

Essay

Choosing to compete: Increasing the magnetism of the New Zealand economy

David Skilling

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The New Zealand Institute

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Essays

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1. INTRODUCTION

Recent headlines speculating about the relocation of Fletcher Building to Australia, the exit of companies like Waste Management from the NZX, and the seemingly unending news of Australian private equity firms purchasing New Zealand companies, like Hirepool and Metropolitan Glass, have generated an increasingly high profile public debate – and mounting concern – about the so-called hollowing out of the New Zealand economy.¹

Is New Zealand becoming a nation of employees, increasingly owned by foreign investors? Does the hollowing out of the New Zealand economy undermine New Zealand's economic sovereignty, and ultimately compromise the performance prospects of the New Zealand economy?

I will frame my remarks on these issues around the notion of making choices. National attitudes in New Zealand often seem to oscillate between complacency – New Zealand is the best country in the world and there is no need to do anything – and fatalism – New Zealand's doomed and there's nothing much we can do about it.

In the context of the hollowing out of the New Zealand economy, I will argue that neither complacency nor fatalism is appropriate. In the first half of this essay, I will explain why complacency is not a reasonable response and that as a country we do need to make some deliberate choices. Current course and speed is not delivering good outcomes.

And in the second half of this essay, I will make the case that fatalism is not an appropriate response either. Although the forces that are driving the hollowing out of the New Zealand economy are powerful, New Zealand has a series of choices available to us that can act to remedy this situation. We have more choices than I think we commonly recognise.

In terms of the structure of this essay, I begin by defining hollowing out and then examine the scale of this issue and form a view on its significance for New Zealand.

The conclusion of this analysis is that the hollowing out of the New Zealand economy is a serious issue. But in order to understand what, if anything, can be done in response, it is important to first understand the underlying dynamics of this process. New Zealand is not the only country grappling with the exit of companies to larger markets, and there is a well-developed body of international thinking and evidence on this powerful tendency towards agglomeration.

It is in this context that the nature of the appropriate policy response for New Zealand is considered. In particular, I will outline the key dimensions of 'magnetic economic policy'; policy settings that are deliberately designed to attract and retain companies in New Zealand.

¹ To give just a few examples of headlines from earlier in the year: 'NZX at risk as raiders eye vulnerable firms', [Dominion Post](#), 6 March 2006, 'Sharemarket at risk of losing biggest firms', [New Zealand Herald](#), 9 March 2006, 'Editorial: New Zealand business like branch of Australia', [New Zealand Herald](#), 30 March 2006, 'Fletcher looks to jump ditch', [New Zealand Herald](#), 4 April 2006.

2. DEFINITIONS

It is useful to define terms at the outset, particularly given that hollowing out can mean very different things to different people. There is no precise technical definition available.

A narrow definition of hollowing out is the international relocation of economic activity away from New Zealand, where companies relocate their production or head office activities from New Zealand to another country – which is sometimes accompanied by a delisting from the NZX if the company is publicly listed.

But this is not a particularly satisfactory definition because it does not distinguish between a situation like Lion Nathan or Baycorp, where the company relocates its head office and listing, and a situation like Pumpkin Patch, F&P Appliances, or Icebreaker, where at least some of the production is located offshore because this is the best way for the New Zealand company to operate in a globally competitive way. In these latter examples, the company continues to be resident in New Zealand – and indeed I think that the development of these business models is to be applauded as a way for New Zealand companies to successfully go global.

It is better to think about hollowing out in terms of reduced New Zealand ownership and control of New Zealand companies. Increased foreign ownership of New Zealand companies means that increasingly the decision-making is controlled by non-New Zealanders and the profit stream accrues to the foreign owners rather than New Zealand investors.

Where ownership is transferred away from New Zealand, the effective New Zealand control of that company is likely to reduce even if the company is located in New Zealand, at least initially. And transfers of ownership are often accompanied by the physical relocation of the head office and listing of the company away from New Zealand.

This definition of hollowing out makes it clear that it is not just the physical location of the economic activity that matters, but the ownership and control of that economic activity. Global economic activity owned and controlled by a New Zealand company is qualitatively different than the international relocation of economic activity from New Zealand by a foreign-owned company.

Hollowing out, on this definition, means a reduced extent of New Zealand's ownership and control of economic activity, either in New Zealand or offshore.

3. HOLLOWING OUT IN NEW ZEALAND

This section examines the extent of hollowing out of the New Zealand economy, using both national-level data as well as company-specific data on ownership.

