CHAPTER 3

ECONOMIC GROWTH

3

To sustain growth the incoming Government needs to maintain a medium-term focus.

3.1 Introduction

The New Zealand economy is performing differently from the way it performed in the 1970s and 1980s, with changes in behaviour by individuals and firms leading to higher growth and employment. Most forecasters see higher growth as sustainable.

To sustain growth, the incoming Government needs to maintain a medium-term focus and look to enhance an environment in which firms and individuals make good decisions, particularly investment decisions.

This chapter discusses the current economic situation and sets out policy implications for three key drivers of future economic growth and rising incomes:

- enhancing skills in the economy and in particular ensuring that the education system is equipping New Zealanders to participate productively in the work force
- contributing to an environment which continues to foster a more innovative business sector that invests, employs and allocates resources in efficient and effective ways
- creating an environment which limits biases against saving and ensures that people consider the longer term and, in particular, their retirement.

Another key element contributing to a good climate for investment is macroeconomic stability. Transparent, credible and consistent macroeconomic policies increase the confidence of individuals and firms when they are considering saving or investing in education, training, or plant and equipment. This issue is discussed in chapter 4.

3.2 The current situation

3.2.1 Higher growth

The incoming Government inherits an economy that is in its sixth successive year of economic growth. Since the trough of the recession, in mid-1991, output has increased by 19.2%.

The consensus among New Zealand forecasters is that growth will average around 3% over the next few years.

In the Pre-election Economic and Fiscal Update, the Treasury forecast that growth will average 3.2% over the four years to June 2000. The consensus among New Zealand forecasters is that growth will average around 3%. This is very different from past recoveries in New Zealand, and indeed in the OECD, in that the economy will have been growing throughout the economic cycle. It is generally accepted that the medium-term sustainable growth rate has increased.

The economic expansion in the 1990s has not led to the pressures of the past. Rapid growth has not given rise to marked inflation and balance of payments pressures. Though monetary policy has had to tighten over recent quarters and the balance of payments deficit has increased, outturns are significantly better than in previous cycles.

Throughout the current economic cycle, inflation has been relatively low, even when the economy has been growing strongly. In the mid-1980s, for instance, the economic expansion was not sustained, as inflation increased to over 16%. This compares to a peak of underlying inflation of under 3% during the current cycle.

While the balance of payments deficit has increased to 4.1% of GDP, it has not reached the levels experienced in past cycles. For instance, the deficit reached 8.9% of GDP in 1986.

As a result of the subdued inflation and balance of payments pressures, Treasury forecasts suggest that the current slowdown in growth will bottom out while the economy is still growing at current rates.

3.2.2 More employment

For most people, being in employment and acquiring skills are the route to higher incomes and better lifestyles. The most significant aspect of economic growth in recent years has been the strong growth in jobs. Over the last five years, employment has grown by over 220,000 jobs, more strongly than at any time in our recent history. There have been more jobs created since 1991 than there were people unemployed in 1991. More people are looking to participate in the labour force than in 1991.

This has been a job-rich recovery, compared with other countries' experiences. For instance, while economic growth in New Zealand and Australia has been similar since mid-1991, employment growth was 15.1% in New Zealand, compared with around 8% in Australia.

Employment expansion is important for economic growth and provides individuals with the opportunity to earn higher incomes.

Job growth has been broad-based and long-term unemployment has fallen more than the average, as has Maori and Pacific Island unemployment over the last four years. Unemployment has also fallen in most regions.

Having more people in employment is important for growth. But getting a start or restart in employment is also a key factor for individuals. People then have the opportunity to move, over time, to higher incomes. This opportunity is illustrated by tax data, which shows that:

- just over a quarter of people in the lowest 20% of the wage and salary distribution move to a higher income group within a year[1]
- people on low wages and salaries tend to receive on average relatively larger proportionate increases.[2]

3.2.3 Higher skills

Increasingly, more people are seeing value in further education and training. Despite increased employment, participation in education by those over 15 increased from 122 people per 1,000 to 132 people in the five years to 1995. Participation in education is increasing across all age groups.

Beyond the education system, the number of industry trainees is forecast to reach record levels by the end of 1996. While it is too early to measure the effects of changes in industry training, the more direct involvement of industry and the link to nationally based standards bring a different approach, with the promise of higher quality training.

In addition, there is evidence that on-the-job training is increasing. The 1995 Infometrics study of manufacturing exporters indicated an increasing interest in, and commitment to, better management, including staff training and development and performance pay.[3]

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1 G. R. Barker, *Income Distribution in New Zealand*, Institute of Policy Studies, Victoria University, Wellington, 1996.

2 J. Creedy, "Income Dynamics over the Life Cycle: New Evidence for New Zealand", Report commissioned by The Treasury, 1995.

