2025 TASKFORCE REPORT 2: FOCUSING ON GROWTH

QUESTIONS AND ANSWERS

General policy questions

Q: What's new in this report? How has your thinking evolved?

This second report more fully articulates the context for the recommendations in last year's report and outlines the case for reform in more detail. It looks more deeply into what a "focus on growth" means, and identifies seven key areas where serious progress is needed if we are serious about closing the gap.

The report also:

- updates New Zealand's productivity statistics and growth projections using the latest data;
- outlines lessons from the latest literature on economic growth and innovation;
- assesses the impact of economic geography on New Zealand's growth;
- examines the case for 'smart active government'; and
- highlights the importance of reducing the large structural fiscal deficits.

Q: Has the income gap with Australia widened or closed? What explains the change over the last year? How should this be interpreted?

In our first report, we noted that real GDP per capita in 2008 was 35 percent higher in Australia than in New Zealand based on OECD data. Over recent years, the New Zealand economy has experienced a recession, and grown only slowly coming out of it, whereas the Australian economy has continued to grow. The OECD is projecting the gap to widen to 42 percent by 2025 – this is in line with other forecasters. As a result, we do not see any realistic possibility that the gap in real per capita income has narrowed in the past year.

Year to year fluctuations in the income gap have occurred and will continue to occur. All sorts of factors affect these annual fluctuations, and only some will reflect anything about the relative strengths of the policy frameworks in the two countries. For this reason, in terms of things like the 2025 goal changes in the income gap are most meaningfully interpreted over the medium term.

Q: Is New Zealand on track to close the per capita GDP gap with Australia by 2025? If we do nothing significantly different, are we on track to maintain our relative income position versus Australia?

We do not think the gap will narrow based on current policy settings. In fact, there is a significant risk that it may widen over the years ahead. Based on OECD projections, on current policy settings, the gap in terms of GDP per capita is projected to increase to 42 percent by 2025 (from 35 percent in 2008).

Q: What does the current income gap, and the projected increase in the gap, mean for New Zealanders?

It means that those living in New Zealand cannot afford the same standard of living – quality housing, education, medical care, infrastructure, etc. – as in Australia. It means that to earn the same, New Zealanders would have to work many more hours. It therefore affects the incentives for New Zealanders to either stay in New Zealand or move to Australia. If the gap continues to widen, we estimate that a net 412,000 New Zealanders could leave New Zealand for Australia over the next 15 years.

Q: Is it realistic that New Zealand could catch up with Australia by 2025 in terms of GDP per capita?

There is no reason why we cannot catch up. New Zealand has most of the advantages and disadvantages that Australia has – both have basically sound economic and social institutions, abundant natural resources, hard working, creative and increasingly well-educated people, and both countries are small by global standards and similarly distant from their major markets.

Many of the policies we need to adopt are already in place in Australia and other developed economies. To grow much faster than Australia, which is forecast to achieve relatively strong growth to 2025, our policies will need to be among the best in the world. We can choose to adopt such policies – the choice is ours.

Q: What would be required for New Zealand to catch Australia in terms of GDP per capita?

New Zealand needs to grow slightly more than two percent per capita per annum faster than Australia. Achieving this requires:

- Unwavering focus on pro-growth policies. Strong political leadership is needed to ensure a consistent policy focus on creating the environment in which the private sector can thrive, driving productivity, sustainable employment creation and growth.

- A major lift in labour productivity (output per worker). Increases in labour productivity, and the private capital investment associated with it, are strongly influenced by policy choices. All policy decisions should be made with this focus on productivity in mind.

To catch Australia, the Taskforce considers that the seven key areas to focus on are:

- reducing government spending and tax;
- reviewing the boundary between the private and public sectors;
- more robust and transparent analysis of infrastructure proposals;
- creating an environment where firms <u>want</u> to invest more in R & D
- remove unnecessary regulatory barriers to private sector investment;
- welcoming foreign investors on the same terms as domestic investors;
- creating world-leading institutions to strengthen the durability of good policy.

Q: What explains New Zealand's income gap with Australia? What about those reasons posed by others to explain the gap such as New Zealand's size and distance from other markets and Australia's mineral resources – why does the Taskforce reject these?

There is no definitive evidence that explains the evolution of the gap fully satisfactorily. The Taskforce has looked carefully at all the plausible explanations and concluded that poor policy choices by successive governments are the primary cause.