National level

New Zealand is running a current account deficit of over 9% of GDP, one of the largest in the OECD and one of the largest in New Zealand's history. Current account deficits are, however, not new in New Zealand; New Zealand has run large current account deficits consistently for the past three decades. Historically this was due to large fiscal deficits that required the government to borrow from international lenders. But New Zealand's borrowing is now driven by the private sector and in large measure by household borrowing.

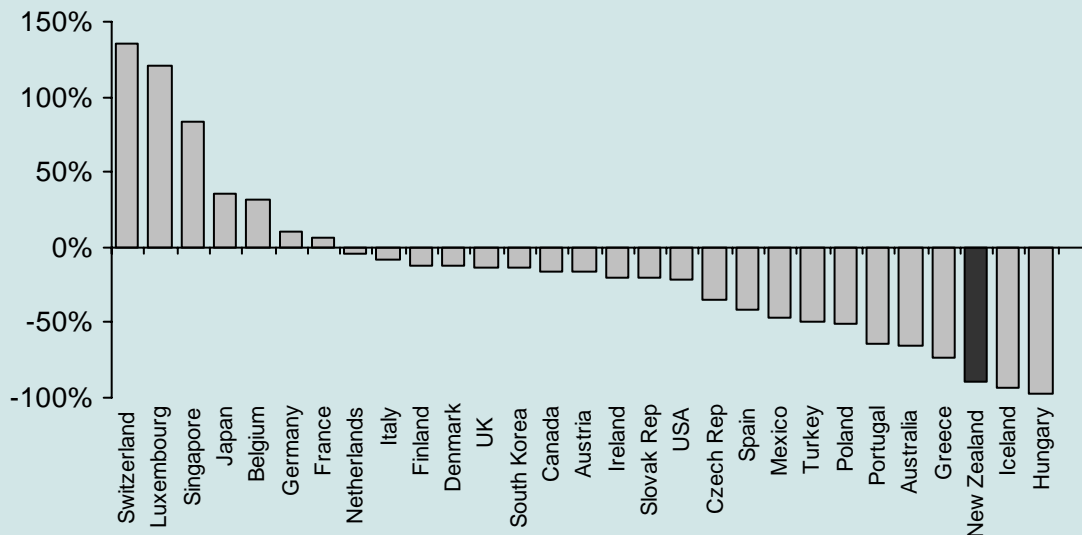
These large, persistent current account deficits have led to New Zealand accumulating one of the highest levels of net external liabilities (debt and equity claims) in the OECD as a share of the size of the economy. As at 31 March 2006, New Zealand's international investment position was -\$133 billion or 85% of GDP, among the largest in the OECD as described in Figure 1. This equates to over \$32,000 of net external liabilities for every resident New Zealander.

This consistent sale of debt and equity claims on the New Zealand economy to foreign investors translates into a high degree of foreign ownership of the productive New Zealand economy. For example, New Zealand has a relatively high stock of inward FDI as a share of the economy by OECD standards at 52% of GDP as at March 2006. New Zealand is in the top quartile of the OECD in terms of inward FDI as a share of GDP and close to the bottom quartile in terms of outward FDI as a share of GDP.

As a consequence of this substantial foreign ownership position about \$12.8 billion, or over 8% of New Zealand's GDP, was exported to foreign investors in the year to March 2006 as the return on their New Zealand investments. New Zealand's current account deficit is driven by the investment income deficit; only about 2% of the 9% current account deficit is due to the trade deficit.

A significant portion of New Zealand's economic growth therefore benefits the foreign savers who have invested their capital in New Zealand. New Zealand is increasingly becoming a nation of employees rather than of owners.

Figure 1: Net external liabilities as a % of GDP, 2004



Source: IMF; Statistics New Zealand.

Little of the FDI received by New Zealand over the past 15 years or so was 'greenfields' investment in which, for example, new manufacturing plants are established with a direct employment and output gain.² Rather, the FDI inflows were largely in the form of purchasing existing enterprises. Although this investment brought benefits to New Zealand in terms of greater efficiency, the introduction of new management practices and so on, it was not a direct addition to the productive base of the New Zealand economy.

Whereas countries like Ireland and Singapore have high levels of inward FDI because of substantial greenfields investment by foreign investors, New Zealand has mainly experienced the buy-out of its economy. Indeed, most of the foreign capital that New Zealand has imported over

² Refer to 'Home is where the money is: The economic importance of savings', New Zealand Institute Discussion Paper 2005/1, for a more detailed discussion of these data.

the past decade has financed residential real estate investment and private consumption growth, neither of which do much to strengthen the productive base of the New Zealand economy.

In addition, the FDI inflows were concentrated in the domestic sector of the New Zealand economy. It is estimated that 75-85% of FDI flows were directed into the domestic economy; for example, finance, property, utilities, and communications. Very little foreign capital was invested in New Zealand's export sector.

