Improving Living Standards: We Need to Talk About Productivity

Speech delivered by Gabriel Makhlouf, Secretary to the Treasury at Catalyst Trust, Queenstown

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[Check against delivery]

Hello everyone, it’s a pleasure to join you here in Queenstown. Thank you for the invitation to come and speak to you.

This is a fascinating place for the adventure-loving tourist and the data-loving economist alike, not that the two are mutually exclusive. Queenstown is of course an icon of New Zealand’s biggest export industry, tourism, and it stands out for good reason. Tourism drives 33 percent of the Queenstown-Lakes District’s GDP, compared with 5.5 percent of New Zealand’s GDP. It employs a lot of people too. Unemployment here was 1.8 percent in 2017, much less than the already low 5 percent for the rest of the country. And last year GDP in the region grew 8.1 percent, well outstripping the national GDP growth rate of 3.6 percent.

With a booming local economy, lots of jobs and, quite possibly, as beautiful a natural setting as you’ll find anywhere in the world, you can enjoy a great standard of living in Queenstown. And many people do. But in reality that’s not the case for all. When you look at some other figures, there are patches of trouble in paradise.

The mean income for people in the Queenstown-Lakes District in 2017 was about $51,000 compared with the national mean of $59,000. With low incomes but the highest average weekly rental cost in the country and an average house value of more than $1.1 million, the housing affordability problem in Queenstown is in the same league as Auckland. In response, the Government’s Housing Infrastructure Fund is contributing $76 million in 10-year interest-free loans to support an increase in Queenstown’s housing supply. Another issue is that productivity growth for the district is a bit behind the pace: last year it was 0.8 percent, two-thirds of the national productivity growth rate of 1.2 percent.¹

¹ Infometrics (2018)
I mention these figures as a local example of the interconnectedness of productivity and the living standards of New Zealanders. Today I want to talk about that interconnectedness. And in fact it’s more than just interconnected: productivity is fundamental to improving our living standards over the long-term.

**Current economic conditions**

But before we focus on that, let me start with a look at current conditions in the New Zealand economy.

The state of the economy could be described in the fashion of Jane Austen as ‘Risk and Respectability’.

First, the risks. A lot of recent commentary has focused on the fact that, according to some surveys, business confidence has been weakening and that it may impact on business investment and GDP growth in coming quarters.

Recent GDP data were softer than expected, with stronger imports and weaker exports and consumption. In addition, as trade tensions escalate in some parts of the world, so too do the risks of the real economy taking a hit from uncertainty and reduced investment. The tariff tit-for-tat between the United States and China has understandably made the rest of the world nervous.

Taking all of these factors into account, there is a risk that economic growth over 2018 will be slower than what the Treasury forecast in last May’s Budget Update.

Now here’s the respectability side of the story, which I think is the relatively stronger side of the story. And, frankly, the respectable side of our economy isn’t acknowledged nearly enough.

From the Treasury’s perspective, the economic outlook for New Zealand is broadly positive. And that’s for a number of reasons, including the fact that low interest rates will continue to support business investment (and for longer than assumed before, as the Reserve Bank confirmed last month). The terms of trade remain around record highs, supported by high prices for meat and dairy. Net exports are expected to be supported further by recent declines in the New Zealand dollar. And, as we said yesterday in our Monthly Economic Indicators report, consumer confidence and the latest retail trade figures are looking strong, suggesting consumer spending is healthy. Private consumption is likely to pick up further as the impact of the Families Package comes through.

Although the economy looks to have grown a little slower than expected through the first half of 2018, tax revenue has held up. Tax revenue as of May is around $0.5 billion ahead of forecast. The extent that tax revenue remains ahead of forecast will be a mitigating factor in any softer economic outlook flowing through to the fiscal outlook.

Some commentators like to describe the economy as either booming or bombing: nuance doesn’t make good headlines. But as you’ll appreciate, the reality is always more complex. And for the Treasury it’s important to start with the facts and build our analysis and advice from there.
New Zealand’s productivity

So let me go back to productivity. As Nobel-winning economist Paul Krugman once observed, “Productivity isn't everything, but, in the long run, it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker”\(^2\).