European Union: In the 1960s and early 1970s, Australia had its first mineral boom, sparked initially by the Australian Government's decision to remove export controls on coal. At the same time, New Zealand's terms of trade fell sharply in the late 1960s and again in the mid 1970s, coupled with the reduction of our biggest export market when the United Kingdom entered the EEC, hit New Zealand hard. These two events occurred within a few years of each other , and contributed substantially to the gap opening up.

Reforms: The policy reforms in the 1980s and early 1990s helped New Zealand gain back some ground, slowing the overall rate of decline relative to other countries. New Zealand achieved strong productivity gains relative to Australia following the economic reforms of the 1980s, especially in those sectors most open to competition. But since 1995 New Zealand has fallen behind as Australia has continued to reform its economic policies and institutions while New Zealand has taken a breather. Since around 1990, New Zealand's per capita growth rates have matched those of the average OECD country, but have still lagged a little behind those of Australia.

Size and distance: In a global context, Australia is similarly disadvantaged by its small size and distance from major markets like New Zealand, so size and distance from markets cannot explain Australia's superior performance. By the same token, size and distance also need not be obstacles to closing the gap – if Australia can do it, so can we.

Commodities: Some people claim that our commodity-centred economy is to blame. The evidence does not support this: commodity products are an unusually high proportion of exports in both New Zealand and Australia. New Zealand's terms of trade have improved quite steadily since the mid 1980s, following a very similar pattern to those in Australia until the last 5 years or so, so differences in the terms of trade cannot explain the gap.

Minerals: In contrast to many popular views about Australia's advantages, New Zealand is relatively well endowed with natural resources – on a per-capita basis perhaps better endowed than Australia. Many high-income countries have much smaller mineral resources than New Zealand, e.g. Singapore, Taiwan, Japan, Denmark, Ireland, and Austria. The Taskforce's view, having looked into this, is that the claims that minerals have made the difference are exaggerated.

Chapter 4 of this year's report discusses this in more detail.

Q: How much of the relative economic performance of the two nations has been driven by changes in relative terms of trade and net migration patterns, rather than by government policies on both sides of the Tasman?

Australia's and New Zealand's terms of trade tracked together until 2003 (see chart below) – so terms of trade wouldn't appear to explain the gap, which opened up largely prior to 2003. Net migration is more a reflection of economic performance rather than a driver – if our economic performance improves relative to Australia, we would expect the net outward migration flow of New Zealanders to reduce.

Q: Is action required across all the policy fronts identified in the Taskforce's report in order to narrow the income gap? Are some recommendations more critical than others – and if so, which ones?

The Taskforce believes that to catch Australia, New Zealand will need to have a growth-friendly policy environment that is second to none – and that this is perfectly realistic. We don't say that progress is needed instantly in all seven of the key areas that we have identified – that is not realistic. But we do consider that significant progress in <u>all</u> these areas will be needed if we are to catch up, and that we need to start now.

Q What role does the exchange rate play in the story?

A high real exchange rate is often a feature of a successful and high-performing economy. In an economy experiencing consistently rapid productivity growth, a rising real exchange rate is how the fruits of economic success are distributed round the economy. Over recent decades, New Zealand's productivity performance has been quite poor, reflected in the wide gap that has opened up between our incomes and those of other advanced countries since the 1970s. Economic literature and international experience suggest that we should have expected to see a falling real exchange rate, as part of the mechanism by which New Zealand adjusted to that decline, and rebalanced (making consumption relatively less attractive and production relatively more attractive) to help reverse the decline. That has not happened (see chart below). In the last few years, the shift back to large fiscal deficits has exacerbated this imbalance.

The sorts of reforms proposed by the Taskforce are designed to improve the overall competitiveness of doing business in New Zealand. If successfully implemented, they could be expect to close the gap between the real exchange rate and our relative economic performance.

Real exchange rate behaviour over periods of decades has nothing to do with how, say, monetary policy is conducted. Monetary policy has a decisive effect on the nominal exchange rate, and can affect the real exchange rate for periods of up to a few years, but longer-term trends in the real exchange rate reflects real economic factors only.

Q: Did the Taskforce consider options for better managing New Zealand's exchange rate?