3 The Infometrics study has been monitoring a group of around 30 leading manufacturing exporters since 1990. The sample of firms has changed only slightly over the period. They account for over half of the total value of exports from their industries.

Increased enthusiasm for education and training is essential. The changes in the world economy are increasing the value of skills, ideas and more flexible production. Many jobs are becoming more knowledge-based and technology-based, with increasing emphasis on quality, marketing and product development. The prospect of continuing rapid technological change means people can expect to undertake training and learn new techniques and approaches repeatedly during their working lives.

3.2.4 Improved firm performance

In the earlier stages of the recovery, improved firm performance was most evident in the export sector. Exporting firms began to improve their competitiveness, and became increasingly dependent on the international side of their business. There has been a noticeable shift over the years from a "production-driven" focus to a more "market-driven" focus.

In the period 1991 to 1996, total export earnings rose by 31%, from $16 billion to $21 billion. Exports to Australia rose by 43%. In the strategically important Asian markets outside Japan, the increase was 74%.

Openness to imports has provided a competitive spur to local firms.

The 1995 Infometrics study of manufacturing exporters (and the 1996 follow-up) indicated that firms are starting to diversify their markets beyond Australia. In 1993, Australia was the key and often sole market, but by 1995 more successful firms were more diversified. There was also interest in investing overseas in plant and in marketing and distribution networks.

Improved performance has extended beyond manufacturing to other export sectors, in particular tourism, where volumes in the year ending March 1996 were 70% higher than four years earlier. The number of visitors arriving in New Zealand in the year to August 1996 was 43% higher than in the year to August 1992.

But the benefits from international trade have gone beyond export gains. Openness to imports has provided a competitive spur that the relatively small domestic market cannot generate.

As a result, improved firm performance has extended into the import-competing sector. Although it has taken time, we are increasingly seeing a changed approach at the firm level.

Firm level performance

A Season of Excellence? is a recently completed stocktake of the extent to which the practices of New Zealand firms are capable of creating sustainable competitive advantage.[4] *A Season of Excellence?* considers sustainable competitive advantage as those behaviours and characteristics that will keep individual firms ahead of their competitors. Its findings are summarised below.

- The nineties have seen a revolution in organisational strategy and practice. This follows an initial period in the late 1980s in which firms struggled for survival and for new strategic direction.
- However, few New Zealand enterprises have yet fully developed these characteristics because the assets of sustainable advantage are created over a number of years.
- The bases of sustainable advantage that have been developed focus on close, cooperative relationships with the workforce and the distribution chain. Very few firms show evidence of brand or product leadership on an international scale.
- Providing the pace of change within firms in the early 1990s is sustained, the prospects are good for expansion of New Zealand's stock of competitive enterprises.
- Key determinants in this expansion will be a heightened ability among managers to adopt more involving, empowering relationships with the people in their organisations; to adopt strategies of greater specialisation and cooperation within networks of business partnerships; and to devote themselves and their organisations to the creation of distinctive customer value.
- The outcome is less a matter of prediction than a question of intent.

There is an increasingly dynamic business sector in New Zealand.

Firm entry and exit statistics show that there is an increasingly dynamic business sector in New Zealand. Over the past few years, there have been increasing numbers both of firms entering business and firms leaving it. The total number of firms in the economy has also been increasing.

The environment in which New Zealand firms operate has made them more willing to take on employees. While the strength of each effect is uncertain, important reasons for the increasing number of jobs generated include:

- the strong rebound in the New Zealand economy in the 1990s
- the Employment Contracts Act 1991 enhancing the speed of labour market adjustment

[4] C. Campbell-Hunt and L. M. Corbett, *A Season of Excellence?An Overview of New Zealand Enterprise in the Nineties*, New Zealand Institute of Economic Research Monograph 65, 1996.

- product market deregulation
- stability and credibility in macroeconomic management.

75% of firms in a recent survey considered the Employment Contracts Act's net impact had been positive.

It is difficult to determine the exact effects of the Employment Contracts Act on labour market outcomes, because of changes in the external economic environment, as well as the effects of other changes in the economy.

A recent survey by the New Zealand Institute of Economic Research (NZIER)[5] found that approximately 75% of the firms responding considered the net impact of the Employment Contracts Act had been positive. The effect on wages and salaries was more complicated. Ordinary time wage rates had tended to increase, while penal rates, overtime rates and fringe benefits declined. There was also a shift towards performance-related pay.

A similar study undertaken by the NZIER in 1993 revealed that in the initial years following the Employment Contracts Act's implementation, firms focused on cost cutting and productivity gains[6]. Firms now appear to be focusing more on longer term investments in their employees, through training and multi-skilling.

3.3 Further improving the performance of the economy

The recent improvement in economic performance should not deflect attention from aspects of the economy that could be improved, with a view to increasing incomes.

