3.
HIGHER INCOMES FROM A GROWING ECONOMY

The New Zealand economy is growing, but that growth should not be taken for granted. A variety of factors, including volatility in world prices and the legacy of high debt, leave New Zealand vulnerable to external events. Even in periods of strong growth and in the absence of unexpected events, it is normal for the growth rate to fluctuate.

There is potential for substantial improvement in economic performance. However, a sustained acceleration in growth will be difficult to achieve and slow to develop, as dynamic firms still represent only a relatively small part of the economy.

To improve performance, Government policy will need to reinforce innovation, flexibility and adaptability within business. It will need to support higher productivity growth through the accumulation of high-quality human and physical capital.

A number of specific areas such as management of state-owned enterprises, tax design, tariffs, agriculture regulation and overall macroeconomic policy remain important. The key to success is getting a lot of things right year in and year out, with consistent Government actions across a range of policy areas.

Growth and higher incomes . . .

A well functioning, growing economy is desirable because it contributes to improved well-being for all New Zealanders. It yields:

- ❑ higher incomes which enable consumption of more goods and services
- ❑ greater scope for quality public services and enhanced environmental quality
- ❑ wider opportunities for people, including the unemployed, to participate more fully in society.

Strong economic growth owes less to the supply of labour and capital than to the productive use to which they are put. That depends on both the quality of the investment in skills and physical capital, and ensuring those investments are devoted to activities that generate the greatest contribution to the community.

... derive increasingly from specialisation.

High incomes are based on individuals specialising in what they do well. As incomes go up, specialisation tends to become more and more sophisticated. For a small country like New Zealand, the opportunities for such specialisation solely within the country's borders are limited. That argues that openness to trade will remain an extremely important engine of growth.

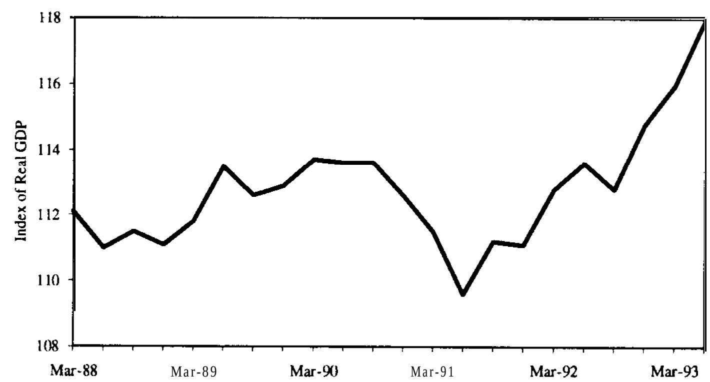
The question for policy, then, is: How does New Zealand in an ever-changing world make better use of its available resources to maximise incomes?

NEW ZEALAND'S IMPROVING PERFORMANCE

Increasing output is underpinned by . . .

The incoming New Zealand Government inherits an economy that is into its third consecutive year of economic growth. Since the trough of the recession in mid-1991, output has increased over 7½%.

Figure 3.1
Rising national income



Source: Statistics New Zealand, Index base 1982/83=100

... improved competitiveness and international orientation.

Improved competitiveness and a growing international orientation underpin this enhanced growth performance.

- Stable macroeconomic conditions and a supportive combination of inflation, interest and exchange rates have improved cost-competitiveness.

- Individuals and firms have responded to the economic reforms of the last decade with new approaches to product development, marketing, staff management and production methods.

The recovery was first led by exports, . . .

These factors have led to a strong export performance over the 1990s. This is most apparent in non-commodity manufactures, where export volumes have increased by an average of 15% over the last two years.

... but growth is now supported by higher consumption and investment.

While the export performance remains strong, the recovery has broadened and growth is now increasingly supported by domestic demand (private consumption, investment and stockbuilding). In particular, growth in private investment has gained momentum through the second half of 1992 and into 1993. Income from the export sector and rising employment have underpinned a rise in consumption spending.

While growth is sustainable, fluctuations are inevitable

Growth of 2½% to 3% is expected . . .

Although current projections point to growth of 2½% to 3% on average over the next few years, substantial variations around this outlook are possible.

Historically, New Zealand has experienced many short-lived periods of growth. In many instances, these were initiated by policies that artificially stimulated domestic demand or temporarily improved competitiveness, or by an income boost from the terms of trade which was quickly reversed. Ultimately these periods of growth were choked off by a build-up of imbalances: an expanding public-sector deficit, inflation pressures, and/or a deteriorating current-account position.

... but without the economic imbalances of the past, . . .