Yes. In our first report, we looked at a variety of options that submitters and others think could achieve a less variable exchange rate. Some – notably a Singapore-style managed rate – would simply not work in New Zealand. Others – notably currency union with Australia or the United States – could generate some gains but would also come with very substantial risks of the sort apparent in Europe. On balance the Taskforce thinks that at this stage they are not worth the cost. Data suggest that the exchange rate is probably not materially more variable than the exchange rates of many other advanced economies.

<u>Administrative questions</u>

Q: What is the total budget of the 2025 Taskforce?

$477,000 from establishment in 2009 to June 2012 (excluding GST).

Q: How much has been spent on this year's report?

The budget for this year's report is $164,000 (excluding GST). We are on track to spend around that amount on this year's report.

Q: When was the Taskforce established and how often has it met?

The Taskforce was announced on 21 July 2009. For last year's report, the Taskforce met 11 times (between 7 September and 23 November 2009). For this year's report, the Taskforce has met a further 10 times.

Process questions

Q: How were decisions made by the Taskforce regarding policy recommendations? Was it all by consensus after discussion, or were there occasions when a vote had to be taken?

The report represents the collective view of the Taskforce – no votes were taken.

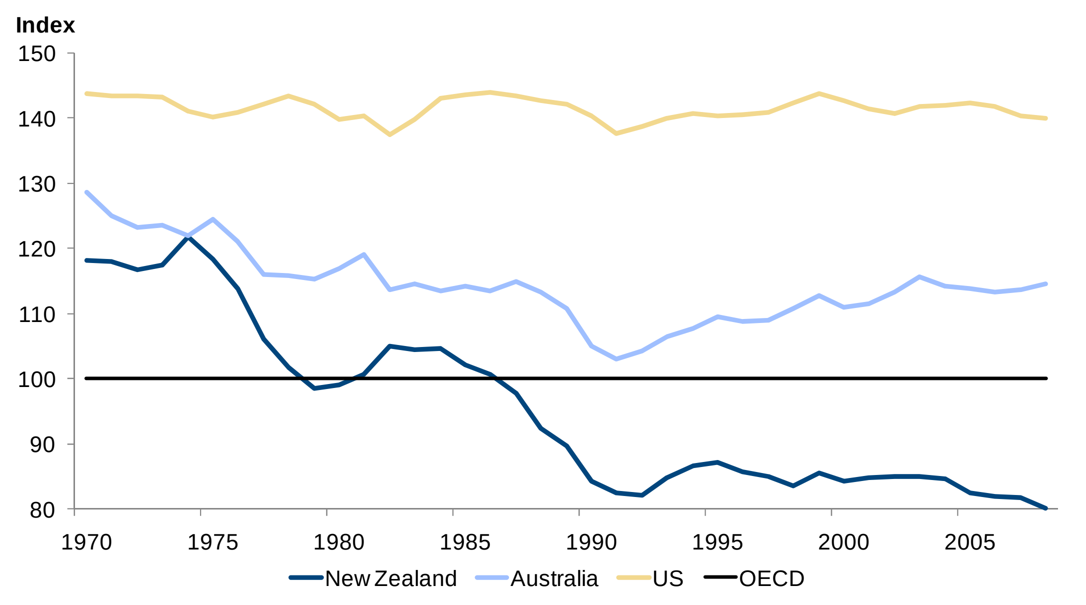
Q: Will the Taskforce issue further reports?

The Taskforce was established in 2009 for a period of three years. This is the Taskforce's second report (in its second year). The Taskforce is required by its Terms of Reference to report again next year (by the end of October 2011).