Over the past 20 years, New Zealand’s GDP growth has averaged 2.9 percent, compared to the OECD average of 2.1 percent. But only 1.1 percent can be attributed to labour productivity growth, making us one of the weaker performers in the OECD. In fact, our level of labour productivity – GDP per hour worked – is now about 20 percent below the OECD average and has been for at least a quarter of a century. This should matter to everyone who wants to see higher living standards in New Zealand.

Our understanding of New Zealand’s productivity performance is improving, thanks to some good work from the Productivity Commission, the OECD, government agencies and others. In fact the ways in which economists think about economic growth and productivity have evolved significantly over recent years. For example, Philip McCann\(^3\) highlights a wide range of considerations, including geography, cities, scale, proximity and market access, and the diffusion of innovation. This evolution has intersected with ‘new’ data at the firm–level, where we observe large performance spreads even in narrowly-defined industries.

More pointedly, in terms of New Zealand, McCann said in 2009 that “policy-makers in New Zealand were looking in the wrong place for answers and ignoring the fact that new generations of economic models provided robust explanations as to what had taken place”\(^4\).

I'd challenge this view and argue that we have increasingly reflected many of these elements and applied the firm-level perspective. But I would agree with the Productivity Commission’s view that rather than talk about a productivity ‘paradox’, we should talk about explanations\(^5\). We know that our productivity levels stem from a number of factors including weak international connections, the small size of domestic markets, low investment in knowledge-based capital and weaknesses in the allocation of labour. Our challenge now is to turn our growing understanding into action that lifts our productivity performance.

It remains a fundamental truth that successful economies need, among other things, a stable and sustainable macroeconomic framework, sound monetary policy and a prudent fiscal policy. It remains true that a well-regulated financial system matters, that properly functioning markets matter, that price signals matter and that incentives matter. And, perhaps most important of all, it remains true that productivity matters.

\(^2\) Krugman (1994)
\(^3\) McCann (2009, 2018)
\(^4\) McCann (2009)
\(^5\) Conway (2018b)
The difference between our living standards today and those, say, 100 years ago is the improvement in our productivity. It’s a phrase or even a word that I’m sure turns people off, or at least non-economists. But it means how people and businesses find new and better ways to make things that other people want, whether those people are in New Zealand or in markets overseas.

The Treasury believes there are a number of factors that always matter for productivity: our human capital, the management of our resources, our international connections, the dynamism of our markets and the effectiveness of our rule-making. I want to say a few words about each of these. To improve our productivity we will have to be more effective in their utilisation and the interactions between them.

**Human Capital**

First, our human capital.

The foundation of any economy is its human capital. We define human capital as the skills, knowledge, mental and physical health that enables an individual to participate fully in work, study, recreation and in society more broadly. The health and skills of New Zealand’s workforce is the most important component of our human capital and the foundation of our productivity. It’s vital that we invest into the ongoing development and sustainability of our skills base as the nature of work changes and as the age and shape of the workforce changes.

Labour market skill requirements are likely to change more often, especially as competition intensifies both domestically and in our export markets, and as the adoption of new technology accelerates across most sectors of the economy.

It’s important that New Zealanders have skills that are adaptable and transferable. People need to be able to move from industries that may be affected by technology and competition to those that are growing, taking up new opportunities that technology and greater international connectedness actually creates.

And demography underlines that. People born today are expected to live up to 20 years longer than those born 100 years ago and have commensurately longer careers. And given the impact of technology, robotics and AI more broadly, the future of work is likely to mean changes of career and not just changes of job.

In the Treasury’s view, to help achieve this there should be an emphasis on attainment of cognitive and non-cognitive foundational skills and social skills that are transferable and support life-long learning, as well as greater rates of progression to higher tertiary qualifications. Indeed a key question is how our education system – and particularly our tertiary system – will help with ongoing learning, a theme raised by the Productivity Commission in its report last year.

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6 Stats NZ, New Zealand population age structure: 1972 - 2060

7 NZ Productivity Commission (2017)
I also suggest that we are likely to need a re-think of how training and development happens alongside what training and development takes place. And employers will need to think about what the ageing workforce is likely to mean for them. Older New Zealanders are already staying in the workforce at much higher rates than previously, with the labour force participation rate over the past 25 years rising from around 26 percent to around 73 percent for those aged between 60 and 64, and from around six percent to around 22 percent for those aged over 65.

Given the proportion of New Zealanders aged over 65 is projected to increase from around 15 percent to around 27 percent by 2060, both supportive employers and supportive policy settings will play important roles in our future prosperity.