Current growth, however, is not driven by policies that artificially stimulate domestic demand. It is also occurring despite a very weak international economy (although the terms of trade have improved over the last two years). At this stage, there is little evidence of substantial macroeconomic imbalances building up.

- ❑ Inflation has remained low since 1991.
- ❑ The fiscal deficit is improving.
- ❑ The current-account deficit is relatively stable between 1% and 2% of GDP (although recent trends have been slightly adverse).

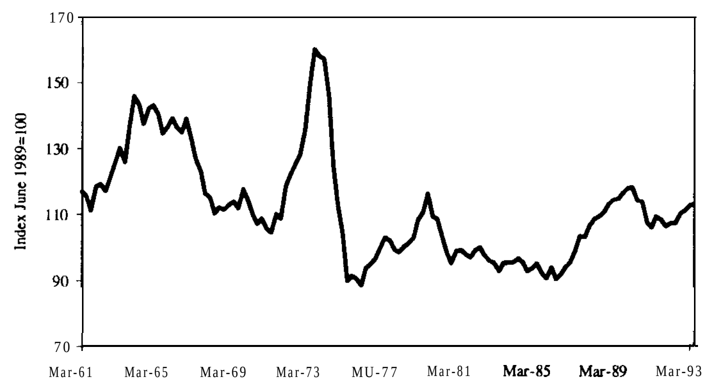
Moreover, business confidence is very high and that is reflected in strong real private investment growth, which is expected to continue. These sorts of considerations lie behind consensus forecasts that suggest growth will be sustained over the next two to three years.

... although fluctuations are inevitable.

Nevertheless, growth is still likely to fluctuate from year to year.

- ❑ As a small, open economy, New Zealand cannot escape changes in the rest of the world. These include volatility in world prices for the goods we buy and sell.

Figure 3.2
The terms of trade are volatile



Source: Statistics New Zealand

- ❑ New Zealand is also vulnerable to weather-related supply disruptions in sectors like agriculture.

- ❑ The legacy of high public and private debt means that New Zealand is vulnerable to movements in international interest and exchange rates (for example, a 1% increase in interest rates would increase the Government's debt-servicing costs by around $200 million per year).

- ❑ It remains to be seen how much previous wage- and price-setting behaviours have changed under the new labour market arrangements and monetary policy framework.

Over time these fluctuations may become smaller.

The effects of some of these risk factors can be expected to diminish over time.

- The vulnerability to terms-of-trade shocks should diminish as exports become more diversified and firms differentiate the products they produce.

- Fiscal surpluses will reduce public debt and contribute to higher national saving, helping to reduce the economy's exposure to changing interest and exchange rates.

- Increased domestic saving will allow more investment to be funded domestically, reducing pressure on the current account.

Growth may be stronger than expected.

Not all of the risks to the current outlook are on the down side, and the economy may grow faster under current policy settings. For example, the economy's medium-term average growth rate may be higher than the 2½% to 3% currently envisaged. There is some uncertainty about the extent to which recent GDP figures indicate a stronger cyclical upswing or a higher long-run average rate of growth. (These issues are developed more fully in the "Economic and Fiscal Outlook" chapter).

Growth will also be strongly influenced by decisions taken in other countries, and by trading conditions in general. The immediate uncertainty over the possible GATT outcome is one example of this; the eventual timing of the upswing in world growth is another.

NEW ZEALAND CAN ACHIEVE HIGHER INCOMES

International comparisons...

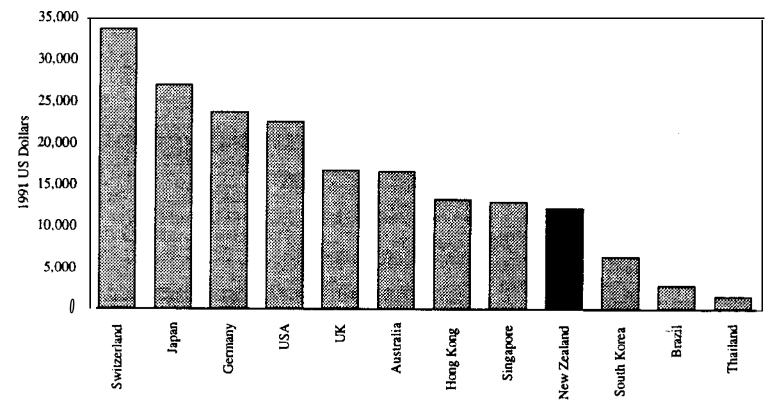
New Zealand's current average per capita income stands at 45% of that of Japan, 54% of the United States, and 73% of Australia's.

... indicate that higher incomes are possible for New Zealanders.