Company ownership data

Goldman Sachs JB Were report that foreign ownership of the New Zealand equity market is about 41% as at March 2006, which is relatively high by international standards.³ Although this has reduced from 60% in 1997, this reduction in foreign ownership has been driven almost entirely by the delisting of New Zealand companies that had a high degree of foreign ownership in 1997; for example, Wilson & Horton, and Lion Nathan.

Companies with a high level of foreign ownership often come under strong pressure to relocate their head office or listing away from New Zealand. The location of ownership has an impact on the location of the company's centre of gravity. As foreign ownership of a company increases, it often becomes more difficult to justify an ongoing New Zealand location. As one example of this, the fact that New Zealand imputation credits are not available to Australian shareholders creates pressure for New Zealand companies with a high degree of Australian ownership to relocate across the Tasman.

Table 1 gives a sense of the type of changes in the composition of the Top 10 listed New Zealand companies over the past decade. The large listed companies of a decade ago look quite different than the companies listed today. Many companies have moved their head office and/or transferred their primary listing away from New Zealand over this period.

Table 1: Top 10 listed companies by market capitalisation, 1996-2006

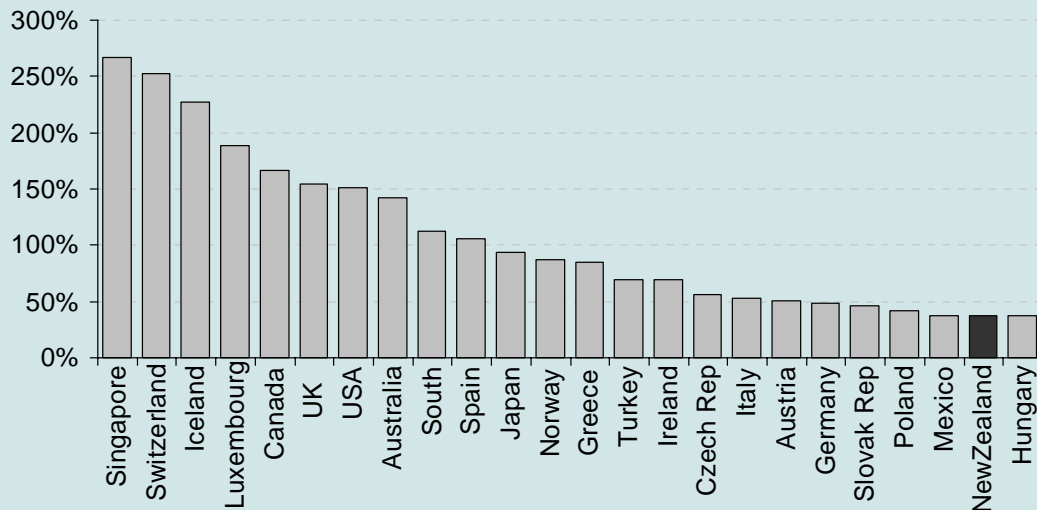
April 7, 2006	December 31, 2001	December 31, 1996
1) Telecom: \$11.45 billion.	1) Telecom: \$9.3 billion.	1) Telecom: \$13.64 billion.
2) Contact Energy: \$4.7 billion, majority owned by Origin.	2) Carter Holt Harvey: \$2.96 billion, delisted.	2) Carter Holt Harvey: \$5.5 billion, delisted.
3) Fletcher Building: \$4.40 billion.	3) Contact Energy: \$2.3 billion, majority owned by Origin.	3) Brierley Investments: \$3.9 billion, now primarily Singapore-based UK hotel owner.
4) Vector: \$2.75 billion.	4) Lion Nathan: \$2.20 billion, Japanese-owned, now listed in Australia.	4) Fletcher Challenge Paper: \$2.15 billion, now owned by Norske Skog.
5) Sky TV: \$2.54 billion.	5) The Warehouse: \$2.01 billion.	5) Fletcher Challenge Forestry: \$1.9 billion, now stripped of trees, trades as Tenon.
6) Auckland International Airport: \$2.48 billion.	6) Fisher & Paykel Healthcare: \$1.75 billion.	6) Lion Nathan: \$1.86 billion, now Japanese owned and Australian listed.
7) Sky City: \$2.28 billion.	7) Independent Newspapers: \$1.54 billion, wholly owned by Fairfax.	7) Fletcher Challenge Building: \$1.61 billion.
8) Fisher & Paykel Healthcare: \$2.08 billion.	8) Sky Network TV: \$1.54 billion, majority owned by News Corp.	8) Fletcher Challenge Energy: \$1.52 billion, now owned by Anglo Dutch Shell.
9) The Warehouse: \$1.35 billion.	9) Auckland International Airport: \$1.52 billion.	9) Wilson & Horton: \$1.13 billion, now owned by Australia's APN.
10) Fisher & Paykel Appliances: \$1.16 billion.	10) Sky City: \$1.29 billion.	10) Air New Zealand: \$1.06 billion, bailed out by the taxpayer but still listed.

