

Towards Higher Living Standards for New Zealanders

Briefing to the Incoming Government
1999



THE TREASURY

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Towards Higher Living Standards for New Zealanders

This briefing paper aims to inform you of the major issues we see facing New Zealand over the next few years. It is a product of much internal sifting and discussion. Rather than focussing on detail and rushing to offer solutions, we set the issues in a broader policy framework and environmental context. We see this briefing as the first written instalment of an ongoing conversation. There is a lot more material available on the big issues canvassed in this paper and we anticipate you will be wanting further work on some issues.

Treasury's perspective

Treasury's role is to advise the Government on economic and financial policy, including fiscal policy, and to manage the Crown's finances. We work to help you achieve higher living standards for New Zealanders.

Living standards are undoubtedly much more than income. Nevertheless, whatever mix of outcomes New Zealanders choose, long-term growth in production and incomes is the foundation upon which higher living standards are built. It is from this perspective that we have identified the issues that follow. Our views are derived from our distillation of the empirical and theoretical literature and are tempered by experience.

Key messages

The Government's policy programme will be played out against a complex backdrop of issues and challenges. These include a dynamic environment where some regions will prosper whilst others decline; where goods, services, capital, people and ideas are becoming more mobile; where income disparities have widened; and where the composition and distribution of the population are changing.

The Government inherits an economy that is poised for moderate long-term growth, and is on the upswing of the business cycle. The challenge is to strengthen that growth path.

Our understanding of what generates growth is far from complete. Government can only indirectly or slowly influence many of the factors that influence long-term growth rates – others are not amenable to influence at all. Academic work and international best practice suggest six elements that should be at the heart of government policy. These are: openness and international linkages, macroeconomic stability, a competitive private sector, a generic skills base, a cohesive society and an effective public sector.

Openness and international linkages

Openness gives New Zealand access to capital, competitively priced goods and services, management and technical skills, new networks and markets, technology, other cultures and fresh perspectives. It is a key contributor to growth, especially for a small economy.

Well-designed trade agreements can further assist in lifting New Zealanders' incomes in the future. There are several opportunities already on the table – Singapore and other free trade agreement possibilities, New Zealand's role as co-chair of the APEC Finance Ministers' process, and the Seattle round of the WTO.

Macroeconomic stability

Over the next few years, monetary and fiscal policy settings can make a major contribution towards sustaining the current economic expansion and therefore improving the prospects for ongoing job growth and higher incomes. Building on the monetary and fiscal credibility that was hard earned in the 1990s will be important.

In recent years, success in reducing inflation and inflationary expectations has allowed the Reserve Bank to lengthen its time horizon when setting monetary policy. Over time, this may help reduce variability in output, interest rates and the exchange rate. If you wish to amend the Policy Targets Agreement, any changes should be made in a way that confirms the Reserve Bank's commitment to maintain price stability.

The Fiscal Responsibility Act requires you to set long-term debt and expense objectives – these should take account of the future fiscal pressures arising from population ageing.

Increasing fiscal surpluses above the levels projected in the *Pre-election Economic and Fiscal Update* would help to reduce the extent to which interest and exchange rates will need to rise as the economic expansion continues. Running

higher surpluses also makes sense as a buffer to the risks to sustainable growth posed by ongoing large current account deficits and high levels of external liabilities.

Well structured and rigorous Budget processes, along with some form of three-year counting framework, will help ensure individual decisions are consistent with the Government's priorities and fiscal intentions.

Competitive private sector

The best contribution the government can make at the micro-level is to sustain an environment that helps individuals and businesses to make good decisions. Quality ground rules must be predictable and consistent whilst avoiding prescription, which reduces the scope for innovation.

A number of OECD countries go further than this by directly assisting firms, typically with a view to helping industry to develop and find its competitive advantage. The potential costs and benefits of such policies need to be very carefully considered and managed. Individual initiatives can vary significantly in the extent to which they create costs and distortions within the economy.