This gap between New Zealand's per capita income provides one indicator of the potential for improved performance.

The latest OECD Survey of New Zealand[1] attributes much of this difference in economic performance to New Zealand's relatively poor productivity record over a long period, rather than to an insufficient amount of capital investment or labour supply. Lifting our standard of living closer to such countries will require New Zealand's productivity to increase faster than theirs.

Figure 3.3
Room for growth in per capita incomes



Source: The World Bank, 1992

New Zealand's location and size, and possibly cultural values such as preferences for leisure and security, may mean that these gaps in income will not be completely closed. On the other hand, the world is becoming increasingly integrated, with technological advances reducing the costs of communication, and capital flowing more freely across international borders. This, together with a general trend towards lower trade restrictions, should assist New Zealand to close the gap in incomes.

1 *OECD Economic Surveys 1992-1993, New Zealand,* January 1993

Some see considerable potential for closing the gap.

The potential for higher incomes is evidenced by the views of various industry groups. For example, a recent New Zealand Trade Development Board (Tradenz) report[2] suggests that there is potential for a wide range of industries and products, from food and beverage to television commercials, to substantially increase their export returns over the next decade.

However much needs to be done.

Similar potential has been identified by the Tourism Board and the New Zealand Forest Industries Council for their sectors. However, there is some gap between those growth scenarios and the outcomes currently expected by many economic analysts.

The Manufacturing Advisory Group[3] argues that to improve general manufacturing's performance from a baseline forecast of a 4% increase in exports per year to 9%, a number of requirements would need to be met by an increasing number of firms:

- ❑ continuous increase in the competitiveness of products through innovation, research and development, quality, design and customer satisfaction
- ❑ investment in physical assets to maintain world-competitive plant and equipment
- ❑ investment in training, workplace practice, information systems and management skills
- ❑ development and expansion of existing and new markets
- ❑ strategic planning by firms to coordinate the factors which will support continuous growth under highly competitive conditions.

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2 Stretching *for* Growth, Tradenz 1993/94
3 *Manufacturing for* Growth, Manufacturing Advisory Group, September 1993.

The Treasury's growth forecasts include some allowance for such improvements. Annual growth projections of 2½% to 3% are underpinned by:

- ❑ continued growth in non-commodity manufacturing exports of around 13% per annum
- ❑ growth in tourism exports of around 7% per annum
- ❑ strong growth in forest-based exports, including a shift to higher-value products.

Faster growth will take time . . .

However, there are practical reasons why significantly faster growth in incomes is difficult to achieve in the short term.

... because the number of dynamic firms is small . . .

Although there are measurement difficulties, it is likely that dynamic companies represent only a relatively small part of the economy. For example, Tradenz estimates that 95% of exports come from only 150 firms. Even within this group there is considerable variation in performance and dynamism.

... and agriculture, still an important part of the economy, is likely to grow slowly.

Agriculture (including processing) still comprises a substantial part of the economy - around 9% to 10% of GDP. Under current forecasts, livestock-based exports are expected to rise only moderately over the next three years.

For growth to accelerate further . . .

For growth to accelerate further over the medium term would require more and more firms, and particularly those in agriculture, to match the growth performance of the most enterprising and innovative.

... will require innovative behaviours to become more widespread.

This will necessitate a stronger trading performance. It will require innovative and responsive behaviours to become embedded more widely across the economy. The "Islands of Excellence?" study[4] showed that while a number of firms are succeeding in developing new products and new markets, for many of them management strategies are still developing in scope and sophistication.

IMPROVING NEW ZEALAND'S INCOME PROSPECTS

The key is to get a lot of things right.

Quick responses to international developments will be needed.

History and experience suggest that the key to higher rates of growth is getting a lot of mutually reinforcing things right. This means encouraging enterprise and innovation through strong international linkages, skill acquisition, and macroeconomic stability. It requires rapid adaptation and responses to an international environment that constantly changes.

Trading patterns will change, . . .

Over the remainder of the decade New Zealand businesses can expect to have to adapt to a number of shifts in trading conditions and patterns of competition.

. . . Australian tariffs will fall, and . . .

- ❑ Australian tariffs will be reduced. This will increase the competition New Zealand manufacturers face in the Australian market.

... competition will increase.

- ❑ Competition will increase in some agricultural and other primary product markets from exporters in Latin America and Eastern Europe.

However, there will be more opportunity in Asia, . . .

- ❑ East Asian growth will outstrip growth in most parts of the world. This will lead to increasing numbers of discerning, higher-income, customers. However, increased competition for these markets will come from all countries.

