comes at a huge cost, both fiscal and in terms of wasted skills and talents. Even when the issues became evident, there has been little effort to address them. We've hugely increased subsidies to tertiary education, even though the private returns to a good education have never been better. And we've provided a very generous universal pension – still among the most generous in the advanced world – that leave many people, behaving quite rationally, with little incentive to save or to think of providing for themselves.

Of course, the New Zealand economy has certainly become much more open and competitive, internationally and domestically, in the last few decades. That has been a significant step forward

and an important part of what has enabled us to largely stop our relative decline. Policymaking during the relatively brief period of serious reform was mostly of an exceptionally high standard, and was clearly focused on moving New Zealand more towards an environment where lower income taxes, better quality regulation, and better utilisation of the government's assets, positioned us to allow business to flourish.

But that period of reform, relentless as it may have felt at the time, was nonetheless quite short-lived. It was the exception when it needed to become more like the norm, if decades of underperformance were to be turned round. The earlier reforms simply weren't sufficient to make any inroads on the gap itself.

As most other countries have moved ahead, we've slipped backwards and we find ourselves now with a middling sort of policy environment. Perhaps that policy environment might be fit enough for purpose if we were a wealthy country content to more or less maintain our international ranking. But we are not. There is a variety of countries that languish near the bottom of the OECD league tables (for longstanding members). It isn't clear that any of them are making much progress towards improving their position, and nor is it clear that our overall policy environment is much better than theirs – certainly not by enough to overcome any disadvantages of distance. The benchmark for reversing an historically significant decline has to be excellence: we haven't been there in recent years and are not there today.

For a country so far off the pace, the substantial backward steps of the last decade are particularly difficult to justify. The last decade was, for the most part, a pretty good time in the world economy – relatively rapid growth and low unemployment. But at no time in the last decade were we making any progress towards closing the gaps. But instead of responding to that, and to the continued large net outflows of New Zealanders, the time has been lost and the improvement in the budgetary position has been frittered away on a succession of initiatives for which little robust economic case was made. We distracted ourselves with increased focus on fashionable causes and issues such "sustainability", all defined with too little reference to market prices or the values individuals actually put on these choices.

Marginal tax rates have been raised for many. We have re-imposed constraints on the flexibility of the operation of labour markets. We've continued to try to back "national champions". And we've been slow to recognise and respond to some of the increasingly costly, almost indefensible, outcomes that measures such as the Resource Management Act have delivered, as local governments pursued their own particular visions of appropriate or sustainable or "smart" growth. We have continue to impinge on property rights – including the ability to build houses – in ways that limit the ability of New Zealand, businesses and families, to realise its potential. More recently, we've spent the last half-decade again rapidly increasing the size of the state, undermining incentives to work and reinforcing a sense of entitlement in too many parts of the community. The current announced government fiscal strategy has for some reason essentially ratified the increase in the size of government, with a 2009 Budget that involved no specific plans for any material reversal of the increase.

If we are remotely serious about matching Australia by 2025, “good enough” just won’t do, especially when there seems to be a constant tendency to reverse or unwind liberalisations already put in place. A few modest liberalisations on the one hand, and sectoral initiatives that risk distorting the efficient allocation of resources on the other, aren’t going to be remotely enough. We have seen too much of that again in the last decade. The evidence is quite clear that countries that get their policies and institutions right are likely to become successful again. Whatever made us as relatively poor as we are, international experience is pretty clear on what would take us back up the rankings again.

We seem to have allowed a culture to develop that too often rewarded lobbying efforts or the latest ingenious paper demonstrating a possible theoretical case for greater involvement in some area or other of the economy. A flourishing economy would have required a good business and regulatory environment that was oriented towards growth and competition.

Looking forward, we need to dampen the rewards to looking to Wellington for intervention and assistance, and strengthen the appetite to look outwards for ideas, market and opportunities. Governments need to focus on doing government excellently, not playing at business. Governments have a vital role in our economic success, but that role is not attempting to apply some superior wisdom – that goes beyond human capabilities – to identifying especially promising sectors or industries, or using taxpayers’ money to back those views. The incentives, the discipline, and the information are just not there for governments to reasonably expect to make a success of business.

Heeding today the siren songs of those sponsoring sectoral growth strategies will be a recipe for continuing to undermine our prospects. At best, these sorts of projects or incentives provide a distraction from the really big issues that have to be addressed if this economy’s fortunes are to be restored.

Standing back from all the details, it is no real surprise to the Taskforce that New Zealand is not doing better. We have an environment where the incentives to invest are modest, perhaps largely because the obstacles to doing so are often real. Obstacles take various forms – some are regulatory, some are about tax, and some are about the high cost of capital, in turn influenced by longstanding tax and policy choices.

But there is no reason why we can’t do much better: match Australian living standards by 2025, and perhaps exceed them from there. It can be done, but not easily. Closing the income gap with Australia, starting now, means that New Zealand needs a per capita GDP growth rate that averages 1.8 percentage points faster than Australia’s each and every year until 2025. Each year that serious reform is delayed just increases the size of the challenge. Exceeding Australia’s per capita growth by 1.8 percent per annum is the sort of sustained performance achieved by only a very small number of developed countries. But they include countries like Korea – with incomes now a little higher than New Zealand’s for the first time – and Slovakia that have been growing that fast in the last decade.

Getting the sustained growth rate that will enable us to catch Australian incomes means creating an environment in which individuals and business find rewarding opportunities that spark more investment (in human capital as well as business capital), that draw able-bodied people from

welfare into work, and that allows and encourages firms to find ways to use that labour and capital ever more efficiently. Young New Zealanders will want to stay, and many who've left will be making their way home again.

A successful long-term reform programme needs to put a much greater emphasis on competitive markets, where individuals and firms can interact and transact to mutual benefit. Competitive markets are critical in the mainstream business sector, but they also have a vital role to play in getting better outcomes more efficiently in key sectors such as health and education. What markets do best is to encourage innovation, reward success and weed out failures. By doing that, markets help to ensure the best possible use of scarce resources: translated, that means we get the most out of what we have, both now and in the future. That is what New Zealand needs. Markets help channel people's ideas and their aspirations to better themselves in ways that the best-intentioned governments never can themselves. Over time they generate much higher living standards, and greater choice, for the community as a whole.

Policy options and recommendations

The 2025 goal is an extremely challenging one. Achieving it is likely to require that New Zealand adopts policies that are much closer to, or perhaps even beyond, the current best in the world, across a wide range of fronts.

The focus of the rest of this report is on the steps that we recommend the Government should take. The recommendations draw on the perspectives outlined in the previous section, that set out our story. They are shaped within a framework that emphasises three things:

- Sharpening private incentives to invest, to save, and to work.
- Minimising the regulatory obstacles the government puts in the way.
- Managing the public sector's own huge assets much more effectively.

Another way of putting it is that government needs to do well the things that only government can do. And private competitive markets need to be given the scope to do well what they do best.

Before we outline our policy and institutional reform recommendations, we explain why we rejected some of the policy options urged on us by submitters.

Policies we recommend should not be adopted

Greater research and development support

Many submitters argued that substantial increases in government financial support for research and development should be an important component in any successful strategy to close the income gap. Those who argue along these lines tend to highlight the relatively low share of GDP spent on research and development (R&D) in New Zealand – on the most recent data, only 7 of the 30 OECD countries had a lower share of spending on R&D than New Zealand. It is often noted that our R&D spending is, as a share of GDP, 23rd in the OECD, and that our GDP per head is 22nd in the OECD. The suggestion is that low R&D spending has, in some sense, caused the continuing economic underperformance.

But on many dimensions the picture is not that clear cut. All but one of the countries where more is spent on R&D than in New Zealand has higher GDP per capita than New Zealand. But is high ongoing spending on R&D resulting in higher incomes or is it the other way round? If we look at economic growth in the ten years prior to the recent recession, of the 10 countries spending more on R&D than the OECD average, only four had faster GDP per capita growth than New Zealand. Six countries spent less on R&D and most grew more rapidly than New Zealand. The countries spending less on R&D mostly have lower incomes than we do – they too no doubt are aspiring to improve their overall economic performance, closing their gaps to the rest of the OECD. It is at least possible that higher spending on R&D is a reflection of an economy's success, and part of the process of maintaining the capabilities within firms that helped make their homelands successful high income countries, rather than being a direct cause of that success. A company like Nokia needs to spend heavily on research and product development to maintain its position in a constantly changing market.

It is also well-recognised that, as a share of GDP, New Zealand government spending on R&D (through universities, Crown Research Institutes and other mechanisms) is not obviously anomalous – indeed, it is higher as a share of GDP than in a number of countries with materially higher incomes (including the United States, the United Kingdom, and Canada).

To the extent that there is a gap to be better understood, it relates to private sector R&D spending, which is materially lower (as a share of GDP) than in most OECD countries. Some research work suggests that New Zealand's rate of research and development spending is not unexpected given the current industry structure of the economy[41]. But, of course, that may be to beg the question: the point of the 2025 goal is that we want the New Zealand economy to look different than it does now, not just to explain why it is how it is today.

The private sector can be expected to invest – and invest heavily – in R&D when it expects there to be a large pay-off, and where the firms doing the investment can capture many or most of the gains. Intellectual property laws are an important component of ensuring that people thinking of doing research can secure enough of the gains to make such spending worthwhile. Many New Zealand firms invest heavily in research and development to develop and expand their product range.

For firms, research and development spending is one component of the overall process of innovation that enables firms to adapt and grow, staying a step or more ahead of competitors from around the world. But it is only one component – and even in-house or contracted research is only one way of positioning a firm at the leading edge of technology. Licensing arrangements, joint ventures with foreign investors, and foreign direct investment itself are also ways of enabling New Zealand to benefit from technological advances. As just one example, most banks here are Australian-owned, but whether their formal research and development spending is physically done in Australia on the one hand or New Zealand on the other doesn't affect the ability of New Zealand

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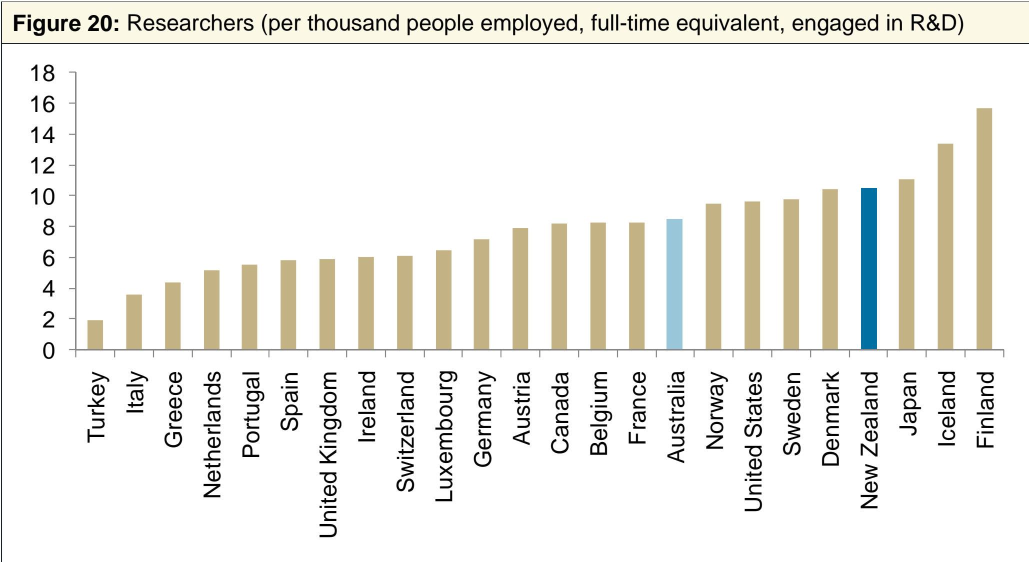
[41] Ron Crawford, Richard Fabling, Arthur Grimes, "National R&D and Patenting: Is New Zealand an outlier?" *New Zealand Economic Papers*, Vol 41(1) June 2007, pp 69-90.

firms and businesses to benefit from the product innovations and technological advances the Australian bank operations here introduce as a result of the parent banks' R&D spending[42].

In understanding the research and development situation in New Zealand, it is also worth considering some data compiled by the OECD on the number of researchers doing R&D. On those figures, New Zealand has the fourth largest proportion of the workforce doing R&D (in fulltime equivalent terms) of any of the 30 OECD countries. How these figures are reconciled with the spending figures is not entirely clear, although one possibility is that our researchers may have relatively little capital to work with by comparison with researchers in other richer countries. It certainly doesn't suggest the lack of a skill base or a lack of willingness to do remunerative research.

Figure 20: Researchers (per thousand people employed, full-time equivalent, engaged in R&D)



Source: OECD

The Taskforce recognises that there is an important role for government in funding some components of scientific research, in particular the so-called "basic research" that does not necessarily lead directly to patentable or marketable products. In those areas, it may not be possible for private investors to capture a sufficient proportion of any gains. The government sector, broadly defined, owns a large proportion of the assets in New Zealand and provides directly a lot of the services. One would expect the owners to be doing, or paying for, the research and development spending required in support of those state-owned or provided activities. But without market disciplines it is an open question whether the right incentives are in place to encourage them to do so adequately.

[42] In some senses, therefore, our low level of national savings, which results in a large proportion of companies operating in New Zealand being foreign-owned (and few offshore firms owned by New Zealanders), may, at the margin, contribute to lower R&D spending taking place in New Zealand. A typical firm is probably more likely to have their principal research and development operations located near head office than associated with a small foreign branch or subsidiary. But R&D spending undertaken for the group as a whole is likely to benefit New Zealand operations too.

There may also be a limited number of areas where additional research spending would benefit a wide variety of parties, but where it might be either extremely difficult to coordinate all the potential beneficiaries, or to limit the use of any resulting research advances primarily to those who have contributed to the cost. Without some government facilitation and/or funding, an inappropriately low level of spending would be likely. To some extent these cases are provided for in the Commodity Levies Act, which enables participants in a single industry to agree on an industry levy (ie not involving government funding) to fund generic research and development spending. In a New Zealand context, bee research (potentially benefiting all agricultural, horticultural and viticultural producers) might be a rare example of something that is best funded from central government.

Whatever research and development spending the government does or funds needs to be managed extremely well. Resources are scarce, and the research capabilities of New Zealand universities and CRIs, for example, are extremely valuable assets. It is important that they are managed, and harnessed, to generate best long-run value for the economy as a whole. We note that the Government has appointed a taskforce to review the Crown Research Institute model and we look forward to the insights that will no doubt be contained in their report.

The Taskforce is not convinced that there is a compelling case for more government spending on research and development, through whatever means. We regard as unproven the case for the sort of joint government and private sector funding recently announced for research and development in the kiwifruit industry. It is not clear to us that a compelling analysis has been undertaken identifying why private sector growers and marketers should not bear the full cost of the research themselves, through established administrative or innovative new market-based coordination mechanisms. The appropriate test is not whether the private sector parties doing the spending would capture all the benefits of research – lots of innovations and inventions paid for by one firm spark competitors to do something similar, reducing the potential benefits to the initial innovator. We still benefit today from the invention of the telephone: the initial patent having long expired, the descendants of Alexander Graham Bell do not.

More generally, we would not favour the re-establishment of a research and development tax credit[43]. The priority for economic reform should be on improving the overall climate for wealth creation. When people or firms find that the barriers in the way of innovation have lessened and the rewards from taking risk have improved, they are more likely to invest in building businesses, and all that goes with that. A better regulatory environment, materially lower marginal tax rates and a lower cost of capital are much more likely to lift overall economic performance and, probably, private sector research and development spending too, than targeted tax credits or similar spending. In a transformed economy in which more profitable opportunities exist, we would expect to see high rates of investment spending and higher rates of research and development spending.

[43] Indeed, a case could be made that the accounting and tax treatment of research and development spending, which allows most such spending to be expensed in full immediately, is already rather concessional in economic terms.

But we get both in the best and most efficient way by creating the right overall climate for business, not by targeted subsidies and specific incentives.

A new government financial institution

Some have argued that there are gaps in the market for finance, constraining growth and development, and that smart government institutions and initiatives could usefully help fill those gaps. We are sceptical.

The best single contribution governments can make to ensure the ready, and efficiently priced, availability of debt and equity finance is to look after the rules of the game. Clear enforceable and transferable property rights, money that holds its value, and a banking system where it is clear that the risks will be borne by the owners of the banks and their creditors, not by the Crown, are the key components of what governments can and should do. Taking direct debt or equity exposure to chosen companies and sectors has little to commend it in almost all circumstances.

Some have argued for the creation of a "new DFC", or an expanded mandate for Kiwibank, or for an expanded scale of funding for the Venture Investment Fund. Some have also argued for guarantees for small business funding. Our overall approach to these options is as follows:

- The overall level of indebtedness of firms, farms, and households suggests considerable reason for scepticism that there are material unwarranted barriers to access to credit.
- On most occasions, when borrowers are unable to secure credit it is because potential lenders do not regard them as creditworthy. In normal circumstances, governments have no reason to second guess those judgements.
- A higher rate of private sector savings could be expected, at the margin, to increase the range of domestic finance options, including deepening domestic capital markets.
- The risks associated with government interventions in this area are large, as repeated international evidence demonstrates.
- If any government venture was to be undertaken, it should be structured to rely heavily on risk-sharing with private sector participants, in which the private sector participants have strong incentives to ensure adequate risk assessment. The Venture Investment Fund appears well-structured in this regard.

Sectoral-based growth strategies

Some have made the case for the Government to focus its efforts on particular sectors, and to use the instruments at its disposable to accelerate growth in the preferred sector(s). The argument usually runs that there is some intrinsic link between high performance in one or more particular sectors and overall success in meeting the economic growth goals.

The Taskforce does not favour such an approach and believes that a particularly rigorous approach needs to be taken to evaluating claims for specific sectoral interventions. Participants in particular industries typically have a very strong belief in the importance and merits of their own industries or activities. That is probably human nature: all of us are prone to it. But participants can also have powerful incentives to, consciously or otherwise, overstate the benefits and understate the risks and

costs of the interventions they promote. And participants know their own industries better than government officials do. Robust and transparent evaluation procedures to assesss any proposed interventions or initiatives of particular importance need to explicitly account for limitations of knowledge. That principle also applies to the design of sector-specific regulations where, for whatever reason, that may be required.

As we have noted earlier, it is not as if proposals to back particular sectors are new, either in New Zealand or abroad. And it is not that all such initiatives have been failures, or would be in the future. But most have been. Government officials and Ministers of the Crown have neither the knowledge nor the incentives nor the external disciplines to make it likely that the typical sectoral intervention will prove successful.

The Taskforce is conscious that there is already a substantial amount of industry-specific assistance provided through various means: from direct appropriations, to less visible tax expenditure provisions favouring particular sectors. Such measures do, of course, tend to boost activity in the assisted sector. That is visible. But it isn't the relevant measure. The longer-term economic costs and distortions are much less visible and almost always larger: resulting from the misallocation of scarce resources which damages prospects in the rest of the economy. Sector-specific support should not be extended further.

Over the decades, every few years particular industries move into favour, and acquire champions encouraging government support for the sector. Some of the many examples are:

- home-grown manufacturing in the late 1930s
- producer board monopolies
- state-sponsored pulp and paper production in the 1950s
- steel manufacturing in the 1960s to take advantage of abundant ironsands
- energy projects in the late 1970s
- farming subsidies in the early 1980s
- forestry tax concessions in the 1990s
- super-yacht building and film-making in the 2000s.

History suggests that very few, if any, of these activities were prudent uses of taxpayer money or state regulatory powers.

Today, other sectors or industries attract particular champions. “Green” industries are just one example. There appear to be a wide range of exciting prospects around many of these technologies, and we would expect private investors to be eager to take up the opportunities that offer genuinely commercial, risk-adjusted, returns.

More generally, it is not clear what would lead the public to think that the current generation of officials and Ministers – capable and well-intentioned as they no doubt are – are any more likely to identify successfully industries and sectors warranting support than their predecessors were.

Government entities are simply not, and never can be, subject to the appropriate disciplines to get those judgements right[44]. At best, sectoral specific support is a distraction from the important issues and policy reform opportunities that could give New Zealand a real chance to catch Australia by 2025.

Initiatives to lift workplace productivity

Several submitters rightly noted that one of the key issues for the 2025 Taskforce is productivity, and highlighted the scope to improve productivity in each and every workplace. They went on to suggest that the government take specific steps to back these sorts of initiatives.

Of course, the New Zealand public sector is, itself, a very large employer, and we would expect public sector managers should face appropriate incentives to seek out best practice tools to manage their own operations and staff resources. We would expect that both private and public sector operations will constantly seek to identify better and smarter ways to work, lifting productivity. Beyond its role as an employer, we do not see any other role for the government in this area. Consultancy firms appear to generate healthy incomes marketing and advising on the implementation of apparently smarter and better ways to do things, and applying the insights of international best practice. This is one of those areas that is clearly best left to private firms and providers.

Compulsory private superannuation savings scheme

Several submitters have urged that New Zealand should introduce a compulsory private savings scheme, following Australia's example.

Australia's rate of national savings has been fairly consistently higher than that in New Zealand, although not unusually high by international standards. Some have argued that the compulsory private retirement savings model, introduced progressively from 1986, may help explain Australia's savings performance.

Resolving that question is not straightforward. It is almost certain that the compulsory savings regime has changed the form in which private savings are held in Australia, and has boosted the managed funds sector. Reserve Bank of Australia research papers conclude that the scheme has probably also boosted household savings.

We are not aware of any studies that look carefully at the impact of the compulsory savings scheme on total national savings (that is, across all sectors of the economy). It is not immediately obvious that Australia's national savings rate has been higher, relative to other OECD countries, than it was previously. And it is almost impossible to know what would have happened otherwise (including what the government would otherwise have done with the money spent on tax concessions to facilitate the compulsory superannuation reform).

[44] For a recent valuable outline of the power of markets as discovery and disciplining processes, see John Kay, *The Future of Markets,* Wincott Lecture, 20 October 2009 (available at http://www.wincott.co.uk/lecture2009.htm)

But even if the compulsory scheme has boosted the national savings rate a little, that would not be an unequivocal endorsement. Other incentives and other tax rates have been changed as part of putting the scheme into place, and to outsiders the system appears enormously complex and riddled with compliance costs and lobbying pressure. And even if there has been a small improvement in national savings, has that lifted real economic investment in Australia? Investment to GDP ratios have long been quite high in Australia, but it is not obvious that – setting aside the recent investment boom driven almost exclusively by high minerals prices – general investment ratios in Australia have been consistently higher in the last 15 years (when the compulsory scheme has been fully in place) than they were previously.

Overall, we are not convinced that the compulsory private savings scheme has made a material difference to Australia's economic performance. It has, however, clearly generated considerable additional business for funds managers, lawyers and accountants. Australia's model has not been widely followed internationally, and we do not think New Zealand should follow it now.

More generally, we believe that it would be considerably better, and more conducive to strengthening long-term economic performance, to improve the overall climate for private savings. We recommend significant steps in that direction later in this report. If government disincentives to private savings were materially reduced, households should be able make their own decisions about how much they prefer to save over the course of their working lives, and at what point in their own lives they are best-placed to save. For example, it is unlikely to be sensible for each household to set aside funds at a constant proportion of their income at all stages of their working lives – regardless of the number of dependents they might have, or their mortgage repayment commitments.

Exchange rate regime

Earlier in the report, we observed that if the large real exchange rate fluctuations New Zealand – and other countries – have experienced could be avoided, all else equal, there would probably be real economic gains.

In this section, we explain why we do not recommend any change in the current regime. Any gains that there might be from possible different regimes would carry risks and costs, some more so than others.

Of course, changes in the level of the exchange rate do not directly enrich or impoverish a country. A higher exchange rate redistributes income from tradables sector producers, to consumers and producers in non-tradables sectors. A lower exchange rate has the reverse effects. Neither tradables nor non-tradables production is intrinsically superior. So there is no sense in which we think there should be a goal of a higher or lower exchange rate for its own sake. What matters is minimising the adverse affects of government actions that impede the ability of private sector firms and households to respond to economic opportunities. Deeply undervalued exchange rates are, in the long run, probably almost as costly as severely overvalued ones: both skew the efficient allocation of resources.

Some exchange rate regime options sometimes advocated are simply not realistic for New Zealand.

Singapore's experience in managing its exchange rate has tantalised some New Zealand commentators. Singapore runs its monetary policy by setting a target band for the exchange rate, and intervening in the foreign exchange market as required to maintain the exchange rate in that range. The scale of the interventions can be very large. For a country with a population similar to that of New Zealand, in 2007 alone Singapore's published reserves increased by US$26 billion. Singapore's total foreign exchange reserves and official net forward foreign exchange positions are well in excess of 100 percent of Singapore's GDP.

