NEW ZEALAND'S ECONOMIC OUTLOOK:

CAN WE EVER CATCH AUSTRALIA?

An address by Don Brash at
AUT University,
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Ladies and Gentlemen,

I've stood for election as a National Party candidate in four elections – in a by-election in 1980, and in the general elections of 1981, 2002, and 2005 – so nobody would be surprised to learn that on election night last year I was pleased to see the National Party win the largest share of the vote.

That's not just because I think John Key will make a fine Prime Minister, or because I know and respect all of the Cabinet, but rather because, speaking as objectively as I can, Helen Clark's Labour Government was a profound disappointment to me and to many others who care about the future of New Zealand.

When she was first elected Prime Minister in 1999, Helen Clark said that her objective was to raise New Zealand's living standards into the top half of the OECD within a decade.

What actually happened? Far from raising New Zealand into the top half of the OECD, we actually sank back a rung or two over the nine years that Labour was in office.

This is extremely serious. If we continue to languish in the bottom third of OECD countries – even worse if we continue to slide backwards – the things which have made New Zealand a pleasant place to live and work will gradually disappear. We won't be able to afford the healthcare which those in richer countries take for granted, nor the standard of education which richer countries take for granted. Income distribution will become progressively less egalitarian – as we're forced to pay our most skilled people some approximation of the lifestyle-adjusted incomes they can earn abroad – with all the social implications of that.

Certainly, with the rest of the world in a severe recession fewer New Zealanders are currently heading for greener pastures abroad, and indeed many who left in the past are keen to head home.

But within a few years the rest of the world will recover – and with it the temptation to head abroad again.

Of course, there are lots of reasons why New Zealanders head overseas to live. Some go for warmer weather. Some go to prove themselves on a bigger stage. Some go because they're sick and tired of the political correctness – around race or gender – in New Zealand. But almost certainly a key reason driving New Zealanders offshore over the last several decades is that it's possible to make a markedly better living for oneself and one's family by going to Australia, or the United Kingdom, or the United States, or Singapore, or Hong Kong.

And in this context, our standard of living compared with Australia is crucial. Australia's the easiest place for New Zealanders seeking a better life to move to – Australians speak almost the same language, play almost the same sports, look almost the same as most New Zealanders, and share a common heritage of British common law. There are a large number of New Zealanders living in Australia, so most New Zealanders have close friends or family already in Australia, making the move even easier. It's almost as quick, and as cheap, to get home to, say, Dunedin from Sydney as it is from Auckland. And of course Australians now have a markedly higher standard of living.

Comparing living standards between different countries is never straightforward. But it seems undeniable that Australian living standards are now materially higher than those in New Zealand.

It was not always so. For more than a century prior to the 1970s, living standards in New Zealand were pretty much on a par with those in Australia, and sometimes they were better. Net migration between the two countries fluctuated around zero, with the annual movement of people depending very much on which country was enjoying a cyclical boom.

But that all began to change in the 1970s. The precise number of people who head for Australia in any given year still depends on the state of the business cycle in each country, but the fluctuations are no longer around zero but around a substantial net outflow. Official statistics for GDP per head suggest that Australians now enjoy incomes one-third higher than New Zealanders do, and the outflow of New Zealanders to Australia suggests that those statistics reflect reality. Some observers believe that, with Australia projected to come out of this current slow-down faster than New Zealand, the gap could increase to 40% within the foreseeable future.

I well recall Michael Cullen being asked in the House why Australia spent more on roads per capita than New Zealand does. I often disagreed with Michael Cullen, but I couldn't fault his answer to this question. He said that, yes, Australia does spend more on roads than New Zealand does. Australia spends more on almost everything than New Zealand does. Australia is wealthier than we are.

It may be that one of the *consequences* of the fact that our income levels went backwards relative to those in other developed countries between the mid-1970s and the early 1990s – and that we've been unable to close that gap in the years since that time – is that we got into the habit of spending far more than we earn. We want to maintain living standards on a par with those in richer countries, even though we haven't earned those living standards. So we over-spend – and sell assets to, or borrow from, foreigners to fund our over-spending.

It's a sobering fact that New Zealand's now more heavily indebted to foreigners than any but two other developed countries, and those two are Hungary and Iceland. Our net indebtedness – the extent to which our gross foreign liabilities exceed our gross foreign assets – is estimated to be some $170 billion, or well over 90% of GDP; roughly $40,000 for every man, woman and child in the country.

It's not the *government* which owes a large amount to foreigners. Indeed, the government now has no net foreign-currency-denominated debt, and hasn't done since the mid-nineties. The government does have a relatively small amount of foreign debt in the form of foreign holdings of New Zealand-dollar-denominated government bonds, and that foreign debt will undoubtedly grow over the next few years as the government greatly expands its borrowing programme.