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4 *Islands **of** Excellence? A Study **of** Management in New Zealand,* NZIER, 1993

... although the extent of trade access is uncertain.

- World trade trends will change depending on the GATT outcome, developments within regional economic groupings (NAFTA and APEC, for example), and gradual reform of the Common Agricultural Policy.

Successes in East Asia offer some lessons.

Many seek to emulate the experiences of East Asia. Although it is risky to transplant a model from one institutional and cultural setting to another, a number of lessons can be drawn from the rapid increase in incomes of East Asian countries. While opinions differ very sharply on the part played by industry policies in their success, there is general agreement that a key to the success in East Asia has been attention to a number of fundamental policies, namely:

- a stable macroeconomic environment
- enhancing the productive skills of the people
- encouraging a dynamic private sector
- keeping price distortions within reasonable bounds
- being open to foreign ideas and technology.

ENCOURAGING ENTERPRISING BEHAVIOUR

The world offers virtually unlimited opportunities for trade, . . .

World markets can provide virtually unlimited opportunities to New Zealand as a small, open economy.

Lessons from East Asia

The success of several East Asian economies in establishing the conditions for rapid growth is frequently cited by the advocates of widely differing economic development policies in support of their views.

A recent World Bank research report[5] has helped to put some of these issues into perspective.

The study found that Hong Kong, Indonesia, Japan, Malaysia, Singapore, South Korea, Taiwan and Thailand followed a diverse mix of policies with varying degrees of government intervention. In large measure these economies achieved high growth by concentrating on the basics:

> "Macroeconomic management was unusually good and macroeconomic performance unusually stable, providing the essential framework for private investment. Policies to increase the integrity of the banking system, and to make it more accessible to non-traditional savers, increased the level of financial savings. Education policies which focused on primary and secondary education generated rapid increases in labour force skills. Agricultural policies stressed productivity change and did not tax the rural economy excessively. All of the [high-performance Asian] economies kept price distortions within reasonable bounds and were open to foreign ideas and technology."

On the role of industry policy, the report's authors reach the judgement that "in a few economies, mainly in north-east Asia, in some instances government interventions resulted in higher and more equal growth than would otherwise have occurred". These policies are interpreted as encouraging increased export orientation and the associated technological upgrading needed to compete on world markets.

The report is not optimistic about the potential for these industry policies to make a positive contribution in other parts of the world. It stresses that the economies of north-east Asia that have followed these policies have institutional structures that allow interventions to take place "in an unusually disciplined and performance-based manner." This includes being willing and able to exit industries that are not meeting international competition. They were conducted in a context of prudent macroeconomic management, clear performance criteria were established, and programmes were administered by a strong civil service.

5 *The East Asian Miracle: Economic Growth and Public Policy,* World Bank, August 1993

... but seizing them is a matter of putting ideas into practice.

Seizing these opportunities is much less a function of the sector in which a business is located, the raw materials it uses or the markets it serves, than of the ability and drive to put ideas into practice. This is not just the domain of a few entrepreneurs It includes small improvements in production processes, product design, market development and training that add up to a competitive edge.

Growth depends on the choices made in the private sector, . . .

Growth depends on the choices made by individuals, families, firms and community groups. It depends on attitudes and behaviours for success, because these shape decisions to:

- invest in skills
- invest in relationships with customers and suppliers
- invest in particular industries, locations and products
- benchmark against best world practice
- seek out international opportunities.

... but Government can help shape those choices in a positive way.

Government policies can substantially shape the choices made and the attitudes that develop. Any policy can have a range of effects, each of which needs to be considered. Policy influences the willingness to take a long view and a calculated risk, the extent to which innovation and effort is rewarded, and the pattern and rate of investment. Consistency across policies will enhance the prospects of achieving high incomes.

Encouraging high-quality investment

Productivity growth depends on high quality investment, . . .

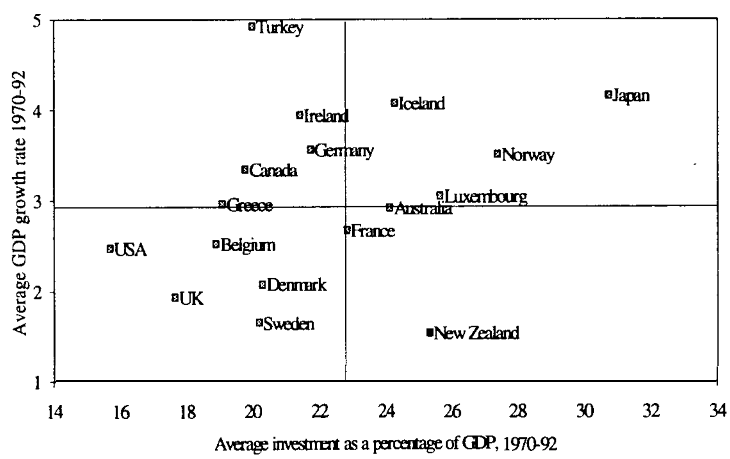
The level and quality of investment, combined with the supply and quality of labour, are determinants of productivity growth. Together, these factors lay the basis for increases in income.