I should also add that we will need to look carefully at whether our social welfare system – which was initially set up to help people make transitions from one job to another in what was expected to be a similar trade – is optimal for the changing world ahead of us.

**Managing our resources**

What about the productive use of the resources that are part of New Zealand’s natural and physical capital? We know that an underlying reason in house price growth in Auckland stems from inefficiencies in our use of land. In fact it has proved to be a self-imposed bottleneck in the country’s growth and productivity.

At the heart of the matter is the allocation and development of our natural and physical resources. On the face of it, the resource management system is currently too slow to respond to society’s changing demands for resources and services. It has contributed significantly to rising housing costs, infrastructure supply shortfalls and freshwater pressures. Moreover, at the moment, it can be argued that too much of our natural resource use is determined by incumbency rather than most efficient use. For example, the ‘first-in first-served’ approach to water allocation means it may not always be allocated to the highest value use, and the current system lacks sufficient incentives for use to move to a higher value one.

The case for change is overwhelming although, of course, precisely what to change to is less straightforward.

Getting incentives right is critical. Better rules around use and around pricing externalities such as pollution are necessary to making best use of resources and are likely to be key to promoting significant diversification of the economy and contributing to an improvement in productivity.

Tax and other economic instruments can be useful tools for management of our resources. The Emissions Trading Scheme is a good example of a tool that can promote the more productive use of resources. Including agriculture within its scope would provide incentives for investment in R&D or innovation in on-farm practices and improve productivity. Similarly, congestion charging in our biggest cities has significant potential to

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8 Stats NZ, Labour force participation rate
9 The Treasury’s Long-Term Fiscal Model
improve productivity through managing travel demand and improve access to jobs and education.

We have a number of economic tools at our disposal and we should use them to support the productive management of our resources.

**International connections**

Let’s move on to international connections. Successive governments have understood how vital connections are for a small and geographically isolated trading nation like New Zealand.

Improving the flow of people, capital, trade and ideas will help improve productivity. Strong people-to-people relationships build confidence and understanding and promote learning. They help our businesses to identify capabilities that will help them improve their productivity and ultimately compete and succeed in both domestic and global markets.

Free trade agreements remain crucial to our global connections and, as the global economy continues to develop, we need to ensure that New Zealand’s trade agenda is broader than goods and encompasses services, the digital economy, non-tariff barriers and investment. Our trading partners are an indispensable source of financial and physical capital that we don’t have enough of ourselves but that we need to improve our productivity.

And it’s not simply about transactions. Investment matters too, both inwards and outwards.

Foreign direct investment often brings new thinking and skills from other parts of the world. New ideas and skills are transferred to New Zealanders through experience, observation and training, and spread through the economy as people move between firms, helping to improve productivity across the board.

In the case of inward investment – where we’ve seen recent changes to the Overseas Investment Act around screening regimes for residential and forestry investment – there is a delicate balance to strike between, on the one hand, keeping control and ownership of particular assets in New Zealand and being a welcoming place for investment that improves our productivity and living standards, on the other.

Similar benefits come from New Zealand businesses investing overseas but we don’t do very well on that score. Overseas investment by New Zealand firms is about 9 percent of GDP\(^{10}\), compared to an OECD average of 49 percent. This might be another area where businesses need to think about international connections differently, not simply in terms of connections to new markets but as an opportunity to gain exposure to different thinking that complements our own.

\(^{10}\) Stats NZ (2018)
Markets

The next factor that always matters for productivity is markets. Markets rely on mutual trust, cooperation, norms of behaviour and faith in institutions like the rule of law. They also rely on competition to push firms to be more productive.

We need to continue to lift the competitive intensity of the New Zealand economy, by reducing any barriers to entry (including for imports, whether in goods or services), or by regulating the price and quality of goods and services in markets where there is little or no competition (such as in our telecommunications and electricity markets). And we also need to maintain the effectiveness of competition laws and institutions. If we want competitive markets and the productivity gains they bring, we have to ask ourselves: what are the regulatory barriers preventing competition and what can we do about them? How bold do we want to be to invite competition?

As I said earlier, properly functioning markets matter and there is a continuing need to detect and prevent anti-competitive conduct, even when the market is seemingly competitive. The Commerce Commission needs to have the powers to ensure that markets are functioning well, particularly in the construction sector as the country’s investment in housing and supporting infrastructure ramps up.