3.3.1 New Zealand's economic performance

New Zealand's per capita GDP is below the OECD average, once differences in the prices of similar goods in different countries are taken into account. It is approximately 90% of Australia's, three-quarters of Japan's, and around two-thirds of the United States' level.

The relative improvement in per capita GDP during the last five years represents only a partial catching up after the relative decline during the previous two decades.

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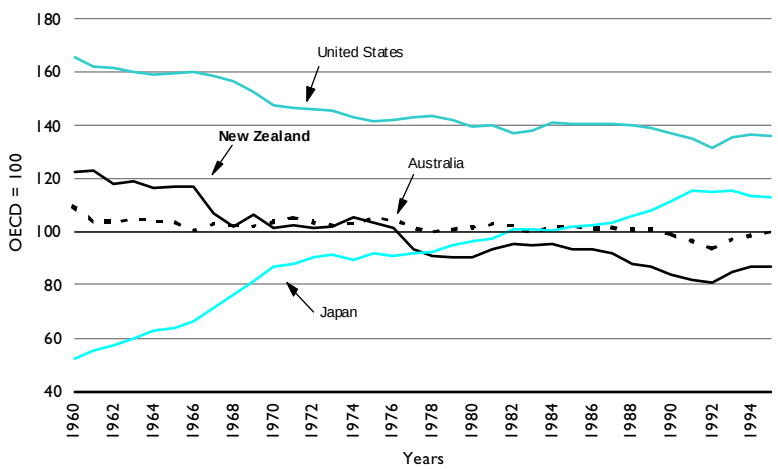
5 J. Savage and D. Cooling, *A Preliminary Report on the Results of a Survey on the Employment Contracts Act*, New Zealand Institute of Economic Research Working Paper 96/7, Wellington, 1996.

6 P. Briggs, *Analysis of the QSBO ECA Survey Results*, New Zealand Institute of Economic Research Working Paper 93/11, Wellington, 1993.

Achieving a high-employment and high-income society requires job creation and strong growth in productivity (and therefore in real wages over time). Some countries have experienced higher productivity and wage growth, but low employment growth, while others have had high employment growth and low wage growth.

New Zealand has experienced a job-rich recovery that has brought benefits with it. There is now greater flexibility in employment arrangements, so that the total numbers employed have increased. These jobs have not always been highly paid, and have sometimes involved changes in work schedules. For some this will have meant a boost to their current income and future prospects through the employment experience gained.

Fig. 3.1 GDP per capita in selected OECD countries



Source: OECD

3.3.2 Areas for government concern and attention

Despite a growing economy, there will always be some individuals who, at a given time, experience low incomes. There is still a large number of people in New Zealand who find it difficult to establish or re-establish themselves on reasonable incomes, despite assistance from the state. Recent reductions in the number of people who have been unemployed for long periods show that there has been some progress, but there is considerable scope for improvement in the way society helps people to improve their circumstances. These issues are discussed in chapter 5.

Moving towards a high-employment, high-income society requires the drivers of job creation and productivity growth to be maintained and reinforced.

More broadly, looking at the economy as a whole, more people in employment can raise growth. It is the numbers and skills of people in employment, the quantity and quality of investment, and the efficiency of the economy as a whole that determine per capita income. To enhance New Zealand's growth prospects, the labour market needs to be open to the best the world has to offer in skills and ideas.

The evidence discussed in the earlier parts of this chapter suggests positive changes in the drivers of improved productivity performance, with:

- increased employment, providing the opportunity to gain the skills and experience needed for higher incomes
- increased participation in education
- more on-the-job training
- business strategies aimed at productivity improvements.

Moving towards a high-employment and high-income society will require the four key drivers of job creation and productivity growth to be maintained and reinforced.

Macroeconomic stability: the more uncertainty there is about the future direction of government policy, the more uncertain the future environment will be, and the more likely it is that firms and individuals will decide either not to invest, or to invest in the wrong areas. This suggests a focus by government on macroeconomic stability, which is a key factor for good quality investment and savings decisions. The role of macroeconomic stability is discussed in chapter 4.

Raising skills: growth in productivity and wages will follow from New Zealanders increasing their relevant skills and training and using these skills well. Skills are gained from schooling, tertiary education, and on-the-job experience and training. There appears to be room for improvement at the school level. For example, on international comparisons, New Zealand's students perform relatively poorly in mathematics compared to students in many similar countries. While New Zealand ranks highly in literacy overall, its ranking slips for less able students, particularly for those whose home language is not the language of instruction.

Improving the performance of businesses: while it is difficult to be precise about what "best practice" is, many businesses in the New Zealand economy do not appear to be matching international best practice. New Zealand's exports are still rising at a slower rate than the growth in international trade generally.

Better saving decisions: the main aim of economic growth in New Zealand is higher incomes, greater opportunities, and welfare for all New Zealanders. Despite high investment returns, New Zealanders have not chosen to be high savers, with the result that their incomes — combining both employment earnings and investment income — have risen less quickly than output. Higher savings well invested would lead to higher incomes in the future.