... but New Zealand's record has been poor.

New Zealand's history has not been one of high-quality investment in either human or physical capital. High tariffs and other regulatory restrictions protected domestic markets. This allowed firms to earn satisfactory profits without competing internationally. For many years New Zealand had high levels of physical investment and low levels of GDP growth.

Figure 3.4

Low returns from poor-quality investment



Source: OECD Economic Outlook

Intangibles investment is becoming increasingly important . . .

Competitive advantage will increasingly depend on less tangible forms of investment such as staff training, market and product development, quality-assurance programmes, research and development, and relationships with customers and suppliers. The moves to open up the New Zealand economy have seen increased attention paid to these forms of investment.

... to stronger productivity and growth.

Investing in better skills is particularly important.

Stronger productivity and growth will also depend on improving the average quality, skill and motivation of labour, and combining it with resources, capital equipment and technology through world-class management. Employment outcomes will be heavily influenced by the skills of available labour, as well as by higher economic growth and flexible labour arrangements. Investing in skills is also essential to ensure that the benefits of a better economic performance are widely shared.

Higher skills and more effective marketing can lead to higher returns for the same level of physical investment.

Government policy has a role to play.

Government policy best supports quality human and physical investment when it:

- exposes decision-makers to world prices and competition for their outputs
- enables decision-makers to acquire high-quality inputs and technologies at world prices
- avoids discrimination between different locations or types of investment
- provides certainty of policy
- encourages high-quality education and training by firms, schools and teaching institutions.

Over the last decade policy has moved in this direction. In particular:

Promoting openness is important, . . .

- Openness to international prices has increased with the reduction of tariffs, though some remain high, and the reduction in regulatory and tax barriers to international capital flows.

... as is minimising distortions in the tax system.

- Taxation increasingly covers a wider base and is less industry specific.

Over this period, the tax structure has been re-designed substantially in order to raise the needed revenue at the lowest possible cost to growth. Continuation of the broad-base, low-rate approach is the best way to minimise the impact of tax considerations on the cost of capital and its allocation across different activities.

Cost of Capital

The most fundamental influence on the cost of capital to New Zealand firms is world interest rates. Since New Zealand is a small player in the international capital market, it has no significant effect on world interest rates or the cost of equity.

However, New Zealand's macroeconomic, tax and regulatory policies affect whether it has an advantage or disadvantage in attracting investment.

Stable macroeconomic conditions are a key determinant of domestic interest rates vis-a-vis overseas rates. With reductions in inflation and improvements in the fiscal position, there has been a decline in the difference between New Zealand and overseas interest rates. Further narrowing of this differential is likely as low inflation becomes embedded, and if the government accounts move into balance and then surplus.

Reduced fiscal deficits increase government saving, which can have a direct effect on national saving and can signal to foreign investors that there is less risk of New Zealand governments adopting anti-investment policies. This will contribute to a lower cost of capital in the long term.

New Zealand taxes tend to raise the cost of capital relative to the pre-tax international level. Many other countries also tax income from capital, but effective rates are very low at the margin. Further improvements in the international tax regime have the potential to reduce the cost of capital at relatively low fiscal cost, provided that the tax treatment of the overseas income of New Zealanders is comparable with that of domestic income.

Many other aspects of government policy affect the costs and risks of supplying funds to business. These include capital market regulation and the extent to which business laws allow creditors and shareholders to contract with firms efficiently. Some reforms, such as the Companies Act and those relating to foreign direct investment, probably help to reduce the cost of capital, while others, such as specific takeover regulation and current insolvency law, including statutory management. may act to increase it.

The Resource Management Act, in providing the framework for achieving environmental goals, affects the great bulk of enterprises and investment. It is important that the regulations permit valued environmental goals to be achieved at least cost.

R & D is like any other investment . . .

Research and development (R&D) is an important area of commercial investment by enterprises in which the government plays a role.

Concern has been expressed that New Zealand private-sector R&D spending, at 0.3% of GDP, is well below average OECD levels of 1.1%. However, the Manufacturing Advisory Group[6] has argued that "although the official statistics record a low level of R&D in New Zealand relative to other countries, there is evidence, both anecdotal and from the sectors' performance, of a robust level of R&D. A considerable proportion is not captured by official statistics."