Source: The New Zealand Herald (with some updated information)

³ Goldman Sachs JB Were, New Zealand Equity Market Structure, 29 May 2006.

Also relevant in this context is the scale of the New Zealand stock exchange, which is very small by international standards and (unusually) has reduced in size over the past decade, from 56% of GDP in 1996 to a bit under 40% today. Figure 2 provides a sense of how the market capitalisation of the NZX compares to exchanges in a range of other countries.

Figure 2: Market capitalisation of national exchange as a % of GDP, 2006



Source: IMF; Deutsche Bank; relevant national exchange for Iceland, Canada, Slovak Rep, and Czech Rep.

A different measure of the extent of hollowing out is provided by an analysis of Management Magazine’s Top 200 database. Of the largest 200 firms by revenue in 2005, 122 firms were majority (50% or more) foreign owned. These firms accounted for 57% of the total revenue of the top 200 firms. Domestically-focused subsidiaries of overseas multinationals had a strong presence among New Zealand’s largest companies: 6 of the top 12 and 11 of the top 25 revenue generators in 2005.

This database also indicates that the significant sectors of the New Zealand economy in which foreign ownership is not widespread are the primary sector and aspects of the energy sector. In both of these sectors there are effective constraints on the sale of companies to foreign investors – cooperatives are common in the primary sector and the SOE model is widespread in the energy sector.

But the hollowing out trend is not just evident among New Zealand’s large companies. At a smaller company level, there is a concern about the conveyor belt of New Zealand companies moving abroad at a relatively early stage in their life, with the upshot that New Zealand retains much less of the upside from the subsequent growth.

One indication of this is in terms of private equity deals. In the latest New Zealand Venture Capital Monitor, it was noted that there had been a substantial surge of private equity deals over the first half of 2006. They noted that “there were five large private equity deals which dominated investment activity, being Griffins Foods, Tegel, Metropolitan Glass, Hirepool and Kathmandu”. These were almost exclusively Australian private equity deals, although some like Griffins and Tegel were sold by one foreign owner to another foreign owner.

So this trend towards hollowing out of the New Zealand economy is widespread, and there is little traffic going in the other direction in terms of New Zealand purchases of foreign assets.

Going forward

This process will continue for as long as New Zealand's household savings rates remain low. Senior figures in New Zealand's capital markets regularly point to the risk of more departures of major New Zealand companies unless meaningful policy action is taken to increase household savings.

The relative lack of savings also means that New Zealand ownership of successful New Zealand companies will continue to decline, as there is not sufficient New Zealand capital available to fund the expansion of these companies. If New Zealand companies want to access substantial amounts of capital to fund new projects, they have to rely in large measure on foreign investors. Being able to access foreign capital is obviously a good thing for these companies, but it would be even better if New Zealand capital were available to fund a greater share of this expansion.

On current course and speed the extent of foreign ownership of New Zealand companies is likely to increase, because of New Zealand's consistently low household savings rates and a relatively small pool of capital compared to other countries. The Reserve Bank report that superannuation funds under management in New Zealand are currently NZ\$31 billion, and that these funds have increased by about NZ\$4 billion over the past five years.

These private savings are supplemented by the New Zealand Superannuation Fund, now containing over \$10 billion. However, only a relatively small proportion of the Fund is invested in domestic companies – the domestic equity allocation is 7.5%.

This contrasts sharply with the Australia situation, where there is a large and growing pool of capital as a consequence of its compulsory superannuation scheme. Private sector pension funds under management in Australia are forecast to rise from about NZ\$840 billion in 2004 to about NZ\$3.0 trillion in 2015.⁴ Indeed the pension fund asset increased by about NZ\$130 billion in 2005 alone. Recent Australian media commentary has focused on the increased difficulty of finding domestic investment opportunities because of the scale of the inflow of funds.

So pension funds under management in Australia are about 27 times larger than pension funds under management in New Zealand, despite the Australian economy being only about six times larger. And the increase in pension funds in Australia in 2005 was about four times the size of the total pension funds under management in New Zealand.

The ultimate limit on hollowing out of the New Zealand economy may occur when foreign investors reach the limit of their desired exposure to New Zealand or can no longer find investable opportunities. But other than these constraints, there are no indications of a significant change in course and speed. The Government's KiwiSaver scheme is a modest step in the right direction in terms of increasing New Zealand's household savings rate, but in the medium term is unlikely to have a material impact on these outcomes.

