

Essay

Lessons from the world's
economic laboratory:
What can Australia learn
from the New Zealand experience?

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Essays

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Dr David Skilling

**Remarks delivered at the Lowy Institute for International Policy, Sydney, Australia
21 June 2006**

Good afternoon.

I would like to offer some observations on the lessons for Australia from the New Zealand economic experience over the past couple of decades. I will argue that the New Zealand experience offers real insight into a range of international policy challenges, and that the New Zealand economic policy debate should therefore be of interest to an international audience.

Australia & New Zealand: some context

There is a common view that increasingly Australia and New Zealand see the world in different ways and are becoming less alike over time. In this view, New Zealand is increasingly an inward-looking, independent country, while Australia is a middle-power actively engaged in a range of regional and global issues and is aligned with the US to a greater extent.

I think that this view is broadly accurate, and is evident at both a government level and also in terms of public opinion. However, these differences should not be exaggerated. What Australia and New Zealand have in common far outweighs the issues on which we differ. And neither do I think that these differences will necessarily be permanent. Indeed, there is reason to believe that New Zealand and Australia will become more similar over the coming decades.

In the context of economic policy, again there is a mix of similarities and differences. New Zealand and Australia have both implemented market-based reforms over the past couple of decades, and have benefited from doing so, and the two economies have become much more integrated over the past couple of decades in terms of people, capital, and trade flows.

But there are also real differences in terms of our respective approaches to economic policy. Bluntly put, New Zealand has adopted a much more hands-off, level playing field approach, whereas Australia has pursued a more pragmatic, deliberate approach to economic policy.

Savings policy provides as good an example as any of these different approaches over the past 10 or 15 years. Australia has had a reasonably aggressive compulsory savings regime in place, at the same time as New Zealand has removed any assistance or encouragement for personal saving. These different approaches are increasingly generating substantial differences in outcomes such as household savings rates and household balance sheets and the state of our respective capital markets.

New Zealand has also gone much further than Australia in removing concessions or advantages in the tax code for various activities, such as R&D spending. And whereas New Zealand has no real restrictions on foreign ownership, Australia maintains a more deliberate approach (e.g. the four pillars banking policy).

There are also differences in terms of top-level economic outcomes. New Zealand's per capita income is about 25-30% lower than that of Australia. New Zealand ranks 21st in the OECD in terms of per capita income compared to Australia's rank of 10th. The main driver of this income difference is the higher level of labour productivity in Australia – New Zealanders work about the same number of hours, but Australian workers generate more value for each hour worked.

There are also similarities. New Zealand and Australia have both experienced strong economic performance over the recent past. Indeed, the rates of economic growth generated in New

Zealand and Australia over the past 15 years have been almost exactly the same, which has kept the trans-Tasman income gap roughly constant. And both New Zealand and Australia have had much improved fiscal performance and have reduced unemployment significantly, with New Zealand generating the better performance on both of these measures.

The relevance of the New Zealand experience

But despite the fact that Australia has higher income and productivity levels than New Zealand, I will argue that New Zealand remains very relevant to Australia and may well become more so over the next few decades. In addition to New Zealand seeking to learn from the Australian experience, the New Zealand experience and debate should be of great interest to Australia and other countries.

The specific claim that I want to make is that New Zealand should be seen as the economic laboratory of the world.

New Zealand has often been called the laboratory of the world because of its long and distinguished record in introducing world-leading social and economic policy. In terms of pioneering social policy, New Zealand was one of the first countries to extend the franchise to women in 1893. Over the next few decades, New Zealand introduced an old age pension, extended benefits to widows and families on limited incomes, and also implemented a comprehensive system of social security. These policy developments were at the cutting edge of international best practice.

More recently, the process of economic reforms that successive New Zealand governments undertook after 1984 was widely regarded as world-leading. New Zealand's economic reforms were noted for their comprehensive nature as well as their consistency and underlying coherency. The reforms went further and moved more rapidly than in most other reforming countries.

Many of the changes made were seen as examples of international best practice; for example, converting the government's commercial operations into for-profit, limited liability companies; reforming the tax system and introducing GST; inflation targeting and central bank independence; fiscal transparency and reporting; and public sector management reform; as well as many others.

People from around the world beat a path to Wellington to find out more, and still do on some issues, and the New Zealand reforms have exerted a significant influence on the international policy debate.

One 1996 study of the New Zealand reforms, published in the *Journal of Economic Literature*, expressed this sentiment in the following way: "Many of the lessons from the New Zealand experience are worthy of emulation by other countries... New Zealand once again appears to be emerging as a laboratory from which results will animate economic debate and policy throughout the world."