For your information: Key charts

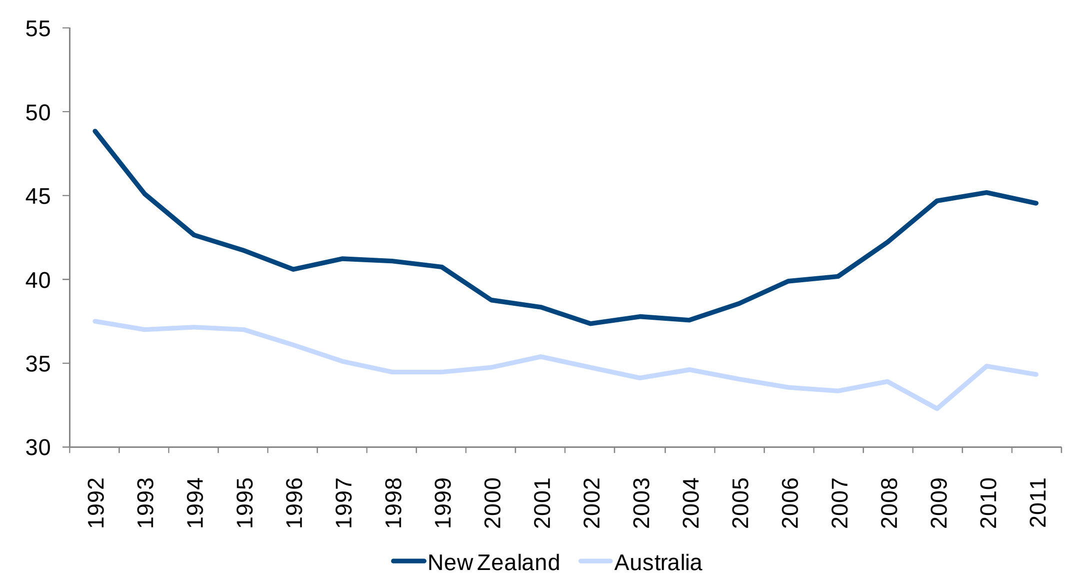
A selection of key charts in the report is reproduced below (figure references are included to indicate the location of charts in the report):

Figure 1: GDP per capita relative to the OECD, 1970 - 2008



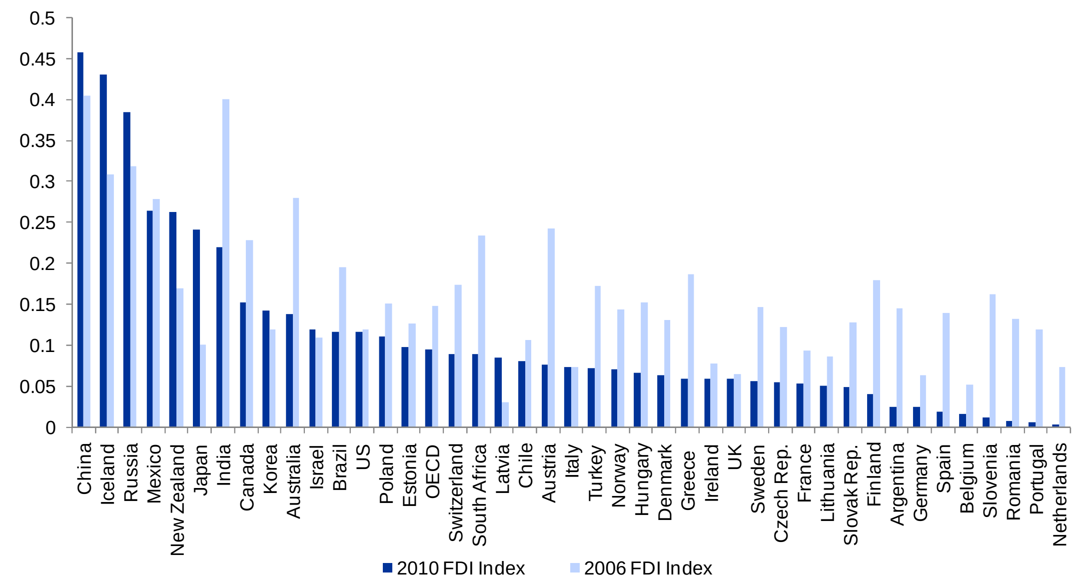
Source: OECD, OECD = 100, current prices and PPPs

Figure 2: General government outlays (percent of GDP)