The following three sections discuss the strategic economic priorities for the incoming Government identified above.

3.4 Raising skills

The earlier discussion in this chapter highlighted the importance of being employed and increasing skills, for both individual and national incomes.

A range of studies suggest the potential impact on firms' performance of a well-educated labour force. For instance, it has been shown that in some circumstances:

- Better education is associated with a lower propensity to leave a job and lower absenteeism.
- Higher levels of schooling completed, and taking particular academic subjects, are linked with higher job productivity.
- More tertiary educated workers help firms to adopt new technologies more quickly, and are better paid in such industries.
- The superior performance of certain industries on international comparisons is based on how well-grounded *average students* are in mathematics, science and other aspects of general education.

Historically, the protected domestic economy led to little premium being placed on the skills needed in a more competitive environment. Many students left school at 15 to take readily available low- or semi-skilled jobs, rather than obtaining higher qualifications.

With the economic reforms, an increased premium was placed on more skilled workers. Thus the gap between wages for skilled and semi-skilled workers increased during the 1980s.

This gap between wages for those with relevant skills and less skilled workers is a key factor driving investment in skills, whether through formal education, on-the-job training, or retraining. In this sense, some degree of wage disparity between high- and low-skilled jobs is needed to generate the dynamic processes required to make human capital a more significant driver of productivity growth. In the longer term, good rewards for skill, combined with good access to learning opportunities is the means of reducing poverty and income disparities. As low income people improve their skills, then both lower and average wage levels can increase.

The infrastructure and processes for education and training must deliver the right opportunities for those who want to learn.

Though increasing the demand and reward for skills is important, it is critical that the infrastructure and processes for education and training ensure that the right opportunities are there for those who want to learn. The government makes a major investment in education and training. The effectiveness of this expenditure will have a major bearing on the individual and collective prosperity of New Zealanders.

An education system which is capable of delivering the quality of education New Zealanders need will feature:

- strong professional leadership, leading to a continued striving for excellence
- responsiveness to student, employer and wider community needs
- accountability for the efficient use of resources and for the quality of outcomes delivered.

The institutional arrangements are the focus of this section.

3.4.1 Schooling

There are links between success at school and a range of social and economic outcomes. The more formal education an individual acquires, and the more successful that education is, the more likely he or she is to be employed and earn more over time.

Many of the developments in the schooling sector in the last decade have been consistent with ideas emerging from some of the research on effective schooling. For instance, effective schools develop clear goals which guide their learning programmes. The Tomorrow's Schools reforms have placed the emphasis on schools developing their own objectives, within the broad framework provided by National Education Guidelines, including a national curriculum. At the same time the reforms have delivered greater freedom to local communities to make decisions about how their schools are organised and managed. For the most part, the move to greater local control has been welcomed by schools and their communities.

However, in many respects this move is not complete. Only a minority of schools have opted in to the direct resourcing model. It seems that many of those schools that have decided not to opt in have done so, not because they do not see the benefits of additional flexibility which direct resourcing could provide, but because they and their staff fear reduced government funding if salaries become the direct liability of the schools. Moves to allay these concerns, thus persuading more schools to adopt direct resourcing, could bring real benefits in terms of better use of resources and through this improved educational outcomes.

Because of the slow move to direct resourcing and the continuation of centralised pay fixing, schools do not have much flexibility in rewarding their staff. Decisions on pay arrangements continue to be made centrally, whereas at the local level there is better information to make judgments on the nature of recruitment and retention difficulties and the performance of staff. Recent moves to introduce a performance management system into schools, and the creation of additional pay units for schools to allocate on the basis of reward, recruitment or retention in the recently settled post-primary teachers' contract, will help to build a more flexible performance culture.

Accountability arrangements have been strengthened in schools over the last decade. The national curriculum clarifies what learning outcomes schools are supposed to be helping students to achieve. It is less apparent that there is effective reporting on the extent to which schools are successfully achieving the objectives set for them. The Education Review Office's increasing focus on effectiveness in its reviews is a positive contribution.

However, many schools still appear to be struggling with their own responsibilities to report on their performance. It is common for schools to be able to measure individual student progress on some dimensions, but not to be able to demonstrate the success of particular learning programmes. The proposal to monitor all students' progress at particular points in their schooling through nationally standardised tests (transition point analysis) can potentially make a very valuable contribution to the measurement of school outcomes, by informing a school on how well its students are progressing relative to their peers in other schools.

Demographics and the planned rise in the school leaving age will cause strong growth in school rolls.

The numbers attending schools over the coming decade are forecast to grow strongly, because of both demographic factors and the planned rise in the school leaving age. This will increase the fiscal cost of education, as more teachers and other resources are required and more classrooms built.