There is scope for improving both the design and the implementation of regulation. Upcoming opportunities include clarification of the Commerce Act; clarification of the regulatory regime as it applies to telecommunications and electricity sectors; and implementation of the tax simplification measures set out in *Less Taxing Tax*.

Skills and participation

Much skill development occurs in the workplace, and Government's labour market and income support policies have a strong indirect influence here. In addition, the performance of the formal education sector makes a contribution. In schooling, there is evidence that many young New Zealanders are leaving school somewhat less skilled than their international counterparts.

There is scope to improve schooling outcomes by refining governance models to improve the effectiveness of poorly performing schools, and improving information on the performance of individual students and individual schools.

Social cohesion

Predictable, consistent policies create an environment that assists decision making and contributes to growth. Such policies require broad societal acceptance. Crown–Maori relationships and retirement income policies are particularly pressing.

Another key concern is persistent disadvantage. Although there is no magic recipe, testing interventions robustly and being prepared to drop those that are not working will help deliver better results. Ensuring adequate living standards is an important policy objective. Whilst income measures suggest that living standards have generally been protected, this may not be the case for everyone. We suggest the adequacy of living standards for low-income people in different circumstances needs further attention.

Effective and innovative public sector

As the owner of commercial assets, you face strong challenges. Trading businesses, state-owned or not, do not stand still. Talented managers and staff are always looking for new opportunities. Smart owners constantly reassess their options. For example, you will soon need to decide on a proposal from TVNZ to invest in digital television.

Much progress has been made in clarifying what the public sector is providing and purchasing, and in improving its efficiency. Pushing forward with Crown entity reform will improve its accountability.

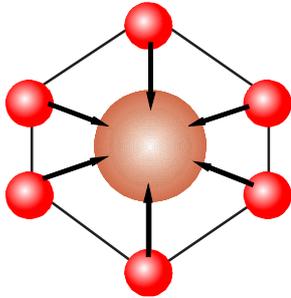
Further gains can be made by placing greater emphasis on the effectiveness of the public sector in achieving the outcomes desired by Government. This points to the need for a strong and clear system for deciding and articulating the Government's objectives and for evaluating the public sector's success in achieving them.

Strategic processes, including the Budget process, can be used to encourage Ministers and departments to take a sector-wide perspective; and to require departments to establish systems to assess and provide evidence of effectiveness of new initiatives and selected existing activities.



Dr A E Bollard
Secretary to the Treasury

TOWARDS HIGHER LIVING STANDARDS FOR NEW ZEALANDERS



Introduction

New Zealand's economic growth comes from the productive efforts of New Zealanders at home, at work, in business and in their communities. It is the result of the thousands upon thousands of choices made by individuals and firms every day.

The quality of our incomes and lifestyles is determined by the individual decisions we make: by our assessments of the costs, benefits and trade-offs involved. These assessments are partly based on economic considerations – environmental, social and political considerations are also influential.

Government's policies, actions, and words shape the environment in which these decisions are made: setting a context and tone, creating incentives and disincentives. The question for governments is how they can help to ensure that good decisions are made – within households, workplaces, public agencies and local and international communities.

In this briefing, we look at six interlinked factors we think are core to delivering strong growth and sustainably higher standards of living. We look at where New Zealand is today, and discuss some of the options and issues to be considered by government as it pursues this goal in the next three years.