Singapore's record is, on the face of it, very attractive, but its situation is also very different from New Zealand's[45]. First, trade as a share of GDP is very much greater than in New Zealand (or Australia for that matter) – so exchange rate fluctuations probably matter more. But much more importantly, Singapore typically runs current account surpluses. The foreign exchange inflows Singapore is intervening to sterilise are largely related to trade flows. Savings rates in Singapore are so high relative to the rate of investment undertaken there that the interest rates consistent with price stability are very low. In fact, interest rates are typically sufficiently low that (debt) capital inflows to Singapore are not usually a particularly important factor.

Dependence on foreign capital may well exacerbate exchange rate volatility a little, all else equal. But our degree of dependence (or otherwise) on foreign capital is determined by New Zealanders' willingness to save and invest, not by the exchange rate regime. In New Zealand, experience continues to suggest that interest rates need to be set relatively high to keep inflation in check (at any particular interest rate, desired investment far exceeds desired savings).

With the public's savings and investing preferences as they stand today, if New Zealand were to attempt to limit a sustained rise in our exchange rate simply by very heavy intervention, the experiment would be likely to end very badly. Such an approach would prompt even more capital inflows, further complicating the sterilisation challenges[46]. Investors would still seek to take advantage of the high interest rates that the domestic economy needs, and might well think the risk (of a sharp fall in the exchange rate) had reduced because the Reserve Bank had intervened to prevent the exchange rate going so high. If the Official Cash Rate were to be cut in an attempt to limit the inflow, inflation pressures would be exacerbated. Real exchange rates – which are what matter for firms' competitiveness – can rise either because the nominal exchange rate is rising, or because the rate of inflation (in costs and prices) is increasing.

[45] In addition to the macroeconomic differences touched on below, Singapore is a more authoritarian country and exercises a degree of directive influence over private business that would not sit easily with our political traditions.

[46] Including increasing the large fiscal cost. By buying foreign exchange, the Reserve Bank acquires a foreign currency asset and a New Zealand dollar liability. Since New Zealand real interest rates are typically materially higher than foreign interest rates (not the situation Singapore faces), the holding costs of such large intervention positions could be very substantial.

The Singapore model has not been adopted by any other advanced economy facing wide exchange rate swings, not even those in Asia such as Japan or Korea, and it does not provide a viable option for New Zealand.

Another option would be to fix our exchange rate firmly to the currency of another country. New Zealand does not have a single dominant trading partner, so fixing our exchange rate against one currency would still leave a lot of variability against all the other currencies. Australia is our largest trading partner, but accounts for only around a quarter of our total trade.

Gains from a fixed exchange rate might come in two main forms:

- Any direct benefits from reduced exchange rate variability. Variability against the currency of the country we pegged to would, of course, fall to zero. If that country's currency was less volatile than the floating New Zealand dollar had been, New Zealand firms would also experience less variability against third currencies.
- A credible fixed exchange rate would mean that we would also have the same market interest rate structure as prevailed in the country we pegged to. Lower real interest rates might help, in conjunction with other aspects of a reform programme that also improved the investment environment, to accelerate progress towards achieving the 2025 goal.

But there are also costs and risks from such an approach.

Advocates of fixing to (or simply adopting) the US dollar point to two stylised facts: the bulk of New Zealand's foreign trade is priced in US dollars (including most of that with third countries), and US interest rates have, almost without exception for the last 15 years, been materially below those in New Zealand. By fixing to the US dollar, we could cut out completely the variability in the NZ exchange rate with the US dollar (one of the more variable exchange rate pairs internationally), and we could instantly acquire US interest rates.

However, this approach would offer some large short-term benefits, but at very high risk of inducing much worse outcomes down the track.

The currency in which foreign trade is denominated matters, but it isn't the dominant consideration for firms trading internationally. If a New Zealand firm is trading with an Indian firm, they may agree to denominate the transaction in US dollars. For specific individual sales contracts, most relatively short-term, the resulting currency risk can be hedged quite readily. What matters more over the longer term are the cost structures and expected returns in local currency terms (rupees and New Zealand dollars). For convenience, many commodities – for example, oil – are traded in US dollar terms, but the US dollar price is influenced by demand and supply across the world. All else equal, a weaker US dollar tends to lead to a higher US dollar price of oil.

The bigger change from fixing to (or adopting) the US dollar would be the interest rate structure facing New Zealand firms and households. As a thought experiment, consider what might have happened if, without other behavioural changes that altered the neutral (price stability consistent) real interest rate, New Zealand had had US interest rates this decade instead of the interest rates we actually had. Over that period, the US official policy rate has been substantially below New Zealand's.

During this decade, at prevailing New Zealand interest rates, New Zealand households, firms, and farmers have been on a borrowing spree: credit to firms, farms and households doubled between 2003 and 2008. Asset prices rose to levels that are almost certainly unsustainable, and the Reserve Bank struggled to keep CPI inflation within the target range. A materially lower interest rate structure through that period would certainly have meant stronger GDP growth for a time. But at what price? The stock of credit would have increased dramatically faster, and asset booms on houses and farms would almost certainly have been greatly accentuated. General inflation in wages and prices would have been considerably higher too, undermining the initial external competitiveness gains. The risks of a much more serious financial crisis would have been materially heightened.

In many respects, this is exactly what has gone on over the last decade or so in some of the euro-area countries. Countries such as Spain and Ireland had previously had interest rates well above those of Germany. Importing a German interest rate, as they did in effect when they adopted the euro, enabled their citizens (firms and households) to bring forward a range of spending. Economic activity soared and house prices boomed. But business competitiveness was progressively, but very substantially, undermined.

And then came the bust. Spain and Ireland are among the worst-affected developed economies in the current global recession. GDP has been falling sharply, unemployment has risen very rapidly, and government finances are imperilled. And those countries now have little scope to ease the adjustment: they cannot alter their nominal exchange rate against trading partners in the rest of the euro-area and can do nothing to adjust interest rates in their own countries. Lulled by the earlier boom into increasing government spending in the good times, fiscal policy also has little or no room to move. Adjustment is having to occur through deep, pro-cyclical, cuts in government spending and significant, difficult to achieve, cuts in nominal wage rates across the economy. As unemployment rates have soared, some of the adjustment has been reflected in increased outward migration. Even within the EU, there are not large fiscal transfers from the less-affected parts of the euro-area to help the worse affected. Less well-known, but even more dramatic, is the current tragedy being played out in Latvia, which had gone through similarly extreme credit and asset booms and is currently desperately trying to defend its peg to the euro – in the process, GDP has fallen 18 percent in the last year.

These salutary European stories relate to countries that have significant structural similarities to their European partners. New Zealand's economy is quite dissimilar to that of the United States. If we were to adopt the US dollar, our economy would be highly exposed in the event of any shock that hit New Zealand harder than it hit the United States. Examples might include a sharp fall in the international prices of dairy products or the collapse of a New Zealand-specific housing boom. . If the US dollar itself appreciated for US specific reasons, we would also be highly exposed, as Argentina found it was after fixing its currency to the US dollar while most of its trade was with Europe. Of course, idiosyncratic shocks happen in individual US states and regions. But labour can and does flow across US state borders in a way that is simply not possible between New Zealand and the United States. And individual US states badly affected by a downturn often benefit from substantial fiscal transfers from the federal government.

Fixing the New Zealand exchange rate to the US dollar is not an option that should be given further consideration. Among the other risks and disadvantages, pegging to or adopting the US dollar would mean exposing ourselves to much greater volatility against the currency of our largest trading partner, Australia.

The idea of adopting the Australian dollar, or negotiating an agreement to make an Australasian currency the currency in New Zealand, deserves to be taken more seriously. That is because our two economies are more structurally similar and better integrated (commodity cycles tend to move broadly together, labour can and does flow readily between the two countries, and banks have loan books diversified across the two countries). The apparent gains from adopting the Australian dollar are probably smaller than those from adopting the US dollar, but the risks are substantially lower also.

Adopting the Australian dollar totally would further eliminate the already low volatility in the New Zealand nominal exchange rate with Australia. Studies of the euro-area suggest that there might still be material trade gains from taking this step, especially for firms looking at making their first foray into export markets and for whom Australia might be an obvious market to try first.

It would also have delivered a somewhat lower interest rate structure to New Zealand – the Australian official interest rate has averaged around 1 percentage point lower than New Zealand's in the last decade[47], even though Australia has a slightly higher inflation target than New Zealand does. Australian banks, funding themselves in a common domestic market, and directly in international markets, would deliver lower interest rates to households, and to firms financing themselves using bank debt. This could also be expected to be reflected in somewhat lower costs for direct corporate bond issuers and for firms raising equity.

But simply adopting the Australian dollar would not alter the neutral (price stability consistent) interest rate in New Zealand. It does nothing to alter how much New Zealand firms and households want to save or invest at any given interest rate. Cheaper access to capital for firms would be accompanied by cheaper access to credit for households – already among the most indebted in the world. Economic activity would be somewhat stronger, boosting domestic spending and asset prices, but there would also be a greater exposure to an eventual shakeout.

The Taskforce does not have a strong view on the option of a common currency with Australia at this stage. We certainly do not see it as some sort of "silver bullet" solution to New Zealand's economic ailments. Indeed, to think of it that way would almost certainly be damaging and quite counter-productive in the long run. Changing the currency regime is not a substitute for serious and sustained microeconomic policy reform although we can see how, if adopted as one part of an overall far-reaching reform agenda, it is possible that a common currency with Australia could assist in meeting the 2025 goal.

The Taskforce is, however, also aware that moves to adopt a common currency are usually one part of an overall project of greater political integration and shared political identity. That has

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[47] Of course, this is only an average. At present, quite unusually, real and nominal interest rates in New Zealand are lower than those in Australia.

certainly been so in Europe. And greater economic and political integration helps to manage the risks that a common currency gives rise to. The merits, or otherwise, of closer political integration with Australia go well beyond the mandate of this Taskforce.

The difficult phase of a live experiment is underway at present in Europe. New Zealand would be well advised to see how that experiment plays out before reaching a view on the merits of currency union. On present forecasts, it seems likely that, despite the very nasty shakeout going on at present, countries such as Ireland and Spain will end up concluding that joining the euro provided them with net long-term economic benefits. But that conclusion is not foreordained, and in both countries there is still a long way to go before they, or we, can reach confident conclusions about whether there have been substantial permanent economic gains. On the basis of what we know at present, revisiting the exchange rate regime does not appear to be a growth priority for New Zealand.

The current floating exchange rate regime is likely to be the best realistically available for New Zealand at present. As Winston Churchill said of democracy, it is the worst form of government, except for all the others that have been tried. Reaching that conclusion does not mean that we are inevitably facing repeats of the exchange rate peaks of 2007 and 2008[48]. Bad policy – in particular the very rapid increases in government spending at a period of peak pressure on resources – helped produce those peaks. But bad policy will produce bad outcomes under any exchange rate system.

In the wake of the recent recession and global financial crisis, there is new global interest in the possibility of other instruments that might help dampen future credit cycles. It is possible that such new macro-prudential tools could help to dampen future credit cycles without so much reliance on the OCR, and hence, without so much pressure on the exchange rate. But it is wise to be cautious at this stage about the potential of these instruments and important to ensure that they are subject to appropriately rigorous regulatory evaluation. Big credit booms and busts have been with us for centuries, and it seems unlikely that they will suddenly dissipate or be materially dampened now, at least not without unwittingly giving rise to other economic costs and risks.

One option periodically championed to reduce the amplitude of exchange rate fluctuations is a "Tobin tax": a very small tax on each and every foreign exchange transaction. Proponents argue that such a tax could materially reduce the volatility of the exchange rate by reducing the volume of very short-term foreign exchange transactions. That is simply wrong. Were such a tax to succeed in reducing the volume of foreign exchange trading, it would quite probably increase short-term volatility. And the big cyclical swings in the exchange rate aren't mainly driven by dealers taking very short-term positions, but by the overwhelming weight of money – some short-term, some

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48 This report is focused on the 2025 goal, not on very short-term conditions. However, in view of recent public focus on exchange rate issues it is worth noting that in late November, New Zealand's exchange rate in trade-weighted terms was around 20 percent below its 2007 peak. Against the Australia dollar – the best metric to use in thinking about New Zealand-specific effects – our exchange rate is well below its average level over the last 20 years. Australia's trade-weighted exchange rate, by contrast, is much closer to its decade peak.

placed for several years – from a diverse range of investors attracted by the yields on offer in New Zealand. As we discussed earlier, it is domestic savings and investment preferences that ultimately determine how high our interest rates are relative to those in the rest of the world.

More immediately to the point, such a tax is simply not a meaningful option for New Zealand in isolation. Most trading in the New Zealand dollar already occurs outside New Zealand – in key foreign exchange centres such as Sydney, Hong Kong, London and New York. Were a Tobin tax to be imposed here, most of the rest of the trading would quickly move offshore too.

Our recommendations

This Taskforce has been focused on the things governments can do to help position New Zealand to achieve the 2025 goal. Governments don't create growth and higher incomes: firms and households do, but they do so within an environment that is materially shaped by the institutions and policies that governments, on behalf of citizens, put in place.

Accordingly, we organize our recommendations under four broad headings, which are structured to encompass the main ways in which governments affect the climate for economic performance:

- Government as spender
- Government as tax collector
- Government as owner of substantial assets
- Government as regulator and law-maker

Members of the Taskforce strongly endorse the overall thrust of what follows. Nonetheless, we are fully conscious of the limited time and resources we have had to bring this report together. In most areas, we focus on highlighting issues and recommending broad directions for future policy. That means that in many cases we outline the flavour of the changes that are likely to be required, and the principles that should guide policymakers in considering reforms, rather than making specific highly detailed recommendations.

Government as spender

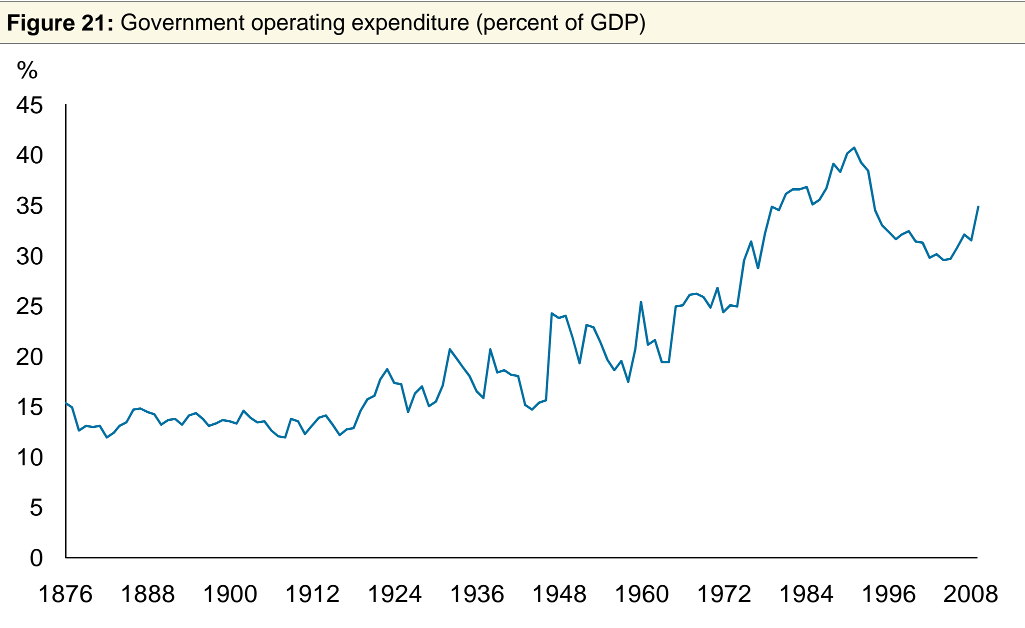
Government spending is, to a first approximation, what citizens get for their taxes. Government spending covers an enormous range of activities and functions: salaries of public servants spanning everything from the army to the Ministry of Women's Affairs, the purchase of police cars to the cost of Members of Parliament, social welfare benefits and KiwiSaver subsidies, new school buildings and the Office of the Race Relations Conciliator. Analytically, governments consume, invest, and make transfer payments (income transfers from taxpayers as a whole to particular income groups).

Context

Government spending has increased enormously over time, both in real per capita terms, and as a share of GDP. On the internationally comparable measure, general government outlays (capital and current, central and local government[49]) are now almost 45 percent of GDP.

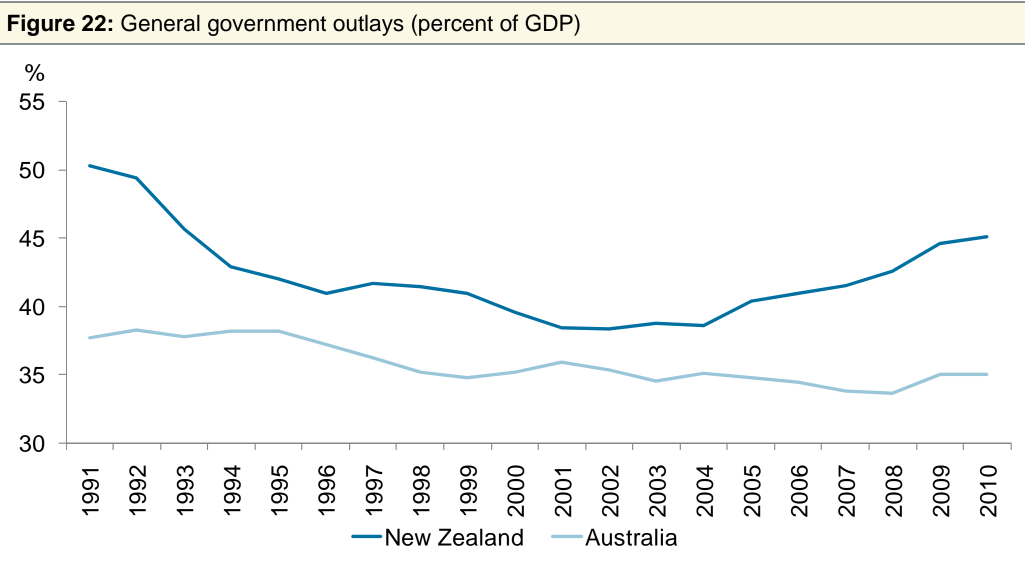
[49] We do not discuss further the aggregate level of local authority expenditure. Local authority expenditure as a share of GDP has been quite stable for many years.

Figure 21: Government operating expenditure (percent of GDP)



Source: Long Term Statistical Series and David Rea (various series)

Figure 22: General government outlays (percent of GDP)



Source: OECD

In the early years of the twentieth century – one hundred years ago – total New Zealand government spending was less than 15 percent of GDP[50]. That was fairly normal, or perhaps slightly on the large size, for the advanced economies then[51]. Those countries did not get to advanced economy status on the basis of heavy government spending. The United Kingdom had

[50] A useful recent review article is David Rea, "Government Expenditure and Revenue in New Zealand: A Brief Overview", *Policy Quarterly,* Vol 5, Issue 3, August 2009.

[51] V Tanzi and L Schuknecht, *Public Spending in the 20th Century: A Global Perspective*, Cambridge University Press, Cambridge, 2000. The authors report 1913 numbers for a variety of advanced economies, with an average of 13 percent of GDP.

led the industrial revolution and was the leading global power of its time: a best estimate of British government spending as a share of GDP as late as 1870 was just under 10 percent of GDP.

By contrast, the average OECD country in 2007 had general government outlays of 40 percent of GDP (very similar to the average for the previous 15 years). That isn't the only model. In several high-performing Asian economies (Singapore, Hong Kong, and Taiwan, themselves with diverse political systems and spending imperatives), total government spending as a share of GDP has consistently been less than 20 percent.

The role of government spending in our story is not one-dimensional. Our approach to the issue is not a "slash and chop" mentality, but rather based on a careful assessment of the implications of the total level of spending (for average tax rates) and of the implications of spending practices in many of the main areas of government activity.

Some of the functions the government undertakes or funds – those which can only be undertaken or funded by government – are absolutely critical to a flourishing high income market economy. A well-functioning efficient and independent judicial system is one of very many examples. In numerous other areas, where successive governments have chosen that the public sector will fund or provide the bulk of the services in question, the efficient delivery of high quality public services has a big impact over time on economic performance and people's sense of their living standards. We rightly expect, for example, high quality school and health systems, and good roading infrastructure.

New Zealand's current level of government spending appears not to be too different from that of the average OECD country. Even if New Zealand were now as wealthy as the average OECD country, there would probably still be reason to look hard at the current level of public spending and the way that money is spent.

As it is, our economic challenge is huge: aiming to overcome a 35 percent income gap in the next 16 years. Our judgement, informed by a reading of the international historical experience, is that it would be almost impossible to achieve the sort of sustained transformation of our growth performance with the size of government at current levels (around 45 percent of GDP). The current size of government stands in the way of economic transformation through a variety of channels. To recapitulate on the channels outlined earlier:

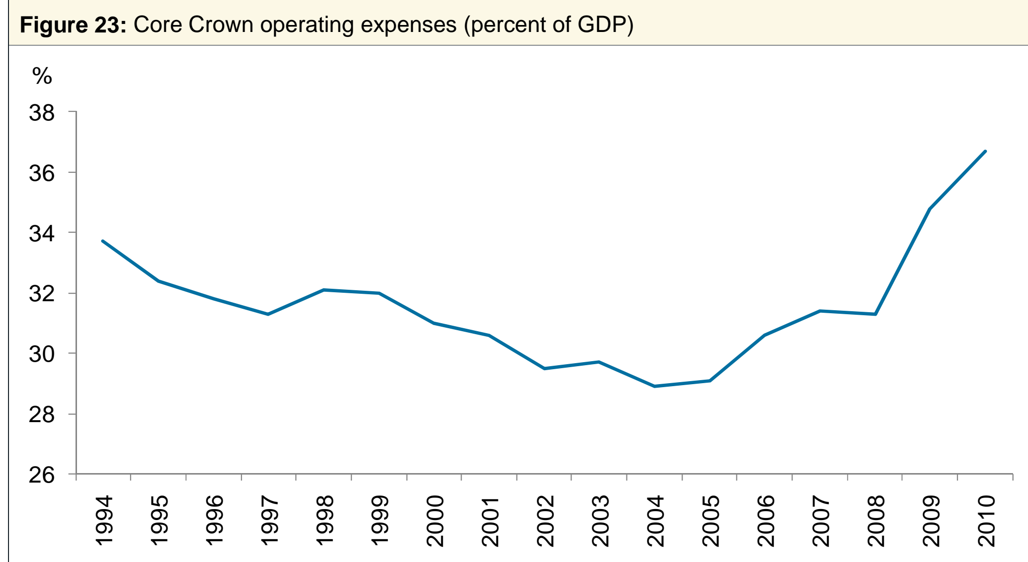
- Government spending needs to be paid for by taxes and almost all taxes reduce the rewards to effort
- Government spending is often not subject to the same rigorous scrutiny that people and firms give to spending their own money
- Some components of government spending themselves further undermine incentives, and hence the level of economic activity and aggregate incomes
- Transitions to a period of markedly higher government spending without raising taxes at the same time put unusually intense pressures on the private sector.

In the course of our deliberations, we have drawn two principal lessons about overall government spending and its connection to our economic performance:

- Government spending can and should be substantially reduced as a share of GDP, and needs to be reduced as part of having any realistic hope of matching Australian living standards by 2025. It has been done before. The fact that the latest step-up in spending has been so recent should make it a little easier to address.
- Government spending needs to be better managed to avoid exacerbating business cycles, and building up government spending (and implicit future commitments) in the good times on the basis of unwarranted assumptions about sustainable future revenues.

For New Zealand purposes, we focus on the Treasury's measure of core Crown operating expenses. This measure captures the operating expenses (including funding for depreciation) under the direct control of central government[52]. We discuss capital spending later.

Figure 23: Core Crown operating expenses (percent of GDP)



Sources: Treasury, Statistics NZ, Secretariat estimates
Note: 2009 Budget forecasts of expenses for the 2010 year were used.

Spending has increased extremely rapidly in recent years, both in the last few years of the previous Government and in the first year of the current Government. Between 2004 and 2009, nominal GDP increased by $42 billion (30 percent), while core Crown expenses increased by $30 billion (56 percent). As we have already noted, core Crown (operating) expenses rose from around 29 percent of GDP in 2004 and 2005 to a projected[53] 36 percent this financial year.