Management of these pressures will be assisted if best use is made of the approximately $4 billion of property available to schools. The range of responses and assistance available to strengthen school management and governance may need to be expanded in order to achieve this.

In the longer term, alternative ways of providing capital to schools may encourage greater efficiency in resource use at the school level.

Non-state schools could have a role in meeting some of the schooling supply pressures faced by the government. Alternative sources of schooling could also provide additional benefits through increasing competition. Increased diversity and innovation in schooling, coupled with appropriate accountability, is likely to help raise standards overall, and ensure a better fit between individual student needs and the schooling available.

The planned rise in the school leaving age will pose additional challenges for schools, not just because of the additional students to be taught, but also because of the need to ensure that the education provided is relevant. Increasingly, in the senior secondary school, the distinction between compulsory and post-compulsory education will become blurred, with schools offering a broader range of vocational and "tertiary" courses. Again, flexibility at the school level will help.

3.4.2 Tertiary education

Tertiary education in New Zealand has been through a period of considerable growth since the mid-1980s. Between 1986 and 1995, the number of students at tertiary education institutions (TEIs), excluding Training Opportunities Programme, increased by nearly 67%, from 127,209 students in 1986 to 212,068 students in 1995. Student demand for places at tertiary institutions is likely to continue to rise in the foreseeable future.

Tertiary enrolments rose by nearly 67% from 1986 to 1995. Further enrolment growth pressures are expected.

Successive governments have responded to the challenge of growth by introducing a series of reforms in the tertiary education sector. These reforms have been aimed at increasing self-management among TEIs, moving to an output-focused funding system, introducing greater competition in the sector, and increasing the share of costs financed by students and their families. Reforms have included introducing the Equivalent Full-Time Student funding system, granting TEIs the right to set fees, introducing the student loans scheme, the tighter targeting of student living allowances, and successively reducing the level of per-student tuition subsidies.

The sector is likely to face continued pressures, including enrolment growth, over the short term. The tertiary sector must be able to respond to the

ongoing challenge of growth, while continuing to provide high quality courses that are cost-effective, and meet the needs of the labour market and of society more generally. Despite the reforms introduced to date, the current mix of policies is unlikely to provide TEIs with either the best tools or the right incentives to meet this challenge.

Greater alignment in funding arrangements across the tertiary sector could encourage the entry of new and innovative providers to the sector, and hence increase the local competition TEIs face. Currently, tuition subsidies vary greatly, depending on the type of programme/course chosen, and whether it is offered by a state or a private provider.

A greater role for student choice in the funding allocation process could also strengthen competitive pressures on TEIs, thereby encouraging them to be more responsive to student demands. Administrative processes of the current funding system constrain these pressures, as they do not allow funding to follow students freely (for example, from institution to institution or from sector to sector). They also still incorporate elements of central planning, in that institutions have to make a case to the Ministry of Education to grant them additional funding.

The extent of detailed scrutiny of tuition costs needs to be related to the formula for providing tuition subsidies. The more that the funding varies with increases in the cost of courses, the more the government is exposed to an open-ended fiscal risk. Options for managing this risk include more centralised monitoring and strengthened incentives on the management of TEIs to contain tuition costs.

Accountabilities within TEIs are often diffuse and unclear.

Key issues face the government on the ownership side. Current weaknesses in pressure for better management performance by TEIs stem from a lack of a clarity in the relationship that exists between the Crown and TEIs. This is discussed further in chapter 6.

Accountabilities within TEIs are often diffuse and unclear. The limited ownership monitoring that takes place is input focused and concentrated on controlling risk, rather than facilitating good business planning. A clearer ownership relationship, accompanied by appropriate monitoring, would allow TEIs more freedom to manage their resources. Such arrangements, which could include measures to ensure institutions faced the cost of their capital, would also allow the government to be comfortable that its investment in TEIs was being managed wisely.

Both the lack of competition and the lack of flexibility and incentives for efficient resource use may be expected over time to have a significant impact on the quality of outcomes achieved from the tertiary sector.

3.4.3 On-the-job training and experience

In addition to formal training, skill development in the work place can contribute to higher individual incomes and better firm performance. This can come from both work experience and training programmes in firms. The Infometrics study of manufacturing exporters indicated that there has been an increasing interest in, and commitment to, better personnel management, through factors such as performance pay, and staff training and development. But as Infometrics[7] points out:

> Around one-third of companies have a high commitment to training. Generally, however, the ability and commitment of firms to identify and develop the skills they require in their workforce is mediocre. Many managers have only a hazy knowledge of their training programmes and how they would measure the return on the money being spent on training.

Improved management performance will improve the commitment to, and quality of, on-the-job training.