New Zealand now

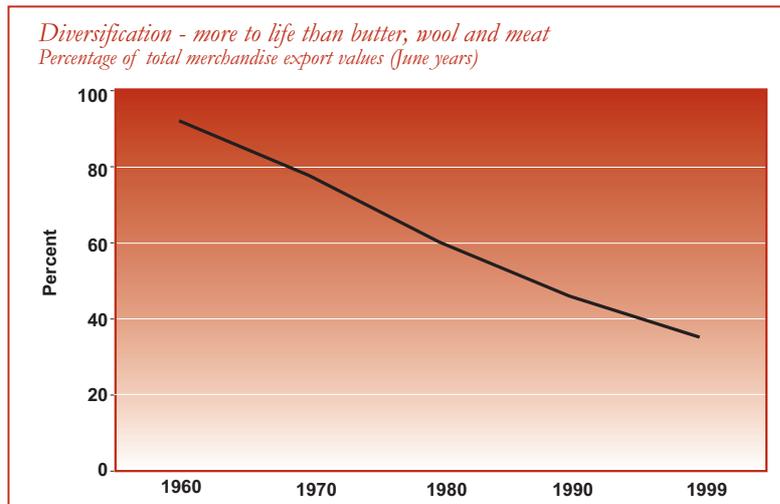
Almost 15 years after the start of comprehensive economic reform, the New Zealand economy is on a growth track that is more sustainable than in the past. Whilst growth will vary over the course of the business cycle, Treasury expects the New Zealand economy to generate long-term income growth of around 1.5 percent per worker per annum – an annual average GDP growth of 2.5 percent.

Although recent economic performance suggests New Zealand may not close the gap with the OECD average in the near future, there are a number of causes for greater optimism in the longer term. New Zealanders are increasingly better educated; firms and workers are more experienced in managing in the open economy; macroeconomic credibility has been embedded; and over time, competitive pressures should improve performance relative to other countries.

New Zealand's growth track is more sustainable than in the past

At the macro level, the resilience and adaptability of macroeconomic policy was demonstrated over the last twelve months in the face of the Asian economic crisis and two severe droughts. The economy proved sufficiently flexible to respond very quickly to those pressures, with the result that total output fell by only 1.7 percent in the first half of 1998.

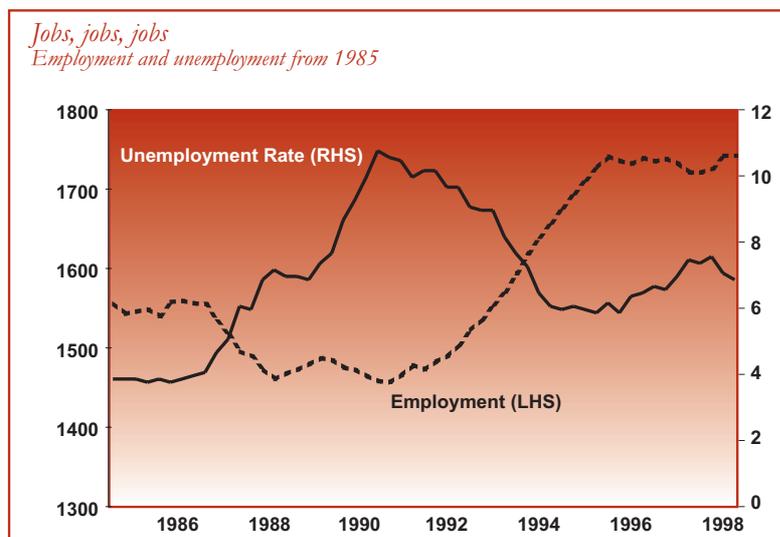
At the micro level, firms are becoming more innovative and focussed on what the customer wants. And consumers are getting the benefit of keener competition.



On the trade front, New Zealand no longer has so many eggs in one basket – there has been continued diversification in the composition and destination of our exports. A significant chunk of exporting effort will continue to be based on traditional outputs, but higher value added products and services will make up a greater proportion of the mix.

More New Zealanders are staying in the education system for longer. The number of students enrolled in formal tertiary

programmes stood at over 214,000 in July 1998, up from just over 201,000 in July 1994. Graduates in the fields of natural and applied sciences, mathematics, computing and engineering numbered 6997 in 1997 – a 95 percent increase over 1994.



While unemployment moves up and down around the business cycle, total employment has continued to grow. The 9.3 percent increase in full-time work and 23.3 percent in part-time work over the five years to December 1998 compares favourably with Australia's 8.2 percent and 22.2 percent, and the United States' 9.1 percent and 9.3 percent.

