Positioning New Zealand for a Post-recession World

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Good morning

I hope you have all had your fill of the fine breakfast kindly provided here today. And I'm sure that most of you, like me, have well and truly had your fill of gloomy economic news that the world has dished up on our plates.

At a time when economic conditions are the toughest they've been for generations, I'd like to focus today on what New Zealand can do to change things for the better. This is a moment of incredible challenges for our country, but also of incredible opportunities. I want to talk about positioning New Zealand for a post-recession world, about how we can come out of this recession stronger than the countries with which we compare ourselves.

Setting ourselves up for success will require us to take steps that lift our productivity and economic growth. We need to have institutions and policies that are not just good, but are world best practice. So what are the sorts of ideas Treasury will be putting to the Government in the period ahead? Actually, there's a long list of possible policies, which do need to be part of an integrated package, so I'll confine myself this morning to four areas of particular significance for growth that deserve attention now – public sector performance, better connecting New Zealand to the world economy, and increasing the attractiveness and competitiveness of our tax and regulatory systems. I'll also argue that when you are facing the worst of times, it can be the best of times to start taking action.

Current economic environment

Before I get into detail about positioning New Zealand for the future, let me start by touching briefly on the position we are in now. Last week's Budget was delivered in one of the most challenging economic environments New Zealand has faced since Michael Joseph Savage was Prime Minister and Walter Nash was preparing the books.

No surprise then that the Budget highlighted some stark changes from recent years. The government faces its first operating deficits in 15 years, and these are projected to last until 2016. Crown debt is increasing to fill the gap between lower tax revenue and higher expenses. Until very recently, economic and fiscal conditions have been surprising on the downside. The fact is there is still considerable volatility and uncertainty to contend with. While stability will return at some point, the big unknown is when.

What is clear is that there are very tight fiscal constraints for the medium term and little room for further fiscal stimulus. It is also clear that we need to extract better value and performance from the state's assets and services.

Deterioration in the Crown fiscal position is hard enough to address on its own, but it also creates other risks and pressures. New Zealand's large current account deficit and high external indebtedness mean we are very exposed to further global financial shocks. Notwithstanding last week's Budget, international investors and credit rating agencies will continue to keep a watchful eye on us, and we need to maintain New Zealand's rating and market credibility if we are to avoid significantly higher credit costs or lower investment.

Many of you here will be involved with companies facing quite enough vulnerability as it is. The financial crisis is landing a number of blows on the real economy, including dropping international demand and confidence, weaker export markets, higher unemployment and lower corporate profits.

The need for productivity growth

This is a situation we all want to make our way out of as soon as we can, but we should also think about how we can make our way out of it as well as we can. A critical part of New Zealand's recovery programme will be bringing public accounts back into surplus as a matter of urgency. What is equally important is to ensure that over the coming years, our economy undergoes the adjustment and rebalancing it needs, with a strong focus on productivity and competitiveness. Now is the time to drive changes that will position New Zealand to come out of the recession stronger and better able to generate higher living standards.

Boosting productivity should be at heart of New Zealand's growth strategy. On average, and despite a slower rate of productivity growth in Australia in recent years, an hour worked in New Zealand still produces approximately 30% less output than an hour worked in Australia and indeed 40% less than an hour worked in the United States. If we aspire to the same standards of living, healthcare and education, we will need a significant increase in our productivity to close the gap between us and the Australians and Americans.

If you compare our fiscal performance with our productivity performance, the contrast is striking. New Zealand is a very respectable 4th in the OECD for net debt but we are languishing as the 22nd ranked country for productivity.

The Treasury has been criticised for saying that as a country we do not save enough. I make no apology for that statement: it reflects the fact that we spend more than we earn, in fact at the moment about $1.09 for $1 of income. So how do we deal to that? Let me suggest two main ways.

New Zealanders like to invest in New Zealand. At the moment, we save disproportionately in housing. I believe we would save more if we had more and better opportunities for investment in New Zealand. The second way is related. We can raise our income as a country, if we shift over time the balance of resources going into the tradeables and non-tradeables sectors: we'll be more productive if more of our activity is in the exporting and import-competing areas.

Both of these ideas are about raising productivity. The Treasury gives considerable thought to the complex challenge of productivity. Taking a broad perspective, we view productivity growth in terms of five interlinked drivers, all of which have a part to play in providing the conditions to enable firms to thrive. These drivers are enterprise, innovation, skills, investment and natural resources.

Enterprise is about seeing a market opportunity and making it happen. Innovation is about developing or coming across a new idea or way of doing things and putting it into practice. The skills driver is about having the right people who can create or identify these ideas and make them work. Investment is about putting money into bricks, mortar and steel - or these days ICT. And natural resource management is about ensuring the clean water, fertile land, and climate is used sustainably - now and into the future. For those of you who are interested, the Treasury has published in-depth papers on each of these productivity drivers on our website.