3.5 Improving the performance of businesses

The second of the three strategic economic priorities discussed here is improving the performance of businesses. To maintain and enhance our future growth prospects, it is critical that New Zealand has an innovative and entrepreneurial private sector that invests, employs, and allocates resources in efficient and effective ways.

A dynamic business sector is characterised by its flexibility to handle change.

A dynamic business sector is characterised by its flexibility to handle change:

- New enterprises emerge.
- Existing businesses re-orient and adjust their investment, in response to new ideas, opportunities and challenges.
- Poorly performing firms exit.

As discussed previously in this chapter, evidence that New Zealand has an increasingly dynamic business sector can be found in a better performing economy and more jobs.

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[7] Infometrics, *Manufacturing Export Study,* report commissioned by The Treasury, 1995.

Much of the competitive pressure leading to improved economic performance comes from an open economy.

Competition helps to spur innovation, quality improvements, tighter cost control and greater attention to customer satisfaction. It helps to make firms more productive, raising real incomes, and enhancing the quality of life in other important ways.

An assessment of openness and competition in the economy will help guide where policy change could improve the welfare of New Zealanders.

Competitive pressures are not even across the economy. Even in some parts of the tradeable goods sector, there is a lack of competitive pressure, particularly when sectors are protected or regulated. Competitive pressures are lower in some parts of the non-tradeable goods and services sectors.

The next three sub-sections provide examples of areas where changes in policy have the potential to increase competitive pressures in the economy.

3.5.1 Increasing competition and openness in the tradeable goods sector

Tariff reductions provide ongoing increases in competition from abroad, thereby helping to ensure that resources are well used and efficiently allocated among sectors.

Currently, about 90% of New Zealand's imports by value are duty-free. Of the balance of dutiable goods, most tariffs fall between 5% and 15%. The main exceptions are motor vehicles, footwear, textiles and clothing, and carpets, which attract tariffs of between 20% and 30%.

In 1994 the Government agreed and announced a further three-year tariff reduction programme, starting on 1 July 1997. Under this programme, all tariffs will fall to 15%, 10%, 5% or zero. It also announced that in 1998, it would determine how to move tariffs towards a zero end point, under a unilateral domestic tariff reduction program.

The more rapid the reduction of tariffs, with clear signalling of the intended programme of reductions, the better off the economy will be.

As a developed member of the Asia-Pacific Economic Co-operation (APEC) grouping, New Zealand is committed, as part of the 1994 Bogor Declaration, to removing all tariffs and barriers to trade in goods, services and investment with other developed APEC member economies by 2010 at the latest.

New Zealand's economic partners impose a range of tariff and non-tariff barriers on our outward flows of goods, services, and investment. The removal of these could make for greater returns on exports and cheaper inputs.

The New Zealand government is the only domestic entity with the ability to lower these barriers (and to minimise the risk of their being raised in the future). Negotiations within APEC and the World Trade Organisation (WTO) provide an important opportunity to influence other countries' policies, and eventually New Zealand's returns from trade with these countries. With such access, firms can increase the size of their markets, and in some cases can then lower unit costs and increase profitability. In other cases, bigger markets mean more opportunities to sell specialised products and services.

Through CER, further negotiations on investment and aviation beyond rights could make a significant difference to the cost of conducting business between the two countries.

Producer boards manage products accounting for around 44% of New Zealand's total goods exports (for the year ending December 1995). Exports from industries controlled by boards with a statutory monopoly accounted for approximately 20% of goods exports for the year ending December 1995.

Several issues are raised by these arrangements:

- With no domestic competition in the export marketing of many agricultural and horticultural products, there is no way of telling whether the single seller is the most efficient way of exporting New Zealand's wares.
- Limiting the range of marketing approaches may reduce the incentives to innovate and may mean that wealth-creating opportunities are overlooked.
- Individual producers cannot get close to their markets and thus determine for themselves what their customers want.
- With returns from a range of activities bundled into one payment, it is difficult for producers to see where their investments are making adequate returns, and where they are not.

When the government is considering whether or not to change regulations, the possible advantages provided by statutory monopoly should be considered against the opportunities that a greater diversity of marketing approaches can bring.

3.5.2 Increasing efficiency in the non-tradeable goods sector through competition and regulation

The government is a very large part of the economy. Its operating expenses alone are more than 35% of GDP. Health, education and welfare — the largest component of which is New Zealand Superannuation — are the major items.

The efficiency of the public sector could be improved by increasing transparency in operation and accountability for outputs. This is discussed in chapter 6.

Opportunity has been provided by changes in the regulatory environment. The Education Act 1989 clarified the rules surrounding foreign fee-paying students, thus providing a more certain environment for schools and tertiary institutions to enrol such students. This opened up opportunities for increased revenue from educational services. The education sector is now generating annual revenue estimated to be over $200 million from this source .

Local government affects the ability of businesses to generate gains and influences overall standards of living.