Almost none of the large increase in government spending can be explained by the recent economic recession. A few components of government spending – notably unemployment benefits – rise directly when the economy slows. However, as it happens, the number of people on the unemployment benefit in June 2009 was almost identical to the number in June 2005. Unlike in

[52] Thus, for example, it excludes the spending of Crown entities, but captures Crown funding of those entities.

[53] Based on 2009 Budget forecasts, adjusted for recently revised nominal GDP data.

many countries, little direct "stimulus" expenditure was undertaken in response to the economic downturn. In a mechanical sense, as GDP fell over 2008 and early 2009, the ratio of government spending to GDP has increased a little. Most estimates, however, suggest that real GDP is probably no more than 2-3 percent below its trend level at present. If so, not much more than 1 percentage point of the increase in the ratio of government spending to GDP can be explained simply by cyclical factors. The substantial real increase in government spending is a structural issue and needs to be tackled as such. The increase will not reverse itself.

Aggregate fiscal policy management

The sharp increase in the share of government spending in recent years – much of it undertaken with very little robust policy justification – is wholly inconsistent with the successful pursuit of the 2025 target. We regard reversing that increase quickly as a matter of high priority. If the New Zealand government could function in 2004 spending 30 percent of all this economy produces, it is difficult to see why it could not also do so again three years from now. We recommend that core Crown operating expenses be cut to around 29 percent of GDP by 2012/13[54]. Our understanding is that the pace of adjustment implied by this target would be similar to what was achieved in the early 1990s. And, once cyclical factors are adjusted for, the speed of the implied fall in the spending ratio roughly mirrors the speed of the increase in the last few years. It can be done, and needs to be.

Getting spending as a share of GDP back to 2005 levels would be a good start, but no more than a good start. In 2004 we were making no progress towards catching Australia. Once core Crown operating expenses have been reduced to 29 percent of GDP, we recommend that the government should actively limit future growth in public spending so that real per capita core Crown operating expenditure does not grow any further. To be clear, that means total real spending would continue to increase, but real per capita spending would be held constant. It does not mean spending cuts in total.

On current projections, an average rate of growth of real GDP of around 4.5 percent per annum will be required to catch Australia by 2025. If that sort of economic growth was achieved, and real per capita government spending was held constant for 15 years, the ratio of core Crown operating spending to GDP would fall to around 19 percent (with all this would mean for taxes and incentives). All else equal, that would reduce general government outlays to around 30 percent of GDP (around the level Korea has had in recent years).

The Taskforce believes that the relative size of government must shrink substantially. Reducing core Crown operating spending to around 20 percent of GDP would certainly not be easy, and setting a goal is not a substitute for the actions that make it happen. But if government spending as a share of the economy were to be reduced towards that sort of level, we would be much more

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[54] Revisions to the historical nominal GDP can alter the absolute level of the spending ratio. The critical element of the recommendation is quickly returning government spending as a share of GDP to the level it was at in 2004 and 2005.

confident about the prospects for once again matching – and even beating – Australian living standards over the long haul.

Institutional changes also have a useful role to play in helping to achieve this sort of fiscal discipline. International experience – highlighted recently by both the IMF and the OECD – suggest that spending rules have a valuable role to play.

In many respects, New Zealand's fiscal reforms in the 1980s and early 1990s were path-breaking. The focus of the Fiscal Responsibility Act 1994 (now embodied in the Public Finance Act) stressed the importance of transparency about fiscal prospects and goals, without putting binding external rules in place to directly constrain policymakers. The Public Finance Act requires the Minister of Finance to outline what he regards as a prudent level of public debt, around which fiscal policy will be oriented.

Debt objectives specified by successive Ministers in the last 15 years appear to have played an important role in guiding and constraining budgetary choices. Reports indicate that real decisions were made differently because the (self-imposed) debt target was in place. That should be no surprise. Self-imposed rules have a role as old as history: in the ancient story, knowing what was good but doubting his own self-control when the pressure mounted, Ulysses had himself bound to the mast, to avoid the temptations of the sirens. Partly as a result of the role the debt targets have played, New Zealand now has a very low level of public debt.

But as we have seen, the debt targets did little to constrain spending, and nor would one have expected them to. Over the course of the last few years, most revenue increases flowed fairly quickly through into increases in spending, provided the debt target was still being met. International experience suggests that, important as debt rules are, expenditure rules also have a valuable role to play. It is all too easy for spending to rise in the boom years that come along every so often, and then never to fall back very much when the good times are over. In its report this year, the OECD recommended that the New Zealand government seriously consider adopting one. We agree.

At very least, the Public Finance Act should be amended to require the Minister of Finance to specify a medium term (five to ten year) target for future real operating spending: either the real per capita level of spending, or spending as a share of GDP[55]. In turn, the Minister would be required to report publicly on progress relative to that goal. In our constitutional system, any of these targets can be changed. The discipline arises through two channels: first, being forced to focus on the question of the desirable long-term level of spending, and second, through the requirement to account for progress relative to the goal, and to explain any changes to the target.

It is not apparent to us that any recent governments have really focused on the question of the appropriate long-term size of government spending. They should have, and now need to. The current system of Budget operating allowances (for additional spending) does not encourage that

[55] The articulation here is deliberately medium-term in nature. It is not, for example, intended to stymie the operation of automatic stabilisers during recessions. The focus should be on the medium-term, beyond temporary periods of recession or of unsustainable boom.

focus: allowances are specified in nominal terms, and without regard to unexpected changes in population (through swings in migration for example).

International experience highlights the diversity of fiscal rules. They vary widely reflecting the considerable differences in the political cultures and constitutional arrangements across countries, and the differences between national and state systems. Some states of the United States – Colorado is perhaps the best known case – have adopted formal constitutional provisions requiring, for example, a public referendum if the government wishes to increase real per capita spending.

New Zealand does not have a written constitution, so the options are different here. In the National/ACT agreement, the National Party has agreed to support through a first reading in Parliament legislation for a "taxpayer bill of rights" along the lines of the Colorado provisions. Discussion of that legislation, and the associated select committee process, is likely to provide a good forum for teasing out in greater depth what could work well for New Zealand. Some other countries have also used independent "fiscal councils", not to replace the decision-making rights of Ministers and Parliament, but to strengthen the independent assessment of the fiscal situation. Such a mechanism might be a useful buttress to limit the pro-cyclicality that has afflicted fiscal policy in New Zealand (and numerous other countries). We urge that the Treasury should be actively engaged in advancing thinking on all the issues in this area.

Specific areas of spending

It is easy for groups such as this Taskforce to call for substantial cuts in the share of government spending. It is quite another to achieve that sort of change in practice. In this section, we outline areas which appear to us to offer significant scope for savings. We want to stress that this should not primarily be an exercise in cost-cutting at the margin. There are, no doubt, many ways in which existing government programmes and agencies could be run more cheaply, and we want all government activities to be run efficiently. But the overall approach to government spending, with the 2025 goal clearly in focus, needs to be more one of asking, across all areas of government:

- Does this particular activity need to be funded by the state at all?
- And if it is funded by the state, does it still need to be provided (ie service delivery done) by the state?

In those areas where it is clear that particular core functions need to be conducted directly by the state and its agencies, those services need to be well resourced and excellently managed (we have already highlighted economic statistics as one example of a vital function that appears to have been under-resourced). What we need government to do, we need done to an excellent standard. But government should be undertaking many fewer functions than it is now, and exploring better ways of delivering many of those it does fund.

We noted the recent public comment from the Secretary to the Treasury[56] that much of the government's total budget could be better spent. We agree. We do not ourselves have the expertise or resources to provide detailed recommendations in all these areas. Instead, we point in

[56] See the speech "Public Sector Performance", 20 July 2009 available on the Treasury website.

the direction of possible change and we endorse the call in the National-ACT agreement for the establishment of a series of high quality taskforces to scrutinise in detail spending in each of the major areas. We focus here on the four largest areas of spending:

- Non-superannuation welfare
- Superannuation
- Health
- Education

The analysis is not exhaustive. Beyond these areas, for example, we share in the general scepticism about whether the increased number of policy analysts employed by government agencies in the last decade is really reflected in a commensurate level of improvement in the overall quality of policy advice and analysis. The generally weak quality of the regulatory impact work being undertaken by government ministries and agencies is among the indicators suggesting not.

Treasury counts the cost of the Working for Families tax credit as part of core Crown operating expenses, but we address this programme in the next chapter, in view of the integral connection between Working for Families and the personal income tax system.

Working age welfare spending

Around 2.1 million people are employed in New Zealand. As at 30 June 2009, another 310,000 people (equivalent to 15 percent of the number of those employed) aged 18-64 were on welfare benefits[57]. We noted earlier in the document that overall hours worked per capita in New Zealand are actually quite high by international standards, and it is well-known that welfare dependency is a significant challenge in many advanced countries.

This large number of working age people not in the workforce, but supported financially by the state, represents a huge fiscal cost. The fiscal cost arises not just because of the costs of the welfare benefits themselves. The lost taxation revenue is also important: if these people were working, they would be paying income taxes on their wages.

Very different groups of people make up the population of working age welfare recipients. Some of those on the Invalids Benefit are society's most vulnerable and needy people, who will never physically be able to earn an income. Looking after those people well is one of the things that marks a compassionate society. But the number of people in that category is likely to be small. The numbers in receipt of sickness and invalids benefits have increased by almost 70 percent in the last decade, in a period when the total population has grown by 12 percent. In that decade, New Zealand has been ravaged by neither war nor an epidemic of crippling illness.

Numbers on the Domestic Purposes Benefit (DPB) have been reasonably stable over the last decade – at around 100,000. More (fit and active) people are on the DPB than on either sickness or invalids benefits. Often the dependency continues for years. We think serious sustained action

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[57] Not including tax credits such as Working for Families. This number also, deliberately, does not include those not working but in receipt of ACC weekly compensation.

is needed. Stringent work tests should be imposed, and serious consideration should be given to introducing an absolute cut-off: there is no obvious reason why anyone should be on the DPB for more than five years (ie until a youngest child, born at the time a parent went onto the DPB, starts school). In many working households, both parents work even when children are very young. In many cases, they would rather that, if economic circumstances permitted, one parent was able to stay at home. It is not obvious why those supported by the taxpayer should be treated more generously.

Welfare reform, and especially the transition from where we are now to a world in which there is greater self-reliance and greater use of family, community and market mechanisms for support, is not easy. But that is no excuse for not starting. ACC has had considerable success in managing down the number of long-term claimants. We believe that the same should be able to be done with people on long-term welfare benefits. The recent report of the Auditor General suggested that little effective work was being done to get recipients of benefits back into the workforce. That has to change.

Welfare reform, well done, is not necessarily a path to large short-term fiscal savings. The entrenched problems are sufficiently severe that significant expenditure could be required to help facilitate the transition. But over the time period relevant to the 2025 goal, the potential fiscal gains are substantial. The gains are not just economic – although they are likely to be large. It is well recognised that welfare dependency is debilitating for the individuals concerned, and in particular for their children. The best way to position the next generation for the challenges and opportunities of a strong and high-performing economy is through the example of parents actively engaged in the workforce. This is as much a strategy about enabling and reintegrating a potential underclass, as anything narrowly fiscal.

Superannuation

New Zealand was the first country in the world to introduce age pensions, in 1898. The age of eligibility was 65. Those pensions were neither generous nor universal. At the time, life expectancy at birth was around 55, and so perhaps only around half of all working adults reached the pension eligibility age. Most adults entered the workforce very young, and would have spent at least 90 percent of their lives above age 15 in the workforce (or within a family unit supported by those in the workforce).

New Zealand has a long history of revisiting its state pension arrangements, and has been through various models in the last 40 years. Since the mid 1970s, we have mostly had a universal and very generous non-contributory pension, with only an undemanding residency qualification. A brief period of means-testing generated enormous political controversy and was abandoned.

The age of universal eligibility was lowered to 60 in the mid 1970s, but was successfully returned to 65 over the ten years to 2002. The vast majority of people now expect to live that long. Life expectancy at 65 is now around 18 years – a little higher for women, a little lower for men – and is increasing quite materially every decade (total life expectancy is increasing by between 1.5 and 2 years a decade). People also now enter the workforce much later now than they did. Someone who enters the workforce at 21, retires at 65 and dies at 83, spends only around two thirds of their adult life in the workforce, and for most of the rest of their adult life is eligible to receive an income

from the state – that is, from other taxpayers. Paying a generous pension to everyone turning 65 to allow them to spend an increasing share of their lives outside the workforce does not seem to fit very well with a serious focus on lifting material living standards for ourselves, our children, and our grandchildren.

Other Western countries have state pensions of one form or another. Those schemes are typically quite a bit less generous – both in terms of eligibility criteria and in income replacement rates – than New Zealand's[58]. Comparing systems is not straightforward. For example, Australia has a lower means-tested age pension, but also has a compulsory private savings scheme. In many other countries, very favourable tax treatment is given to private retirement savings schemes – transferring public money to the elderly through a different channel than a direct pension payment.

However, the relatively favoured position of the elderly in New Zealand is fairly firmly established[59]. The poverty rate among those aged over 65 in New Zealand is among the very lowest found anywhere in the OECD countries. But poverty rates among the working age population, who are paying for New Zealand Superannuation, do not look anywhere near that low. Locally, a recent Statistics New Zealand survey of well-being of different classes of people in New Zealand reported that on almost every dimension (other than health) those aged over 65 were better off than other age groups[60].

As a state pension scheme, New Zealand Superannuation has some positive features. It is very administratively simple, as universal schemes tend to be. There is no penalty to anyone staying in the workforce beyond 65, so there is no direct deterrent to remaining in the workforce. But the level of the pension is sufficiently high that most people feel no need to go on working, even if they have made no material financial provision for retirement themselves. New Zealand Superannuation appears to provide the most generous state pension (relative to average earnings) anywhere in the developed world[61].

Changes to New Zealand Superannuation are vital and are already well overdue. Changes would not be expected to generate material short-term fiscal savings. But over the medium-term the amounts involved are very substantial. These savings take various forms:

- Lower spending on superannuation itself.
- Higher tax revenue from increased participation of older people in the labour force.
- Modestly reduced health spending (it is well-established that if people remain active longer they also tend to keep in better health).

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58 It should be acknowledged that New Zealand's total pension spending does not appear to have been particularly large by international standards in recent years. That partly reflects the success in raising the age of eligibility to 65, the absence of any early retirement provisions in the New Zealand scheme, and our relatively young population.

59 Further reinforced recently by the SuperGold card scheme.

60 Reported in the *New Zealand Herald,* 29 October 2009.

61 OECD, Pensions at a Glance, 2007.

GDP per capita would be raised and public spending would be cut. That would enable overall tax rates for everyone to be cut. Tax cuts and the prospect of a less generous state pension scheme boosting national savings would tend to generate further real economic gains.

Many others have already made important contributions to the discussion on these issues, including the many publications of the Retirement Commission and the recent long-term fiscal statement by the Treasury. We believe that a more serious debate needs to start now. That debate shouldn't be narrowly focused. It needs to open up the question of how best to think of a state pension. At present, New Zealand Superannuation appears to be treated by most as an entitlement, but it would perhaps be better for society and the economy if it was conceived once again as a modest safety net for those unable to provide for themselves at the point where they approach physical infirmity.

Other countries are already acting to reduce future pension costs, by lifting the age of eligibility beyond 65. Among them, the Australian government in its 2009 Budget announced that the age of eligibility for the age pension will be progressively raised to 67. Germany is also raising the eligibility age to 67, and the United Kingdom is gradually raising its eligibility age to 68. Denmark has gone further, both raising the eligibility age to 67 and then indexing the age of eligibility to future improvements in life expectancy.

We believe that a serious review of the issues would result in an increase in the pension eligibility age, and – *inter alia*, to help neutralise future political controversy – seek to draw a link between improvements in health and life expectancy and future increases in the eligibility age. Consideration also needs to be given to the rate of payment: we believe that it would be appropriate for a period of some years to shift from wage-indexation to CPI indexation.

Mean-testing of age pensions is a fraught issue, and something of a double-edged sword. There is a risk that poorly done means-testing could further discourage private savings by middle income people. A better outcome all round would be achieved if the pension was to once again be regarded by all concerned as a safety net: there for those unable to provide for themselves in times of infirmity, but with most people taking pride in their ability to support themselves through work, private savings and the assistance of family.

KiwiSaver was established several years ago, in two stages. The first stage involved automatic default enrolment, from which an employee could opt out if they chose. This was later supplemented by very generous tax concessions to employers and contributing members. The subsidies appear to have been motivated by two considerations: a genuine wish on the part of the then Government to promote actively a change in the "savings culture" in New Zealand. The other consideration was more tactical: KiwiSaver subsidies were a form of tax cut, but with limited short-run demand effects, and hence carrying risk of prompting a further tightening in monetary policy in a period of intense overall pressure on resources.

At the end of last year, the incoming Government significantly reduced the subsidies. We think more should be done. Around $1 billion per annum is being spent on KiwiSaver subsidies, in a scheme where the funds can mostly not be withdrawn until retirement age. As noted above, provision for the elderly is already very generous. There is clear reason to expect that KiwiSaver

subsidies will change the form in which people save, but much less reason to think they will make much difference to national savings. At best, KiwiSaver subsidies are second-best responses to policy disincentives to save. These disincentives should be addressed directly and KiwiSaver subsidies should be discontinued.

Health

The OECD is among observers to note that health outcomes in New Zealand are quite good for a country with our relatively low incomes. But our aspirations need to be better than that.

Health spending in New Zealand has increased enormously over the last decade (by $6.5 billion or 110 percent). Some of the specific factors prompting spending increases were substantially unavoidable: labour market pressures and the ease with which medical professionals could take up higher paying opportunities abroad probably meant that substantial salary increases were unavoidable.

But that is a very different matter from the question of whether total health spending needed to increase to anything like the extent it has, even given the level of health outcomes the government was seeking to provide. Careful research suggests that productivity in the state health sector has fallen over the course of this decade. To be clear, this is not just a drop in the productivity growth rate, it means that as taxpayers we now appear to be getting fewer health outputs for every unit of input to the system[62]. There have been big increases in spending with few perceptible health gains. That must be unacceptable if we are at all serious about the 2025 goal, the more so given the relentless pressures governments will otherwise face to increase health spending further as the range of treatments and drugs improves and the average age of the population increases.

Getting health right is not easy. The current US debate is highlighting many of the issues and challenges around information, incentives and choice. However, New Zealand already has some worthwhile domestic precedents. In the 1990s, the Health Funding Authority had developed a sophisticated body of expertise in the difficult area of contracting, specifying outputs etc, based around a model which distinguished carefully between the role of the state as funder of health services, and the role of government-owned hospitals as (predominant) providers. Moving away from that model was a serious backward step, with considerable cost: it means we get worse health outcome for the same money, or we have to tax economic activity more heavily to get the sort of health outcomes we want.

In its 2009 report on New Zealand, the OECD recommended serious consideration be given to moving back towards a funder-provider split model. We think that case is already proven. The model is also already well-established in another government agency, ACC – all of the surgery ACC pays for is contracted from providers, 80 percent from private providers[63]. In such a world, there is little obvious place for district health boards (DHBs), much less 21 of them.

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[62] Mani Maniparathy, *Productivity Performance of New Zealand Public Hospitals 1998/99 to 2005/06*, New Zealand Business Roundtable, 2008

[63] Beyond the health sector, the retirement home sector is also another functioning and successful example of the funder/provider split.

Small and probably quite sensible reforms have been initiated by DHBs and the government over the last year or two, but they do not go the heart of the real issues in getting to grips with the cost of the health system. Some, such as the move to a single agency managing human resource issues, may reinforce other weaknesses in the system such as the extent of centralised wage bargaining. There is no obvious logic to a common pay scale for doctors or nurses in Auckland, Invercargill and Whakatane; private providers almost certainly do not pay the same in all three places.

In terms of specific options for savings, the Taskforce finds puzzling the extent of the subsidies on prescription pharmaceuticals in New Zealand. For other than the very poor and the chronically ill, we believe that pharmaceutical pricing more akin to that in Australia (where there is a fee of up to $30 per prescription) should be considered.

We also see little justification for the significant increase in recent years in the extent of universal subsidies paid for visits to the doctor. For many people, these are simply churn: they pay in taxes, what they later get back in benefits. The insurance benefits to the individuals are very minor, but there are real economic costs because tax rates have to be a little higher than otherwise. The considerable benefits to good health are primarily personal, and there is little obvious reason for subsidising doctor's visits for the middle-aged middle class – any more than we subsidise that other necessity of life, food. The amounts involved are hundreds of millions of dollars per annum. But high as the fiscal cost is, it is also important not to lose sight of the increased regulatory control and administrative hassle that tends to accompany greater government funding, stifling innovation and enterprise.

Longer-term, we urge the government to establish a separate health taskforce, with a more ambitious mandate than the recent Horn review, to look at the best health models in the world, and ways to capture the benefits of such approaches and insights for New Zealand.

Education

Education encompasses so much of what matters to us as people. It is part of passing on the heritage and culture of our society, as well as of developing in people the sort of skills that help equip them to achieve their economic potential and raise their living standards. In many respects, the New Zealand education system appears to produce reasonably good results. By international standards, there is now a high rate of participation in (and graduation from) tertiary education.

The huge amount of government spending in the education sector, broadly defined, covers all ages and stages of life: from universal subsidies to early childhood care, universally available (and notionally free to the user) state primary and secondary education for children, and heavily subsidised tertiary education and income support (either direct or in the form of interest-free loans) taken up by a wide range of people from 17 to 77 (at least). There appears to be little coherence to the way in which spending is undertaken in the sector.

Take provision as just one example. In the early childhood sector, most providers are private, with many for-profit operators. In the school sector, the state is the overwhelming provider (much more so, say, than in Australia), but the integrated schools sector can be seen as representing something like a funder-provider split in action. The bulk of the tertiary sector falls into a muddled middle.

There are significant issues in each of these sectors. We see little merit in the middle class churn involved in universal early childcare subsidies (which have trebled in cost over the last five years, to around $1.2 billion per annum), and have seen no evidence to suppose that any valuable public policy objective has been met by the initiative. Even though the childcare facilities are not state-provided, the sector appears to have been subject to an increasingly expensive overlay of unnecessary regulation and cost. Given the choice of competing providers, it is not obvious, for example, why the state specifies minimum academic qualifications for workers in such centres. If such qualifications truly add value, presumably parents will seek out centres that employ such staff. As a general observation, contracting models of the sort the Taskforce favours do need well-specified contracts, but we give maximum scope for innovation if the focus is more on desired outcomes than on specific inputs, governance structures of provider bodies, etc.

There has been considerable focus this year on new national standards for childhood numeracy and literacy. There are few things schools can provide that are more important to getting a successful start in life than numeracy and literacy (and, at present, there is a disturbingly long tail of underperformance in this area, especially among Maori and Pacific children). To that extent, the new standards make a useful point about community expectations and accountability. But measured against the scale of the issues, this year's changes strike us as marginal at best.

The school system remains unresponsive and without mechanisms to generate serious accountability and to reward excellence. At the heart of the issue is the lack of effective choice. State schools are all managed independently, with neither the incentive nor the ability to take a successful model and replicate it in another community. Private schools seeking to enter the market get very little government funding (even though the prior decision has already been made to require all children to attend school, so that the state is obliged to fund each child's education). And the lack of choice reinforces the power of teacher and principal unions to avoid serious accountability to purchasers – whether conceived of as the state or parents. International evidence suggests that, in teaching as elsewhere, choice and pay for performance work[64]. People are rational: they respond to incentives. If we want better schools – better educational outcomes, better choice, and better value for money – we need better models of ownership, governance and accountability, and remuneration.

One model that would, over time, allow greater choice and more effective discipline on existing providers is that adopted by Sweden – a country in which the state still spends much more heavily as a share of GDP than is the case in New Zealand. Under its far-reaching reforms (which we understand are now supported by teacher unions in Sweden) any new provider (for profit or otherwise) can set up a school (or chain of schools) and be funded for each pupil who attends[65].

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[64] As just one recent example, see "Teacher Performance Pay: Experimental Evidence from India" by K Muralidharan and V Sundararaman, 2009, mimeo. The authors report on an apparently carefully structured large scale programme in India, tying teacher bonuses to test performance. The authors report not only that test scores improved, but so did student performance over a much wider range of dimensions of educational outcomes.

[65] We note the Swedish model not because Sweden necessarily has better education outcomes than New Zealand but because it provides an established model for introducing greater choice and for facilitating the entry of new providers in which school education remains overwhelmingly state-funded.

Allowing private for-profit providers has been an important component of the success of the scheme, as private providers have a strong and direct profit motive to expand capacity when an existing successful school reaches capacity limit. Queues and administered rationing of access (in education, this means things like zoning limits which ration access to good schools based largely on parents' ability to afford a house in certain suburbs) are simply much less common when the private sector provides goods and services than when the government does so.