So the nature of New Zealand's policy innovations is the standard reason why New Zealand is regarded as an economic laboratory. But outside of new policies like the New Zealand Superannuation Fund, a policy of government saving to pre-fund a portion of the government's public pension obligation that has been one of the models for the Australian Future Fund, there is not as much policy innovation taking place in New Zealand as there was.

The dominant sense in New Zealand is one of good management of the policy status quo, with occasional policy tinkering, rather than of bold reform. New Zealand is not seen as a world-leader in economic policy in the way that it was 20 years ago.

But there is another sense in which I think New Zealand should be regarded as the economic laboratory of the world, and should therefore continue to be of interest to countries like Australia. The ongoing relevance of the New Zealand experience is due to the fact that New Zealand can be regarded as the ‘canary down the mine’ of the global economy.

Major global trends can be seen clearly and quickly in New Zealand because of the small size of the New Zealand economy. New Zealand is a knife edge economy. If something hits New Zealand, it will often have an obvious and immediate effect. In larger economies, these trends may be disguised because there is much more background noise. And there is a tendency for larger economies to muddle on by virtue of their size, which is not possible in New Zealand. New Zealand needs to be consistently close to best practice in order to generate acceptable economic outcomes.

A friend of mine, Brian Sweeney, has developed a metaphor that I think captures this insight well. It is the notion of the edge. New Zealand is a small country, physically at the edge of the world. But the metaphor comes from biology – the interesting things tend to happen on the edge of organisms rather than at the core. Similarly, there is a sense in which new things and ideas are more likely to manifest first at the periphery of the global economy and then work their way in to have an impact at the core.

And the edge also speaks to the freedom to do things differently in response to these challenges and opportunities. The periphery is more likely to generate different, independent, fresh thinking than that which occurs at the centre. In Brian’s words, “every world needs an edge”

Larger countries, such as Australia, inhabit the same global economy as New Zealand and are subject to the same global trends. But if these trends manifest first in New Zealand, observing the impact of these trends on the New Zealand economy and the nature of the appropriate policy response may provide a valuable heads-up as to what is coming down the track. This is particularly so given that New Zealand has a track-record of creative policy responses, and at least in principle can move quickly.

One of the obvious downsides for New Zealand of being the world’s economic laboratory is that New Zealand will frequently need to be a first-mover and will have less international experience on which to draw. This increases the risk profile for New Zealand. It increases the scale of the challenges that are faced, but also opens up enormous opportunities for New Zealand.

Peripherality in a globalising world

Major, disruptive changes have been occurring in the global economy over the past few decades. It is a cliché, but the globalisation of economic activity is having a profound effect. Cross border flows of goods, services, ideas, knowledge, capital and people are growing at a very rapid pace, and will likely continue to do so.

The decline in transportation and communication costs have contributed to the emergence of global production chains, and to many more firms developing a global footprint. Increasingly, the competition is global rather than regional or local. Countries are being drawn into the global economy and need to be able to compete in a much larger economic space.

As part of this process, companies, financial capital, and people, are increasingly internationally mobile, and can locate where the best returns and opportunities are. This trend towards agglomeration, and the physical concentration of economic activity, is a very powerful force. This

is not a uniform process, and there are obviously examples that run counter to this. But there is a general trend. The world is not flat as Thomas Friedman would have us believe. Declining transport and communication costs do not automatically confer significant benefits on peripheral regions of the global economy.

This physical concentration of economic activity is particularly acute in terms of knowledge intensive activities, which are one of the key drivers of economic growth. For example, refer to the rapid rise of the services economy, the rapid growth of technology intensive exports, and so on.

The small size and physical remoteness of the New Zealand market make participation in these new types of economic activity challenging. New Zealand is on the wrong side of these agglomeration forces, and there is a powerful pull of economic activity away from New Zealand. Resources are increasingly flowing to their most highly valued uses, and often this will be in existing areas of concentration. This is obviously not just one-way traffic, but it is a powerful tendency.

These forces can be seen in terms of the challenges that New Zealand faces in terms of attracting and retaining both people and companies.

In terms of people flows, New Zealand experiences very substantial migration flows. On average over the past decade, New Zealand has exported and imported a bit under 2% of its resident population every year. About 70,000 people a year leave New Zealand on a permanent or long-term basis. New Zealand has slightly more than compensated for this by inflows of migrants, many from Asia.