There will be valuable research that enterprises may not undertake because its benefits cannot be captured sufficiently. This is the rationale behind the Public Good Science Fund. The Government spends approximately $300 million per annum through the Public Good Science Fund and the Technology for Business Growth programme. It is important that the Government ensures that it is getting value for money from its considerable expenditures in this area.

... in that the focus should be on quality, not quantity,

It is important that firms see commercial R&D as an integral part of investment decision-making. The focus should be on the quality of investment, including R&D, rather than expenditure levels as such.

Minimising the cost of capital

The cost of capital depends on international and domestic factors . . .

Investment decisions depend in part upon the cost of capital. The cost of capital reflects not only international factors such as world interest rates,

6 *Manufacturing for Growth*, Manufacturing Advisory Group, September 1993.

but also the risk of investing in New Zealand and the taxation of capital by New Zealand.

... and has been falling, . . .

The cost of capital has fallen over recent years. This is most obvious in interest rates, where the differential between New Zealand's nominal long-term interest rates and similar rates in major overseas economies has fallen from around 4½% in early 1990 to 1% to 1½% now. The sharemarket has also risen, helping to reduce the cost of equity.

... with further reductions possible from improved fiscal performance . . . .

Continued improvement in fiscal performance is critical to further reducing the cost of capital. Improved government saving would reduce public-debt ratios and increase overall savings in the economy. As a result, investors could be expected to be more confident about future interest and tax rates, and about the resilience of the economy to external shocks.

... and improvements in tax and regulatory policies.

Equally important are many other aspects of Government policy which contribute to the long-term attractiveness of investing in New Zealand. Overall policy stability and consistency, and the tax and regulatory treatment of savings and investment all contribute to the views investors form about the risk of doing business in New Zealand. The importance of the tax regime is illustrated by the impact that the decision of the New Zealand Debt Management Office to meet the cost of the Approved Issuer Levy on Crown borrowings and the recent changes in the tax regime for foreign portfolio investment have had on the cost of capital. While it is difficult to identify the magnitude of these effects, they appear to have been large relative to the revenue forgone.

Ensuring infrastructure and other inputs are provided efficiently

The provision of transport, energy, water, waste disposal, education and health services all affect the cost of doing business, the performance of the economy and the quality of life.

The Government has a significant impact on the cost and quality of the provision of many services through regulation, supply by a government entity, or a combination of both.

*Substantial efficiency gains have been made in the provision **of services.***

The Crown has a sizeable commercial operation. State-owned enterprises (SOEs), for example, have assets totalling around $13 billion. Substantial efficiency gains in the use of some of these resources by the Government's commercial operations have already been achieved through restructuring (including deregulation, corporatisation, and divestment).

Efficient and competitive provision leads to lower prices.

The Government typically owns businesses to realise public-policy objectives, rather than solely to generate new shareholder wealth. Where no public-policy objectives are served by continuing ownership, divestment provides the best basis for contributing to efficiency in the economy as a whole, while at the same time reducing risk to the taxpayer. For example, a more effective telecommunications sector is offering vastly improved services to New Zealanders and at lower prices.

Clear objectives and effective accountability are essential.

Where the Government has decided that the entity is better kept in public ownership, experience points to the importance of providing clear objectives and effective accountability. Delivery mechanisms should be designed in such a way as to motivate management to place a strong emphasis on quality, innovation and cost-effectiveness.

In those areas where Crown-owned trading entities are competing with private-sector organisations, the management of commercial risk is particularly important. Inevitably, SOE directors will place pressures on Ministers from time to time to expand the scope of the organisation or to inject more capital. The proposals need to be critically examined and the ability of the private sector to undertake the investment assessed.

International economic strategy

The GATT Uruguay Round still offers the best prospects for improved trade rules in all fields, particularly agriculture and services. It is scheduled to be completed by 15 December 1993. This deadline is of most importance to the US, given that it represents the last realistic time in which the Administration can act under the legislation track approved by Congress. The date is also accepted by most other countries as the final deadline.

Although the GATT Round is unlikely to achieve as much as New Zealand might have wanted in respect of the liberalisation of agriculture, some progress is expected. The main benefit from GATT commitments is that it improves access and locks in lower barriers that are difficult to raise subsequently.

As is emphasised in the Ministry of Foreign Affairs and Trade document "New Zealand Trade Policy"[7], irrespective of the GATT outcome New Zealand should continue to explore bilateral, regional or other trade opportunities as they may arise. The basis for entry into such relationships should be to provide our international sector with greater market access while gradually reducing our own trade barriers. The arrangements we enter should involve no raising of barriers to other nations, no exclusivity, and wide and significant reductions in barriers to trade between the parties involved.