Fundamentally, these drivers are about making New Zealand a compelling place to locate and do business and an attractive place for skilled workers to apply their skills. There's global competition for these factors and given our remoteness and size, we have to do better than most to win our share.

If we look at how well these drivers are functioning in New Zealand, the picture is a bit patchy. Our enterprise performance is rather mixed, and our innovation performance suffers from the low level of research and development undertaken by New Zealand firms and poor rates of commercialisation of some of the good research the country does produce. It's a better story for skills. Overall, skill levels in New Zealand are improving, but we have a long tail of underachievement. We have a lot of room for improvement in the investment area, given New Zealand's low levels of capital per worker. And for natural resources, fresh water is under increasing pressure in regions where the resource is shrinking but the competing demands are growing.

What matters in each of these productivity drivers are the key barriers and incentives that affect decisions individuals and firms make. Thinking about the drivers in a New Zealand context, two specific factors leap to mind.

First, we are a small country far from the world's major hubs of economic activity, and plate tectonics won't be doing us any favours on this front any time soon. Work by the OECD estimates New Zealand's distance from markets lowers GDP per person by around 10% through trade costs, distance from sources of knowledge, reduced competition and other factors. Our small population further restricts competition in the domestic market and makes it hard for firms to achieve economies of scale.

The second factor is that New Zealand is unusual for our reliance on commodities, particularly in our export base. This creates some challenges, not least of which are high levels of trade barriers and subsidies. We only need to look at the subsidies for American dairy farmers announced last week to see evidence of that. Our reliance on commodities also means we face stiff competition abroad and rising pressures on key natural resource inputs at home.

How and when should we respond?

I suppose in talking about some of these long-standing constraints on growth I'm stating the obvious: things aren't perfect. They never have been, they never will be, and we can't expect them to be. But we can expect things to be better than they are now – as long as we are committed to making the right changes. We have a lot of influence on our own destiny.

A recent economic survey by the OECD posed the challenge to New Zealand to "create advantages" – in other words, set up policies that are "attractive and welcoming enough to overcome the geographic handicap and attract the drivers of prosperity – investment, skills and ideas – to New Zealand."

I believe we are up to the challenge. Overcoming the hurdle of geography and lifting productivity are not impossible tasks. They can be done. But they require New Zealand to set and achieve some high standards. In short, if we are to improve our economic performance and living standards significantly, we need to have institutions and policies in place across a wide range of areas that are not just good, but up with the best in the world.

Our judgement is that many of New Zealand's current policy settings will not deliver the performance we need. I don't have time today to discuss them all, but one area I should touch on very briefly is the public sector and its role in a growth strategy.

Taking resources out of the private sector to fund public services can create value – it may come as a shock that not everybody in the Treasury believes in leaving everything to the market! But it does come at a cost, and this cost rises the more you take out. This means we should set a very high threshold for additional public spending, if we want to provide both social benefits and sustainable economic performance. Otherwise, poor value and excessive spending acts as a tax on the competitiveness of the tradeables sector.

Unfortunately, the high rates of growth in public expenditure over recent years suggest that we have failed to reach that threshold. There are also grounds for thinking that fiscal policy has not supported the international competitiveness of the tradable sector over the past few years.

If we are serious about growth, we need to move from an environment in which you need to present a strong case to **prevent** further spending, to one which requires powerful evidence to **justify** further spending. Put simply, we need to shift the onus of proof and focus government spending where the benefits are greatest – that's true for existing, as well as new, government expenditure. And, of course, delivering better services for less applies to SOEs as well, where the earnings rate has been far from stellar.

Supportive fiscal policies and high value for money in public spending must be part of an integrated package of policy responses for boosting New Zealand's productivity. But that's a speech for another day. What I want to devote the rest of my time on this morning is three pervasive areas that have significant impacts on the quality and attractiveness of the business environment. They are also three areas where we require urgent action – as part of that integrated package of policies - to start us on the path to higher productivity and greater competitiveness coming out of the recession. These areas are New Zealand's international connectedness, our tax regime and our regulatory regime.

International environment

My earlier comments about the impact of New Zealand's geographical isolation were just one example of the importance of the international environment for our economic well-being. Our connections to the world matter for a number of reasons. Global links provide access to key economic resources, and they allow firms to specialise and achieve economies of scale by expanding into larger markets. New Zealand firms benefit too through access to new ideas, processes and technologies that add value to our goods and services. And global links promote stronger competition in our domestic market, increasing incentives for local firms to innovate, invest and move resources to areas where they have an edge. Adding value is as or more important to boosting productivity as cutting costs. Connecting well globally helps both, but especially the former.