No, most of the foreign debt is owed by the private sector, with the largest single part of that debt being money borrowed by the banking system to fund an orgy of borrowing by the private sector, much of it to bid up the price of housing and enable dairy farmers to pay exorbitant prices for the farm next door.

More worrying still, despite the very high prices we enjoyed for some of our export commodities until we were skewered by the international recession, we have been adding to that net foreign indebtedness at a rate of some $16 billion annually in the last year or two – or about $44 million every *day*.

I've said I was *pleased* to see John Key and his colleagues form a Government after the election. I was *ecstatic* that one of the first things the National Party did was to sign a Confidence and Supply agreement with the ACT Party which commits the new Government to lifting New Zealand's living standards to parity with those in Australia by 2025, and to setting up "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 fulfill National's and ACT's aspirations".

And as you may have seen, a few days ago it was announced that I am to chair that advisory group. I very much hope that, in that role, I'll be able to play a part in lifting our living standards to parity with those in Australia, something which for me has been an almost life-long ambition.

Well, can we do it? Can we ever catch Australia? Well, one thing is certain: we will not catch Australia on our current track. All the signs are that if we simply continue as we have done in recent years the gap between living standards in New Zealand and those in Australia will continue to get wider. If that happens, it's probably no exaggeration to say that Australia's attraction to more and more New Zealanders will rip us apart more comprehensively than the Australian fast bowlers routinely do to the Black Caps (or the Wallabies sometimes do to the All Blacks!).

Happily, there's every indication that the Government knows this, and since last year's election we've seen a useful start on the reform of the Resource Management Act (with the promise of more to come), a major increase in investment in the road network, the canning of some of the sillier parts of the previous Government's investment programme (such as the Waterview tunnel), and a commitment to look seriously at the obstacles created by the regulatory framework within which the business sector has to operate.

Will it be enough? I don't believe anybody – whether in the Government or in the wider community – thinks it will be, yet. And I'm certainly not going to prejudge the conclusions of the advisory group which I've been asked to chair. But let me make a few preliminary comments.

The first thing to say is that catching Australia is *not* about working harder or working longer: New Zealanders already work more hours per year than those in most other developed countries.

The popular wisdom, encouraged by some rather ill-informed remarks by Michael Cullen, is that New Zealand can't ever really catch Australia because of that country's enormous mineral wealth. And certainly, Australia does have a huge abundance of mineral wealth.

But New Zealand also has an abundance of natural resources: a report circulated by the World Bank some years ago ranked New Zealand second in the world (behind only Saudi Arabia, and well ahead of Australia) in terms of natural wealth per capita, partly no doubt because of the quality of our farmland.[1] We have more natural gas than we thought we had just three or four years ago, and a considerable geothermal resource. We know we have substantial quantities of coal and iron sands, even though very large parts of the country have been locked up in the conservation estate, and never properly explored. We have one of the largest salt-water fisheries in the world; and we have a large amount of fresh water which, if properly used, can be an enormously valuable asset.

Moreover, the entire Australian mining industry contributes only about 5% towards Australian GDP, and employs not much more than 1% of the workforce.

It's only a few months ago that we were congratulating ourselves for being an exporter of foodstuffs rather than minerals on the grounds that the world may not need to buy more cars and flat-screen TV sets – the things made from the commodities which Australia exports – but the world would certainly need to continue buying the things which we export, because people will continue to need to eat.

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[1] *Estimating National Wealth: Methodology and Results*, by Arundhati Kunte et al, a paper circulated by the Environment Department of the World Bank, dated January 1998. Figures in the paper suggest that, based on 1994 data, New Zealand had "natural capital" of US$51,000 per capita, behind Saudi Arabia's US$72,000 per capita but well ahead of Australia's US$35,000 per head.

So we certainly can't complain that our natural resources somehow leave us at a disadvantage to Australia. Of course, even if we had virtually no natural resources, we could still have high incomes, as countries like Japan and Singapore have long since proved. So that excuse for the gap in living standards simply won't wash.

Perhaps the problem is that New Zealand is just too far from world markets to enjoy the standard of living enjoyed by those in other developed countries. Some recent research by the OECD[2] suggests that this factor will always mean that our standard of living can't ever quite catch up with the most affluent countries.

But even if this were true, Australia suffers from an identical "handicap", so while distance might mean that we can never quite overtake US living standards, there is no earthly reason why we can't overtake Australia's.

Moreover, to me this distance argument seems weak. After all, we had some of the highest living standards in the world until 30 or 40 years ago, even though at that time the average dollar value of a tonne of our exports was almost certainly lower than it is now and, because transport and communication costs were vastly higher then than they are now, we were in economic terms even further from our major markets at that time.