Local government effectiveness also makes a substantial difference to the ability of businesses to generate gains for the economy, as well as overall standards of living. The regulatory and operational activities of local government are substantial. For example, total expenditure by the 50 largest territorial authorities exceeded $2.8 billion in 1993/94. Local government activities such as provision of local roads, operation of water supplies and wastewater facilities, and administration of the Resource Management Act 1991, have a pervasive influence on businesses throughout the economy.

Where efficient pricing is possible, it is likely that private provision will result in appropriate investment in infrastructure, provided that the regulatory environment does not impede it. In this regard, ensuring that legislation such as the Local Government Act 1974 do not unnecessarily impact on private investment needs to be a primary policy objective.

Where efficient pricing is not possible, and thus private ownership unlikely, the key goal is a regulatory environment that promotes good governance arrangements. For example, ensuring that the Local Authority Trading Enterprise (LATE) framework is working effectively will be crucial.

3.5.3 Minimising the distortions the tax system imposes on investment

Competition and openness are important drivers of investment decisions in an innovative and entrepreneurial private sector.

The tax system also has significant effects on the quality and quantity of investment. It is particularly important that the tax system distorts as little as possible the production, investment, employment and training decisions of individuals and businesses.

By broadening the tax base and lowering tax rates, tax reforms since 1985 have significantly lessened the extent to which tax considerations lead to poor quality investment decisions. However, the current income tax system still has significant effects on investment decisions. Companies face different effective tax rates on their investments in different assets, because of factors such as accelerated depreciation and sector-specific tax arrangements for forestry, mining and offshore investments. Investment in owner-occupied housing attracts an effective tax rate of 0%.

The policy conclusion here is that monitoring, protecting and improving the tax base continues to be a central issue for government. Changes in commercial practice, sometimes specifically to avoid tax liabilities, mean that various details of the tax law can become outdated; this can jeopardise the fiscal position and create distortions which discourage efficient investment. The Treasury and the Inland Revenue Department maintain a joint work programme to address the priority issues as they arise.

3.6 Better saving decisions

The amounts that New Zealand households, firms and the government save matter, because saving that is wisely invested is a key determinant of the future income of individual New Zealanders.

3.6.1 Future incomes

Higher domestic saving would mean higher future incomes for New Zealanders.

Gross *domestic* product (GDP) measures what is produced in *New Zealand*, regardless of whether New Zealanders or foreigners get the income from production. Gross *national* product (GNP) measures what *New Zealanders* produce and earn, regardless of whether production takes place here or overseas. GNP is therefore a better measure of the income of New Zealanders.

Because investment opportunities in New Zealand outstrip the saving of New Zealanders, much of what is produced in the country is not fully owned by New Zealanders. GNP is therefore around 6% lower than GDP. Higher domestic saving would mean more ownership of investment (whether here or overseas), and higher future incomes for New Zealanders.

Thus a nation of savers will be wealthier in the long term, and a nation of dissavers will eventually have to service the resulting debts.

3.6.2 Exposure to a change in investor confidence

A country where investment is higher than savings will have a current account deficit. Investors who fund the gap between national spending and income will do so only if they are confident of the borrower's ability and willingness to repay them. There may come a point where investors become less confident, and a higher interest rate is required to maintain the inflow of funds.

As New Zealanders have used foreign saving to fund domestic investment, New Zealand has a history of persistent current account deficits, reflecting the sustained imbalance between the rates of investment and saving. In the year ending March 1995, New Zealand's net foreign liabilities were around 86% of GDP, with about three-quarters being private sector liabilities.

An increase in domestic saving would reduce the call on foreign saving.

Recent developments in the current account and the net external liability position should be considered in the context of the changes to the economy discussed above. For example, given fiscal surpluses, New Zealand's contemporary current account deficits indicate that private-sector investment is higher than private saving. At the same time, the recent credit upgrades by Moody's and Standard and Poor's reflect the rating agencies' assessment of the government's creditworthiness. This is turn is reflected by the willingness of foreign investors to invest in New Zealand government securities.

Nonetheless, an increase in domestic saving would reduce the call we make on foreign saving, and therefore our exposure to a change in investor confidence.

3.6.3 Factors that influence savings

Governments influence national saving. Fiscal surpluses contribute to national saving, and will increase it, unless fully offset by reduced private saving.

Growing incomes provide greater opportunities for people to save. It is very difficult to save when an individual's or family's income is just sufficient to cover living costs. Higher household incomes give people more choice about whether to spend or save the extra income.

People's saving patterns change through their lifetime, with potentially greater scope to save when in employment, and less during periods in education or retirement. As a result, the demographic profile of a country will influence private savings levels and rates.

The return to saving (the after-tax, after-inflation rate of return on investments), and the ease of access and level of sophistication of savings vehicles, will also influence how much and the different ways in which people save.