At the tertiary level, there is evidence of very significant misallocation of resources and of pricing restrictions that threaten the ability of providers to generate the sort of world-class education New Zealand will need for a high performing future. As it is, the quality of universities is no better than average – in one recent international comparative exercise, not a single one of our universities made it into the top 200 in the world, and several did not make the top 500. There is almost certainly a place for a considerable diversity of types of tertiary institutions (such as, for example, there is in the United States) but present structures make it hard for any to become a top-flight research-led university. That also jeopardises the ability of our universities to compete in international markets for students (itself a significant export industry).

Some years ago, a major study concluded that the benefits from tertiary education were around three-quarters private and one quarter public, and that the charging and income support regime should reflect that. For now, we are not revisiting whether that proportion remains the right one, but we have seen no evidence to justify the shift over recent years that has materially reduced the private share of the cost of tertiary education.

On the one hand, we have the totally indefensible policy of providing interest-free (not even inflation-indexed) student loans, including to people of an age where there is no probable public benefit at all to study and little prospect of the loan ever being repaid. Student loans need to be moved back to being provided at, at least, the cost to government of funding the debt. The nominal value of student loans is now around $10 billion, suggesting the policy is costing well in excess of $500 million per annum.

And on the other hand we have fee caps and subsidy levels that starve universities of resources (including the ability to continue to compete for top-flight staff) and probably encourage too many people to undertake study that has little or no public or private benefit.

Price controls restrict the supply of a quality product – they encourage providers to produce only what the fee will cover. As a matter of priority, we urge the Government to abolish the fee caps applying to university fees.

Finally, we suspect there would be considerable gains from substantially reforming the ownership and governance structures of our main tertiary institutions. At present, accountability and incentive structures seem to be flawed, with a resulting substantial overlay of bureaucracy through the Tertiary Education Commission and the Ministry of Education. It is not obvious why the government needs to continue to own and control polytechnics: different models would be likely to lead to consolidation, greater efficiency and improved training outcomes. It may also be worth considering establishing universities as independent foundations – akin to many universities in the US and UK – and at the same time ensuring that other providers, perhaps the better Australian

universities, can enter the New Zealand market on the same funding basis as existing providers. We want our young to have access to excellent education here, and should not be greatly concerned who provides it.

In all of this we are highlighting ideas, and the power of incentives. The details of this area warrant further in-depth reporting and analysis. But there is scope for very substantial gains in performance and efficiency.

More generally, the government is by far the largest spender in the economy. It needs to be much smarter and better-focused, using expensive resources much better to position us for 2025.

Government as tax-collector

The previous chapter has discussed in some depth the overall level of government spending, and made some recommendations to materially lower that level over time (as a share of GDP). In the long run, the chosen level of government spending determines the average tax rate in the economy – both the current actual rate, and the rate that firms and households expect to pay in the future. Fluctuations in the overall fiscal picture mean that this relationship is not exact in the short-term: sustained surpluses, for example, could result from cuts in government spending that are not translated into lower tax rates. But over the long term, and especially looking ahead now from a position where the initial level of public debt is prudently low, it is choices about the level of spending that will determine how low average tax rates in New Zealand can be. The fastest growing countries in the last twenty years have tended to have lower average tax rates than New Zealand has. Lowering taxes is a high priority, and the spending reductions recommended in the previous chapter open the way to some surprisingly far-reaching options.

This chapter focuses on the tax system itself, and the way in which decisions around tax structure options could help position New Zealand for achieving the 2025 goal. In its 2007 survey of New Zealand, the OECD – long a strong supporter of the comprehensive broad-base low-rate approach adopted here since the late 1980s – encouraged New Zealand to review the appropriate structure of its tax system.

Tax reduction and system restructuring options

The current Government appears to have recognised that tax structure issues may be significant and has appointed a Tax Working Group (TWG), which is expected to report shortly. The report of that group is likely to be complementary to our own. The TWG has been able to devote significantly greater amounts of time to tax issues than the 2025 Taskforce has. But its mandate was also considerably different to our own. The TWG has looked at tax and transfer system issues, but has not had the mandate to look at the overall level or composition of government spending. Removing that constraint could alter one’s conclusion around the tax structure. The TWG has also not been asked to focus on anywhere near as ambitious a goal as that of closing the income gap with Australia by 2025.

Tax rates, and especially marginal tax rates, are among the most potent instruments governments have at their disposal. Tax rate changes can materially alter incentives to work, to consume, to

save, and to invest, and can influence relative returns within each of these categories (favouring, or penalising, for example, some classes of workers or some classes of investment over others).

It is common ground among us that reducing overall effective marginal tax rates (EMTRs) needs to be a high priority, if there is to be any material chance of closing the income gap[66]. On their own, substantially lower marginal tax rates will make a material difference, but the effects are more likely to be large if done in conjunction with other reforms to materially improve the overall business environment.

We have not, however, taken a view on how reductions in overall tax rates should be achieved. That choice involves balancing a variety of important considerations, and we believe that further more intensive work needs to be done on each of the main classes of options. The focus of the rest of this chapter is on identifying some of the key issues with the current tax system, and some of the considerations that might influence choices about which tax structure might best position New Zealand to meet the 2025 goal. There are some very real, and quite substantially different, options.

There are some significant issues with the current income tax system. Four of the most notable are:

- New Zealand's maximum marginal tax rate (38 percent) is one of the lower among OECD countries, but that rate cuts in at an income which, as a ratio to the average income, is relatively low by international standards.
- The interaction of the higher marginal income tax rates and the abatement rules for the Working for Families scheme means that many middle income working families with children are facing effective marginal tax rates of 53 or 58 percent.
- The gap between the corporate tax rate (30 percent) and the maximum personal tax rate (38 percent), which has increased in two steps this decade, is not abnormally large by international standards, but the rules appear not to have been designed to ensure that the boundaries are effectively enforced. There is clear evidence of widespread use of legal techniques to avoid the 38 percent rate (with the result that estimates of the cost of reducing that rate are surprisingly small).
- Despite the gap, our company tax rate is not low by international standards, and Australia has an official review underway, due to report shortly, which is expected to lead to a further reduction in the Australian company tax rate over the next few years (Australia is, at present, the largest source of foreign equity investment in New Zealand and a material difference in the company tax rates in the two countries increases the likelihood of income being reallocated to the country with the lower tax rate).

[66] In a recent note Robert Barro and Charles Redlick,("Design and effectiveness of fiscal-stimulus programmes", http://www.voxeu.org/index.php?q=node/4144) report research results suggesting that that a 1 percentage point cut in economy-wide EMTRs could boost annual GDP growth by 0.6 percentage points. That estimate seems too large to be plausible, but even if the true number were only a third of the Barro and Redlick estimate, lowering EMTRs could make a major contribution to closing the income gap to Australia.

As already noted, we do not share the popular view that the income tax system treats leveraged purchases of investment rental properties in a way inconsistent with other assets, especially other real assets. Un-leveraged owner-occupied housing can certainly be seen as being treated in a preferred manner (an issue dealt with in the McLeod review of the tax system in 2001). But any bias is not obviously greater in New Zealand than in many other countries.

Other facts are:

- Total tax revenue in New Zealand as a share of GDP has been almost exactly equal to the OECD average over the last 15 years.
- The share of GDP taken in taxes on labour is low by international advanced economy standards (only six countries in the OECD have lower overall labour taxes, although notably they include Australia, Slovakia, Ireland and Korea).
- The share of GDP taken in taxes on capital income (profits, dividends, interest) is among the highest among the OECD countries.
- The share of GDP taken in taxes on consumption (GST) is around the OECD average (a very efficient GST system, with a relatively low rate).
- The share of GDP taken in taxes on immovable property (including local authority rates) is well above the OECD average.

Other stylised facts of potential relevance to tax structure choices have been covered earlier in this report:

- Labour force participation rates are relatively high by international standards, and the number of hours worked per head of population is above that in the average OECD country.
- Investment spending per worker is low by international standards, and the size of the capital stock per worker may also be small.
- National savings per head of population is also low by OECD standards (and even more so relative to the high performing Asian economies such as Singapore, Hong Kong and Taiwan).

We believe that something significant must be done about the implications of the interaction between the tax system and the Working for Families credit for effective marginal tax rates facing middle income working families. There is a variety of options, in principle including:

- Abolishing Working for Families completely, which would generate substantial fiscal savings, and avoid any abatement rate issues. Even under current tax rates, no one would then face an effective marginal tax rate in excess of 38 percent. Overall tax rates could be lowered further as a result.
- Cutting Working for Families payments, so that the current 20 percent abatement rate would apply over a smaller range of incomes.
- Lowering the abatement rate further, which would reduce the very high EMTRs, but produce still-high EMTRs for working families over an even wider range of income.
- Moving to a universal child benefit, or child tax credit, perhaps by reallocating the current total spending on Working for Families (around $2.9 billion per annum). This option would provide no fiscal savings, but would eliminate the EMTR problems associated with the current scheme.

It might be conceived as akin to the child or dependent tax credit common in many overseas systems, presumably in part reflecting a sense that ability to pay is a consideration relevant to the design of the personal income tax system.

Too much detailed legislation?

Today, each of Singapore, Malaysia, and Hong Kong still has 300 or so pages of income tax legislation. New Zealand's current income tax legislation has ten times that many. Inland Revenue has a team of people whose full-time task it is to tinker, ceaselessly, with the legislation. It seems to be a cunning plan to disguise the real unemployment figures among the illiterate and the unthinking. The New Zealand definition section (of the Income Tax Act) is longer than the entire taxation legislation of each of Singapore, Malaysia, and Hong Kong. The latter have few reported tax cases. New Zealand has an industry in them: an industry which diverts, from real productivity, the resources of the commercial sector.

From 'New Zealand: Cuckoos in the Nest in an otherwise promising trust and investment jurisdiction', by Tony Molloy QC, in "Offshore Investment" November 2009, page 21

The Taskforce has not taken a position on the appropriate way forward, but we all regard the current system as inconsistent with the sort of incentives to work, and to accumulate human capital, that achieving the 2025 goal is likely to require.

The vision that guided the comprehensive tax reform undertaken in New Zealand in the 1980s was to have a comprehensive broad-based relatively low rate system, treating all factor incomes the same (whether earned from capital or labour, regardless of the corporate form etc), while applying a very comprehensive and high-yielding value-added tax at a common rate across all goods and services (other than financial services). The tax reforms represented a substantial step in the right direction, significantly reducing the distortions in the system, and the incentives to rent-seeking behaviour. A critical dimension of that simplicity was that the compliance costs for taxpayers, and enforcement costs for the Inland Revenue, were kept to a minimum. As important, governments eschewed the use of the tax system to "pick winners".

It is common ground that much of the strength of the current system (or at least of the original form of it, before it was undermined by the various "tweaks" in the last 10 years) should be retained. Indeed, since there has been considerable slippage, we favour a focus on re-establishing a more neutral tax-system. The Taskforce believes that the tax system should treat all labour income similarly, all capital income similarly, and all goods and services similarly. We strongly oppose any attempt to use the tax system to artificially favour particular sectors or activities. We oppose, for example, research and development tax credits, we oppose tax incentives for forestry, mining, petroleum exploration, racing, film-making or any other industry. We oppose KiwiSaver tax credits, and are sceptical about the PIE regime under which some forms of capital income are able to be taxed more favourably than those not held within a PIE.

It is also clear that if any serious consideration is given to raising the rate of GST – which we do not favour – it is vital that no ground be conceded in undermining the comprehensiveness of the current, widely-admired, GST system. For example, periodic calls arise for food to be exempted

from GST to help poorer people. In fact, while low income people spend a larger proportion of their incomes on food than higher income people do, most of the GST on food is raised from high income people. Exempting food would, over time, hurt those it was designed to help, as well as adding considerable complexity and avoidance possibilities.

Where there should be a more open debate and in-depth examination of the issues is around the question of whether incomes earned from labour and capital should be treated differently.

Much of the discussion and political debate in New Zealand in recent times has centred around the notion of once-again aligning the company tax rate, the trust rate, and the maximum personal tax rate. The National-United agreement, for example, refers to a goal of aligning at 30 percent (the current company tax rate). Moving to an aligned structure of that sort would be a step forward. It would remove the considerable incentives to tax planning activity which exist at present, and would strengthen incentives. But the level of avoidance at present is sufficiently widespread that the incentive effects would probably only improve materially if the harmonised rate could be set well below 30 percent. The sorts of cuts to government spending recommended in the previous chapter suggest that a harmonised maximum rate of 20 percent would be quite feasible. Estimated direct static fiscal costs, provided to us by Treasury, for various aligned options are set out in Table 2:

Table 2: Direct fiscal costs of aligned tax options[67]

Aligned at 30 percent	$1.6 billion per annum
Aligned at 25 percent	$4.1 billion per annum
Aligned at 20 percent	$7.0 billion per annum

Source: The Treasury

Getting core Crown operating expenses below 30 percent of GDP in the next few years would make a 20-20-20 option fiscally feasible.

But getting spending under control also opens up alternative approaches to cutting taxes. For example, an alternative approach might be to consider a dual income tax system (of the sort now used in a number of European countries), in which income earned from labour is taxed at one set of (progressive) rates, and income earned from capital is taxed at a materially lower rate. (To be clear, the distinction here is not between company and personal income, but between the factors of production from which the income is generated.)

Over the last 25 years there has been an increasing shift in the economics literature towards a view that, to the extent that the focus in tax design is on overall economic performance, the taxation of capital income in particular should be minimised. In a recent paper on optimal taxation issues, Greg Mankiw (professor of economics at Harvard, and former chairman of the US Council of Economic Advisers) and co-authors summarise the point as follows:

[67] For any given tax rate a flat tax option is considerably cheaper. That is because, all else equal, a flat tax would raise taxes on those earning low taxable incomes.

...the logic for low capital taxes is powerful: the supply of capital is highly elastic, capital taxes yield large distortions to intertemporal consumption plans and discourage saving, and capital accumulation is central to the aggregate output of the economy.[68]

These conclusions hold in both open and closed economies, but are of particular importance in a country like New Zealand with a heavy dependence on foreign capital. As highlighted above, we also appear to be an economy with relatively low levels of investment taking place: the tax rate on capital income may therefore be something that is particularly important to focus on in conjunction with other reforms to improve the business climate.

The OECD has recently surveyed the in-depth work on the connections between taxation and economic performance. Those results confirm that, at a national level, higher taxes tend to lower potential incomes. But they also highlight the importance of the structure of the tax system. In particular, they find – consistent with the theoretical literature – that taxes on consumption and immovable property tend to have the least distorting effects. Taxes on labour are next, and corporate income taxes are most distorting and costly[69].

This approach to tax issues is recognised, to some extent, in the widespread practice of keeping the corporate tax rate lower than personal tax rates. That is not an approach we support. A more robust approach (practically and analytically) is that adopted in a number of countries, particularly in Scandinavia, of setting the tax rate on capital income materially lower than that on labour income. In those high tax countries, the capital tax rate itself is not particularly low, but it is much lower than the (very progressive) rate on labour income. Focusing on keep the most distortionary taxes low is a way of minimising the economic costs of high levels of total government spending.

A dual income tax approach has been in place in some other countries for some years, so in canvassing it here as possibility for New Zealand, we are not dealing with some abstract curiosity from the literature. Other countries have found practical solutions to the issues of isolating labour income from capital income in the case of closely-held companies and the self-employed.

The OECD itself, in its 2007 review of New Zealand, recommended that New Zealand look seriously at the possible benefits of such an approach: drawing a possible linkage between cutting the tax rate on capital income and lifting the relatively low level of investment and savings taking place in New Zealand. Moreover, we noted with interest the 2009 submission to the Australian tax review by the Business Council of Australia[70] which, for similar reasons, called for a dual tax option (with a capital income tax rate of 15 percent proposed) to be modelled and tested. We have not formally costed such an option. However, our sense is that, in the New Zealand context, a capital income taxation rate of, say, 12.5 percent (currently the lowest marginal tax rate) would still allow substantial reductions in the maximum labour tax rate for a similar total cost to aligning all

[68] G Mankiw, M Weinzerl and D Yagan, "Optimal Taxation in Theory and Practice", mimeo, 2009

[69] See, for example, the Taxation and Economic Growth chapter in the OECD's 2009 *Going for Growth*. Data limitations mean that most empirical studies focus on corporate income rather than capital income.

[70] "Unrealised gains: The competitive possibilities of tax reform", June 2009 (http://www.bca.com.au/Content/101576.aspx)

maximum rates at 20 percent. We understand that the Australian review has considered the dual option carefully, although we will not know for some time what that review finally recommends.

A considerably lower tax rate on capital income could be expected to increase the rewards to entrepreneurship, encourage domestic investment and national savings (and would also counteract some of the distortions arising from the interaction of inflation and the tax system)[71].

A natural initial reaction to such an option is to focus, in a static sense, on the relative wealth of workers and owners of non-human capital. However, this static perspective is deeply misleading. Again there is a fairly substantial consensus in the economics literature that the incidence of taxation on capital income falls on labour: in other words, it is workers, and especially relatively immobile ones, who are most adversely affected by taxing capital income. Why? In short, because taxes on capital income means less capital accumulation occurs. Greater capital accumulation and domestic investment, in response to perceived profitable opportunities, are key elements of the process of lifting incomes, including wages. As discussed earlier in the report, one reason why incomes and wage rates in New Zealand are so much lower than in most of the rest of the OECD is that many fewer new initiatives and, hence, much less investment has taken place here. To the extent that capital taxes hold back the accumulation of capital in New Zealand, over time they hold back wage rates in New Zealand.

Some also suggest that a dual tax option would represent some sort of windfall to existing owners of investment projects. In fact, that seems unlikely. Since investors can be expected to focus on after-tax returns, lower taxes on capital income could be expected, through the competitive process involving the addition of new capacity, to lower pre-tax returns for existing owners of capital.

Of course, in the short-term there are no free lunches. For any given level of government spending, raising less tax on capital income means raising more tax elsewhere (labour, consumption spending, land or other assets). But the overall recommendations of this report envisage reducing government spending and tax rates on both labour and capital income. Boundary and enforcement issues would be greater under a dual system than under an aligned system, though probably less severe under either system than the present unsatisfactory situation.

Cutting taxes is critical. But in reaching a judgement about *how* to cut taxes, the Government would need to consider a number of factors including:

- The more weight one placed on administrative simplicity, the more one would favour an aligned maximum rate.
- The more pessimistic one was about the ability to quickly deliver deep cuts in the overall spending (and, hence, tax) to GDP ratio, the more one would be inclined to lean towards a dual rate system.

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[71] To the extent that there was concern about leveraged ownership of investment rental properties, note that a much lower capital tax rate would substantially reduce the benefit of being able to deduct losses on rental property against other income (since losses could be deducted only at the capital income tax rate, not the labour income rate).

- The more one thought that one of New Zealand's major economic weaknesses was under-investment in human capital (and that this was related to, say, taxes rather than the education system), the less one would be inclined to favour a dual rate structure.
- The more one thought that international labour mobility was influenced materially by personal marginal tax rates (as distinct from either the total tax burden, the net bundle of taxes and public spending, or pre-tax incomes), the more inclined one would be not to favour a dual rate system.
- The more one focused on New Zealand's low levels of domestic investment and national savings as symptoms of New Zealand's economic underperformance, the more favourably one might look on a dual system.

One other consideration that may be relevant to choices in this area is that, when the inflation rate is positive, the taxation of all nominal interest income at a taxpayer's personal marginal tax rates means that a much higher tax is imposed on real interest income than on, say, labour incomes. With a positive inflation rate, much of any interest earned is simply compensation for lost purchasing power, not a real income. There is, of course, a range of possible responses to this distortion.

This discussion, and list of possible considerations, is not intended to be comprehensive. Each heading encompasses a range of complex issues that would need some further work before the Government could make a robust decision on how the tax and transfer system might best support the 2025 goal.

Other tax issues

As noted, the Taskforce does not believe that a higher rate of GST is necessary or desirable as a part of the structural tax reform needed to achieve the 2025 goal. GST is a very efficient tax, and were higher tax revenue ever to be required it would probably be the fallback option. But government spending has risen so much, and there is so much scope to cut the share of government spending in GDP over the coming years, that we do not believe that a higher rate of GST should be considered. Raising GST would tend to have the effect of validating ill-considered low-quality increases in government spending, shifting the focus from where it needs to be. The 1989 increase in GST should probably be best seen in this light, deferring necessary adjustment to spending. Of course, as income tax rates are cut, the mix of total taxation revenue would shift towards consumption taxes. That shift is certainly appropriate.

There has been public discussion and debate over recent months around two possible tax base broadening measures.

The case for a land tax – levying a small annual tax, of perhaps 1 percent, on the unimproved value of all land – is reasonably well made in the literature. Unimproved land is the ultimate immobile asset, and because of this a tax on land is, in principle, quite minimally distorting. Local authority rates are already either a house and land, or a pure land, tax (depending on whether a particular local authority uses land or capital value rating), and a land tax operates at a national level in Denmark. We do not favour the introduction of a national land tax here for several reasons:

- We do not have actual estimates of unimproved land values. Rural land values include the value of pasture, drainage etc, and hence a land tax would affect incentives to invest in improving the quality of the land.
- At best, even a 1 percent land tax, on all land, would raise revenue equal to around 1 percent of GDP. This is because land values at present are unsustainably high, and a land tax itself would materially further reduce long-term equilibrium real land prices. Current informal revenue estimates suggesting a greater revenue potential are almost certainly too high.
- History suggests[72] that the pressure to introduce carve-outs, differential rates and so on would be very difficult to resist, over time even if not initially. If so, that would seriously undermine the in-principle case for such a tax.
- The transitional issues for the agricultural sector in particular would be very substantial. Were there a pre-existing subsidy, we would have no hesitation in recommending its removal, but it is not obvious why, in the absence of such distortions, we would want to impose a large transitional burden on producers in the agricultural sector, especially in a period when the focus needs to be on catching Australian incomes.

We do not seeing a pressing need to extend the existing provisions of the Income Tax Act under which some capital gains are assessable as income for tax purposes.

Much of the recent debate around taxation of capital gains centres on house prices, and especially prices of investment rental properties. House prices have risen very substantially. At current levels, they are almost certainly unsustainable. We propose measures in a later chapter to reduce or remove regulatory barriers that impede the supply of new houses when prices rise. The Taskforce strongly favours dealing with distortions at source, not responding to symptoms with second-best instruments. Ongoing discussion around the possibility of a capital gains tax, on real capital gains, should be conducted on its own merits, as a matter of appropriate tax system design, not as substitute for fixing weaknesses in policy in other areas.

However, if New Zealand is to meet the 2025 goal, the focus of economic policymaking needs to be on creating a climate that encourages and rewards wealth creation. It is not clear how well taxing capital gains – whether on houses that provide valuable rental services to many, or on other business assets – fits that framework. The capital value of any asset only increases sustainably when the market attaches a greater value to the future income that the asset is expected to generate. When future profits or future rents actually rise, they are liable for tax as income, but there is no compelling reason to tax both the capital value and the expected future income that the increase in the capital value embodies. Doing so could be considered as, in effect, double-taxation. The parallel with labour should illuminate the point: when the wages of health professionals rise we tax the wages, not the capitalised value of the investment in human capital that makes it possible for those people to earn the higher wages. There are no costless windfalls on offer: taxing capital gains more heavily would raise more revenue but would be expected to reduce innovation and

[72] New Zealand had a land tax system for many years, only finally abolished in the 1990 Budget.

capital accumulation. Finally, actual working capital gains taxes are materially less attractive than textbook versions.

Tax reform and fiscal constraints

We consider that tax cuts and tax reform will be integral features of a successful strategy to meet the 2025 goal. We also believe that substantial tax reform will generate significant real economic gains, including significant increases in revenue over the longer-term.

Nonetheless, tax cuts and any material tax reform must be based on identified and implemented cuts in the ratio of government spending to GDP, and on realistic estimates of the likely short-run revenue costs of cutting average tax rates. The low level of public debt is one of the great strengths of the New Zealand economy. It should not be jeopardised by cutting tax rates in the hope that expenditure savings can be secured in the years to come. That sort of approach is usually a recipe for higher tax rates again before too long, while degrading the quality of core public services in the process.