Maybe the problem is what Helen Clark called "the failed policies of the past". But even Helen Clark couldn't really have believed that. The policies implemented by the Labour Government of the eighties and the first Bolger Government were mainstream by the standards of other high income countries and were enormously beneficial to our growth potential. Between the two Governments, Labour and National, subsidies to inefficient industries were largely removed, the tax system was made one of the most efficient in the developed world, inflation was eliminated, inefficient government trading operations were corporatised and in many cases privatized, labour laws were substantially liberalized, and legislation was

[2] *Have Developed Countries Escaped the Curse of Distance?*, OECD Economics Department Working Papers, May 2008

passed which led in subsequent years to a huge reduction in the government's debt.

After the initial trauma of the policy changes was passed, production per person in the so-called "measured sector"[3] of the economy started to grow more strongly than for many years – indeed, in the eight years from 1992 to 2000, productivity growth in New Zealand was somewhat better, on average, than in Australia (whether measured as labour productivity or multi-factor productivity).

Over the next eight years, from 2000 to 2008, as the Labour Government started reversing some of the policies put in place in the late eighties and early nineties, productivity growth in the measured sector of the economy slowed abruptly. So much for the "failed policies of the past" as an explanation for our failure to close the gap with Australia!

So why *is* there still a big gap between living standards in New Zealand and those in Australia?

Answering that question will be a major focus of the group I've been asked to chair and, as I've already indicated, I won't try to pre-empt in any definitive way the conclusions we may reach.

But a number of explanations have been proposed.

One explanation is that Australian workers may have more capital – more plant and machinery, better infrastructure – to work with than New Zealand workers do. And that indeed seems to be the case: although all estimates of this kind are fraught with imprecision, it seems clear that Australian workers have quite a lot more capital to work with than New Zealand workers do[4], so that the amount of output which each Australian worker can produce is also markedly higher than can be achieved by New Zealand workers.

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[3] The "measured sector" of the economy is basically the private sector part of the economy, plus the state-owned enterprises, together some 73% of the total economy.

[4] A study undertaken by the Ministry of Economic Development and the Treasury in 2005 estimated that capital per unit of labour in New Zealand was about 74% of the Australian level, and other estimates suggest the figure may be even lower than that. See *Investment, Productivity and the Cost of Capital: Understanding New Zealand's "Capital Shallowness"*, New Zealand Treasury, April 2008.

Ah! We must be investing too much of our available savings in housing! That's exactly what I assumed. But OECD data covering the 16 years from 1990 to 2005 suggest that the 5.4% of GDP which we've invested in housing is actually slightly below the average for the OECD for that period (5.9%), despite our population growth being rather higher than the OECD average, and well below the 6.5% of GDP which Australia invested in housing over the same period.

So why *do* New Zealand workers have less capital to work with than their Australian counter-parts?

Part of the answer may lie in the fact that inflation-adjusted interest rates are relatively high in New Zealand. But why is that the case? In a country where it is easy to borrow money overseas, one would expect inflation-adjusted interest rates to be not too far away from rates in international capital markets, adjusted for the risk of lending to a small and heavily-indebted country. And perhaps high real interest rates in New Zealand do simply reflect the risk premium which is the inevitable consequence of our small size and high external debt.

But if real interest rates are relatively high in New Zealand, why are we such enthusiastic borrowers and such reluctant savers? I used to argue that we're reluctant savers partly because successive governments have told us all that we don't need to save – that government will provide for the education of our children, for our healthcare if we get sick, and for our basic needs in retirement; and partly because governments told us we'd be silly to save given that inflation would steal most of our savings in any case. But plenty of countries in Europe have social safety nets which are at least as generous as the social safety net we have in New Zealand (an exception may be New Zealand Superannuation, which appears more generous, relative to income levels, than is the case in many other countries), and their saving rates are well above ours; and both Australia and the US had relatively high inflation for years on end during much the same period that we did.

Perhaps there is something about our culture. I well recall talking to the wife of John Spencer – the man who then owned the Caxton Paper mill in Kawerau. Mr Spencer's wife, Tutti, was originally from Finland. She said to me once that Europeans had a very different attitude to building wealth than New Zealanders did. She said that in Europe you sought to build wealth for the sake of your grandchildren. In New Zealand, if we can't get rich in five years, then to hell with it.

But I suspect that Australian "culture" is not very different, and in any event it doesn't explain why we were once one of the wealthiest countries in the world and are now in the bottom third of developed countries – unless of course our culture has been changed for the worse by recent policy changes.

