

Towards an economic strategy for New Zealand

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It's great to have a goal. And closing the GDP per capita gap versus Australia by 2025 would be a great outcome. But goals without strategies inevitably lead to disappointment. New Zealanders are waiting for Government's announcements of economic strategies to achieve the goal.

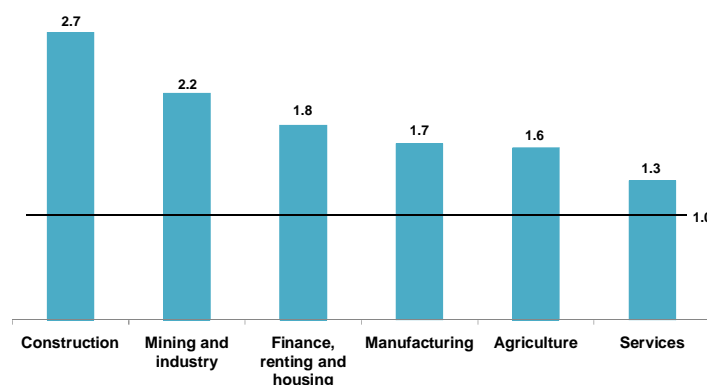
Alan Bollard has stated he does not think the goal is achievable. Government may have a different view but the opportunities being floated are not bold enough. Our calculations indicate that an annual GDP growth rate of 4% to 5% would be needed over the next 15 years to achieve the goal. In recent years Ireland is the only advanced economy that has achieved growth that strong. Ireland succeeded by the bold step of cutting corporate tax rates to 12.5% overall and 10% in some instances to attract foreign investment in technology based businesses.

The economic gap versus Australia emerged between 1970 and 1990. New Zealand's economy was highly dependent on agricultural commodity exports so we were hit very hard by Britain's entry to the European Union. Subsidies contributed to high debt levels that became unsustainable and forced the reforms of the 1980s. Those reforms may have been necessary but they did not stop our economy's deterioration relative to Australia.

The GDP per capita gap with Australia has remained similar for the last 20 years. Today it is around NZ\$20,000 per person per annum. Now Government has set the target to close the gap and there is an effort to identify policy changes that will contribute.

However, the effort lacks rigour as a strategy development process. Policies are being proposed based on sensible views that positive changes would have beneficial effects. For example, improving the effectiveness of government and reducing unnecessary regulation are easy to agree with as opportunities for economic improvement but will they make enough difference? In 2007, Australia's core government services were 19% of GDP, similar to New Zealand's 17% of GDP. Further, analysis of 2000-2007 OECD data reveals a low correlation of total taxes as a proportion of GDP with growth in GDP per capita. The World Economic Forum rates the business constraint from regulation as similar for the two countries.

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A better approach would be to design policy initiatives based on understanding the drivers of the GDP per capita gap. Investigation of the gap reveals an important insight; the large productivity difference exists in all major sectors of the economy. Any explanation of the gap needs to acknowledge that fact. And any proposal that focuses on a single sector of the economy may be helpful but it will not be enough.

Our initial estimates indicate that a substantial portion, around 40%, of the GDP per capita gap can be explained by two factors: differences in the capital intensity of the productive economy, and differences in innovation and business sophistication. Australia has more productive capital per worker and is more innovative.

We know enough about the economic development of advanced economies to understand that capital and innovation matter a lot. We also know that Australia has vigorous policies to promote savings and so their capital formation is strong while ours is much weaker. Innovation has been systematically encouraged in Australia for around 30 years; here for only about 10 years.

Surely the most promising way to close the gap is to go after opportunities like these. We know that New Zealand's tax settings have encouraged investment in residential housing but our productive economy has been starved of capital. We know New Zealand is unusual in not having either compulsory savings or strong tax breaks to encourage savings. We know our businesses are not well-equipped to convert our inventiveness to international business success. And almost all countries provide strong incentives and assistance for innovation but New Zealand's are weaker.

Specific policies need to be carefully crafted but there are obvious changes that would make a large difference. New Zealanders need to save more so there is more capital available, and the tax system needs to encourage investment in productive assets and innovative new ventures. The current emphasis on improving the production of scientific results with commercial potential is helpful but it will not make a huge difference because the most important innovation deficit is in the ability to convert inventiveness into international business success.

The New Zealand Institute's work on economic strategy remains a work in progress. However, these early findings point to two opportunities that should be aggressively pursued.

Alan Bollard will be proved correct if we do not take the right bold steps soon. If Government is serious about closing the gap it needs to identify the policy changes that will make a big difference and tell a compelling story so they will be supported and adopted. Incremental change may be easier to sell and implement but it will not be enough.