Construction costs for an average house have risen 28 percent in the last 5 years and 180 percent over the last 20 years. We know that the housing and construction sector in New Zealand suffers from small size and low productivity, with an average of 2 houses built each year per firm at the peak of the cycle, and 1 house at bottom of cycle. Cyclical uncertainties mean that there is a reluctance to invest in pre-fabrication or training apprentices. In booms, prices go up because firms don’t have enough workers or capital; in busts, workers migrate or change sectors, and firms go bust. This may be an explanation for the cost structure in the industry but we – and in particular the Commerce Commission – need to make sure that the market is indeed competitive.

And the question of properly-functioning markets isn’t simply about whether big or small firms can compete. It’s about all markets and whether they are functioning well. For example, do our skills and labour markets operate efficiently? Do our professional and vocational qualifications operate to promote the competition and innovation that could make a difference to productivity? In fact does occupational regulation act as a barrier to competition by restricting people with the right skills and experience from entering the market, particularly when it creates unnecessary high costs for young people and other new entrants? Are those regulations fit for purpose? I suggest this is another area that deserves a close look.

We also need to look carefully at how well our capital markets are working. Well-functioning capital markets are essential for our productivity as they help firms to raise funds to grow and, by helping individuals to save or borrow, allow funds to be allocated to their best uses. They may also encourage firms to remain in or to relocate to New Zealand. And while New Zealand capital markets may adequately support more mature companies, we need to ensure that some young, innovative or fast-growing companies are also able to raise sufficient early-stage capitals.

11 Johnson, Howden-Chapman and Eaqub (2018)
I would encourage us all to keep an open mind about the effectiveness of our markets and the quality of our policy-settings. Some parts may be working well but it would not be a surprise if some parts were no longer be fit-for-purpose. We may need to challenge accepted paradigms if we want to ensure that our markets are encouraging the competition, entrepreneurship and innovation that make a difference to productivity.

Rules

Let me now talk about the effectiveness of our rules. Rule-makers in the public sphere (whether in central or local government) have a double responsibility: to ensure effectiveness in public spending and decision-making, and to provide the best possible regulatory and policy settings. The policy advice that informs decisions must be built on a strong foundation. We have to make sure what looks like a good policy idea is backed up by solid evidence and quality analysis. Better data and analytics can make a big impact in our understanding of the economic system, measuring the effectiveness of regulation and policy, and feeding evidence of performance back into decision-making.

Government has an active and key role in shaping the environment that businesses operate in and in facilitating business development (as we saw with Rocketlab, for example). But its role goes beyond rules and regulations. Given the transition to an economy based on low emissions and more intensive technology, government will need to ensure incentives are right to help businesses develop in new directions and that capital and labour flow to them.

It’s also important that rule-making is followed by evaluation. We need to ask the question whether a policy is having the impact we thought it would or whether a service is delivering value for money. It shouldn’t surprise us if the pace of change delivers a new set of challenges and circumstances that current policy just isn’t equipped to deal with. If the facts and evidence change, we need to be prepared to admit that and change tack too.

And on the subject of solutions, before we suggest new regulations, we need to test whether the problem they’re supposed to sort out couldn't be better solved by a non-regulatory arrangement. If we do choose a regulatory option, we need to know the benefits will outweigh the costs, that the regulatory solution will be proportionate to the problem, that it provides the right incentives, and that there won’t be unintended consequences.

Speaking of incentives, I find the situation around the eradication of mycoplasma bovis an interesting one. Responsibility for the genesis and subsequent spread of the mycoplasma bovis outbreak sits with the cattle industry. The question is, should the taxpayer compensate those affected, or should the industry pay for the consequences of the industry's making? We might also ask what incentives are signalled to the industry by these different options.
I’d like to turn now to tax, probably one of the more significant ‘rules’ that impact on the way we do things.

The tax system is an important enabler of wellbeing and living standards. Taxation is a source of revenue for the public services that underpin our standard of living; it is also a means of redistribution that allows all New Zealanders, regardless of their market income, to participate fully in society. And of course tax can also be used a policy instrument in its own right, to incentivise or discourage certain activities and behaviours.