On the other hand, the (standardised) unemployment rate in New Zealand is currently 6.8 percent, which contrasts with 4.2 percent in the USA.

Financially, the government is in much better shape than 15 years ago. A sound 10-year framework has been established. Net public debt is at its lowest since the early 1980s and is forecast to fall further, to 17.8 percent of GDP by 2002/03.

The public sector balance sheet is now in much better shape, but New Zealand's high level of private sector external indebtedness and current account deficit suggests households and firms may be living beyond their means. Good financial market regulation implies that borrowing should be well founded, but borrowing and investment are based on expectations and there is a risk that these may prove optimistic.

Issues and challenges for the incoming government

The incoming government has a sound base from which to build its policy programme

The incoming government has a sound base from which to build a policy programme designed to increase living standards. That programme will be played out against a complex backdrop of issues and challenges. At the same time, there remains scope for further improving performance across a wide range of sectors.

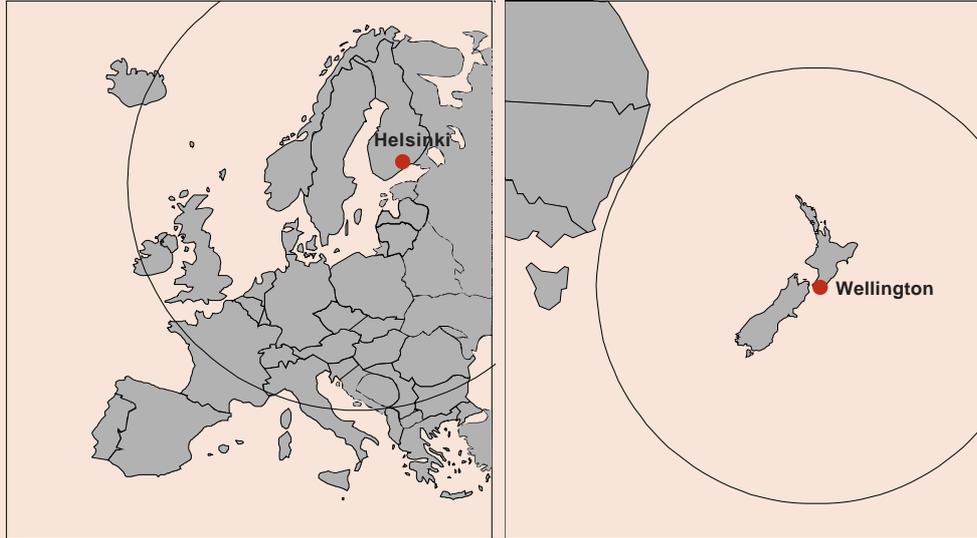
As a small, isolated, trade-dependent economy New Zealand is at a disadvantage in areas that require physical proximity to markets. We also have difficulties in areas that require economies of scale, although – as our major urban areas grow and our links with offshore markets become even stronger – these difficulties may lessen. In any case, there are opportunities in niche markets and in smaller scale production. As transport and communication costs continue to fall (the latter stimulated by growth in e-commerce) some of these disadvantages will be eased – although research suggests distance creates a trade barrier ten times greater than can be explained by transport costs alone.

Greater integration with Australia has an up and a down side

People, goods and services, firms and capital are moving across the world with an ever-increasing degree of freedom. This implies greater opportunities for New Zealand to benefit from increased exposure to international practices and tastes, and from world economic growth. Increasing mobility also implies that our economy is likely to become even more integrated with the Australian economy – giving New Zealanders more opportunities to benefit from Australia's run of economic success.

Where is everybody?

Draw a circle with a radius of 2,200 kilometres centred on Wellington and you capture within it 3.8 million New Zealanders and rather a lot of seagulls. Draw a similar circle centred on Helsinki and you capture within it a population of over 300 million, from 39 countries.



On the downside, becoming more integrated with Australia may also have implications for the location of economic activity. It is possible that more firms may wish to move to Australia to take advantage of the larger market and scope for economies of scale, meeting New Zealand demand through exports rather than domestic operations.