Government as owner of substantial assets

Introduction

The New Zealand government owns very substantial assets, and the size of its balance sheet has grown considerably over the last decade. Total assets on the government's published balance sheet as at 30 June 2009 were $217 billion (around 120 percent of GDP). These assets take various forms. They include:

- financial assets held by various reserve funds (for example, Reserve Bank, New Zealand Superannuation Fund, the Earthquake Commission, The Treasury's Debt Management Office)
- commercial operations (including SOEs, Crown-owned companies such as Television New Zealand, and a controlling shareholding in a major listed company (Air New Zealand))
- assets held directly as part of the delivery of public services by the state (schools, hospitals, roads, police stations, Defence Force bases, and so on).

In addition to the assets recorded on the balance sheet, the Crown has very substantial mineral rights holdings.

Local governments held a further $95 billion of assets[73], again in a mix of forms, and with a mix of functions – some largely commercial, most directly related to the delivery of what are currently public services.

Both central and local government assets far exceed the market capitalisation of companies listed on the New Zealand stock exchange (around $54 billion in mid November) or the total assets of those companies. Looking beyond the listed company sector, total private sector assets far exceed those held by the public sector. But in New Zealand – as in most countries – the government is by far the largest asset holder in the country, and local government is probably also the largest asset owner in most regions.

[73] As at 30 June 2008.

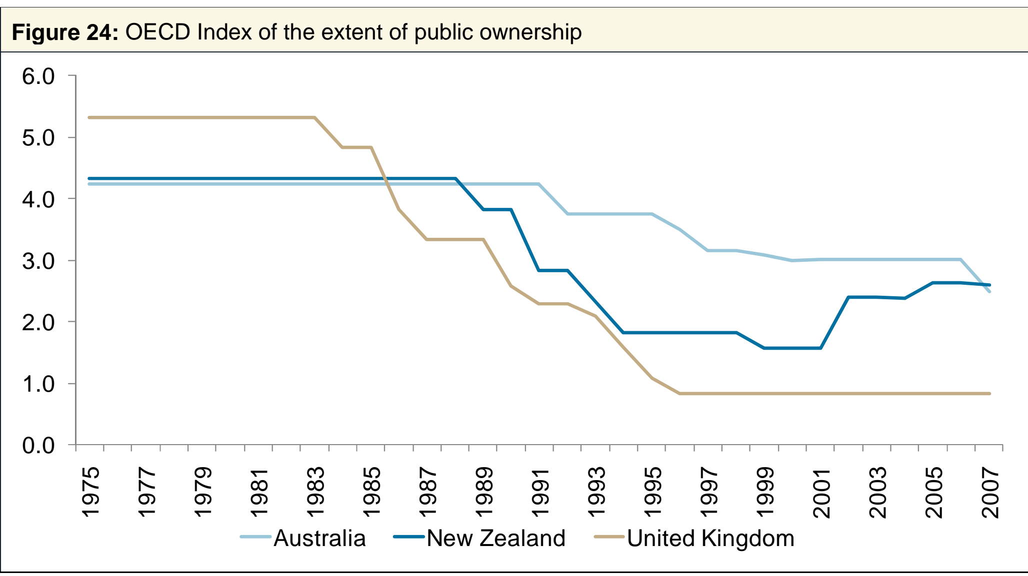
Governments hold those assets on behalf of citizens and in most cases there are no direct market performance disciplines. That makes it particularly important that governments' portfolios of assets are managed extremely well. There are vitally important and wholly legitimate public policy roles that governments need to undertake. Many of the functions governments undertake may well require government agencies to own assets. But there should be no reason to accept weak or inefficient management and governance – starting so far behind in the income stakes, and with aspirations to do so much better, New Zealand simply does not have that luxury. In that regard, we welcome the current Government's indications that it intends to place greater weight on balance sheet management issues.

The Taskforce believes it is vital that a comprehensive review is undertaken of the government's asset portfolio. In many cases, we do not believe that the case for continued Crown ownership would prove compelling. That is not to suggest that government assets are always and everywhere badly managed. But the clear evidence is that, on average over time, the private sector will do a considerably better job of ensuring that productive assets are managed efficiently and used to their most productive ends. However, where there is a strong case for continued government ownership, or where governments conclude that, for whatever reason, Crown ownership should continue, it is vital that strong management and governance structures are in place, to extract the best possible long-term value from the assets.

Existing central government trading assets

Previous governments privatised substantial numbers of trading operations and companies in the late 1980s and 1990s. Despite that, the New Zealand government remains the owner of a large number of substantial business assets. Indeed, direct government involvement in business operations has increased materially over the course of the last decade. Since 1999, there have been no state asset sales. In some cases, state-owned enterprises have purchased profitable private companies. Kiwibank has been established, under government aegis, by New Zealand Post. A majority stake in (previously privatised) Air New Zealand was purchased in 2001. And, in two separate stages, first the railway track and then the operations of KiwiRail were brought back into full state ownership.

Figure 24: OECD Index of the extent of public ownership



Source: OECD

Note: Airlines, Telecom, Electricity, Gas, Post, Rail, Road

There should be a strong presumption against continuing state ownership of operating businesses. It is difficult to conceive of a reason why the New Zealand government should own a large coal-mining company, three major electricity generating and retail companies, one of New Zealand's largest exporting firms (Air New Zealand), and so on.

The framework established under the State Owned Enterprises Act is a good one for reducing the risks and costs of state ownership of operating businesses. That framework has worked reasonably well. But it is not a recipe for the sort of consistent excellence and innovation that New Zealand needs. Boards of directors of SOEs are appointed by Ministers, and on occasion appointments to such Boards have been used as political sinecures. But however good individual Board members are, they will never face the same incentives to produce high quality performance – both maximising returns on existing assets and identifying new opportunities – that directors of a private company face. Ministers of the Crown – who are the shareholders in SOEs – are rarely motivated to go into politics to ensure maximum returns on business assets. But that is what private shareholders and capital markets seek to do. What is more, there is always a risk that state-owned businesses will face implicit pressure to run, or feel rewarded for running, their businesses in ways that support the other political priorities of the government of the day, rather than responding to economic incentives and opportunities.

To some extent, earlier New Zealand privatisations were undertaken under the shadow of a high level of public debt. Just like individuals or companies, governments that get overextended find it necessary or prudent to sell off some assets and pay down the debt.

Successive governments have achieved very substantial and sustained reductions in government debt, and the New Zealand government now has among the lowest debt levels (as a share of GDP) anywhere. Repaying debt is not a reason to sell assets now: getting the best possible return on government assets and economic resources is. This is not a story about financial risk or economic vulnerability, but about lifting economic performance and achieving the 2025 goal.

We urge the Government, as a matter or priority, to review its continuing ownership of its commercial trading assets, with a strong predisposition to selling each of them provided that they operate in competitive markets or in markets where competition is feasible. Many of these firms are among the largest companies in New Zealand, and we predispose ourselves to failure if we do not allow these companies to achieve their full potential. We do not know what that potential might be – governments never can – but market disciplines sharpen incentives, and provide the flexibility to generate and respond to innovative ideas about products, processes and markets. To the extent that government owned or controlled entities are not always operating in response to price signals there is good reason to doubt whether appropriate levels of investment will be undertaken. For network sectors in particular, there is reason to think that there has been a correlation – and not one by coincidence – between the extent of state domination of particular sectors, and the emergence of serious capacity constraints in New Zealand[74].

It would take time to sell all the SOEs in full. In the meantime, in the transitional phase, some gains could also be achieved from partial floats of each of the SOEs. Sale of, say, a 40 percent stake in each would still leave the government with unquestioned ownership control, but the disciplines of a daily-traded share price and the appointment of private sector directors would almost certainly strengthen the performance, and commercial focus, of the SOEs. The example of Air New Zealand is instructive: the Crown holds a dominant majority stake, but the presence of outside shareholders and directors helps ensure that the company is managed in the interests of all shareholders, at less risk of responding to the political imperatives and constraints of the government of the day.

However, partial floats are likely to be a rather poor middle ground: for any large company, the continued presence of a large government stake is likely to create expectations of an implicit government guarantee, undermining the market disciplines that are fostered when creditors face real credit risk. Such a pattern of ownership may prove unsustainable in the long run – and not necessarily in a way that leads to good long term outcomes.

The sale of some or all of the government's portfolio of trading assets would be likely to have the incidental benefit of increasing somewhat the size of New Zealand's private capital markets. This is not, in itself, the reason to promote the sale of assets: the focus is the probable better (more valuable) use of the assets in private hands (whether that is achieved through a trade sale, a public float, or some combination of the two). The expected improvement in performance will be reflected in the price purchasers will pay. Moreover, even if SOEs were floated, a sustained increase in the depth of public capital markets is by no means guaranteed – nor should it be a consideration in determining the chosen means of sale. Experience in the last couple of decades suggests that the relatively small

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[74] Dr Brent Layton, formerly Director of the New Zealand Institute of Economic Research, compiled some years ago an interesting graph along those lines, which is reproduced in Roger Kerr, "Reducing barriers to investment in infrastructure", November 2004. Such a correlation, to the extent it exists, is not an inevitable feature. At some times and some places, heavy government ownership has also been associated with over-investment. The critical issue is the difficulty of ensuring that investment is undertaken in response to price signals when entities responsible for those investments are not themselves subject to market disciplines.

stock of domestic savings is part of the reason why many New Zealand companies have been taken over by foreign owners, for whom, among other advantages, the cost of capital is lower.

Some have asserted that if a government was under no immediate pressure to reduce debt, it would be worse off financially from selling trading assets. The argument appears to be that business investments typically earn a higher return than the interest rate that the government pays on its debt. In fact, the price a bidder pays will largely reflect the expected future returns on the asset. And the evidence, here and abroad, is that private owners are able to obtain better returns from the assets than government owners do: rates of return on the government's investment in New Zealand SOEs have generally been no better than adequate, and often worse than that. In other words, privatisation of government assets, into a competitive market, will generally improve the government's financial position, and the performance of the economy as a whole. Nor is there a compelling argument that in some sense the government's cost of capital is lower than that of the private sector: the government's ability to raise capital is directly premised on its power to tax. The cost of capital to the private sector – what it would be able to profitably do with money the government now has – should be thought of as the true cost of capital the government, as representative of its citizens, faces. Projects and asset sales decisions should be evaluated accordingly.

Finally, while trading companies are held by government, there is a case for strengthening the appointment procedures for Board directors. We do not believe that directors should be appointed to such boards on any grounds other than those that would apply were the same businesses in the private sector looking for directors. While Ministers, as shareholders, must retain the ultimate right to hire and fire directors, there is a case for a more transparent mechanism for evaluating the suitability of potential appointees to SOE Boards. An independent Crown Commercial Appointments Commission could be responsible for making recommendations to Ministers, and for publishing a suitability assessment of anyone appointed to the Boards of such commercial entities.

Local authority trading assets

Local authorities also have very substantial trading assets. The most obvious of these are the ports[75]. Ports are vital gateways for an island trading nation. All New Zealand's ports have majority local authority ownership: in most cases now 100 percent local authority ownership. Only in one or two cases is there any effective market-based discipline on the use of capital in the port sector. Moreover, the economic return on capital appears to have been well below what would normally be expected from port assets that are run fully commercially[76].

The OECD, in its latest biennial review of the New Zealand economy, highlights port ownership as a significant economic issue for New Zealand. We agree. There are indications that New Zealand ports are fairly technically efficient for their size and scale: huge improvements in the productivity of the port sector occurred during the 1990s following the 1989 port reforms. Thus, in some sense, the main losers from the current ownership structures may well be the ratepayer owners, rather than exporters, importers, or shipping lines. However, those income losses are real. As importantly,

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[75] But include, in many areas, substantial holdings in airports and water storage and distribution assets.

[76] See, for example, McDouall Stuart's 2006 report "The New Zealand Port Sector: Storm Front Approaching".

local authority ownership tends to militate against the sort of consolidation and evolution of the port model in New Zealand that would be likely to occur with freely traded capital and majority private sector ownership.

We would not recommend that local authorities retain minority holdings in port companies but the biggest gains are likely to arise from the sale of majority stakes. As a somewhat parallel example, we note that Auckland and Wellington airports now have majority private sector ownership, but local authorities have retained significant minority shareholdings.

In addition to the port holdings, many local authorities have large ownership interests in public transport fleets, airports, commercial land and so on, Ownership of ports and these other assets is not a matter for central government to decide, but we strongly recommend that all local authorities should seriously review the ownership and governance of their existing trading assets with a view towards sale. The benefits – both for ratepayers as owners of these assets, and for overall economic performance – are likely to be just as real (perhaps more so) as those that would flow from the sale of central government's commercial assets.

New Zealand Superannuation Fund

The New Zealand Superannuation Fund (NZSF) was established by the previous Government, as part of its strategy to cope with expected demographic pressures on public finances that, on current policies, would become apparent from around the mid 2020s. At a time when the government was running large operating surpluses, it was also apparently designed to play a role in limiting the rate of growth in public spending. The suggestion was that any such discipline would be more effective than if the government had simply used the surpluses to repay outstanding public debt issues at a faster rate.

The extraordinary rate of increase in government spending that has occurred since 2004 – among the largest as a share of GDP anywhere in the developed world – makes it questionable just how much additional spending discipline the mechanism of the Fund has provided.

We do not believe that there is a case for retaining the Fund. It should be wound up and its assets used to repay debt. A number of considerations lead to this recommendation.

The government is no longer in budget surplus, and if it were to make contributions to the NZSF that could fairly be characterised as borrowing to engage in speculative investment. We find the case for that unconvincing, to say the least.

Perhaps more importantly, as we discussed in the chapter on government spending, we believe the demographic and related pressures can and should be addressed at source. There is simply no obvious reason to allow the share of GDP devoted to superannuation spending to increase very materially over time.

Thus, if and when the government accounts again show a credible prospect of moving into surplus, we believe that the benefits of getting spending under control should be used primarily to cut tax rates. In a country in New Zealand's position, lowering tax rates is likely to be the most productive use of any sustained improvement in the country's financial position. We would take the same approach if the sale of trading assets and wind-up of the Fund were to push the Crown into a

material net financial asset position. Surplus resources should be returned to taxpayers, who are likely to use them more effectively than the government.

The governance arrangements for the New Zealand Superannuation Fund are of very high quality. They put specific investment decisions at a considerable arms-length from the government of the day. Nonetheless, the risks to the efficient allocation of capital if the Fund were to be allowed to continue have already become apparent.

The current Government campaigned on increasing the share of the Fund's assets allocated to New Zealand investments to 40 percent. This has not been mandated by statute, but over time it would be difficult for the Fund and its Guardians to resist the soft pressure to respond to government aspirations regarding the allocation of what is, after all, public money. That is particularly so if the Fund were to have been allowed to grow to the originally expected peak size (up to 50 percent of GDP).

As the Fund has grown even to its current size, calls from political leaders and leaders of various interest groups for the Fund's resources to be used for this or that infrastructure project, or to promote other apparently worthy objectives such as capital market development, have become more frequently heard. With the best intentions in the world, it is very difficult for a democratic polity to manage well large accumulations of assets[77]. That matters a lot more than it might otherwise in view of the scale of the 2025 challenge.

Government capital and investment spending

The Taskforce has serious concerns about the overall quality of decisions being made on capital spending items. The role of rigorous cost-benefit analysis in central government decision-making appears to have declined markedly, almost certainly at considerable cost to the quality of the decisions made on capital spending proposals. The incoming Government has increased its capital spending allowance for the next few years. Getting value for money is likely to involve much more rigorous analysis and evaluation than appears to have been undertaken in recent years.

It is, of course, only fair to note that the quality of capital spending analysis undertaken in many countries appears to leave a considerable amount to be desired. In particular, we have noted in the media, and heard from submitters, similar concerns raised in Australia. But although it becomes somewhat tedious to reiterate, we simply have to do better. We won't close the 35 percent income gap if we fritter away the resources we have.

We believe that a full economic cost-benefit analysis should be conducted, and should play a central part in decision-making, when any significant capital, infrastructure, or asset purchase decision is being made. Such cost-benefit analyses should be routinely published, whenever possible before final decisions are made, to enable more informed scrutiny of decision-making by citizens. A formal review by Treasury should be a requirement for all projects over a certain size

[77] The only successful example we are aware of is Norway's Petroleum Fund, with the important difference that those assets have been accumulated not from tax revenue but from a resource windfall, and in an economy with a large excess of desired savings over desired investment.

(perhaps $50 million) and Treasury should provide robust, published, guidelines to all agencies on methodologies to be used in preparing cost-benefit analysis.

The concept of a cost-benefit analysis is relatively simple. Projects shouldn't be undertaken when the costs exceed the benefits. Doing the analysis involves on the one hand estimating the direct and indirect costs of undertaking any project (using direct price evidence wherever possible), and on the other hand seeking to rigorously evaluate the benefits to (in the case of government projects) citizens. In a society such as ours "benefits" need to be those that citizens themselves place a value on, and evidence needs to be brought to bear to illuminate that discussion. Benefits identified by officials, with particular visions of what growth or development "should" look like, should not be relevant to the calculus.

A cost-benefit approach recognises that capital devoted to projects can't be used for other purposes: that cost of capital is factored into the calculation. And the cost of capital highlights starkly that a benefit 10 years ahead is much less valuable than the same sized benefit that can be achieved a year from now. Even, in straightforward commercial operations – where the costs might be clear, and the interests of the owner are also clear – cost-benefit analysis isn't always easy. In public sector projects where direct price signals are often unavailable, the challenges are even greater. But accepting that such analysis is difficult does not change the importance of doing it well, including testing and evaluating credible alternative scenarios, and exposing the analysis and assumptions as far as possible to public scrutiny. A cost-benefit analysis framework needs to be pre-eminent among the factors shaping decisions on all government spending, and especially on government capital projects.

Rail

We are particularly concerned about the quality of decisions that have been made around rail. It has been clear for some time that the price paid for the rail operations in 2008 was manifestly excessive, and that this was known to officials at the time the purchase was undertaken. Overpaying for an asset crystallises a permanent loss: the amount of the excessive payment has gone, along with the annual national income that capital sum might have generated. Perhaps even more concerning is that it is not clear whether, at any positive price, KiwiRail would have offered an attractive economic proposition. There must be serious questions around the economic viability of rail except for the carriage of a limited number of bulk commodities on a limited number of lines, and perhaps some (but not all) Wellington commuter lines. It seems quite plausible that most of the overall value in KiwiRail is in its land holdings, most of which could almost certainly be used more productively in other uses.

Independently of the decision to purchase and establish KiwiRail, we believe that decisions around urban rail in Auckland in particular have been highly questionable. It is hard to avoid the conclusion that decisions to commit very large amounts of money have been made, perhaps are still being made, with almost no weight given to a proper cost-benefit analysis. Nothing we have seen or heard suggests that, on any reasonably credible assumptions, the benefits of urban rail development in Auckland would exceed the costs – let alone by enough to beat out more beneficial investment projects in other sectors.

Sunk costs are bygones, but it is critical that hard-headed decisions are now made about any future capital spending on the rail network.

Roads

In contrast to the very low benefit/cost ratios applicable to many rail projects, in recent decades road projects, at a national level, have often only been funded when they have had a benefit/cost ratio of around 4 (ie economic benefits exceed costs by 4 times). When investment allocation decisions are made by government agencies, because the government has decided to own the assets itself and not charge at point of use, it is important that a realistic assessment of the economic benefits to all users and of the costs (construction and ongoing maintenance) to the Crown guides decision making. There is good reason to suppose that there has been signficant underinvestment in roading infrastructure, a conclusion that was endorsed by the OECD in their recent survey of New Zealand. Urban congestion has real and material economic costs and better quality inter-city roads would better enable the productivity gains from larger trucks to be achieved.

Both the current and previous governments have put priority on increasing spending on road infrastructure. We think that this approach is probably consistent with the direction required to meet the 2025 goal. However, we believe it is important to consider again possible reforms that might lead to a consistently better allocation of capital to roading through time. This is not a matter of raising total revenue from road users: we have been advised that total excise revenue on petrol, and road user charges, approximately cover the total cost of the roading network. Instead, the critical issue is about sharpening pricing incentives and information, both for road users and for those responsible for decisions on road building.

In the longer-term we suspect that full road-use pricing, differentiated by location and time of day, is likely to have a valuable role to play, both in relieving congestion and in ensuring that appropriate pricing signals face the New Zealand Transport Agency (NZTA) and other road-builders. The technology does not yet exist to make a full electronic pricing model feasible, although we understand that it is approaching the point where it could be economic for heavy vehicles. In the meantime, we believe that further work on the option of congestion charging for central Auckland and Wellington should be pursued. Congestion charging is now an established technology in a number of large cities and we understand that a cost-benefit analysis would now support its use in Auckland.

In the absence of road pricing, the current governance model for roading is not bad: regional committees provide ranked input to a national process in which roading priorities are determined. However, even within this framework we believe it is important that primacy once again be given to economic efficiency and proper robust and transparent cost/benefit considerations in determining roading priorities. In principle, provided costs and benefits are properly identified, it is appropriate to fund all projects for which the benefits exceed the costs. The Crown is not heavily-indebted at present, and although we recommended the sale of purely commercial assets to realise the full potential of those existing assets, such sales would enable well-justified public capital spending to occur without further increasing the level of overall public debt.

Broadband

The Government has this year launched an ultra-high speed broadband initiative, in conjunction with private providers. This initiative will involve the commitment of $1.5 billion of public money over the next 10 years.

Broadband technology has made a great deal of difference to many people's lives, and to many businesses. It seems likely that the technology will continue to develop rapidly, and that many opportunities – business and leisure – will unfold in future years. It is difficult for researchers to meaningfully assess in advance how large those benefits are likely to be, but we can easily look backwards at other technologies, now commonplace and integral to our lives and commerce, which struggled to get a foothold, or whose potential may have been underestimated at the time. We think, for example, of cell-phone networks.

The case for government involvement in the further development of broadband technology in New Zealand is much less apparent. As the Government noted in announcing this initiative: "private sector companies have decided, on behalf of their shareholders and as a commercial decision, not to invest in a nationwide network of fibre-to-the-home at this point in time". We have not seen any sort of robust analysis of what market failure might justify government involvement in the provision of this sort of infrastructure when private investors, with all the incentives to properly internalise the costs, risks, and potential benefits, have chosen not to. There has been no clear or convincing articulation of the market failure in any of the material released with the announcement of this initiative.

The Taskforce has no way of knowing whether economic returns would, in fact, exist for investment of this sort undertaken at this stage. But it is not clear that government officials or Ministers do either. In that respect, it is not obvious what marks out this initiative from, say, some of the numerous government commercial investment projects undertaken over the decades, including, for example, the Think Big projects. Not all of them were guaranteed in advance to produce disastrous results. There were specific sets of assumptions under which they could have proved a good investment for the Crown. But the Crown was not then, and is not now, better positioned to make that call than private investors. We recognise that the Australian government is also spending considerable amounts of money on an initiative like this, but we have read and heard serious critiques of the quality of the decision-making on that project too. If good economic returns actually do exist, in prospect, it is not obvious why private providers, individually or collectively, would not invest to capture them, rather than sharing the benefits with the Crown.

The amounts involved in this initiative are very substantial. We highlight it for two other reasons:

- It is a direction in government policy which seems inimical to meeting the 2025 target. As we have repeatedly highlighted throughout this report, governments have had a consistently poor record in picking sectors to back.
- It is an example of the apparent absence of a rigorous assessment of the economic costs and benefits of the plan (certainly such an assessment has not been made public).
- It also raises issues around the appropriate governance of commercial operations involving central government. The apparent direct involvement of Ministers in deciding which firms will be

partners with the Crown in this project, and talk of ongoing involvement by Ministers in major decisions of the planned Crown-owned company, do not appear consistent with best practice, as modelled in, for example, the SOE framework.

We would urge that, if at all possible, the initiative should be put on hold now, and subjected to a comprehensive independent scrutiny and evaluation of the economics of the proposal. This should include rigorous identification of factors and risks that mean private investors will not take up the opportunity without government involvement. Regulatory uncertainty may be one possibility – an issue which might be better addressed at source – but we think the public has a right to see a much more compelling case articulated and tested.

Mineral assets

As noted earlier, the Crown has very substantial mineral rights holdings. In New Zealand, the Crown owns all gold, silver, uranium and petroleum, whether found under public or private land, or under the sea[78]. By virtue of its position as the largest landowner, and its control of the seabed, the Crown also has an ownership interest in much of the rest of whatever minerals exist in New Zealand territory. Most of the Crown land is under the control of the Department of Conservation (in turn, around 30 percent of the total land area of New Zealand). Indications are that New Zealand is rich in mineral resources, and that much of those resources belong to the Crown (the Minerals Industry Association estimates that up to 70 percent of the mineral resources in New Zealand are under land belonging to the Crown).

The mineral resources are an underutilised asset at present, and there probably needs to be a better framework established for the management of the resource.