For example, the prospect of an outward-looking Asia-Pacific free-trade area presents New Zealand with potential access to over two billion consumers. The pace of any APEC liberalisation is, however, likely to be slow and is therefore unlikely to deliver early concrete gains. Faster progress, albeit with less gain, may be possible through bilateral free trade agreements with nations that are rapidly liberalising.

7 *New Zealand Trade Policy*, Ministry of Foreign Affairs and Trade, September 1993.

International linkages and facilitation

Stronger trade performance is assisted by international linkages at the private sector and Government sector levels.

Stronger trade performance and reduced vulnerability to international forces can be assisted by strong linkages and relationships between the peoples, firms and governments of New Zealand and its economic partners.

Government policy can shape the ways linkages may develop and the depth of these relationships. For example:

- A strong international orientation to policy will signal to firms that success will be linked to investment in lasting commercial relationships with overseas customers and suppliers.

- A liberal approach to foreign investment, air access and international telecommunications will reduce barriers between New Zealand and overseas countries.

- More formal relationships such as technology agreements, bilateral tax agreements, investment agreements, formal economic relations (such as CER) and multilateral trade agreements can help reduce the uncertainty faced by firms in developing international linkages.

*Further linkages with Asia will be important to take advantage **of** increasing trade opportunities.*

East Asian and, to a lesser extent, Latin American economies are expected to be among the fastest growing parts of the world over the next decade. These are areas where New Zealand is still developing cultural and trade relationships of the depth of those we have with trading partners such as Australia. New Zealanders will need to develop their knowledge and understanding of those economies in order to take advantage of the potential opportunities they offer.

Government is facilitating this process . . .

The Government spends up to $230 million a year assisting international linkages of New Zealand enterprises, through the Ministry of Foreign Affairs and Trade (MFAT), Tradenz and the Tourism Board. In addition, enterprise assistance is provided through organisations like Business Development Boards, bringing expected total expenditure in 1993/94 to around $270 million.

. . . but must continually reassess its focus.

It is important that such expenditure be focused on those behaviours the Government sees as needing strongest reinforcement. It is also important that such policies are regularly re-evaluated in order to maintain pressures to further develop successful business strategies and international relationships. This requires the Government to ensure that those responsible for designing and managing such programmes maintain a strategic focus.

Using the spur of competition

Competition forces innovation and productivity.

Competition is one of the strongest spurs to innovation and productivity. It necessitates new ideas and alliances with customers and suppliers and continued attention to the skills of management and staff.

New Zealand's history shows clearly that if firms are protected from competition they are much less likely to look for new opportunities or innovations, especially internationally.

Regulations affect the extent and scope of competition in many parts of the economy. Reforms in a number of areas of regulation in the past decade have acted to increase competition and thereby raise productivity and stimulate innovation.

Lower tariffs have improved competitiveness and innovation . . .

The move to lower import protection has not only assisted sectors of the economy such as agriculture. It has also helped underpin the development of what is now a much stronger and more dynamic manufacturing sector.

... though current levels are still high by OECD standards.

While tariffs are reducing, the general level of tariffs for goods made in New Zealand is relatively high and uneven by OECD standards. The average tariff on imports competing with New Zealand-made products will still be above 10% in 1996, while assistance for industries such as car assembly, textiles, carpet, footwear and clothing will be much higher.

A review of post-1996 tariff policy is scheduled for 1994. Given the importance of tariff policy, the outcome of this review will attract a great deal of attention and will be judged by many as an important indicator of the Government's approach to economic development. Tariff policy would be most supportive of growth if it recognised that high and variable tariff levels reduce the productivity of labour and capital by encouraging scarce capital and skilled labour to areas that are not internationally competitive.

Keeping up the pressure to perform

Management will be forced to perform . . .

Increasingly, New Zealand will find itself in a world where management has to constantly adapt to new challenges, while maintaining a long-term vision of the way ahead. Rapid technological and product changes will require innovative work practices, emphasising the need for on-the-job training and investment in staff. The way in which work is organised and financed will need to change in the face of new technology, new competitors and new products. Competition within financial markets will maintain pressure for more innovative ways of financing and raising investment capital.

... to meet new challenges.

At the same time, investors and other stakeholders will want to manage their risks. They will seek assurances that management is responsive to their interests and that management and directors can be held to account for the management of the resources at their disposal.