We are seen internationally as a good place in which to invest, to set up business and a home. It will be important to maintain that competitiveness. To retain firms requires a favourable business environment – including well designed and implemented regulations and tax laws, and access to skilled people and to capital.

Bright lights, really big cities

Economic geographers have found that big cities have more than bright lights to offer their inhabitants. Productivity is higher in large, dense cities. Wages are higher and grow faster. The flow of knowledge is greater, so there is more innovation. Human capital accumulates more rapidly. There are more opportunities for specialisation – and its attendant efficiency gains. And as a result, there is greater variety in employees and employers and in goods and services.

Young New Zealanders will continue to travel, work and study overseas. It will be important to maintain an environment (ecologically, culturally, socially and economically) to which they will want to return, bringing with them new skills, experience and contacts.

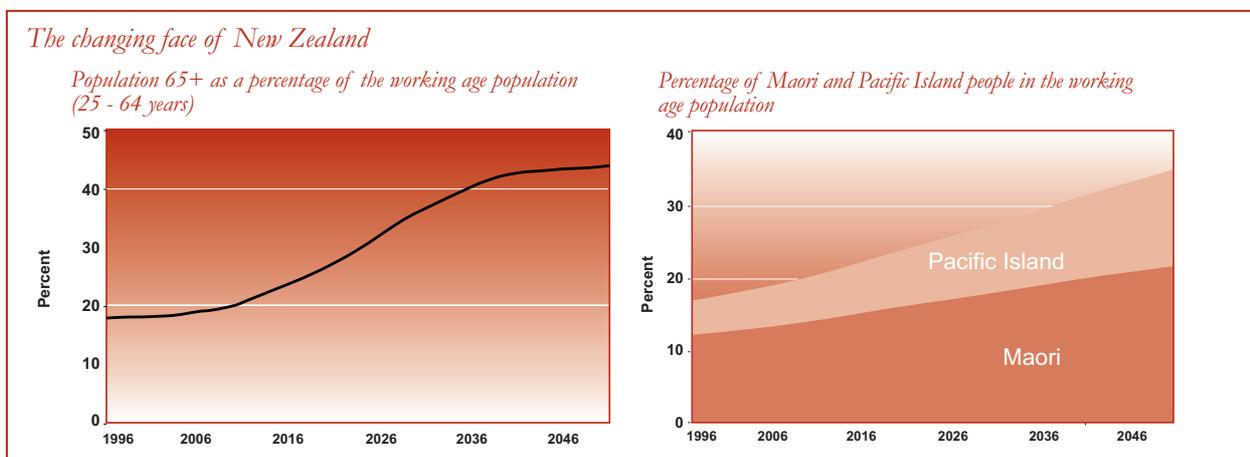
Productivity is likely to increase most in larger urban centres

It is difficult to predict where growth will occur. New Zealand's experience and new work in economic geography suggest we should expect most of it to be in urban centres. As a consequence, we can expect a continuing urban, largely northbound, drift. International evidence suggests that we should expect the biggest improvements in productivity to occur in our larger urban centres.

Growth is a dynamic process: firms and industries are born, expand and, without innovation, die. Such stories of adaptation and evolution are a natural part of the growth process. The most visible signs of this evolution are often the closures of larger plants. The start-ups and emerging enterprises are less obvious. For society as a whole, it is the improvement over time that matters.

The incoming government may face public concern about increasing income disparity. Worldwide, this trend is associated with increasing global competition and increasing returns to higher levels of skill. In New Zealand, it was also associated with the reduction of border protection and labour and product market regulation in many sectors of the economy. The consequent sharp reduction in employment opportunities in those sectors disproportionately affected low skilled groups, especially Maori.

Demographic change also poses challenges. Like all developed countries, New Zealand is experiencing population ageing. A higher proportion of the population will be in retirement, and there may be higher consumption of



health services. At the same time, this will mean more opportunities for Maori and Pacific Island people who will form an increasing proportion of new entrants to the workforce.