This is particularly noticeable in terms of trans-Tasman flows. Over the past three years, about 90,000 New Zealanders have left for Australia and about 40,000 have returned, for a net loss of about 50,000. This net loss represents about 1.2% of the New Zealand population, a substantial proportion. These migration flows are driven partly by the easy access to the Australian labour market and by the substantial income gap between New Zealand and Australia,

These outflows have resulted in a very large Kiwi diaspora. Estimates of the number of New Zealanders living overseas vary between 500,000 and 1 million people. The OECD recently estimated that New Zealand has the highest share of its highly skilled population living offshore – about 24% – of any OECD country. One of the reasons for this is the relatively attractive returns and opportunities available in other countries.

In terms of company location choices, there is concern about New Zealand becoming a ‘branch office economy’ with company head offices relocating to larger markets, such as Australia or further a field. There have been a number of examples of this over the past decade. New Zealand has a high degree of foreign ownership of its economy, with a high stock of inward FDI. For the most part, this FDI has come into service the domestic New Zealand economy, e.g. banking, insurance, rather than to undertake new economic activity or to service international markets from a New Zealand base.

Now Australia is one step up on the food chain from New Zealand. Many of the debates about these issues in New Zealand also resonate on the Australian side of the Tasman. Australia is concerned about the exit of companies and talent to London, New York, and Hong Kong, in the way that New Zealand is concerned about hollowing out to Sydney and Melbourne.

The nature of the appropriate response

Countries across the world are facing enormous challenges and opportunities. The global economy has changed in very disruptive ways over the past few decades, and governments (as

well as businesses) are grappling with the best way to respond to this process. From a policy perspective, how do countries remain competitive and ensure that they can continue to generate world-class returns and opportunities?

These challenges are exposed cleanly on the periphery of the global economy. I would like to draw out three lessons from the current economic policy debate in New Zealand that I believe have general application.

1. Good policy settings are necessary but not sufficient

New Zealand has among the cleanest, most efficient set of economic policies around. This is evident in OECD and IMF country reviews of New Zealand and also in rankings such as the Heritage Foundation's economic freedom index or the World Economic Forum's Global Competitiveness Report. New Zealand's policies are not perfect, and more needs to be done, but New Zealand benchmarks well against most other developed countries. Indeed, on these measures of economic policies and institutions, New Zealand generally comes out looking better than Australia.

New Zealand's economic performance has clearly improved as a consequence of the reforms after 1984. New Zealand has generated higher rates of economic growth, low and stable inflation, a very substantial fiscal surplus, and has very low unemployment and high rates of labour market participation.

However, there is now a much greater sense of the limitations of orthodox reforms. Improving basic policy settings is necessary and worthwhile. But the mistake is to believe that this is the end of the process rather than the start of the process. They should rather be seen as a platform on which a competitive economy can be built.

There is a growing sense in New Zealand that more is needed. It is increasingly difficult to sustain an argument that the major factor holding New Zealand back is the absence of sufficiently aggressive policy reform. The OECD in a recent country review of New Zealand noted that "the mystery is why a country that seems close to best practice in many of the policies that are regarded as the key drivers of growth is nevertheless just an average performer".

More can and should be done to improve the quality of New Zealand's economic policy platform, but the remaining items on the reform agenda are unlikely to be transformational in nature. This insight fits into the broader debate about the Washington Consensus, about which Dani Rodrik and others have written much. There is a greater awareness that there is no automatic mapping of orthodox policy settings onto economic outcomes. Because of this, the centre of gravity in the New Zealand economic policy debate has begun to shift.

2. The importance of ongoing competitive upgrading

Having clean, efficient, non-distortionary policy settings is only part of the process. Market forces may lead to a globally efficient resource allocation, but this does not help New Zealand much if the most efficient global resource allocation is for resources to flow away from New Zealand. The more important part of strengthening New Zealand's economic performance is being able to compete successfully for talent, for companies, for capital, and putting in place the environment that enables New Zealand companies to compete successfully in international markets.

New Zealand has tried to respond to global competition in the past by putting up the shutters. This approach is doomed to failure. Ignoring the global economy does not make it go away. Rather, the challenge for economies, be they peripheral or at the core, is to identify and invest in areas of genuine competitive strength. And New Zealand has to fight hard in this regard because it is peripheral.

Issues like building a domestic pool of capital and strengthening capital markets, investing in research and science, and working hard to integrate the New Zealand economy into the regional and global economy, are vitally important parts of this competitive upgrading process. And New Zealand's education system, infrastructure, the tax system, the quality of government spending all need to be at world-class levels.