In a dynamic economy, some firms will expand while others will contract or even go out of business. Changes in company directors and management will occur through mergers and takeovers, and assist in reorientating the focus of a firm. All of these mechanisms help create a dynamic economy.

Business law is important.

The legal framework that surrounds business activity is very important in shaping management attitudes and providing the opportunity as well as keeping up the pressure to perform. For example:

- Basic contract law and the court system are designed to allow parties to negotiate and enforce agreements with certainty, speed and low cost.

- Company law helps shape whether a business can organise itself to best reduce its risks and maximise its opportunities. At the same time, it is vital that it provides a clear and certain framework of the rights and obligations of shareholders, creditors and directors in the company.

- The Commerce Act has an important role in protecting the competitive process and guarding against abuse by dominant firms, while allowing innovation.

A series of reforms since the late 1980s, culminating in the new Companies Act, allows more efficient and diverse corporate governance arrangements to emerge, including better accountability between directors, financiers and shareholders.

The major reforms in this area need to bed down before further regulation is implemented. Attention should focus on measures to lower the cost of enforcing contracts, and reviewing insolvency law.

Better performance from agriculture can enhance growth.

Given the size and export orientation of agriculture, it is extremely important this sector perform well. Small increases in the sector's growth will make a significant contribution to boosting overall growth rates. However, the agricultural sector is expected to underperform the economy as a whole. Despite being an area of strong potential competitive advantage for New Zealand, the agricultural sector is forecast to fall as a percentage of GDP.

Slow growth in agriculture is expected.

This raises questions as to why independent forecasters do not expect agriculture to be one of the dynamic sectors in the economy. New Zealand's primary producers are internationally competitive and the reforms over the last decade in areas like ports and transport have substantially reduced off-farm costs in a number of areas. This focuses attention on processing and marketing.

There are considerable international threats and opportunities.

Despite the likelihood of greater competitive threats from producers in Eastern Europe and the Americas, there are considerable opportunities for agriculture in high-income, fast-growing markets, that New Zealand firms can increasingly exploit. The organisations that control processing and marketing will need to be very innovative and adaptive if they are going to respond to these threats and make the most of the opportunities.

The structure of the agricultural sector is distinctive and highly regulated.

In contrast to forestry, fishing and some aspects of food processing, agricultural processing and marketing are distinguished by statutory boards and co-operative operations. While there is continued strong support for these arrangements in many areas, they are being increasingly questioned from both outside and inside the industries.

There are some problems with the current arrangements. For example, the structures backed by regulations have the consequential effect of limiting the involvement of commercial firms in the processing and marketing of product in some of these areas. However, the overall evidence is not conclusive, given that there is little information on the commercial performance of the processing and marketing operations.

A number of important issues are emerging that these agricultural industries will be dealing with over the next three years, such as the future of kiwifruit marketing arrangements. As the boards are creatures of statute, the Government will, inevitability, be involved in many of these issues. This is reinforced by the reality that banks are usually lending on the basis of the boards' single-desk export regulatory rights. The issues involved will generally be complex. Because arrangements differ among different industries in the sector these issues will need to be addressed on an industry-by-industry basis.

Government will be involved in addressing the problems.

The Government should work closely with industries to ensure the solution to their problems enables the agriculture sector to achieve its full potential.

POLICY INTEGRATION

Government decisions can affect business.

The Government makes many decisions each year which can have important implications for business behaviour and costs, such as decisions on taxes, regulations and publicly provided services. Advice on, and implementation of, these decisions is provided by a large number of agencies at both the central and local government level.

A successful, internationally competitive enterprise culture . . .

The development of a successful, internationally competitive, enterprise culture will be aided if individual proposals in these disparate areas are informed by high-level strategic objectives, a clearer idea of the priorities for action and a wider appreciation of the trade-offs involved, and a more conscious focus on the behaviours and attitudes that the Government is wanting to influence.

... is supported by consistent policy direction.

Consistency of policy direction, together with good communication, plays a key role in promoting adaptive and enterprising responses. It reduces the adverse effects of policy uncertainty on investor confidence. It also discourages sectoral interest groups from investing in lobbying to have policy modified in ways that are not consistent with the overall strategy.

Coherent processes for setting the policy agenda and providing appropriate terms of reference and personnel for policy reviews are essential to ensure that all areas of policy pull in a consistent direction.

While it will not be simple to devise an efficient process to review interventions in a strategic manner, it would be desirable for the Government to consider options that will help produce this result.

The Government plays a key role in helping achieve higher incomes.

In summary, Government influences many choices made by the private sector through its policies and interventions in the economy. A consistent focus across all of government will help the development of a successful and internationally competitive enterprise culture.