Paying off a mortgage is an important form of savings. The fact that people pay mortgages off at different rates reflects different consumption decisions over time. For some, the interest saved by paying the mortgage off faster is enough to motivate them to forgo some spending today. Others decide to spend more today, even though the total interest bill over the lifetime of the mortgage may be considerably higher.

The government plays a major role in setting the environment in which people and firms make saving decisions. Inflation is likely to discourage saving in financial assets, given that it erodes the real value of money, and, with frequent price rises, encourages spending.

High income tax rates affect the return to saving. The effects accumulate over time, and thus reduce the capability of individuals and families to provide privately for the long term (e.g. retirement). However, specific tax incentives invariably distort patterns of savings in favour of some savings vehicles and against others.

Key savings policy areas include promoting an environment conducive to economic growth and low inflation, the tax system, and publicly funded retirement income.

Government funding, through taxes, of a range of areas, including retirement income, means that people do not currently save as much as they might otherwise for such purposes. Any consideration of how the government could make the environment more conducive to savings needs to factor in the various effects of government taxing, spending and regulatory policies.

3.6.4 Areas for attention

Given the influences above, key policy areas for the incoming Government include:

- promoting an environment conducive to economic growth and low inflation
- the tax system
- publicly funded retirement income.

Economic growth and low inflation can lead to higher savings. As discussed in chapter 4, low inflation is a characteristic of a stable macroeconomic environment, and this environment will in turn encourage growth.

Because the tax system reduces returns to savings, it probably results in lower national savings, compared with a tax system that collects the same amount of revenue without taxing returns to savings. As discussed above, it is important to maintain an ongoing work programme to identify features of the tax system which distort investment and saving decisions.

In the longer term, policy on public provision of retirement income is likely to be what most directly affects how much people save.

Expectations of future retirement incomes policy will influence individuals' saving decisions today.

A key consideration is the impact that publicly funded retirement income has on private savings. Where people expect to have an income provided for them, this is likely to decrease (or "crowd out") their own private savings.

The government itself could save more now to fund future retirement income for New Zealanders. But there is some evidence from overseas that the Government does a poor job at investing and managing its savings, relative to the private sector. For example, a comparison of rates of return of selected funds in the 1980s shows that privately managed pension funds outperformed publicly managed funds.[8]

Changes in publicly funded retirement incomes policy are disruptive to people's planning. The elderly have little or no capacity to adjust to changes in policy. It is therefore critical that the incoming Government take a long-term view of retirement incomes policy, and if changes are to be brought in, that they are brought in over a period of time.

The Retirement Income Accord sets up a process for reviewing domestic savings patterns and advising the government on a range of issues related to retirement income. The Periodic Report mechanism set out in the Accord document requires a report on retirement incomes policies every six years, by a group comprising representatives of non-government sectors, officials, and the Retirement Commissioner. Key issues for the 1997 review will include:

- whether private provision for retirement is increasing
- whether the long-term economic and fiscal outlook based on current retirement incomes policies appears satisfactory
- whether the system is delivering a more or less than adequate standard of living to retirees
- whether there is a broad consensus in favour of the current system
- whether the current system is delivering reasonable economic efficiency and fairness.

[8] World Bank, *Averting the Old Age Crisis*, Oxford University Press, 1994.

As discussed in chapter 2, in taking decisions on retirement incomes, the government should have as its key aim the desirability of maintaining a longer-term stable fiscal position that enhances growth and enables individuals to plan and save for their retirement. Decisions made by individuals today will be influenced by their expectations of retirement incomes policy in the future. Transparency and stability on retirement incomes policy will help people make their decisions with more certainty.

3.7 Conclusion

This chapter has covered a wide spectrum of issues that are important to improving the growth performance of the economy, and delivering jobs and higher incomes for New Zealanders.

- Higher skills are needed to enable people to work in a world where jobs are becoming increasingly knowledge- and technology- based. Higher skills mean people can add greater value to what they are doing in their jobs, and earn higher wages.
- Better business performance is critical to raising growth and incomes. More competition and openness, good quality regulation, and a tax system that distorts business decisions as little as possible, will spur improvements in the way businesses operate and encourage sound investment decisions.
- Saving decisions matter because they play a big part in New Zealanders' future incomes. Better savings decisions will be possible with attention to low inflation, the effect that taxes have on savings, and, perhaps most importantly, the future shape and form of publicly provided retirement income.

Each set of policies is important on its own. However, for the overall economy to perform well, it is critically important that the broad range of economic policies complement each other and work together; and that a consistent policy direction is pursued over time. This will lead to greater macroeconomic stability, and confidence that sharp adjustments to policies will not be required.

Consistency and stability in the overall stance of government policy helps to build credibility. Credibility means that households and businesses will make more and better quality training, investment and savings decisions. And it is these decisions that will shape the future incomes and well-being of all New Zealanders.