Source: OECD

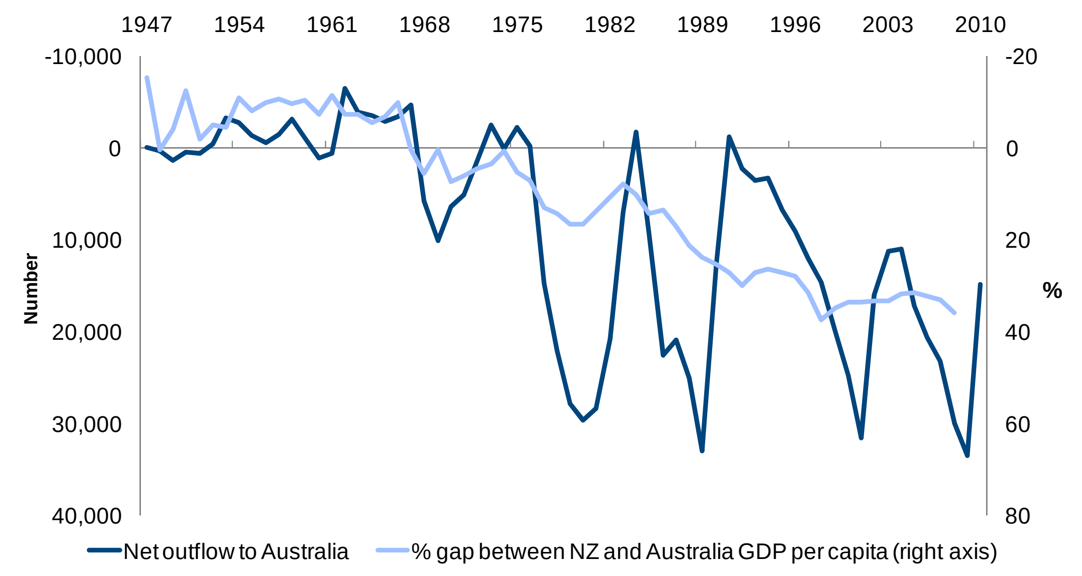
Figure 3: Index of FDI restrictiveness by country, 2006 and 2010



Source: OECD

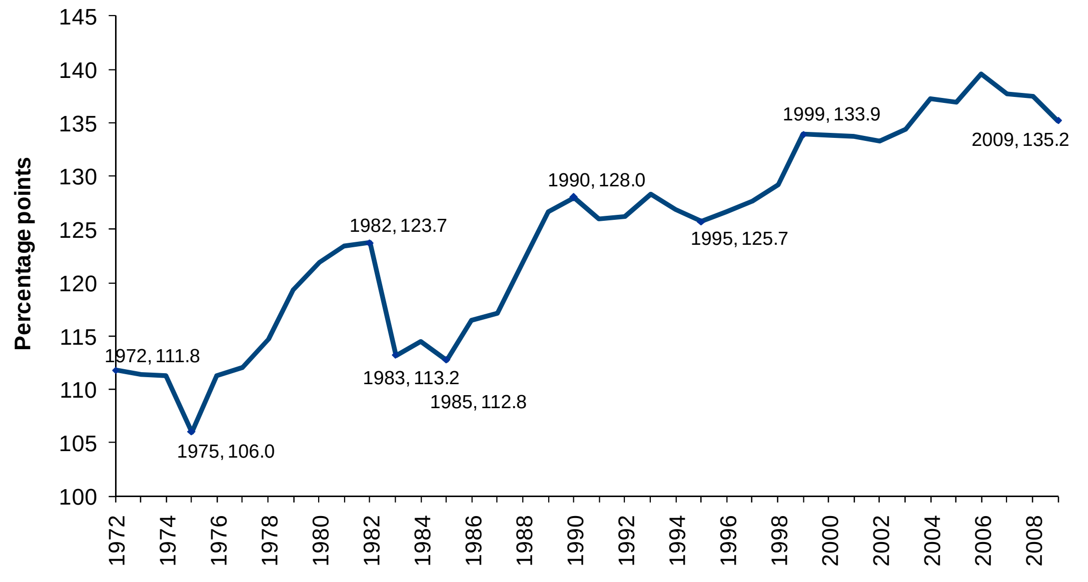
Note: On the y-axis, numbers are between 0 (open) and 1 (closed)