On one hand, New Zealand is relatively open to the world. We have very few barriers at the border when it comes to international business. On the other hand, we are still only moderately well connected to the world economy. It's a bit like leaving your front door open, but not making enough effort to be on great terms with the neighbours.

Now is the time to really start making that effort. The current financial crisis has demonstrated how crucial international links are to us – especially in light of the sudden tightening of credit, and the temptation of many countries to dress the wolf of protectionist measures in the sheep's clothing of fiscal stimulus.

The crisis is also likely to lead to huge changes to the world economic system. Around the world, capital and skilled people are responding to deteriorating local economic circumstances and searching out better returns elsewhere. Just ask Dubai, where there have towed 3,000 abandoned cars out of the international airport car park as skilled ex-pats have left the country. New Zealand has the second highest proclivity to migrate with changing economic conditions in the OECD. Put simply, our ability to retain and attract skills rests on how well our economy is doing. This presents both a challenge and an opportunity. New Zealand needs to be at the forefront of developments in the world economic system, and able to make the most of opportunities.

Both the Treasury and the OECD have done work that points to possible ways forward on international connections that will make opportunities easier to grasp.

The first salient point from this work is that we have underestimated the importance of people flows for growth. New Zealand relies heavily on these flows, not just to meet our labour needs but also for the exchange of ideas and innovation. All of our population growth, and half of our employment growth, between 1996 and 2006 was due to inward migration. And we have one of the highest rates of foreign-born residents in the OECD – almost one in four people living in New Zealand.

The Treasury thinks there is scope to make much more of the advantages that can come from the movement of people both in and out of New Zealand. We could look at ways of shifting incentives, so that people sometimes study overseas and then come home, rather than the other way around. We could also enhance knowledge flows and innovation through stronger student and researcher exchanges. And we could do more to better integrate migrants, so that we can make the most of the skills, knowledge and connections they bring with them.

The other pertinent finding from our work reinforces the point I made earlier: we think of New Zealand as an open country, but in some indicators we still lag other countries. Effective changes that could be put on the table include reducing the costs of Customs processes, removing all remaining tariffs, and lowering or even removing investment screening on all but the most sensitive of items. None of these on its own is a big hit, but they would add to the perception abroad that New Zealand is open for business. Never underestimate the importance of the signals we give.

Tax environment

That brings me to the second key area that has a significant impact on the attractiveness of New Zealand's business environment: taxation.

As I've noted, firms' decisions on where to invest or people's decisions on where to locate increasingly span international borders. This international competition for labour, capital and goods means that our tax system can't be allowed to get too far out of line with other economies. Ideally it should be better, because a middle-of-the-road, generic tax environment won't have the pulling power for the people, businesses and investment that we want.

Meaningful tax reform is not an easy undertaking, and it's harder in times of fiscal stringency. Nevertheless, there are several pressing reasons why the Treasury believes the time to take action is now.

Without changes to the tax system, there is a real risk that the government's revenue base will be unsustainable in the medium term, given growing competition for production factors and an aging population. More broadly, the tax system as it is currently structured does not seem fit for growth.

The mobility of production factors – especially skills and capital – is of particular relevance to New Zealand's tax system and economy. New Zealand has one of the most internationally mobile labour forces in the OECD, and we have very high demand for inward investment. Our tax system should be encouraging investment to keep coming here and skilled people to keep staying here.

Unfortunately that doesn't appear to be the case at the moment. A key priority has to be reducing effective marginal tax rates and increasing the rewards for effort. There is a growing view that the high mobility of our skills base means high personal income taxes are especially harmful for New Zealand's growth and productivity.

There is also growing evidence that productivity is being held back by high corporate tax rates. New Zealand's company tax rates are at the upper end of the scale by the standards of the OECD and other open, small economies. With average OECD rates trending down, keeping our corporate tax rates competitive will be a priority. The pressure on us will be even stronger if the review of Australia's tax system currently underway leads to further company tax cuts across the Tasman.

Another major component of a tax reform strategy should be shifting investment incentives, by taxing returns to capital in a more even-handed way. And at the risk of being chased down by an angry crowd with pitchforks and flaming torches, yes this should include consideration of moving the boundaries to tax more capital gains – for example on investment property - and shifting more of the tax base towards consumption.

I know there is a lot of passionate debate on this matter, but capital gains or property taxes would be beneficial for encouraging investment in productive activity. A more complete capital income tax base reduces the impact of tax distortions on investment decisions, thereby improving the allocation of capital in the economy. It also improves fairness, and provides revenues that can be used to reduce overall income tax rates. Greater reliance on consumption tax – aligned with reduced income and corporate tax rates – should help strengthen incentives for savings.