Implications

Should we be concerned about this hollowing out trend? The conventional official view has been that the increasing extent of foreign ownership and control of the New Zealand economy is of no real concern, and that this simply reflects market forces working well.

Common arguments made in this context are that foreign ownership brings benefits to the New Zealand economy, that it is a vote of confidence in the New Zealand economy, and that it frees up cash which the former New Zealand owners can use for other purposes.

⁴ Presentation by Andrew Mohl to an AMP conference, January 2006.

And indeed, foreign capital does provide benefits for many of the companies involved. Particularly given New Zealand's low savings rates and absence of domestic capital, foreign capital has allowed for expansion that would not otherwise have been possible. But it is an issue of balance, and I don't think that we have struck the appropriate balance.

There are a few ways in which the hollowing out of the New Zealand economy, and the loss of New Zealand control over economic activity, has serious economic consequences

First, there is the direct effect on the amount of economic activity in New Zealand. Reduced domestic ownership – and certainly the relocation of companies offshore – will lead to reduced incomes in terms of dividends, wage income, tax revenues, among other financial losses. The loss of large listed companies from the New Zealand tax base is very costly.

More generally, it is ownership that generates economic wealth – countries cannot spend their way to prosperity on the back of foreign credit or become rich by relying on employment income.

Second, hollowing out leads to the loss of supporting industries, specialised infrastructure, and career opportunities, which are associated with head office activities of large companies. The exit of New Zealand company head offices erodes the infrastructure that surrounds capital markets in terms of the professional advisory services that accountants, lawyers, and bankers offer. This is likely to make future capital raising more difficult for New Zealand companies, large and small.

Hollowing out, and becoming a 'branch office economy', also means that there is a reduced ability for New Zealanders to build a global career in a New Zealand company. There are fewer opportunities for corporate 'apprenticeship' in large New Zealand companies relative to the situation of two or three decades ago. The relative absence of career opportunities in New Zealand, and a desire to work in the head office rather than branch office, is one factor that causes New Zealanders to relocate. Estimates vary, but between 500,000 and 1 million New Zealanders are likely to live offshore. And the OECD estimates that 24% of New Zealand's skilled population live offshore, the highest proportion in the OECD. So the hollowing out of the New Zealand economy and the hollowing out of human capital from New Zealand are obviously related.

Third, the location of ownership matters in terms of the behaviour of these firms and for the type of decision-making that occurs. Domestic subsidiaries of foreign owned companies are generally here to service the domestic market, with relatively little interest in substantial investments or expansion, funding major research projects, and so on. It is common to hear stories of domestic subsidiaries of foreign-owned companies finding it very difficult to get approval for capital expenditure of any significance because New Zealand is such a small part of their overall balance sheet. Often the mandate of the New Zealand company is to earn their cost of capital and not cause problems for the head office.

So the relative absence of New Zealand companies with control of significant amounts of capital has a negative impact on attitudes towards expansion in New Zealand.

Implicit in the hollowing out debate is the intuition that hollowing out makes New Zealand's future economic success less likely – there is a hollowing out not just of economic activity but also of capacity and potential. New Zealand's productive base is being eroded in such a way that our economic prospects are weakened significantly.

The implications of New Zealand's current course and speed may not be catastrophic, but becoming a nation of employees is not a great outcome. Continued hollowing out of the New Zealand economy will make it very difficult to close the income gap with Australia and for New Zealand to move back to the top half of the OECD in terms of per capita income. New Zealand may be a full employment economy, but increasingly the profits are flowing offshore.

4. THE POWER OF AGGLOMERATION

So it is appropriate to be concerned about this hollowing out tendency. But before thinking about the appropriate policy response, it is necessary to understand what is driving the decision-making around location. Is there any real scope for policy changes to impact on this decision-making process?

New Zealand is of course not the only country to be concerned about hollowing out. This is a feature, for example, of the Australian debate, as it is in Canada, and in the United States there is concern about the loss of economic activity to Bangalore.