Still another possibility is that our saving habits are not unlike those in other developed countries – or at least not unlike those in Australia and the US – when adjusted for the way we tax savings. In 2005, an OECD study suggested that, as a share of GDP, New Zealand's tax on income from capital (profits, dividends, interest, etc.) was the second highest in the OECD – behind only Norway. If this is correct, and given New Zealand has a relatively small stock of capital per worker, or per unit of GDP, New Zealand's effective tax on capital may have been the highest in the OECD that year. That is particularly likely since so much of New Zealand's capital is financed by borrowing from abroad, on which very little New Zealand tax is paid. This suggests that the effective tax rate on the New Zealand component of savings, and on investment, was in aggregate particularly high in 2005.

Of course, since 2005 there have been some changes in the New Zealand tax regime. The company tax rate has been reduced slightly, from 33% to a still-above-average 30%, and, probably of greater significance, the PIE regime has been introduced.

But it may well be that this relatively heavy taxation of investment income in New Zealand is an important factor in the relatively small amount of capital New Zealand workers have at their disposal – and as a consequence, a factor in our failure to close the gap in living standards between us and Australia.

On the other hand, some observers regard this explanation for our failure to close the gap with Australia as totally incorrect. They note that a prodigious saving rate in Japan hasn't produced rapid growth in that country over the last two decades. They argue that what distinguishes rich countries from poor is the quality of their institutions, and the policies which go with those institutions. They argue that when New Zealand adopted the institutions and policies of most other developed countries in the late eighties and early nineties we lifted our growth in productivity up to that in successful countries, and that when we started abandoning those policies – gradually in the late nineties and more rapidly since 2000 – our productivity growth started to fall off sharply. Among other things, they point to:

- The rapid increase in government spending after the first MMP election in 1996, and especially after 2005, to the point where government spending in New Zealand is now markedly higher than in Australia as a share of GDP;
- The increased complexity throughout the tax system as a consequence of the increase in the top personal income tax rate in 2000, thus splitting the top personal rate from the company tax rate for the first time since 1988;
- The increased rigidities in the labour market as a consequence of the repeal of the Employment Contracts Act in 2000, and the refusal until this year to contemplate even a very short period during which an employer can dismiss a new employee without the risk of costly personal grievance action;
- The extraordinary obstacles put in front of almost any new investment – be it in roads, electricity transmission, wood processing, or residential land subdivision – by the Resource Management Act, and the way in which local and regional authorities have been allowed to interpret that Act to thwart investment and erode the rights of property owners; and
- The capricious way in which the Labour Government over-rode the rights of the shareholders in Auckland International Airport – and the rights of two major international investors wanting to buy shares in that company – and the rights of Telecom shareholders when the Government decided to unilaterally abrogate the agreement under which the company had been privatised.

Is it any wonder that investors hesitate to invest in New Zealand?

Of course, still other observers wonder whether these factors alone – most of them relatively recent – are large enough to explain longstanding divergences between our economic performance and that in Australia. They note, for example, that our labour market is still generally regarded as less heavily regulated than Australia's, and that our economic institutions generally compare quite favourably with those in some of the countries with the highest standards of living – notwithstanding the back-sliding of the last decade.

So there are lots of difficult questions to answer, and there'll no doubt be a range of views within the advisory group. In broad outline, we know what it takes to achieve strong growth, and we have a pretty good idea of where New Zealand scores badly. But clearly there are differences of emphasis and interpretation, and the 2025 Taskforce is going to need to identify the areas where the biggest sustainable payoffs can be achieved.

So finally we get back to the question: can we ever catch Australia? I've no doubt at all that we can, if there's the political will to do so. There's nothing inevitable about our relative decline: if it continues, it'll be because New Zealanders choose policies which give us that result.

But note well: given the gap which emerged from the mid-seventies to the early nineties, it will not be sufficient to lift our growth rate to the average of other developed countries, or to Australia's growth rate. We will have to grow consistently *faster* than Australia for many years, and that means we will need to have *better* policies than Australia, and better institutions across a broad range of policy areas.

This is arguably the biggest challenge New Zealand has faced since the Second World War. Small policy changes here and there won't cut the mustard. Substantial changes will be needed in government spending, in the regulatory framework, in investment, and in tax structures.

As an aside, I hope that the tax advisory group which the Minister of Finance has set up with some of the best tax experts in the country will see one of its primary goals as advising how the tax system can help eliminate the gap in living standards between New Zealand and Australia.

Some of the choices required to reach Australian living standards by 2025 won't be easy, and will require political courage of the highest order.

But if we flunk those decisions, we have to accept that our grandchildren will grow up cheering for the Wallabies.

I am greatly encouraged by the Prime Minister’s personal commitment not to let that happen.