Figure 1.2: Net emigration to Australia and the income gap



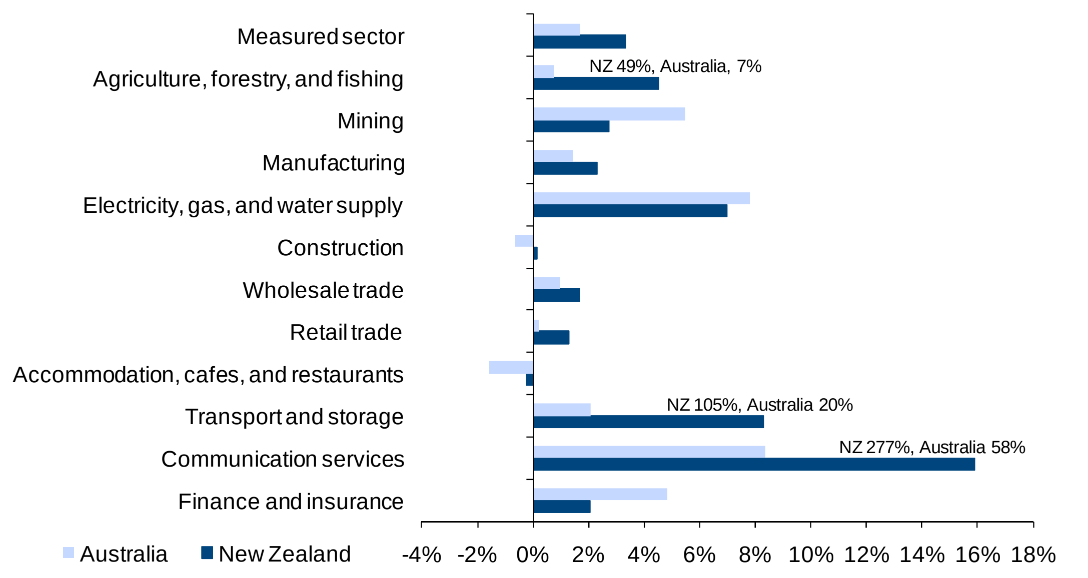
Source: Statistics NZ, GDP per capita from Maddison, constant prices, 1990 international Geary-Khamis dollars

Figure 2.1: GDP per capita, PPP basis Australia/New Zealand



Source: Statistics New Zealand report for the 2025 Taskforce. Years ended March for New Zealand. Years ended June for Australia

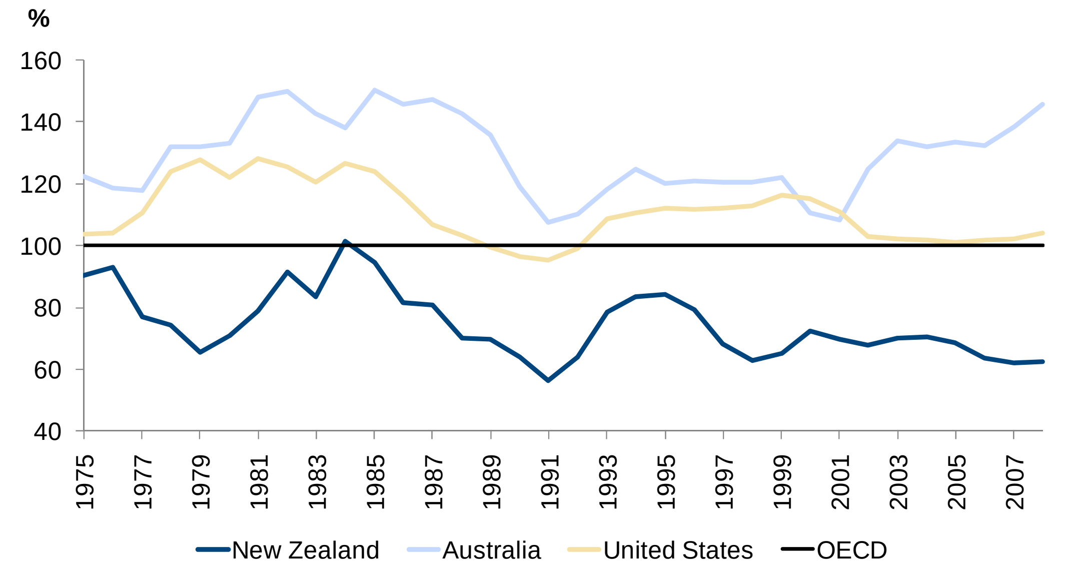
Figure 2.2: Annual average labour productivity growth in New Zealand and Australia,1986-1995



Source: Statistics New Zealand

Note: Percentages on the graph refer to cumulative growth over the entire period.