The key insight from New Zealand is that these issues need to be addressed in the context of exposure to a high level of international factor mobility. Increased investments in tertiary education funding, and funding of the research and science system, as New Zealand has done over the past decade, generate less of a benefit to New Zealand if these people or companies subsequently relocate overseas. New Zealanders may indeed be a generous people, but educating the world is perhaps not the best use of taxpayer dollars.

For an economy like New Zealand, the priority needs to be to invest in 'sticky assets', which act to attract and retain economic activity in New Zealand. Investments should increasingly be made in relatively immobile assets, such as research infrastructure or a communications network, which act to make mobile factors, like companies and people, more productive in New Zealand than anywhere else – and so these companies and people choose to locate in New Zealand. In addition to investing heavily in tertiary education, for example, consideration should be given to policies and actions that make these graduates productive in New Zealand.

This insight has a range of implications from the way in which the education and research system is funded and structured, to the way in which the country's tax system is designed. Governments do have a strategic role in the competitive upgrading of economies, and increasingly need to design policy so as to address international factor mobility.

New Zealand has begun to move in this direction, but has not moved nearly as aggressively as is required. Australia looks to have done a better job of strengthening its economy for competitive success than has New Zealand, in terms of compulsory savings, investment promotion, and investing in research and science. These are the issues that will increasingly drive economic success.

3. The importance of political leadership and social cohesion

Economics is a social science, rather than a physical science, and cannot be separated easily from the political, cultural, historical context. There is an increasing awareness in New Zealand that insufficient attention has been paid to the softer aspects of economic policy, like the impact that various economic policies have on attitudes and the political environment.

By way of example, the reforms were implemented in a very rapid way from 1984 and caused substantial dislocation at the time. Public dissatisfaction with this process led to a change in the voting system, which was largely an attempt to constrain the freedom of political manoeuvre, and has also substantially diminished the constituency for economic growth. This is obviously easy to say with the benefit of hindsight – at the time, the situation was thought to demand very rapid action – but I think we are now more aware of the enduring costs that were associated with the way in which the reforms were implemented. New Zealand has probably lost a decade in terms of the absence of constituency for change.

One of the lessons from other small countries that have done well over a sustained period of time is that they paid more attention to the politics and were able to sustain widespread support. In Ireland for example, there was a bipartisan commitment to the broad economic direction together with broadly-based public support.

This highlights the importance of political leadership in the economic growth process. Building a competitive economy is a long term process. The job is never done in a global economy that is unlikely to become less competitive anytime soon. Because of this, countries need political leaders who can assemble and sustain a coalition around economic growth over a long period of time. Leaders need to be able to provide a strategic view of where the country needs to position itself in order to achieve success, and bring the population along with them.

This can be seen clearly in New Zealand, where substantial action is required on an ongoing basis. Without strong public and political support, the task of ongoing competitive upgrading of the economy will be difficult to achieve.

Going forward

The issues I have identified are relevant to Australia, and indeed many other countries, as much as they are to New Zealand. They may take more time to manifest, but they will. The good news is that although these trends are powerful, they are not deterministic and nor are they fatal to a country's economic prospects. But the response does need to involve deliberate, aggressive, sustained action.

New Zealand has some substantial economic challenges to address, particularly given its exposure to international factor mobility, and this will require a substantial process of competitive upgrading of its economy. But when New Zealand puts its mind to something, it can move with real aggression, purpose, and speed. One of the likely reasons that New Zealand has consistently been at the forefront of policy change is that doing things is easier in New Zealand. Having a reasonably clean decision-making structure is one of the luxuries of being a small country. If we choose to do something, it can generally be achieved in a very rapid manner.

And we probably have more degrees of freedom in New Zealand to implement policies that are creative and world-leading. There is at least one FDR scholar in the room this afternoon and, in that spirit, I'd like to suggest that one of the good things about New Zealand is that we can engage in "bold, persistent experimentation".

The debate in New Zealand is shifting towards a much greater appreciation of the importance of the strategic positioning of the New Zealand economy for global competitive advantage given the challenges of international factor mobility. For this reason, I think it is likely that New Zealand and Australia will become more alike over the coming decades as New Zealand learns from Australia, and increasingly as Australia learns from New Zealand's policy development.

In sum, I think that the New Zealand economic experience is something that you may want to spend some time thinking about. What are the global forces at work, and how have they affected a developed but peripheral economy? What policy responses have worked well, and what has worked less well? And what does this suggest for the type of policy choices that Australia will be making going forward?