These issues add up to a complex set of challenges for policy development and implementation, where it will be important to retain a medium- to long-term focus. This may mean stretching the focus to a longer time frame in areas where predictability and the absence of sudden change matters most.

Perhaps the most obvious of these is retirement income, where present arrangements and/or current tax rates are unlikely to be sustainable over the long term. Adjustment is inevitable, but moving now will be smoother and less costly than moving later. Mechanisms to ensure reasonable stability are important.

Many of the problems that remain are not straightforward and may require a variety of approaches. This suggests learning what we can from overseas experience and focussing on pilot programmes and careful evaluation. Welfare and industry policies lend themselves to such an approach.

There will need to be careful attention paid to implementation and change management – partly to avoid reform fatigue but also to help build a consensus for change.

Prioritisation will be essential to ensure that the government's objectives, strategy and implementation programmes are achievable, well designed, well communicated and well executed. The government will want to establish indicators for monitoring progress against those priorities and objectives. To do otherwise is to risk an over-ambitious agenda and perceived or actual failure to deliver.

Overall, the incoming Government will need to ensure its policy programme is consistent and well integrated. Mixed messages are expensive – in terms of political credibility and public and private sector resources.

Higher living standards for New Zealanders

Understandings of what makes up higher living standards vary from person to person and over time. The sources of happiness can be far removed from the economic aggregates normally used to measure economic success.

The bundle that makes up higher living standards can include items that are not traded in markets. These include goods, services, and intangibles (such as a greater sense of security) produced by households, families, and community groups, at the local, national and even international level.

Paying careful attention to change management will help build a consensus for change

Understandings of higher living standards are based on market and non-market considerations

Higher living standards are built on long-term growth in production and incomes

This bundle may include our enjoyment of our physical environment, pride in New Zealand's stance on a foreign policy issue or pride in New Zealand culture and achievements. And it may also include a degree of altruism – we may value making provision for other groups of New Zealanders, or for future generations, that we will not directly share in.

That said, a large portion of what matters to individuals and families has to be paid for. Whatever mix of outcomes New Zealanders choose, long-term growth in production and incomes is the foundation upon which higher living standards are built.

The causes of growth have been the subject of much recent study and theorising. Even so, economists' understanding of what generates growth is far from complete. Studies have tended to focus on identifying factors that explain differences in rates of growth internationally.

Growth – what's behind the numbers

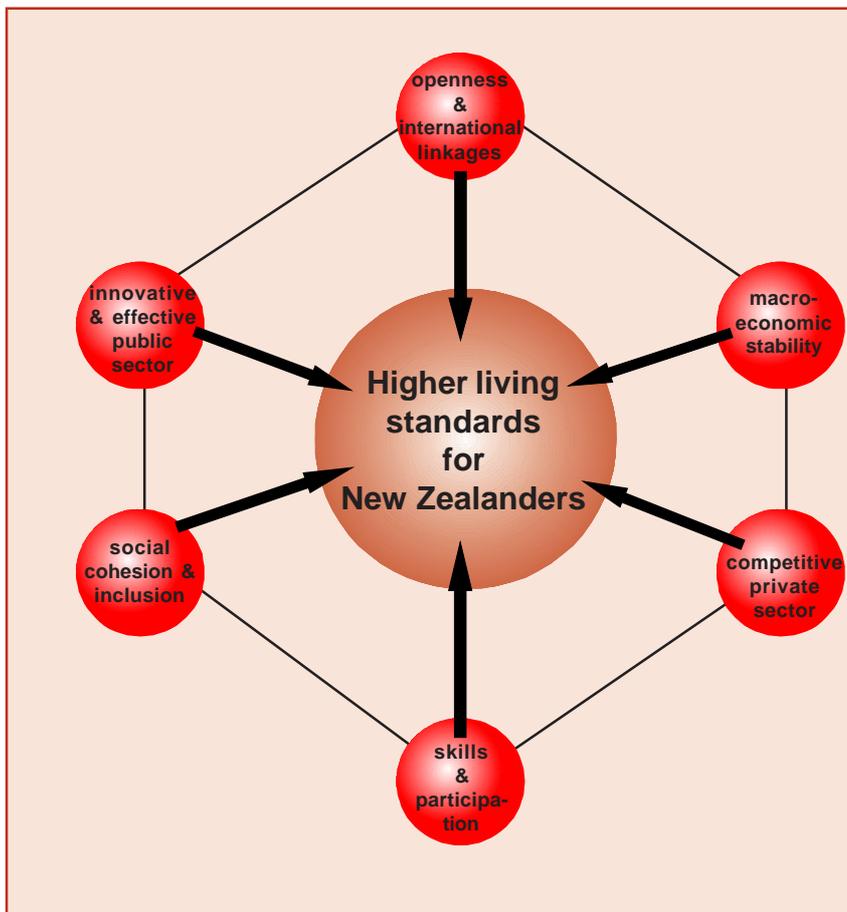
Research into the determinants of long-term rates of growth tend to emphasise the following key factors:

- if a country started with a high initial level of income back in the 1960s (when the studies began) it grew less quickly; i.e., growth is quicker the further behind the country is and the larger the potential for catch-up
- openness has a positive effect by promoting exposure to competition, improved transfer of technology, and access to growing markets (this effect may take time to flow through)
- rapid population growth and high fertility rates tend to have a negative effect, diluting the per capita growth
- increasing savings and investment has a positive effect
- human capital, usually measured by participation in schooling, has a positive effect on growth rates
- technology and innovation are positive
- an economy focussed on primary production typically does not grow as fast
- institutions matter – especially those that provide for the security of property rights and respect for law, and provide an environment for innovation and intellectual property development. Other cultural factors matter too
- geographical factors and economy of scale effects are important
- macroeconomic conditions – low inflation has a positive effect
- a high government share of output is unhelpful to growth. Within the moderate range, the size of government in the economy is not closely associated with growth (although the effectiveness of spending clearly matters).

Many of these factors help explain New Zealand's modest growth performance from the 1960s through to the 1990s.

Governments can often only indirectly or slowly influence some of the factors that will raise long-term rates of growth. Many factors, such as geographical position, remain rather more resistant to government influence. These growth studies and New Zealand's recent performance suggest six elements that should be at the heart of government policy. These are:

- openness and international linkages
- macroeconomic stability
- competitive private sector
- skills and participation
- social cohesion and inclusion
- innovative and effective public sector.



These elements support and reinforce the goal of higher living standards and growth. The relationship between them and the goal is complex, the interlinkages multifarious. Good performance in each area will enhance performance in others. Poor performance in one area may undermine performance across the board. Together they encapsulate the key attributes of an economy that fosters long-term sustainable growth, and provide a standard against which the Government can assess its policy strategy.

A stable macroeconomic environment makes it more likely that New Zealand will reap the full benefits of micro-economic reform. Cohesion and trust are essential if the legal and regulatory frameworks governing the private sector are to work. A strongly performing private sector and a skilled workforce are necessary if we are to improve social outcomes.

*Good performance in one area
will enhance performance
across the board*

Better public sector performance can help the Government meet its fiscal objectives as well as delivering good quality public services.

Economic openness encourages a strong private sector but must, if it is to be seen as providing opportunities rather than threats, be accompanied by cohesion and trust.

Even declining inflationary expectations (a core achievement over the last decade) can be seen as an expression of trust in the stability and predictability of the macroeconomic environment.

Government interventions can have wide-ranging and unintended consequences, affecting performance across the board. As the Government considers policy change in one area it will be important to ask how this change or intervention affects performance in other areas.

In the following sections, we look at each of the above elements in turn. These sections identify current performance and the forthcoming policy issues that are likely to strongly influence performance in each area, and suggest ways of sustaining and strengthening growth.