Indeed, the trend towards agglomeration of economic activity is one of the more notable trends in international economic activity. As Tony Venables, one of the world's leading economic geographers, notes "the key building block is the recognition that proximity is good for productivity; dense configurations of economic activity work better than sparse or fragmented ones. Mobile factors – firms and possibly workers – will locate in order to take advantage of higher productivity, and this creates a positive feedback. Firms and workers go where productivity is high, and by so doing tend to further raise productivity, creating an uneven distribution of activity and spatial income disparities".⁵

Companies prefer to concentrate their activities where they can access specialised inputs, be it staff, professional advisors, or inputs into the productive process, as well as output markets. This will generally be in large areas of existing concentrations of economic activity. And to some extent the ICT revolution and the decline in transport costs have reinforced this agglomeration process, by making it easier for companies to reach output markets from anywhere. Accordingly, the location choice for head offices is increasingly driven by the access to specialised inputs.⁶

The world is not as flat as authors like Thomas Friedman have suggested. Areas like Silicon Valley and the City in London are not disappearing because of the heightened importance of tacit, localised knowledge, which cannot easily be communicated electronically. As one example of this, corporate head offices are increasingly moving back to Manhattan so that they can get better access to the best and brightest in terms of professional advisors while maintaining a relatively low cost base by keeping the bulk of the staff in lower cost locations.⁷

But even if other countries are grappling with some of these issues, New Zealand is particularly exposed to international factor mobility and is perhaps the most exposed country in the developed world by virtue of our small size and physical remoteness. As such, New Zealand is probably the developed country in which these trends are most obvious – I have described New Zealand as the 'canary down the mine of the global economy'.⁸ This is not one way traffic, and people and companies do choose to locate in New Zealand. But there is a strong tendency towards agglomeration.

⁵ Anthony J. Venables, 'Shifts in economic geography and their causes', paper presented at the 2006 Jackson Hole Symposium.

⁶ Edward Leamer & Michael Storper, 'The Economic Geography of the Internet Age', [NBER Working Paper 8450](#), August 2001.

⁷ New York Times, 3 July 2006.

⁸ 'Lessons from the world's economic laboratory: What can Australia learn from the New Zealand experience?', remarks delivered at the Lowy Institute for International Policy, Sydney, Australia 21 June 2006, available on the New Zealand Institute website.

These agglomeration trends are reinforced by the actions of various government agencies that are competing to attract economic activity into their location. This competition for economic activity happens at multiple levels of government, and is increasingly aggressive.

5. POLICY RESPONSE

There is a spectrum of policy responses that can be contemplated in response to the observed hollowing out of the New Zealand economy.

At the passive end of the spectrum, New Zealand can adopt a King Canute like approach; a belief that hollowing out is simply a fact of life and that there is nothing that New Zealand can do that will lead to different outcomes. The forces are too strong, and we should just focus on New Zealand issues by removing distortions and cleaning up the economy.

One version of this argument is that New Zealand needs to integrate/harmonise with Australia, because we are too small to make a go of it alone. But countries, including New Zealand, do have choices available to them and fatalism is not an appropriate response to the New Zealand situation. Trans-Tasman economic integration is likely to bring benefits, but it is not the only choice open to us.

The next type of approach is to emphasise the importance of having competitive policy settings. In this approach, the emphasis is on making the New Zealand economy attractive by ensuring that New Zealand's tax and regulatory regimes compare favourably to other countries that are competing for companies and talent so that the New Zealand economy is as competitive as possible on some core dimensions of policy. The desire to have a headline company tax rate that compares favourably with Australia is one of the major themes in the current debate around the Business Tax Review.

Indeed, given New Zealand's starting position, there needs to be some daylight between New Zealand's policy settings and those in other countries. But the strength of the agglomeration effect is likely to overwhelm the improvements that can be generated by improving New Zealand's tax and regulatory settings; these are substantial differences and more is needed than cutting the tax rate by several percentage points (there is a 25% trans-Tasman labour productivity gap). Although there is a need for New Zealand to be more aggressive in having truly competitive policy settings, we should be realistic about how much upside this will deliver. Although this is worthwhile, we need to do more.

The next step is to tailor policy design that will specifically address the hollowing out, and focus on deliberately positioning New Zealand to compete effectively. This is what I call 'magnetic policy' – policy that is deliberately aimed at attracting and retaining New Zealand companies (and people) in New Zealand. This is a step beyond the level playing field approach.

The difficulty with a level playing field approach, which emphasises the importance of policy settings that generate an efficient allocation of resources, is that the globally efficient resource allocation may involve resources flowing away from New Zealand – if, for example, a unit of capital may be more highly valued in Australia than in New Zealand. This may be good for the world, but it is not so good for New Zealand.

One of the key challenges in improving New Zealand's economic performance is to respond to our exposure to international factor mobility; the fact that companies, people, and capital are increasingly mobile internationally and there is intense competition for these factors of production. What is needed is to develop policies that make companies want to locate in New Zealand rather than other locations.

There are choices that we can make. Neither fatalism nor complacency is appropriate; rather deliberate, aggressive, sustained attention is required. Improved outcomes are possible if we take meaningful, decisive action. As a country, it is important that New Zealand chooses to compete.