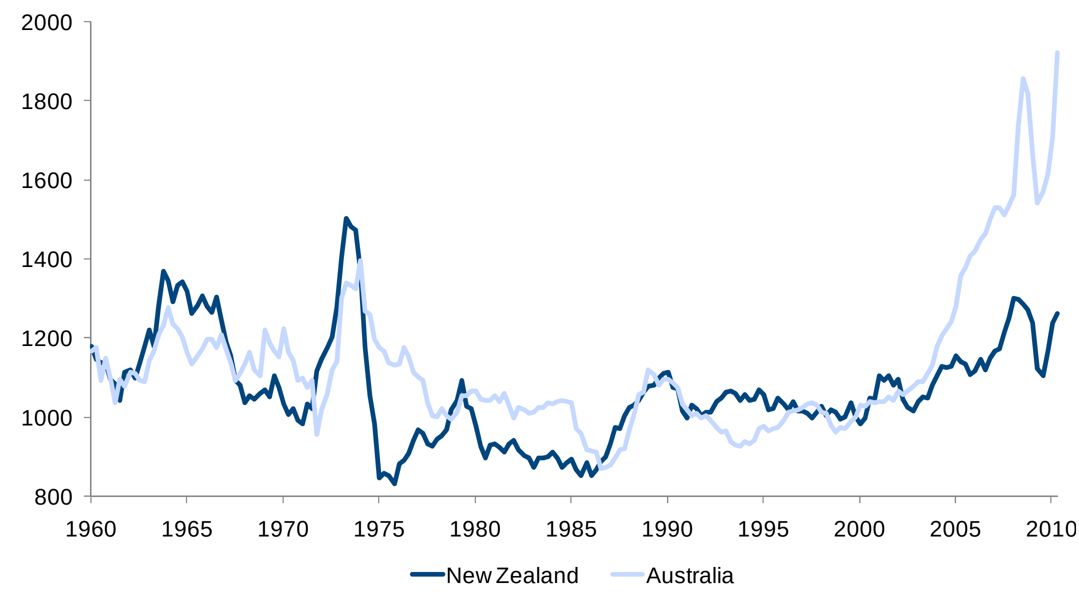
Figure 2.5: New investment per worker (relative to the OECD average)



Source: OECD

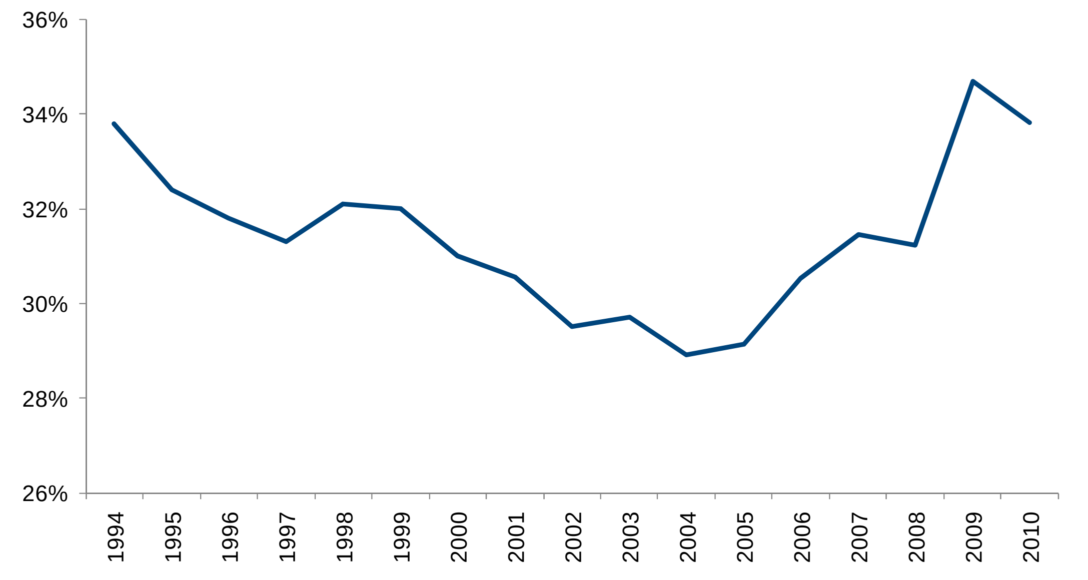
Note: Non-residential gross fixed capital formation per worker at current prices and current PPPs (OECD = 100).