If we look at this at a high level, shifting from a system that relies heavily on income and corporate tax towards one that is weighted more towards taxing consumption – and bringing untaxed, or under-taxed, income-earning activity into the tax net – such a shift would better support higher productivity and growth. It would help address the sustainability challenges and tensions, where governments will increasingly grapple with competitive pressures to reduce taxes and demographic spending pressures to increase them. It would also help reduce our vulnerability to overseas events by reducing the pressure on the current account and thus external indebtedness.

To be sure, such a shift would involve imposing challenges. But now, when hopefully we are at the bottom of the business cycle, is the most propitious time to make these changes.

Regulatory environment

The third big area where we need to take action is the regulatory environment.

Some may question why there is any need for urgent steps on regulation. New Zealand has a good track record in scoring well in international measures like the World Bank's Ease of Doing Business Survey, and we continue to rate comparatively well in these indices.

However, our relative position and advantage have declined recently.

Other countries have improved the quality of their regulation, while we haven't made similar gains to ensure we stay with the leaders rather than slip back among the also-rans. As I've argued before, our particular circumstances make it important to be best practice.

Having a high-quality regulatory environment should be an enduring policy objective. Those of you here today will know more than most that regulations affect firm and individual behaviour, and shape their incentives to compete, invest in new capital, develop skills, take risks, and add value to their products and services. Labour market regulation, for example, affects all these incentives.

When we are in the midst of a financial crisis, the quality of the regulatory environment takes on even greater importance. With the era of cheap credit over and higher levels of risk aversion from investors, New Zealand will need to work much harder to attract foreign direct investment. After all, if you are an investor in Europe and have opportunities just across your border where you can easily monitor performance, why would you look at New Zealand? It makes as much sense as being hungry on Willis Street and driving all the way to the Hutt Valley for just a burger. The fact is that our regulatory system must be better than good to attract investment, so having a system that is clearly ahead of the pack will be a crucial part of our growth strategy.

We are already seeing things starting to move on this front. The government has recently commenced a major process of reviewing significant pieces of legislation such as the Overseas Investment Act, the Building Act, and the Resource Management Act, with the aim of removing barriers and improving productivity. Steps are also being taken within government to improve the process of developing regulation.

There is scope to make even more fundamental changes right now. There are still strong incentives within the wider political system for regulation. In the absence of fiscal surpluses, politicians may face stronger pressures to regulate –responding to the old familiar catch-cry of “the government should do something about it”. That’s a tough impulse to turn around. The questions we face are: how to provide counter-incentives? How do we bring about a culture of continuous review and improvement? And how do we shift the responsibility so that the onus of proof rests on the proponents of new regulation to prove the value of the changes they are suggesting? A long and arduous journey in our British and European heritages should emphasise for us the importance of respecting property rights, and our recent treatment of Maori post-Treaty should reinforce that with a vengeance.

One approach is to strengthen our institutional arrangements around regulations. For example, we could create independent entities to assess policies and regulations, including their costs and benefits. This is one of the roles the Productivity Commission plays in Australia. We could also introduce statutory checks and balances on the nature and quality of regulation. A taskforce is currently looking at the best way to take forward a Regulatory Responsibility Bill. Another example where it makes sense would be to pursue close harmonisation or mutual recognition between our regulatory system and those of our major trading partners, particularly in the Asia-Pacific region. That would certainly help smooth the path of international trade and investment.

Taking the debate forward

To sum things up, the main message I want to get across today is that New Zealand has an opportunity to do things better – to differentiate ourselves in a positive way from our international comparators.

We are confronted by one of the most challenging economic environments in over 60 years, and facing up to that challenge requires significant adjustment and change. And actually our history proves we can be quite good at that. It is important not just to tackle the immediate fiscal and economic pressures, but also position New Zealand to come out of this recession stronger than countries with which we compare ourselves. Part of this involves overcoming long-standing and New Zealand-specific constraints on growth. In overcoming these constraints, we need to create advantages that foster our productivity and competitiveness. That's not easy, but major shifts and moving outside of traditional comfort zones never is. For all the big obstacles the current crisis has put in our way, I believe it has opened up even bigger opportunities. Opportunities to do things better in the public sector, in the international environment, in the tax environment, and in the regulatory environment. The time to grab these opportunities is now.

Finally, and maybe most importantly, the wider community needs to be involved in the process of debating and making these choices. These are, in a very real sense, choices about the economic strength of New Zealand and the future well-being of New Zealanders. That debate should be thoughtful and not knee-jerk. That's something we all have an interest in. The future could be very exciting.

There's no time like the present to get the discussion started, so I'd be happy to take your questions.