We welcome the review that the Government has initiated on the mineral potential of conservation land. As so often, there are competing interests. Some of the Department of Conservation land has enormously great scenic and recreational value; much of it does not. Moreover, mining technology is changing rapidly, and the ability to mine in ways that do minimal damage to sensitive environments is improving steadily. In our view there should be few areas where mining would not be considered at all, no matter how large the potential benefits might be, or how small the environmental risks and costs. Costs and benefit to citizens should be captured in appropriately rigorous transparent cost-benefit analyses.

More generally, given the apparent potential of mining, we would encourage the Government to consider afresh whether the policy environment encouraging the private sector to develop Crown mineral resources is appropriately specified. There are some distinctive issues around royalty regimes etc relevant to mining, and we need to ensure that the regime to develop the Crown's mineral assets is set, and operated, in an appropriately competitively neutral manner.

We note with some concern suggestions in some circles for the establishment of a Crown oil company or Crown mining company. A consistent theme of this report is that Crown commercial operations are rarely, if ever, the best way to maximise the value of an asset or resource, either to

[78] By contrast, in Australia all minerals are owned by the Crown.

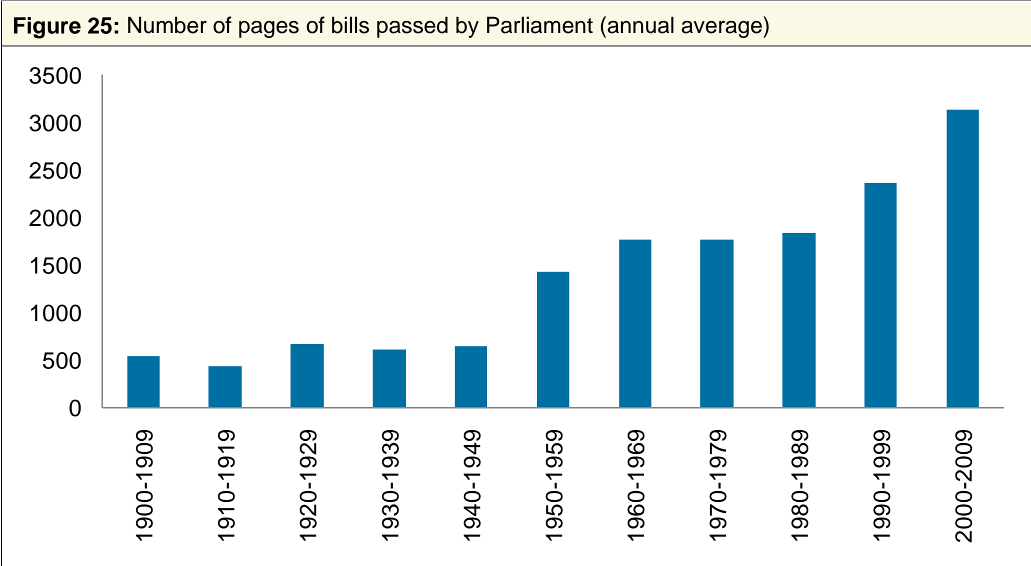
the Crown itself or to the economy as a whole. The Crown's financial interest is best protected by appropriate royalty arrangements. Private operators are much more likely to bring a degree of technological and market innovation, and considerable international expertise, to the utilisation of the Crown's mineral resources.

Government as regulator and lawmaker

The government spends a vast share of everything produced in this economy. It raises money with taxes we pay on almost everything we earn and everything we spend. And it owns assets we see, use, or trade with routinely – roads, schools, hospitals, most of the power companies, and the postal service. But the government's regulatory and lawmaking powers – actual and potential – are huge. Laws and regulations touch, in one way or another on almost every aspect of business life and activity and directly or indirectly on our individual lives as citizens. There has been a steadily increasing volume of such law over a very long time.

Much of the time the impact of these regulations – the behaviours they encourage or discourage, the activities they permit or frustrate – are not visible to most of us. And New Zealand isn't unique here. Across the developed world, the web of regulatory and lawmaking activities appears to have become ever more pervasive, even as direct control of prices or direct government provision of services has diminished. Estimates suggest that, whatever the benefits of many of the individual measures (and in many areas good regulatory structures and clear identification of property rights are critical if markets are to work well), the overall economic costs may be large.

Figure 25: Number of pages of bills passed by Parliament (annual average)



Source: Parliamentary Library and Parliamentary Counsel Office

Good estimates done in other countries, using a variety of methodologies, suggest that as much as a third of the income gap to Australia could be closed if we were able to move New Zealand to world best practice across all the major areas of regulation. The scope for better economic outcomes probably rests at least as much on improving the regulatory environment, and letting markets work better, as it does on other things touched on in Part II of this report. Better regulation

matters, a lot. The Government has indicated that it is seeking better regulation and less regulation.

Improving the overall framework

As part of the National – ACT agreement, a Regulatory Responsibility Taskforce was established to assess the Regulatory Responsibility Bill considered by Parliament in 2007 and 2008. That taskforce recently reported[79]. Two of its members are also members of the 2025 Taskforce. We endorse the approach recommended by the Regulatory Responsibility Taskforce. We favour the passing by Parliament of legislation that would establish sound principles for responsible regulation, emphasising the importance of avoiding arbitrary impositions on citizens and the exercise of lawmaking powers without due regard for the costs of those actions to citizens affected.

The principles outlined by the Regulatory Responsibility Taskforce for legislation are reproduced below.

- **Rule of law** – legislation should be clear and accessible, not adversely affect rights, or impose obligations retrospectively, treat people equally before the law, and resolve issues of legal right and liability by application of law, rather than the exercise of administrative discretion.
- **Liberties** – legislation should not diminish a person's liberty, personal security, freedom of choice or action, or rights to own, use or dispose of property, except as necessary to provide for any such liberty, freedom or right of another person.
- **Taking of property** – legislation should not take or impair, or authorize the taking or impairment of, property, without the consent of the owner, unless it is necessary in the public interest and full compensation is provided to the owner, such compensation to be provided, to the extent practicable, by or on behalf of the persons who obtain the benefit of the taking or impairment.
- **Taxes and charges** – legislation should not impose, or authorise the imposition of, taxes, except by or under an Act, nor should it impose or authorise charges that exceed the reasonable cost of providing the goods or services, or the benefit that payers are likely to obtain.
- **Role of Courts** – legislation should preserve the Courts' role of authoritatively determining the meaning of legislation, and where legislation authorises a public entity to make decisions that may adversely affect any person or property, it should state appropriate criteria for making those decisions, and provide a right of appeal on the merits against those decisions to a Court or other independent body.
- **Good law making** – legislation should not be made unless those likely to be affected by the legislation have been consulted and there has been a careful evaluation of the need for legislation to address the issue concerned. Furthermore the benefits of any legislation should outweigh its costs, and any legislation should be the most effective, efficient and proportionate response to the issue available.

Under these proposals, Ministers and public sector chief executives proposing legislation would be required to certify that the proposed legislation is consistent with the principles, and Ministers would

[79] That Taskforce's report can be found on The Treasury's website.

be required to justify any incompatibilities. Parliament would remain sovereign, but the Courts would be able, on application, to declare that a particular piece of legislation was in some respect incompatible with the principles. The transparency of this procedure could be expected, over time, to improve the general quality of legislation. The Regulatory Responsibility Taskforce also proposed that over time the existing stock of legislation would be reviewed for consistency with the principles. We agree. A somewhat similar framework should also be adopted in respect of local government.

More generally, we consider that in all areas where government legislative or administrative power is exercised it is vital that much greater weight is consistently placed on the full set of costs and benefits, to the Crown and to other affected parties, from proposed actions. New Zealand does not have a written constitution but, within a model that similarly relies on declarations of incompatibility, we see merit in amending the Bill of Rights Act to insert a provision establishing the importance of the protection of private property rights (a feature found in the United Nations Universal Declaration of Human Rights).

This Taskforce, with the 2025 goal firmly in mind, also believes that it is imperative that a considerably greater weight be consistently given to ensuring that any regulatory or legislative frameworks give appropriately high weight to developing and maintaining a policy environment conducive to long-term wealth creation. The evidence suggests that, at present, we are a long way from that position in many areas. As often throughout this report, it is not that New Zealand is necessarily worse than the average of its peers in other advanced countries. But we have a rather greater challenge, to close the gap to Australia. Much bad regulation is simply destructive, but perhaps some can be thought of as a luxury good: the sort of thing one can afford when rich, but that is just a little bit costly when we set out to close a 35 percentage points of GDP income gap.

We recommended earlier that the primacy of a rigorous cost-benefit analysis be restored when capital expenditure decisions are being made by government bodies. We have endorsed the Regulatory Responsibility Taskforce's principles for legislation. A third leg of that overall package of improving the quality of decision-making is a recommendation that the Government (Ministers and central government agencies) treats as a high priority a strengthening of the regulatory impact analysis undertaken when regulations or spending decisions are being considered. We have noted a recent review conducted for Treasury by the NZIER[80]. That review highlights ongoing serious deficiencies in the process, and suggests that in many areas such an assessment – in substance as well as form – is an after-thought done when decisions have already been made. Having such analysis done, and making it public at an appropriately early stage, strengthens the likelihood of more consistently rigorous good quality decisions being made.

Finally, as part of strengthening the overall quality of decision-making in microeconomic reform areas, we believe that New Zealand would benefit from a small independent highly-skilled centre of excellence in microeconomic reform matters, along similar lines to the Australian Productivity Commission. The Australian Productivity Commission has made a huge ongoing contribution in advancing the debate on regulatory issues in Australia. Lots of these issues are very complex, and

[80] Also available on the Treasury website.

needs in-depth rigorous assessment before decisions are made, drawing on specialist expertise not bogged down in the day-to-day demands of line ministries. The sort of work such an agency would undertake is a prime example of one of those things governments must be doing excellently. It would need to be provided with sufficient resources to draw on the best analytical and research capability here and around the world. There is a huge ongoing payoff to getting regulatory reform right. A Productivity Commission should be modelled on the Law Commission: set up both to address issues formally referred to it by Ministers, and to conduct investigations into issues that the Commission itself regards as important.

Resource Management Act

The Resource Management Act (RMA) was introduced in 1991. Almost ever since it was enacted there has been a constant stream of complaints regarding either the Act itself or the way in which it is applied and interpreted by local authorities. It is widely regarded as impeding development and changes in land use in response to changing economic opportunities. The status quo – existing land use – was protected, and hence in some sense the impact of the legislation has become more important, and more binding, as the time since it was passed has increased and fresh opportunities have arisen. An increased focus on environmental "sustainability" (beyond what is reflected in evidence of what citizens themselves put value on), and "smart growth" strategies favoured by local planners, is seen by many as having inappropriately increased the hurdles that restrict development. There is a growing sense that under the Act officials tend to see the changed use of private land as a privilege bestowed by government agencies, rather than a right which might be modified only in narrow and well-specified predictable ways.

Defenders of the legislation point to the high proportion of resource consents granted without contest. But that simply isn't the appropriate measure: what one would want to know is how many projects, and of what significance, never even got to the point of seeking a consent. Argument by anecdote is always less than satisfying, but some of the striking examples of people's entanglement with the RMA, as administered by particular councils, are set out in the Appendix 2.

Land use issues are tricky and it is likely that, in this age in a society like ours, if there was no RMA many of the issues would not be acceptably dealt with under the common law. But many more could be. The issue is about how far-reaching the reforms of the RMA need to be to provide a better climate for growth and development and a stronger bias towards allowing owners, not local authorities, to determine what is done on particular pieces of land. Some of it should be simple: we hear accounts that almost no local authorities are consistently meeting the processing deadlines set out in the Act. That is simply unacceptable, and the failure should not be treated lightly. Recent law changes mean councils cannot collect a consent fee where the processing deadline is not met, but to reinforce the point serious consideration needs to be given to automatically granting any consent not dealt with in the statutory timeframes.

Some amendments to the Resource Management Act were enacted recently. We have heard mixed messages from submitters about even these changes. Some are definite, if modest, steps in the right direction: for example, a requirement now that objectors must have some legitimate interest in the issues affected by a consent being sought, and the restriction on allowing

competitors to use the consent process to slow the emergence of competition. The ability to take major contested consent cases straight to the Environment Court should also speed up the process in these cases. On the other hand, we have heard of at least one council concluding that its costs will rise, and the complexity of handling applications will actually increase in some cases. If true, it seems quite contrary to the direction in which change is needed.

There has long been a degree of tension in identifying the real nature of the problem. Some have long considered the RMA to be a fundamentally flawed piece of legislation. Those who have run this argument consider that the policy processes behind it failed to identify clearly where and why private arrangements do not work adequately, or consider how best to remedy weaknesses in previous legislation, and they had inadequate regard for quasi-constitutional considerations relating to limits on the use of private property. Other people, equally concerned about the outcomes, appear to have been cautious in coming to a conclusion that the legislation was fundamentally flawed, focusing instead on wrongheaded attitudes by implementing agents.

The Taskforce is clear that much more, and more significant, change is needed. We need to move away from such heavy reliance on judgements by, and preferences of, local authority officials. A comprehensive review is needed to go back to fundamentals, asking hard questions about what specifically we are trying to achieve with planning law, and how to write such a law in a way that intrudes to the minimum extent possible on private property rights, and hence development and changing land use opportunities. We agree that use of one's land should be a right, constrained by law to the minimum extent feasible, not a privilege granted or withheld by officials with limited accountability, and little requirement to internalise the costs to others of their choices and decisions. These issues are not "just" business issues, important as those are in facilitating investment and future prosperity. Laws that restrict a person's ability to chop down their own suburban tree, or constrain the colour one can paint one's house, or prevent one altering the character of one's own house, are scarcely consistent with fostering a culture of enterprise and opportunity that the 2025 goal seems likely to require.

Macrocarpa at heart of consent: process versus safety

A battle over an application to chop down a tree outside an industrial development in Avondale has taken some new and incongruous turns. Property for Industry Ltd got consent last September for a two-storey development on the two hectare site at 61-69 Patiki Rd, a short distance from the North-western Motorway ramps to and from Avondale, and also got consent to remove 15 trees. But one macrocarpa was left, its trunk firmly planted on the PFI side of the boundary but its branches and thick foliage extending across the footpath.

At a hearing in April, Auckland City Council planners and its arborist opposed felling the tree but agreed to some tip pruning. The independent commissioner who heard the application, David Chandler, went back to the site to check sightlines before issuing a decision in which he allowed for pruning to include a lower branch inhibiting drivers' views.

PFI appealed to the Environment Court, and there began a new round of unusual correspondence.

The company asked to remove the tree in the first place because project contractors were concerned about the poor sightline as they exited the site. This week, PFI told its planning consultant, Hamish Firth, that pruning had become more urgent after some near misses by vehicles exiting the site.

However, because the original consent has been appealed, the council's planners have told Mr Firth that PFI can't use the pruning allowance of that consent. Instead, he was told, the company might need to apply for a new pruning consent. "Please refrain from the pruning work until this is clarified," he was told.

Mr Firth's response: "As the last consent took over 50 working days to process, I wonder how long this one will take." At the April hearing, Mr Firth acknowledged the application didn't conform to planning rules: "We do not contend we meet any of the provisions of the district plan, but this is not about the district plan. This is about health and safety. This is not an oak tree planted by one of the early settlers, it's not a kauri planted by Kupe, it's a macrocarpa!" he declared.

However, the council planners saw the tree's removal as a restricted discretionary activity: "The purpose of this control is to ensure that the existing general tree cover within the city is retained wherever possible, and to reduce the risk of serious or irreparable damage being done to the local environment through unnecessary or undesirable tree removal."

Mr Firth said this week the council's stance raised questions of liability from now until October, when the Environment Court is due to hear the appeal.

From the Bob Dey Property Report of 22 July 2009

Housing supply

When the price of a good or service goes up (relative to those of other goods and services), it is usually a potent signal to producers in the sector in question to produce more of that good or service. The price mechanism usually works when governments don't get in the way. It doesn't always do so quickly or cleanly, depending on the nature of the good, but it works.

Houses in New Zealand are now among the most expensive, relative to incomes, anywhere the world[81]. Systematic international data tell as much[82]. A quick search of a website will reveal vast swathes of the United States – a much richer country than New Zealand – where good houses, in cities the size of our cities, cost far less than such a house would in New Zealand. That is a sign of a major market – and the supply of new houses represents around 5 percent of our GDP, bigger than the dairy industry – not working efficiently. As we intimated earlier, we reject the repeated claim that in some sense too many resources are devoted to housing in New Zealand. Existing houses cost too much mainly because too few real resources are devoted to house-building,

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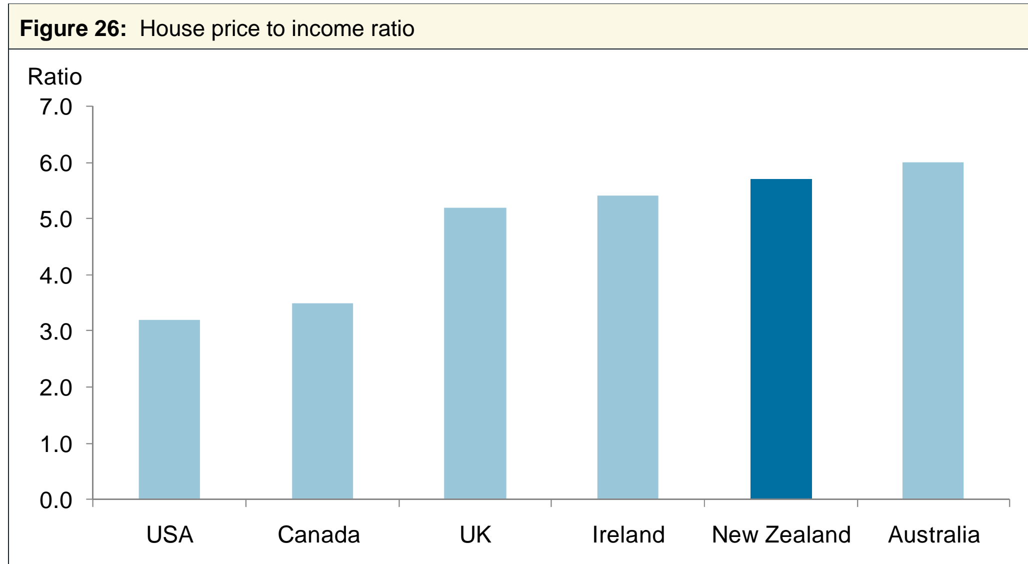
[81] Some indicators already suggest that we may be about to return to a period of double digit house price inflation again (eg days to sell measures and Reserve Bank data on the size of the average mortgage approval).

[82] See, for example, 5th Annual Demographia International Housing Affordability Survey: 2009 Ratings for Metropolitan Markets (www.demographia.com/dhi-ix2005q3.pdf)

providing people with the houses they want and need. Aside from the vast economic inefficiency involved, this should be thought of as a wildly inequitable wealth transfer: young families find buying a house in our major cities very difficult, while old people trading down capture a windfall.

Figure 26: House price to income ratio



Source: Demographia (ratio of median house price to median income)

Provisions of the Building Act and council policies on development levies affect the cost of new housing. There are real infrastructure costs associated with new developments, although whether these are best recouped upfront or over time is an open question. We welcome the review of the Building Act that is underway, including the announcement recently of a certificated approved design model that will allow large house-building operations to use the same designs in different council areas, without going through the whole consent process in each individual region.

However, the biggest obstacle is land. The most valuable use of land in this country is not for grazing dairy cows (worth maybe $20,000 per hectare in normal times), but for housing. At present, urban sections, of less than a tenth of a hectare, in middling suburbs not particularly close to city centres, sell for in excess of $300,000. Council zoning restrictions and arbitrary “urban limits” prevent the release of sufficient land to lower the overall price of housing. Dr Arthur Grimes provided a presentation to the Taskforce (available on our website) reporting on his published research work on the detrimental economic impact of the Auckland Metropolitan Urban Limit (MUL). Beyond that limit, housing development is not permitted, and land just inside that boundary trades at around 10 times the price of otherwise identical land outside the boundary. There are few more striking concrete examples than that of costly inefficient regulation, allowed to persist with no proper economic cost-benefit analysis. Such a cost-benefit analysis should focus on the real revealed preferences of individuals, not ill-defined “smart growth” strategies or preferences of local body politicians or officials. These preferences seem little different, no more grounded in rigorous transparent tested analysis, and perhaps more damaging (given the pervasive influence of planning law on what can be done) than the repeated efforts by successive central governments to favour particular industries or sectors.

In other places, local councils limit the amount of land zoned residential and are then complacent when a few developers acquire sufficient market power that makes very slow release of land a profit-maximising strategy for the developers. There is no shortage of land in this country, but local authorities prevent it being used for its most valuable purpose. That has to change. When it changes, housing will be a great deal more affordable: our incomes will stretch further. We think that legislative changes should require councils to take explicit account of any differences between the price of residential-zoned undeveloped land and other undeveloped land in similar areas. These differences should be reported on publicly each year by local authorities, and there should be a strong presumption that scarcity of zoned land (judged largely by reference to price indicators) should prompt action by the relevant council to increase the supply of land zoned for residential development. At present, the price of land seems not to be seen by Councils as the critical indicator of excess demand (or, equivalently, insufficient supply). A good example of the apparent mindset is briefly illustrated in the following box. Such thinking has to change[83].

[83] Concerns are sometimes expressed that making housing supply more responsive to demand might lead to a large excess stock of houses building up. The evidence in the United States, through the recent housing market boom and bust, has been that in regions where it is easy to open up new land for residential developments the cycles have been much less marked than elsewhere.

An adequate supply of residential land in Tauranga?

"There are a number of significant issues with the housing stock in Tauranga City.

- Declining affordability due to less housing stock in the less than $400,000 bracket.
- Housing type not reflective of the changing demographic profile – with insufficient new supply in the one and two bedroom market.
- Housing supply and section size not reflective of affordability profile in Tauranga.
- Land values increasing significantly since 1997 significantly impacting on affordability.
- There is sufficient zoned and serviced residential land supply."

From "Housing Stock and Housing Demand", staff paper for the Tauranga City Council Strategy and Policy Committee, November 2009. (http://www.tauranga.govt.nz/news/council-meetings-detail/tabid/855/aid/2590/tctl/1802_ViewAnnouncement/Default.aspx)

Tradable water rights

As noted earlier, New Zealand has among the most abundant resources of fresh water anywhere in world. Much commentary suggests that fresh water is likely to quickly become a highly valuable asset internationally. And we know that pressure on water resources locally in some regions of New Zealand (particularly Canterbury) is becoming more apparent. Against this background, both economic and environmental considerations point in the direction of establishing a good system of tradable water rights. This should be treated as a matter of high priority. Getting this right early – as we did with fisheries management in the 1980s – is one of the opportunities for maximising the long-term value we get from our resource base.

Labour market

We have just come through a 10 year period in which New Zealand's unemployment rate has been one of the lowest in the OECD, and fairly consistently lower than that in Australia (as it has been for most of the last 40 years). The outcomes have mostly been pretty good and that has led to some complacency around the state of labour market regulation in New Zealand. Over that period, there has been a significant increase in the burden of labour market regulation. Receding tides reveal the rocks; in the labour market recessions tend to bring the cost of labour market restrictions to light more clearly and we are beginning to see clear evidence of that now.

We believe there is room to do considerably better, in ways that would benefit both firms and workers, and hence the economy as a whole. In some ways it is puzzling that we have regarded a 3.5 percent unemployment rate as very low; it is equivalent to every worker spending 1.5 years unemployed[84] over the course of a 45 year working career. Labour markets should be able to utilise resources better than that. Doing so will take us closer to matching or exceeding Australian incomes.

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[84] Unemployed in the HLFS sense of the term: not taking time out, not discouraged, not just searching the newspaper or a website, but actively pursuing a job.

It is worth recalling that although the Employment Contracts Act of 1991 greatly liberalised the labour market in respect of hitherto unionised staff, it brought a whole new category of employee within the ambit of labour law. Professional staff and senior executives had hitherto been employed under conventional common law terms, subject to any contractual terms and protections they themselves may have negotiated. The Employment Contracts Act brought all these employees, from chief executives downwards, under the coverage of employment law, which materially reduced the scope for freedom of contracting. That situation carried over into the Employment Relations Act. It can be exceedingly difficult even for a Board to rid itself of a failing chief executive – a position critical to the success of any business – without negotiating the long and tortuous path of the dismissal procedures of labour law (or making large payouts). Actual cases are probably few, because people adapt to operate within the constraints of the law, but reducing flexibility in that way has costs. We believe that the Employment Relations Act should be amended to tighten up unfair dismissal procedures across the board, and in particular to put much less emphasis on requirements relating to process (as opposed to substance). We also think it is time to undo the mistake made in 1991. We recommend that those earning more than, say, $100,000 per annum should be removed from the coverage of the Employment Relations Act. The Taskforce does not have very much sympathy with the common assertion that workers are in a much weaker bargaining position in the labour market than employers are. The best protection for workers is the ability to move easily to an alternative job. However, to the extent that the wider community shares those concerns in respect of lower level workers, it is difficult to see them credibly extending to highly paid professional and managerial staff.