The tax system also has a role to play in the productivity of the economy. The choices around taxation – what is or is not taxed, how much is taxed – affect decisions by consumers, workers, and businesses on their spending, saving, and investment. We therefore need to think carefully about the signals and incentives generated by the tax system. We certainly want to avoid a situation where the tax system inadvertently encourages investment into non-productive uses.

New Zealand’s current approach to taxation has many strengths. Most of the taxes levied in New Zealand have broad bases, meaning there are few ‘holes’ in the tax base. As a result, the New Zealand tax system is much less distortionary than the tax systems of other OECD countries.

But there is one area where we stand out as an outlier and which I think needs further attention. The current approach to the treatment of capital income – in particular, capital gains – is highly inconsistent. Some gains are already taxed but others are not. The result is therefore something of a patchwork, the results of which can be unfair, regressive and distortionary. A more consistent approach to the taxation of capital gains would increase the fairness of the tax system, and reduce distortions by levelling the playing field between different types of investments.

For these reasons, the Treasury has long believed there is a real case to extend the taxation of capital income. I recognise that this would come with its own risks, and give rise to higher compliance and administration costs. But there are interventions available to address these risks. The extent to which the impacts are realised – whether positive or negative – will depend significantly on the design of policy.

To reiterate, there are a number of factors that always matter for productivity: our human capital, the management of our resources, our international connections, the dynamism of our markets and the effectiveness of our rule-making. I should also add that there are many things being done to address points I’ve just raised. The government has been working on education and training, welfare reform, tax reform and trade relations, to name just a few of the actions happening.
Role of cooperatives

There are two more issues I want to touch briefly on, the role of co-operatives and public sector productivity.

Most of our firms are very small. And one response to some of the disadvantages of size has been the development of co-operatives. Although they are most prominent in the primary sector, the co-operative form is widespread throughout New Zealand business, including in retail, insurance and finance.

Co-operatives meet some obvious interests and provide some real advantages in the New Zealand context. They provide a strong sense of control for members, an effective mechanism for spreading risk, and better ability to weather cyclical downswings in revenues.

However, there are also certain disadvantages: co-operatives are typically less transparent in performance reporting; owners are more motivated by growing the value of their own businesses than providing for the growth of the co-operative; usual market disciplines faced by conventionally structured entities tend to be less visible and effective for co-operatives; and governance is also often less transparent and more challenging.

So given the centrality of co-operatives to the New Zealand economy, are the advantages of this corporate form sufficient to outweigh any disadvantages? Or to put it another way, do cooperative structures support innovation and promote increased productivity? I think this is an area that deserves further analysis and consideration.

Public sector productivity

The productivity imperative applies to the public sector as much as it does to the private sector. We are a big economic presence. The government makes up around a quarter of the total economy. And when you add all of the Crown’s interests – not just the core Crown – the significance of public sector productivity becomes even more apparent.

The Productivity Commission has recently published a report\(^\text{12}\) on public sector productivity and recommends a number of changes to improve performance including setting clearer expectations for productivity gain, building capability to measure productivity and more regular reporting on core public service efficiency. I welcome research in this area and we will study the report carefully.

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\(^\text{12}\) Productivity Commission (2018)
Conclusion

Productivity matters. It is how we grow more prosperous. It underpins improvements in our living standards. It means we are using our resources more efficiently. Improved productivity provides more choice, for citizens, businesses, and government. As Andy Haldane, the Bank of England’s Chief Economist put it in a recent speech, “the one thing we do know is that productivity is crucial to our pay and living standards over the longer run. Productivity is what pays for pay rises. And productivity is what puts the life into living standards”\(^\text{13}\).

There is no single productivity accelerator that we can just press harder on. There are many gears, levers, buttons and switches. We need to work on all of them. And the ‘we’ means everyone: businesses, workers and government seizing the opportunities offered by being part of, and closer to, the fastest-growing region in the world. We can learn from others’ experiences but we should be wary of the pathology of foreign paradigms: we need solutions that are relevant to the particular challenges that New Zealand\(^\text{14}\) faces. We can however aspire to others’ performance. Recent research indicates that if New Zealand’s productivity caught up with the better-performing countries in the OECD, our incomes would be 50-60% higher\(^\text{15}\). That would improve our living standards and New Zealand’s intergenerational wellbeing.

\(^{13}\) Haldane (2018b)
\(^{14}\) See, for example, Conway (2018)
\(^{15}\) Conway (2018)
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