A key reason that the New Zealand economy has been subject to hollowing out to the extent that it has is that we have not responded appropriately to our exposure to factor mobility. Policy settings in New Zealand have been animated by notions of efficiency and competitive neutrality rather than by notions of competing to win. If we aspire to better economic outcomes, a greater focus on competing is needed in New Zealand's economic policy settings.

6. MAGNETIC ECONOMIC POLICY

Magnetic policy is based on this decision to compete. I have identified five related areas for policy action that are important in terms of attracting and retaining the ownership and control of companies in New Zealand.

i. Build a larger pool of New Zealand capital

Ultimately, the reason for the high level of foreign ownership is New Zealand's low level of savings. If we want to raise domestic ownership, much increased private savings are imperative. The Australian experience is instructive in this regard – they are in a position to buy New Zealand assets because they have made hard decisions with respect to savings.

An increased household savings rate is a vital element in strengthening New Zealand's capital markets, providing New Zealand funds to finance the expansion of New Zealand companies, developing the venture capital industry, and creating new asset classes like infrastructure funds. An increased weight of New Zealand capital will give companies a reason to use New Zealand as a base from which to take on the world, and will help to counteract the agglomeration pressure to move to markets like Australia.

Domestic capital provides an anchor for New Zealand companies; even if they go global, a domestic shareholder base makes it more likely that the company will remain New Zealand headquartered (in addition to ensuring that the profits from the international operations of the company flow back to New Zealand).

The government's KiwiSaver scheme is a step in the right direction, and it is encouraging to see policy movement on household savings after at least 15 years of inaction. But to generate a domestic pool of capital that will have a material impact on hollowing out within a reasonable period of time, a much more ambitious policy approach to savings is required. This will likely include both required contributions and more generous financial incentives on voluntary contributions.⁹

ii. Create a global New Zealand economy

Make New Zealand a much more attractive location from which to go global. International expansion can be a daunting challenge for New Zealand firms, but there are a range of actions that can be taken to strengthen the international engagement of the New Zealand economy.

⁹ A detailed 'KiwiSaver Plus' proposal is outlined in the New Zealand Institute's KiwiSaver Bill submission, available on the Institute's website.

These actions are summarised in a recent New Zealand Institute report, and will be elaborated in a series of reports to be released shortly.¹⁰

The policy measures include improving the international tax regime, developing a larger pool of capital, strengthening New Zealand's offshore representation and making more substantial in-market investments, and ensuring that New Zealand's international supply chains are as efficient as possible. The aim is to create a situation where New Zealand firms don't think that they need to relocate ownership and control to offshore markets in order to go global.

iii. Invest in immobile assets

If firms are mobile internationally, then New Zealand policy should have a clear focus on investing in immobile assets that make the mobile factors of production, like companies and people, more productive in New Zealand than elsewhere.

There are two types of immobile assets that I would like to talk about. The first is hard or physical investments. This includes investment in world class communications infrastructure as well as research, energy, and transport infrastructure, so that companies expect to be more profitable and productive in New Zealand than in other competing locations. Interestingly, low capital intensity is a major cause of lower levels of productivity in New Zealand – both in terms of business investment and also in terms of infrastructure. So encouraging greater investment should strengthen the incentives for people to locate in New Zealand.

The Biopolis project in Singapore provides an excellent example of this approach.¹¹ Biopolis is a multi-billion dollar commitment to building world-leading research infrastructure in the life sciences and attracting the world's best researchers to Singapore. This attracts people and companies to Singapore, because it is among the best locations in the world to undertake this type of research, as well as providing opportunities for local people and companies.

New Zealand has spent lots of money on human capital in New Zealand, our most mobile asset, over the past decade but much less in terms of immobile assets like world-class research infrastructure. 'Educating the world' is all well and good, but New Zealand needs to act more strategically in terms of complementary investments in physical capital. Where money has been spent in New Zealand to develop research strengths, it has generally been sub-scale and fragmented.

The second type of immobile asset is the development of distinctive assets that are unique to New Zealand. We need to focus on developing strengths that other locations find difficult to replicate, and which provides New Zealand with a genuine advantage in attracting firms and workers because they can be more productive in New Zealand than elsewhere. If firms see a combination of world class assets and world class capability in New Zealand, then New Zealand becomes much less exposed to hollowing out.

Truly distinctive assets should be sticky and difficult to relocate. This is similar to the notion of competitive advantage in a company context; areas of distinctive advantage that other companies cannot replicate or poach. Such advantage is about more than a few key people or companies – it is the culture, systems, and networks that are embedded. Examples are seen in locations like Silicon Valley, an ecosystem of talent and expertise, which is very difficult to relocate.