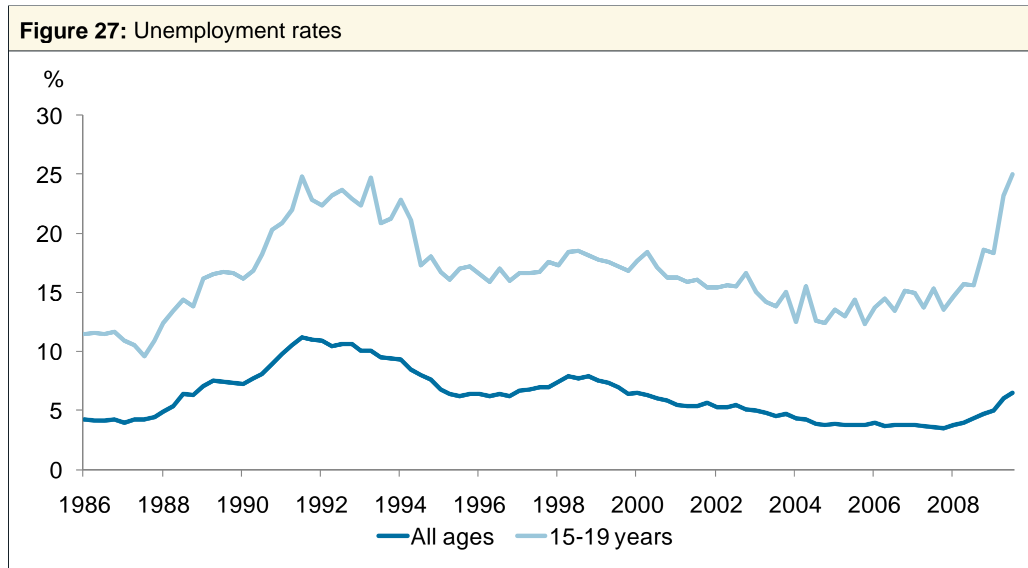
The new Government introduced a useful modest reform allowing new employees and employers with fewer than 20 staff to mutually agree to a trial or probationary period of up to 90 days. We think this reform should be taken materially further (as it has been in Australia). We do not see any particular reason to distinguish between small and large firms, and recommend that employees and employers should be able to agree to enforceable probationary periods of up to 12 months. It is important to stress that these probationary periods cannot be imposed unilaterally, and that employers face an incentive not to use the provision inappropriately. Capable experienced people might be quite unwilling to sign on with one employer trying to insist on a 12 months trial period when another was offering a similar job with no probation period. The real benefit of these provisions is to help enable new entrants to the workforce or those with a chequered track record to find employers willing to take the risk of hiring them in the first place. As above, the best protection workers have is a strong and highly competitive labour market, in which they have credible alternative employment options.

Minimum wage legislation has taken material steps backwards in the last decade. New Zealand now has one of the highest minimum wage rates, relative to incomes in the wider economy, of any developed country. The minimum wage was increased sharply during the boom years of labour shortages, and most recently last year the separate lower youth minimum wage was abolished (putting all young employees on the same minimum wage as adults). In boom times it is often difficult to see the adverse effects of such changes. They are now becoming very apparent. Already, the unemployment rate for 15-19 year olds has risen to the same rate it reached in

1991/92, even though the overall unemployment rate is still only 6.5 percent, less than two-thirds the early 1990s peak. Making sure that young people are easily able to get into the workforce is important – for them, and for the wider economy. We do young people no favours when we make it hard for them to get into work. We are disturbed, but not surprised, to hear reports of employers now actively preferring adult workers rather than young people in what are often very basic jobs.

High minimum wages are also likely to seriously impede any determined efforts to reduce long-term welfare dependency. The case for any minimum wage at all is questionable, but at least we believe the government should quickly move to lower the minimum wage to the level, relative to the average wage, that it was in 1999. As a matter of urgency, the youth minimum wage should be reinstated, at its 1999 relativities.

Figure 27: Unemployment rates



Source: Statistics NZ, seasonally adjusted

Part of ensuring that we have a responsive labour market is ensuring that immigration procedures are predictable, efficient, and practical. That appears to be far from the case at present. The Taskforce does not see the absolute level of migration as terribly important one way or the other to New Zealand's overall economic performance and the future living standards of New Zealanders[85]. What really matters is the overall environment which the people who live here, and the firms that invest here, face in making the most of their talents and opportunities. Most New Zealanders would probably prefer that the outflow of New Zealanders was not so large and if so it is likely that gross inflows would also be lower.

But whatever the level of inward migration, several things matter. Composition is one of those. There probably aren't large productivity advantages to becoming a retirement home for wealthy Americans and North Europeans who simply like the landscape or the fishing. We want skilled and committed people, determined to work and achieve, in ways that will benefit both them and us. We

[85] As one example, a recent Department of Labour working paper found very little long-term impact on labour productivity from either substantial net outflows or substantial net inflows.

want to make it easier to get and keep the people who know us – successful foreign students who study in our universities, or foreign spouses of expatriate New Zealanders. We think that, subject to security checks etc, a standing offer of permanent residence should be open to anyone completing a degree in a New Zealand university. By then, they'll know the language, will be aware of our own culture, and will have demonstrated a capacity to work.

Policy trumps common sense: skilled talent and the immigration process

In order to accept his role as chief executive of a listed business, X endured enormous difficulties. Over many decades, he'd enjoyed work for a blue-chip multinational company working in many different parts of the world. Despite an unblemished employment record, Immigration officials demanded police clearance from second and third world countries where such documents are extremely difficult to obtain. He then had to prove his 25 year marriage was not a 'sham'.

It took 10 months for senior finance professional Y to obtain the right to live and work in New Zealand. Within 10 days of arriving in the country he had been short-listed for three opportunities. Within a month he was working. The cost to New Zealand in lost income tax revenue for those 10 months was around $100,000. This does not include the benefits to the country of him investing savings and spending his earnings on goods and services and property.

You have to *really* want to move to New Zealand as a skilled migrant/senior executive. The processes are just terrible. There isn't even a box to tick on the forms for a senior manager. And the paperwork is ridiculously onerous. I wonder how many just give up?

From a submission from Kerridge & Partners dated October 2009

The other thing that matters is responsiveness. General skill shortages typically tell us more about how overheated the economy is – a matter for macroeconomic policy – than anything specific to the labour market. But in a small country, specific highly specialist skills will often best be found abroad. To make that work well for everyone, employers need a prompt and predictable Immigration Service.

Finally, in the area of labour markets, we draw attention to the occupational licensing regime and related restrictions in New Zealand. In many areas, New Zealand is more restrictive than other OECD countries. It remains something of a mystery, for example, what the economic case is for the restriction that allows only qualified pharmacists to own pharmacies. It protects existing pharmacies no doubt, at the cost of the consumer. Governments need to focus on strengthening markets and the long-term interests of consumers, not protecting the position of owners of individual classes of firms.

Foreign trade and investment

New Zealand had, for a long time, one of the most protected economies in the OECD. Tariffs and import licenses protected New Zealand producers in a static sense, but did not encourage the development of innovative and competitive firms and hotly-contested markets. Consumers and the whole economy suffered. Tariffs primarily hurt domestic consumers not foreign producers.

Considerable progress has been made in liberalising our foreign trade. Against that backdrop, the Taskforce was disappointed to learn of the Government's recent decision to suspend tariff reductions until at least 2015. The New Zealand economy needs the intense competition of foreign producers and markets, not protection for local firms which have already had decades to adapt to the prospect of the eventual removal of trade protection.

We are reminded that in 1994, the leaders of the APEC countries (including New Zealand) issued the Bogor Declaration committing the industrialised country members of APEC to free and open trade and investment within the Asia-Pacific region by 2010. As noted earlier, in the 1990s the then government had already legislated to abolish all tariffs by 2006. One way the government could demonstrate early the seriousness of its commitment to achieving the 2025 goal, would be to now give 12 months unilateral notice of its intention to abolish all tariffs on imports to New Zealand. A serious review of the anti-dumping regime also appears called for, including materially tightening up the criteria for the imposition of anti-dumping duties, and requiring clear evidence that any such duties would be in the interests of the New Zealand consumer.

Local artist hit with anti-dumping levy

A Wellington artist says bureaucracy gone mad has forced him out of his fledgling business making diaries.

Michael McCormack, an artist of Irish extraction living in Island Bay, found success when he produced a diary featuring his works of Wellington scenes in 2008.

But when he had another run made in China for 2009, he was surprised to find he could not pick them up until he paid a 53 percent "anti-dumping" levy.

Mr McCormack said he had been gobsmacked. "I'm an artist and this is a way for me to pay my bills.

"I argued that my diary was just a gift book, with small local market potential, sold on consignment to a few shops. How could I possibly be accused of dumping?"

At one point, he said, well-meaning ministry staff suggested he re-export the diaries to Australia, even though they featured Wellington scenes.

The cost of the diaries plus tax was $9000, and he still had about 1000 stored under his house although he had managed to sell about half.

Ministry spokeswoman Emilia Mazur said ministerial approval was being sought for a refund for Mr McCormack and it was hoped that could be done before Christmas.

The diary duties were imposed after a complaint from the New Zealand industry, of which Croxley Stationery is the largest producer.

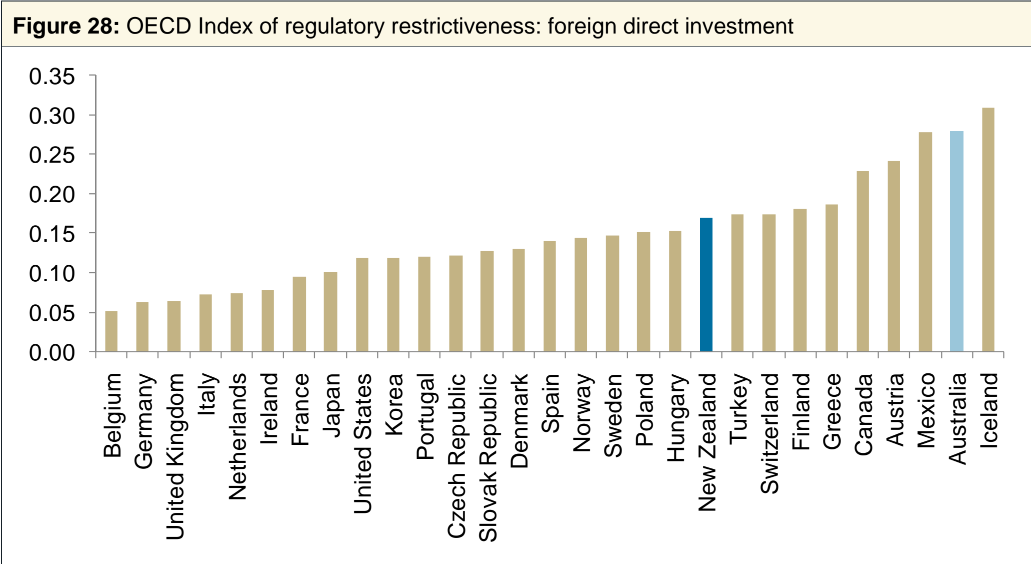
The levies could be applied only if there was evidence not only of dumping but that it was hurting, or threatening to hurt, New Zealand manufacturers of the same product.

Ms Mazur said Mr McCormack would get a 60 percent refund on his duty based on World Trade Organisation rules on dumping margins at the time of importation and investigation.

Dominion-Post, 9 November 2009

New Zealand has one of the more restrictive environments for overseas investment in the OECD (although the regime is materially less restrictive than that in Australia). Decisions of a review announced earlier this year are welcome small steps in the right direction. But any successful transformational reform programme that gives us any chance of meeting the 2025 goal is likely to involve substantial increases in both domestic and foreign investment. We recommend that officials be sent back to the drawing board, this time with a mandate to come up with the most liberal feasible foreign investment regime, to be implemented as soon as possible, including looking again at those sectors (notably fishing quota) where foreign investment is still prohibited. Moves like that would be a serious sign to business and to the public of the Government's determination to achieve the 2025 goal. Some changes can't be done quickly. These ones can.

Figure 28: OECD Index of regulatory restrictiveness: foreign direct investment



Source: OECD

The new Emissions Trading Scheme is being put in place at present. The Taskforce has chosen not to comment in depth on the scheme for the time being, given the fluidity of the situation. The Emissions Trading Scheme and whatever target commitments are adopted as part of any future international agreements could have a serious impact on the business environment and on the prospects for closing the gap with Australia.

Getting the scheme right, and enabling New Zealand to achieve any carbon reduction goals at minimum economic cost, will be very important. The impact of the scheme will have to be monitored closely and periodically reviewed. We have been a little surprised that none of the advice we have seen – including that from Treasury – noted that it would be difficult to close the large income gap with Australia over the next 16 years without our emissions being somewhat higher than they would otherwise have been. We also note with concern the Treasury's assessment of the (inadequate) regulatory impact analysis conducted on the new legislation.

The emissions trading legislation and any future emissions reduction targets the Government adopts need to be independently monitored and periodically reviewed. Such reviews should focus on monitoring the economic impact of any carbon abatement goals, and the impact of chosen abatement regimes (here and abroad) on prospects for achieving the 2025 goal.

Competition policy and network industries

Network industries – electricity and telecommunications – are critical parts of any successful market economy. Good regulatory environments are sometimes necessary to get good and efficient outcomes. Those rules need to be structured in a predictable and stable way that encourages the entry of new competitors. Where regulatory actions are necessary which impair the rights of owners of existing assets, serious consideration needs to be given to compensation.

Competition (or antitrust) policy is a vexed issue in many countries, and New Zealand is no exception. In principle, there is a case to supplement market competition with regulation to deal with significant problems of monopoly power, although properly detecting abuses and avoiding doing more harm than good is challenging.

In economies with open markets, competition policy is likely to be, at most, a minor contributor to economic performance. As we have noted elsewhere, the imperatives of accelerating growth and raising productivity put a premium on minimising policy barriers in the way of resource reallocation and restructuring.

There is widespread agreement among economists that the goal of antitrust policy should be economic efficiency in the long-term interests of consumers, and that dynamic efficiency is particularly important. For many years, the Commerce Commission and the courts took economic efficiency to be the goal of the Commerce Act, but in recent years amendments to the Act and decisions under it have blurred this goal. Wealth transfers rather than efficiency have entered into some of the Commission's assessments. In addition, there are now different purpose statements in the general part of the Act and Part IV, and in the Telecommunications Act and the Electricity Act. This creates uncertainty and the risk of inconsistent policy.

We think that a review of the Commerce Act in 2010 should be undertaken. Any changes recommended should be consistent with the overall goal of simplifying and reducing the costs of the whole array of economic regulation. In particular, there should be a focus on restoring the primacy of economic efficiency considerations and long-term consumer interests in the design and conduct of competition policy.

Financial and capital markets

Financial and capital markets are critical parts of any successful market economy. A considerable amount of new regulation has been put in place in the last decade. We are concerned that the additional regulatory burden should not impede markets and investors in mobilising and disseminating the savings, domestic and foreign, that finance investment in New Zealand.

Equally, we are wary of capital market development as an independent goal. If, for whatever reason, the domestic private sector decides to save a low share of its income, it is unlikely that a small country will ever have large or deep capital markets. To the extent that foreign capital is

substitutable for domestic capital, it will not matter either. Our bias is that funds seeking a home generate capital markets, not the other way round. Earlier recommendations, if adopted, would materially reduce current disincentives to save.

Securities law, companies law, and prudential regulation (including proposals to use prudential tools to, in some sense, complement monetary policy) all need to be examined with a bias against measures which add to the regulatory burden unless there is a strong case that such restrictions will also foster the environment for greater wealth creation over the long-term.

Maori land

We are aware of significant issues outstanding around the ability of Maori land in multiple ownership to readily be used by its owners to its maximum potential economic value. There are complex cultural, economic and legal issues here, and they affect private land. We are not in a position to take a view on either the materiality of the issue or whether it raises real issues that are amenable to policy solutions. It might be exactly the sort of issue that a Productivity Commission can help to illuminate.

Transportation of raw milk

K Ltd was set up near a large milk processing factory. To limit the initial level of investment required, it was decided that rather than set up its own pasteurizing equipment, K would purchase pasteurized milk from the nearby factory. K's resource consent was written along those lines. (By way of background, K is located in a district that is among the largest producers of raw milk in the country, producing in excess of 1 billion litres of raw milk per annum. In this district, raw milk is everywhere – it is on every farm and is transported widely throughout the district. Resource consent is not required to produce or transport raw milk on either local roads or highways. Raw milk as such does not present any health hazard.) After a year's operation, K decided for practical reasons to install its own pasteurizing equipment. This would involve raw milk being taken onto K's site (about 50 metres from highway entry to milk silo). The local authority required a full variation process for K Ltd's resource consent (including establishing whether or not this could produce a health hazard).

There seems no valid reason why a consenting authority is not authorised to modify a consent when it makes sense to do so in the circumstances (in this case even the staff thought this was silly but felt constrained to require the variation process by "the rules").

From a submission by the Hon Wyatt Creech dated October 2009

Commodity export companies

Fonterra is New Zealand's largest company. It is a private company, owned by its shareholders, and we have studiously avoided commenting on individual private companies elsewhere in this report. However, Fonterra exists in its current dominant position only because of exceptions granted to the Commerce Act to allow it to form. The Dairy Industry Restructuring Act continues to influence it and the sector as a whole. Fonterra's performance matters for New Zealand and in view of Parliament's role in the creation of Fonterra, the Government has a legitimate strong

interest in the future structure of the company in a way that it would not if a more competitive model had been adopted earlier.

As with so many state-sponsored or facilitated businesses, Fonterra has not lived up to the promise sold to New Zealanders when it was allowed to form. We do not believe that in its present cooperative structure it can do so, and we believe it is important for the long-term health of the dairy industry in New Zealand, and hence for farmer shareholders, that a transition to a conventional corporate form with outside traded capital occurs expeditiously. That choice is one that is in the hands of farmers, but we believe it is important that the Government keeps legitimate pressure on, using any appropriate instruments to encourage the transition to be made. No consideration of accommodation for Fonterra on any other front should be countenanced until the transformation of the company is irreversibly underway.

Zespri has a statutory monopoly on the export of kiwifruit to markets other than Australia. This legacy of the old monopoly producer boards is anachronistic. The monopoly powers should be revoked. Competitive markets need to be promoted, not forestalled by government fiat. Where there are legitimate reasons for companies to work together in international markets, it will be in their interests to find private vehicles to make that cooperation effective. We are not persuaded by the test that the monopoly should only be removed when a majority of growers favour such a change. It is not clear what public policy interest would justify a Zespri monopoly that prevented, say, 35 percent of growers who wished to do so from selling their fruit abroad through other companies. The vines and the fruit are private property: in successful market economies governments need a compelling public interest case to constrain property rights in such a way.

Some concluding general issues

The discussion in this chapter touches on only a subset of the regulatory issues relevant to maximising New Zealand's long-term economic prospects. We urge the Government to undertake a thoroughgoing review of how well-aligned regulatory provisions are with the 2025 goal. If New Zealand is to achieve the goal, we need better policy and better regulation across as many fronts as possible. We have been struck by reports that no new plant varieties have been allowed into New Zealand for years, and by the potential impact of the ongoing restrictions on genetically modified organisms. Maybe agriculture and pastoral science is not our future, but we need to make it possible for competitive market processes to sort that out, empowering entrepreneurs to explore and test, and fail if that is what the market dictates. Those outcomes should not be pre-determined by regulatory choices that have given insufficient weight to fostering an environment that encourages prosperity.

As a final observation in the regulatory area, we have noted a strong push over the years, under the ambit of the Single Economic Market initiative, to align our regulatory policies with those of Australia. The Taskforce's position is that alignment with the regulatory policies in the economy of our largest trading partner has merit, where the Australian policies themselves are sensible and robustly tested. But the policy environment in Australia is neither so good, nor the Australian economy so dominant, that the case for alignment automatically trumps the case for excellent policy. That assessment needs to be made on a case by case basis.

What happens if we don't take action soon?

New Zealand and the rest of the advanced world have just come through a fairly significant recession. The recession has been considerably milder in New Zealand and Australia than in many other parts of the OECD, but the path GDP takes in various countries over the next few years is still very much an open question.

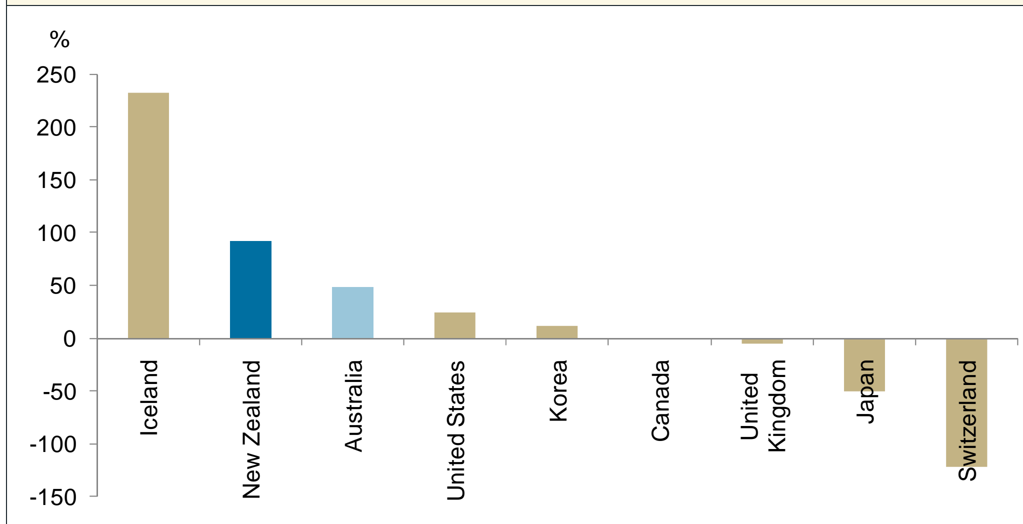
It is clear, however, that on the current set of policies and institutions no credible analyst or forecaster, here or abroad, believes that the gap – be it to Australia or to the wider OECD grouping of countries – is likely to close sustainably. That view is reflected in the most recent International Monetary Fund projections for the two countries out to 2014. Locally, the Treasury has recently advised the government that, in its assessment "there is nothing in the current projections or set of policies that suggests material progress is likely in reversing the large per capita income gap that exists between New Zealand and the average of its OECD peers, or, most notably, Australia" [86]. We understand that the OECD itself has recently undertaken a scenario exercise in which the gap between New Zealand and Australia widens further over coming years, although we have not been exposed to the reasoning that justifies that scenario.

A significant portion of New Zealand's economic growth in the last decade has taken forms that reflected unsustainably large increases in consumption spending, associated with unsustainably high asset prices, all financed by very large increases in overseas borrowing. There are serious questions about whether even current private sector levels of debt are sustainable. New Zealand already has among the very highest levels of external indebtedness among longstanding OECD countries (though nowhere near as high as crisis-ravaged Iceland). At these sorts of levels, credit rating agencies tend to start asking serious questions and it is not clear whether an underperforming economy can sustain even current levels of debt. Whether or not current debt levels can be sustained, it seems most unlikely that growth over the next 10-15 years can be financed by further increases in our indebtedness. In the same paper cited above the Treasury notes that the ongoing large macroeconomic imbalances and vulnerabilities are among the factors that pose a risk that the gap to other OECD countries will widen further[87].

[86] Treasury Report "Getting Started on Closing the Income Gaps", 19 August 2009. http://www.treasury.govt.nz/publications/informationreleases/closingincomegaps

[87] It is, of course, fair to note that Australia has many significant imbalances of its own.

Figure 29: Net external liabilities (percent of GDP)



Source: Reserve Bank of New Zealand

On current policies it is clear that the income gap remains large, is most unlikely tol narrow to any material extent, and there is a material risk that the gap could widen further over the years ahead.

If the income gap were to start widening again, migration from New Zealand could also increase materially further. More and more people are heard asking themselves "why do I stay?". A new generation, that has known only an underperforming New Zealand, might conclude that there is no good reason to hope that New Zealand will ever be able to offer them the sort of incomes and opportunities they see over the Tasman or when working abroad in Europe, Asia, or North America. The intangible barriers to leaving New Zealand are continuing to fall – travel and communications costs drop ever lower, so it is easier to keep ties to New Zealand even while settling overseas.

Relatively poor countries rarely pay even skilled professionals what those people could earn in richer countries. However, migration opportunities are generally better for relatively more skilled people and this is likely to be reflected in wide income disparities between those who can migrate and those who can't. The situation is a little different in New Zealand, because our unskilled people can also freely migrate to Australia. New Zealanders have a strong sense of the importance of the well-being of the relatively less well-off. In the short-run, the lot of the less skilled, less mobile, and less fortunate can be improved by redistributing the existing pie, but the long-term living standards of the immobile elderly, the least skilled and the least well-off are primarily determined by how well the institutional environment and policy framework enable the country to lift its overall economic performance. Sometimes people talk rather condescendingly about the need to reform to keep our "brightest and best". That isn't our case at all: reform is vital for all of us, and perhaps for the poorest and least able most of all.

There is nothing inevitable about continuing economic decline. But that comforting thought is no cause for complacency, because there is also nothing pre-ordained about New Zealand avoiding further decline. The examples of once-wealthy South American countries, such as Argentina and Uruguay, should be salutary. In 1950, they too were about 30 percent poorer than countries like Australia, much as we are now, but still materially better off than many of the major European

countries. Now, Argentina and Uruguay are no longer remotely first world countries. The deeper the economic hole, the harder it becomes to climb out – and partly because it can become harder to avoid self-reinforcing cycles of poor policy. New Zealand simply cannot afford a further protracted period of delay in acting to reverse decades of economic underperformance. Nor can it afford further diversions down the path of "smart growth" strategies that have, in various guises, been tried numerous times before, and have failed.

The rate of "catch-up" required to match Australian living standards is towards the upper end of what could be achieved. If there are further delays in taking substantial steps to seriously address the problem, the implied rate of convergence will rapidly become impossible. If the income gap widens even further over the next few years the 2025 goal will become ever more difficult.. Change involves risk, but for New Zealand now probably the bigger risks lie with not changing much at all. Our journey towards Australia needs to start now.

What if we do start to act soon?

The Prime Minister has recently reiterated that his vision is to catch Australia by 2025. We respect that strong commitment.

Serious reform on the scale recommended in this report is the work of many years, but there is no reason why substantial steps should not have been taken by next year's Budget. The six months to the Budget provides time for a full road-map to be sorted out, but we would hope that in the forthcoming Budget Policy Statement the Government will be providing some direction on how it intends to use next year's Budget to accelerate the reform process, putting New Zealand on a path for the 2025 goal. Throughout the report we have also highlighted a number of measures that could be taken almost immediately. Strong early actions will help to convince individuals and firms, here and abroad, that change really is coming.

Over time, as a programme along these lines was implemented, we would expect to see the beginnings of a marked reorientation of the economy. A new readiness by firms to put projects in place would be apparent, and a degree of energy around new opportunities would be evident. Households might be more focused on saving, to position themselves for their own future and to capture some share for themselves of the profits that a fast-growing economy would be beginning to generate. There would be a new ability to get business projects underway expeditiously, with local authorities looking to facilitate landowners' plans to use their own properties. Houses would be getting cheaper, and businesses would be realizing that the real opportunities lie in developing products and markets, not lobbying government for this intervention or that form of support. Government would be clearly focused on contracting to ensure that excellent public services were being delivered, and on ensuring that robust transparent cost-benefit analysis shaped its own spending and regulatory decisions.

Of course, economic transformations on the scale required to achieve the 2025 target are not always smooth. Dynamic change often isn't. Resources are shifting into new industries, new opportunities are appearing, and the optimism can become contagious, among potential borrowers and potential lenders. Greater risk-taking and enterprise are integral elements of the path to prosperity and the financial system has a vital part to play in that. Change and risk mean many ventures will pay off handsomely. Others will fail, sometimes spectacularly. As part of any accelerated reform programme, the Government must ensure that the system of banking regulation is fit for purpose, in particular that disciplines are in place to ensure that the risks fall on shareholders and creditors, best placed to assess and manage them, and not on the Crown.

The large current account deficits New Zealand has run fairly consistently since the 1970s have attracted considerable comment and analysis over the years. A successful programme that puts New Zealand on a path towards the 2025 goal is, of course, likely to see the current deficit widen for many years, not narrow. Whether or not private savings rates rise much, this report has highlighted that materially higher levels of investment are likely to occur as firms respond to the better opportunities. Current account deficits, in isolation, are neither good nor bad. Singapore, for example, ran very large current account deficits as it financed its rapid growth. As we catch

Australia, current account deficits could well be as large as, or larger than, they have been in recent decades, but such deficits would be likely to rest on better foundations, supporting a market-driven acceleration in investment spending, not a debt-fuelled consumption binge.

Conclusion

Sometimes it can be easy to despair of New Zealand's prospects. For a long time, New Zealand was one of the richest countries on earth. But that time is now far in the past, and in the intervening decades so many of our people have left for better prospects abroad. There has been too little sign of any sustained change of direction that would allow us to return to the first rank of developed countries. The great exodus of New Zealanders seems not to be sufficiently recognised as a mark of serious and sustained failure as a country, or as a reproach to successive governments. And some commentators, and some submitters, have been inclined to conclude that the 2025 goal itself is just not realistic and that, in some sense, we are fated to a future as a perpetually poor cousin to our trans-Tasman neighbour.

Members of the Taskforce, however, are united in their belief in New Zealand's economic potential. In reiterating his commitment to the 2025 goal, the Prime Minister has repeatedly expressed his confidence in New Zealand. We entirely agree with him. New Zealand has good economic and social institutions, abundant natural resources, hard-working, creative, and increasingly well-educated people, a relatively high birth rate, and innovative firms able to compete in world markets. We shouldn't be waving goodbye permanently to so many of our young people, who judge that the opportunities for them and their children are better abroad. There is nothing inevitable about continuing economic decline relative to Australia. There are so many areas where we can do things so much better.

But there is also nothing inevitable about once again matching the incomes of Australians or those of the rest of the advanced world. It is most unlikely to happen by chance, and the sort of reforms proposed in this report will not implement themselves. If it is going to be achieved, all government departments and agencies will need to be viewing policy development and advice through a 2025 lens. In all areas of life, it is the choices people make that reveal what really matters to them.

Matching Australia by 2025 will mean facing hard choices. We can be reasonably confident of closing the gap with Australia only if political leaders choose to make extensive, at times no doubt courageous, reforms, over a succession of years. Successful reforming political leaders find ways to do so that take the public with them. That means helping persuade people of the seriousness of the situation and the magnitude of the problems. It also means credibly convincing people that the sort of reform needed is not done to advance particular sectional interests, or to pursue some ideology for its own abstract sake. Groups like the 2025 Taskforce can outline the prescriptions, but political leaders make it happen, partly by their ability to inspire people to believe that catching Australia really is about improving opportunities and choices for all of us – a better country for us, and for generations to come.

There is apparently a belief in some circles that far-reaching economic reform means inevitable electoral suicide. That simply has not been the experience in New Zealand or in other countries – in Australia, in the United Kingdom, in Ireland, in the United States. Were it otherwise durable reform would never happen. We believe that New Zealanders hanker for something better. The Taskforce will continue to play a role over the next two years in helping to build a climate for reform.

We commend this report to the public and to the political leaders of New Zealand. We trust that it will help to fuel a robust public debate and we hope that it helps spark action. Political leaders in successive governments have failed the people of New Zealand. That must change now.

Don Brash (Chairman)
David Caygill

Jeremy Moon
Judith Sloan

Bryce Wilkinson

30 November 2009

Appendix 1 – List of submissions received by the Taskforce

The following individuals and organisations made submissions to the Taskforce[88]:

Winton Bates	New Zealand Chambers of Commerce
Al Belcher	New Zealand Council of Trade Unions (CTU)
BRANZ	New Zealand Institute of Chartered Accountants
Business New Zealand	New Zealand Manufacturers and Exporters Association
Sir Paul Callaghan	New Zealand Venture Investment Fund
Committee for Auckland	New Zealand Vice-Chancellors' Committee
Len Cook	NZ Heavy Engineering Research Association
Corporate Taxpayers Group	NZICT Group
Wyatt Creech	Property Council NZ
EMA Northern	Property for Industry Ltd
Federated Farmers of New Zealand	David Rycroft
James Forsberg	Seafood Industry Council
Tony Friedlander	Seqel Partners
Norman Geary	SKYCITY Entertainment Group
Sir Peter Gluckman	Tim Stewart
Gary Hawke	Talley's Group Ltd
Ranald Hendriks	Steven Thomas
Shaun Holt	Sir Stephen Tindall
Independent Business Foundation	Tower Investments
Independent Research Association of NZ	TR Group
Industry Training Federation	Carl Turney
Institution of Professional Engineers	Vodafone New Zealand
Rodney Jones	Gordon Ward
Kerridge & Partners	Peter Weir
Warren Lewis	Andrew West
Kerry McDonald	Westpac
Wayne McDonald	John Williams
New Zealand Business Roundtable	Malcolm Wright

88 This list includes all submissions received by 25 November 2009.

Appendix 2 – Some concrete examples of burdensome regulation

Each of these examples is presented as the Taskforce received them. We have not made an independent attempt to verify the accuracy of the accounts, and include them here not as definitive, but as illustrative of the widespread sense that the regulatory system in New Zealand, by design or implementation, is unnecessarily impeding economic activity in New Zealand.

Resource Management Act and/or local government

"Drawn-out battle to axe palm pest"

How many people does it take to chop a dangerous palm tree and a poisonous leaf shrub on a community reserve?

Yesterday, three Takapuna hearings commissioners took half a day to consider an application by the city council's parks department to remove a phoenix palm and an oleander tree from the Castor Bay Beach reserve. They gave consent, on condition the trees be replaced by more benign species.

They had first considered a report on the application under the Resource Management Act by land use consents planner Suzanne Murray, who recommended consent be granted. Her recommendation had been reviewed by the council's team leader land use consents and approved by the council's operations and resource management group manager.

Ms Murray's report was partly based on information from specialist assessments by the council's central ward environment services arborist, Gavin Donaldson, who supported the application, which had been prepared by Andre Le Claire, the council's parks arborist. Mr Donaldson had his report "peer reviewed" by a different land use consents planner to Ms Murray. Arborist Mr Le Claire's report was reviewed by the parks operations manager and approved by the parks liaison manager….

Yesterday, the Takapuna commissioners …. agreed to the trees' removal.

However, this was not their first try at dealing with the application. When the proposal was first brought before them, in November, they decided that a meeting on site at the park, with 20 residents, in September 2008, was not adequate public consultation. They ordered the proposal be debated with the community, including obtaining the views of the Takapuna Community Board and the Castor Bay Association.

The community board voted to give its consent, as land owner, for removal. The proposal was again taken to the Takapuna commissioners in May (2009), when the decision was taken to notify, or fully advertise, the proposal. The reason was that consultation had not resulted in a consensus of support within the neighbourhood. Notification of the proposal resulted in written submission from 13 parties.

From nzherald.co.nz, 8 September 2009

791-793 Great South Road, Penrose

This site was purchased around 1990 by Andrew Hastings. He spent 14 years trying to gain consents to develop the site. In 2002, he won a case in the Environment Court relating to the zoning of the land. The decision confirmed that it was appropriate that the land be zoned Business 6, and set aside the wishes of the Auckland City Council, which wanted to rezone the land as Open Space 1. In 2004, Mr Hastings passed away unexpectedly and, on the basis of the Environment Court's decision, the TR Group purchased the site. We have since spent a further five frustrating years trying to gain consents to develop the site.

From the day we purchased the land, we set about creating a practical outcome for it. This involved countless efforts to engage with Auckland City Council, Auckland Regional Council, Department of Conservation and other interested or affected parties. What became very clear is that no one wanted to engage with us in a meaningful way.

For example, we put a proposal to DOC in November 2008. They undertook to respond to this in February 2009. By March no response had been received. They would not return calls. Eventually we were contacted by their lawyer saying that they were not going to respond and would prefer the consent ended up in a hearing or Court case so they could attend and make their statements there. In May, the Minister of Conservation forced them to engage with us. During this meeting and subsequent discussions, they stated that our proposal "was neutral, in a worst case scenario, from an ecological point of view, however we generally prefer not to engage with land owners and would like to hear what others think in a hearing situation." Notwithstanding this, and under pressure from the Minister, they undertook to respond to our proposals within two weeks. Six weeks later a request for more information was received from them and it became clear that they were simply going to stall until the hearing date rather than provide a genuine response.

During the hearing, which lasted for four days, there were approximately 20 people present at all times, including six Commissioners, a meeting organiser, and three people from each of the Auckland City Council and Auckland Regional Council.

The fee from ARC alone for processing the Resource Consent application is $91,000 plus GST. The fee from the Auckland City Council is $45,000. We have estimated the cost of the hearing to be $180,000. The total cost to us, of professional fees, since purchasing the land is approximately $600,000. This does not factor in anything for lost opportunity or cost of funds committed (land was purchased for $4 million in May 2004).

At the hearing, people representing the ARC and ACC made submissions to Commissioners (also representing the ARC and ACC). These people read statements up to 50 pages long expressing their opinions on the land. These are the same people that we had been trying to engage with over the last five years, but they were not willing to do so. They work within a system, to processes, that have long since lost sight of practical, balanced and productive outcomes.

For people from the private sector, this process is incredible. To see, in public, an organisation pitching a case to itself is very odd. To endure four days of documents being read out when they could have been distributed prior to the hearing is unusual… It is beyond us why each organisation

could not gather a group of appropriate people together and meet with us, the client, to resolve an outcome well before a hearing is needed.

There are obvious problems and shortcomings within these organisations. However, it is the knock-on effect they have on the rest of New Zealand industry and society where the real damage is done. Productivity loss and damage to New Zealand's morale is the multiplier effect. How many people simply don't even try to start something because they know it will be too hard?

From a submission by the TR Group dated 15 October 2009

In a subsequent email in early November, TR Group's CEO advised that a decision had been reached, with the Auckland City Council granting its consent to the company's application but with the Auckland Regional Council declining consent "on every matter requested… We are now preparing an appeal to the Environment Court and allowing for a further 12 months for this to play out (plus significant cost also). It is hard to know what to make of all this – regardless of the final answer, the methods and style adopted by ARC are nothing short of ridiculous. There is no intent to find balanced outcomes from ARC, no intent to engage constructively, and every intent to utilize the costs and mechanisms of the system to prevent progress. We can't even find anyone there to engage with…"

Even government agencies frequently stymied by the RMA

When I joined Transit New Zealand in 2000 as Regional Manager, I was immediately struck with the challenge of accelerating large roading projects in order to respond to increasing allocation of transport funding. At that time, I discovered that it took four years to take regional projects through RMA processes and only three years to construct them… It is important to record that the four years involved in getting through RMA processes was often not the fault of the legislation but of the way professionals in various consenting agencies interpreted the RMA… So I don't blame legislation but I am critical of the way some professionals seek to apply it.

Email from Wayne McDonald, NZ Transport Agency, dated 6 November 2009

Birds' nest shells not PC say Maori

Culturally unacceptable sand scuttled a beach project and now culturally unacceptable shells threaten to delay nesting beds for dotterels already holding up a major motorway. A Maori group says shells from Thames for eight rare dotterels, which have delayed building the $32 million Esmonde Rd motorway interchange project, aren't acceptable.

The nesting beds to keep the rate birds happy are expected to cost about $200,000. Ngati Whatua representatives are unhappy over mixing local and outside shells, and want them sourced locally…

From "North Shore Times Advertiser", 27 February 2003

Ernslaw One's "trial by RMA"

A few years ago, NZ forestry company Ernslaw One gained a resource consent from Environment Waikato and the Thames Coromandel District Council to build a state-of-the-art sawmill in the centre of Whangapoua forest on the Coromandel – on an out of the way 10 hectare grass paddock up a dirt road about six kilometres back from Whangapoua Harbour, on a run-down marginal farm purchased for the project, and adjacent to the stock-grazed, wooly-nightshade infested, banks of the Opitonui River.

NZ's well know "NIMBY" phenomenon saw a local environment protection society quickly formed to oppose the sawmill project. The group argued that all those in the area who wanted jobs already had work, that new timber workers would be unwelcome (despite the area then being a WINZ job-short no-go area and the proposed sawmill being high-tech and requiring a small workforce of computer savvy technicians to drive it). The opposition group immediately appealed the sawmill's consents to the Environment Court with assistance from the Ministry for the Environment's Legal Defence Fund.

While the Environment Court found that almost all of the sawmill's effects on the surrounding physical environment (air, land and water – including the Whangapoua harbour) would be truly minor, given the various mitigating measures proposed by Ernslaw One and the consent conditions set by the Councils, the Environment Court was persuaded to reject the project's land use consent by arguments on rural landscape and pleasantness, and the fact that the adjacent river bank was a place where people might like to picnic, despite the fact they never have and probably never will do.

The whole RMA process was a huge drain on the company, and the outcome exceedingly disappointing (Ernslaw One had imported all the machine centres and other hardware for the proposed sawmill from Scandinavia).

One of the many perverse twists in the saga was that the Department of Conservation appealed the positive decision of the Council's four independent Hearing Commissioners, despite the fact one Commissioner was appointed by DoC itself! DoC's ability to use the resources of the Crown to oppose a project promoted under the (Government's) Wood Processing Strategy indicates how the wires have become crossed in Government thinking and process.

In today's environment, investors in wood processing are increasingly likely to head across the Tasman or further afield. At the time of the court appeal, there were 22 sawmills under development in Australia (then NZ's largest market for sawn timber), which have now provided the Lucky Country with the equivalent capacity in sawn timber to what it was importing in 2005. An Australasian forest industry magazine at the time reported that the decision was a "Shocker" and that New Zealand was closed for business.

From an email from Mr Peter Weir dated 5 November 2009

Other examples

The case of Mrs M Taylor

New Zealand-born herself, Mrs Taylor decided after 20 years overseas to return to New Zealand. She described gaining residency for her non-New Zealand husband as "an appalling trial, financially and emotionally. Married for 12 years and now with three children, we sent our wedding certificates, children's birth certificates and family photographs to immigration, only for them to be returned. We were told that we hadn't fulfilled the requirements of our application and further proof of the validity of our marriage was required, not less proof that we were sexually exclusive during our marriage…. It's understandable that there needs to be a rigorous system, but why are born-and-bred New Zealand passport holders put through this? Do you want us back in the country or not? You had my heart, but somewhere along the way, while I was dealing with yet another irritating and pointlessly discriminating piece of legislation and form-filling, you lost it."

Letter by Mrs M Taylor in the "Listener", 9 July 2005

Obstacles to increased productivity in the fishing industry

While its foundations remain strong, the Quota Management System is not reaching its full potential in terms of efficient resource use and management. Regulatory uncertainty in relation to quota rights continues to hinder industry investment. It is also a huge distraction for the industry and necessitates a lot of unproductive activity, including litigation, to protect the value of the industry's quota assets.

There are significant differences between the Australian and New Zealand regimes. For example, several Australian states provide statutory compensation or adjustment assistance for reductions in spatial access for commercial fisheries, and several have progressive regimes for managing recreational fishing, including the use of licensing. In contrast, New Zealand deals with these issues through exhaustive, time-consuming and costly multi-stakeholder consultations which focus on process rather than outcome and which inevitably ultimately result in uncompensated reductions in commercial fishing access. (The West Coast Marine Protected Areas Planning Forum is an example. To date, a five year multi-stakeholder process proposed a series of marine reserves which (a) are of undemonstrated benefit to biodiversity, (b) are not a least cost approach to regulation, and (c) if implemented, will result in significant uncompensated reduction of commercial fishing access.)

From submission by the Seafood Industry Council dated 21 October 2009

A plea for less bureaucracy from a structural engineer

I have received a letter from the Christchurch City Council, requiring further information from Professional Structural Engineers (with effect from the beginning of August) at the time a building consent is applied for, as required by the Department of Building…

One bureaucrat in the Department of Building at the stroke of his pen has now reduced the productive effort of all Structural Engineers in the country by making them compile information that provides no benefit, is already provided in the calculations, and takes up valuable design time. Such a request is like asking a surgeon to write down his step by step operation on a patient after the operation.

Why is it that Structural Engineers have to be checked up on by an army of bureaucrats when structural failures are minimal in this country, due to the good training and professional standards

required? Mechanics don't have Local Authority staff checking their work and yet their entry standards are low and their failures kill people. Medical staff kill more people by mistakes than are killed on the road, and yet they don't have Local Authority staff checking everything they do. Quite honestly, if all the Local Authority staff were equipped with vans and told to maintain household smoke detectors, their efforts would save and protect a lot more lives than their present actions of pouncing on pieces of paper and demanding more paper from anyone who tries to do something productive. Bureaucratic drag on the productive sector is becoming endemic in this country.

From letter from Mr Warren Lewis of Lewis & Barrow Ltd, 28 July 2009

Another opportunity blocked because of red tape?

Medical research is hugely important to our well-being. Despite this, a study from Auckland University showed no clear increase in the number of clinical trials occurring in New Zealand in recent years. Funding may be contributing to this lack of growth, but a major factor is the system of ethical approval of medical research. Ethics committees were introduced in the 1970s… Since then the process has grown into a hugely complicated bureaucracy, which has lost touch with its original aims.

As an experienced medical researcher and an ex-member of an ethics committee, I am likely to know about the ethical requirements of medical research. Last year, I submitted an application for a simple study to see if honey could help treat a common skin infection in children that is otherwise very difficult to treat. Only 15 children were required for the study, and all the caregivers had to do was to apply the honey, cover with a dressing and see if it seemed to help.

In order to apply to the ethics committee, I had to consult a Maori health provider to make sure there were no cultural issues if any Maori children took part and see a justice of the peace to sign a statutory declaration. The application itself needed around 9000 words to complete and over 350 pages had to be submitted. For a study which could not be any simpler and had almost no chance of causing any harm, the application process took longer than doing the study would have.

The study was rejected by the committee and around 40 points were raised, most of which were either wrong or not relevant to the ethics of the study. For example, I was told to consult at least two more Maori health providers and to have systems in place for interpreters, even though the study was to be undertaken by a few GPs who would ask their own patients with this condition if they wanted to take part.

This example demonstrates how the ethics review system is extremely onerous for researchers and not capable of quickly approving simple ethical studies. Rather than the international standard of five committee members of whom one is a lay person, New Zealand requirements are for 12 members of whom at least half are lay people, and a lay person chairs the committee.

From 'Our ethics system is now so unwieldy, it's unethical',
by Dr Shaun Holt, from nzherald.co.nz, 2 March 2009

Dr Holt advised the Taskforce that if the New Zealand Ethics Committee system were streamlined, New Zealand would become an important place for medical research and drug development, with the consequence that scientists and researchers would be retained in New Zealand and export revenue in excess of $100 million annually would be generated within a short period of time.

Effects of the Gambling Act 2003

The legislation which authorised the establishment and operation of licensed casinos in New Zealand, the Casino Control Act 1990, had as its purpose the promotion of economic development, job growth and tourism, while providing for the regulation of the casinos in the public interest.

With the advent of the Gambling Act 2003, there was a significant change in emphasis with the primary focus on preventing and minimizing harm and no recognition of the economic benefit casinos bring to any economy… This single-minded approach of the Gambling Act has resulted in huge inefficiencies for our business. It is at odds with most gambling legislation around the world where the economic benefits associated with gambling are recognised in tandem with the need for regulation which is consistent with the public interest…

This approach, combined with the interpretation that the Courts have given several key sections of the Act (such as Section 12 – “no increase in the opportunities for casino gambling”), have meant we have ended up with some absurd situations, like having to reduce the number of seats at Blackjack tables from 7 to 5 in order to introduce “automatic card shufflers”. The catalyst for that development (which has no parallel in any casino in the world) was the regulator’s argument that the increase in efficiency and game speed caused by the “card shufflers” would increase the opportunity for casino gambling…. We now find ourselves having to go through tortuous exercises in comparing the speed of one game for another (the argument being that replacing a “slow” game with a “fast” game would mean that we would be “increasing opportunities” in contravention of Section 12).

From a letter from Mr Peter Treacy, General Manager – Government and Industry Affairs, SkyCity Entertainment, dated 29 September 2009.

In a subsequent email, Mr Treacy explained that SkyCity had been able to restore their Blackjack games to seven boxes, “largely as a result of introducing a large number of Poker tables, which tend to be very slow games”.