¹⁰ 'The Flight of the Kiwi: Going global from the end of the world', New Zealand Institute Discussion Paper 2006/1, 2006.

¹¹ More information on Biopolis is available at: www.a-star.edu.sg/astar/biopolis/index.do

Identifying areas of potential advantage and then investing in them ought to be a real priority. Possible examples include biotech, where we can leverage the institutional knowledge that New Zealand has accumulated of biological systems, or New Zealand's time zone in the context of developing an offshore financial services centre. But if New Zealand is serious about developing competitive strength in, say, an area of biotech, then substantial investments are required. We have to do more than just talk about it.

iv. Head hunt companies

New Zealand needs to be much more prepared to do deals to attract and retain companies in New Zealand that will contribute to the productive base of the economy.

In terms of attracting FDI, the Boston Consulting Group undertook a recent study that contained a series of recommendations as to what a best practice investment promotion agency (IPA) for New Zealand would look like.¹² But these recommendations have not been implemented in a serious way, and the New Zealand IPA does not benchmark well in terms of either resourcing or outcomes. Compare, for example, the visibility of Investment Australia, with regular full page ads in the Economist, with the activities of the New Zealand IPA.

New Zealand policy should also include a preparedness to do what it takes to keep New Zealand companies here, rather than simply accepting the exit of companies from New Zealand with a mood of resignation. In addition to attracting new business, we need to ensure that we protect the base. Countries like Singapore and Australia seem to operate a much more determined policy approach in terms of retaining economic activity in their countries. There are some recent indications of a change in the New Zealand approach, with a recent deal aimed in part at retaining a high-tech company in New Zealand. But the overall sense is that we have not been that serious about retaining companies here.

v. Internationally competitive policy foundations

Magnetic economic policy also includes the need for internationally competitive policy foundations in areas like tax rates, compliance costs, and the broader regulatory environment. New Zealand needs to have a favourable business environment. It is worth noting that on many of the measures of policy and institutional quality, New Zealand ranks well internationally, having made substantial progress over the past couple of decades. But the international environment is intensively competitive, and New Zealand needs to ensure that we stay well ahead of the pack – particularly given some of the disadvantages that we face as a country.

7. CONCLUDING REMARKS

The overall message is that New Zealand has choices available in order to respond to the exposure to international factor mobility and the consequent hollowing out of the New Zealand economy. Fundamentally, New Zealand needs to choose to compete and then follow through with policy choices that strengthen the competitive position of the New Zealand economy.

Yes, there are powerful trends that lead to the concentration of resources but New Zealand policy has not responded in a determined way. New Zealand's policy approach over the past 15 years has been relatively passive in nature – we have tended to accept what has come our way rather than seeking to alter the competitive landscape.

¹² Boston Consulting Group, [Building The Future: Using FDI To Help Fuel New Zealand's Economic Prosperity](#), report to the New Zealand Government, 2002.

Going forward, rather than talking the language of competitive neutrality, we need to be talking about competing to win in what is an increasingly competitive international environment. New Zealand will have to fight for relevance given that we do not have the natural advantages of countries like Ireland and Singapore. Interestingly, even those countries did not believe that a level playing field approach would be sufficient; they all adopted aggressive policy approaches to attract people and companies.

New Zealand now needs to approach this task with real seriousness of purpose. It is true that moves in some of these areas have been made over the past 15 years or so, but the missing ingredient has been materiality. In general, the policy changes and the commitments of fiscal resource over this period have not been sufficient to generate a material improvement in outcomes. We have become the country of the sub-therapeutic dose in terms of economic policy, never quite doing enough to have an impact.

This, in large measure, reflects a risk averse approach to economic policy in New Zealand. In this regard, I think that the Muldoon years cast a very long shadow over economic policy making. The most common response to Think Big seems to have been to think small. This small thinking pushes policy towards small-scale intervention, as described above, which will almost inevitably not deliver the desired outcomes.

We need to have more confidence as a country that we can shape the environment in which we operate to a much greater extent, and that we do have real choices open to us. The challenge facing New Zealand is less about the shortage of good ideas but around leadership that converts ideas into meaningful action.

Substantially improved outcomes are possible, and there is no need to be fatalist and to accept the outcomes that have been generated as an unfortunate fact of life. Many of New Zealand's poor outcomes have been self-inflicted in the sense that we have not pursued appropriate policies in response to our exposure to international factor mobility. The good news is that if we change the flavour of our economic policy, along the lines suggested above, New Zealand can exercise more control over our economic and national destiny and generate improved economic performance.