Figure 4.1: Terms of trade (Dec 99=1000)



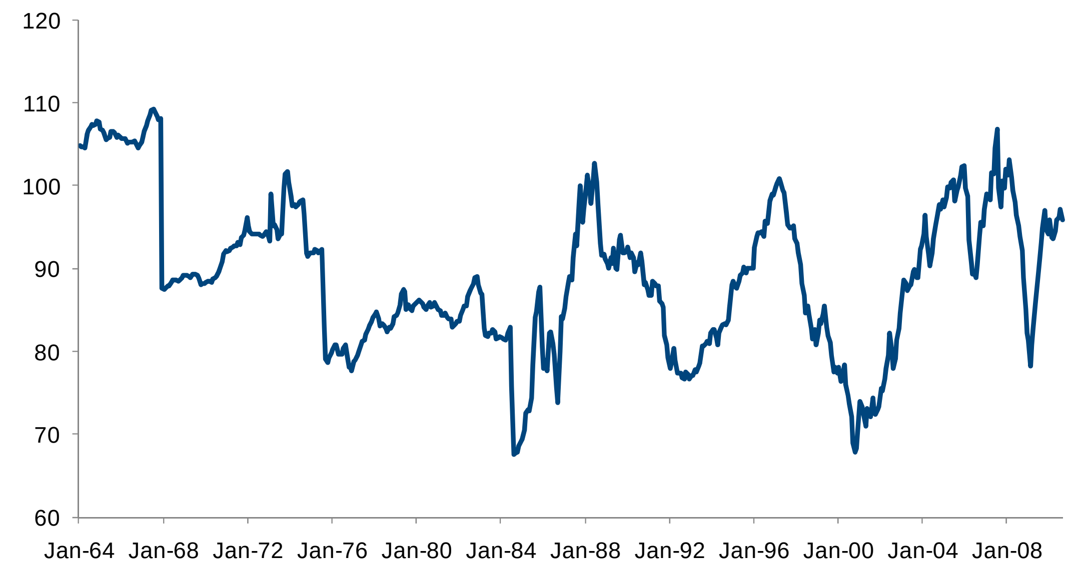
Source: Bank for International Settlements

Figure 5.2: Core Crown operating expenses (percent of GDP)



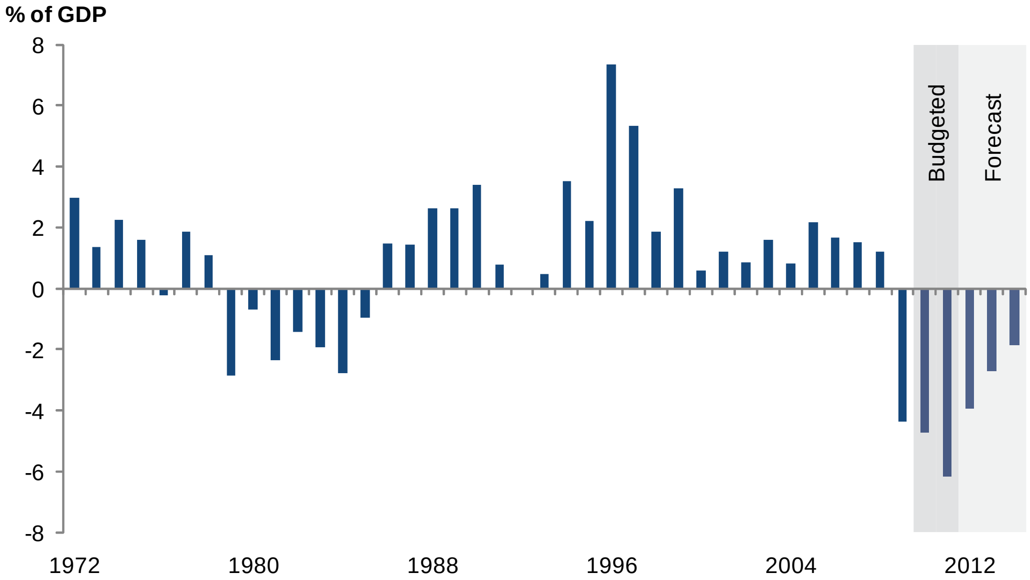
Sources: Treasury, Statistics NZ.

Figure 6.1: New Zealand's real effective exchange rate (relative CPIs)



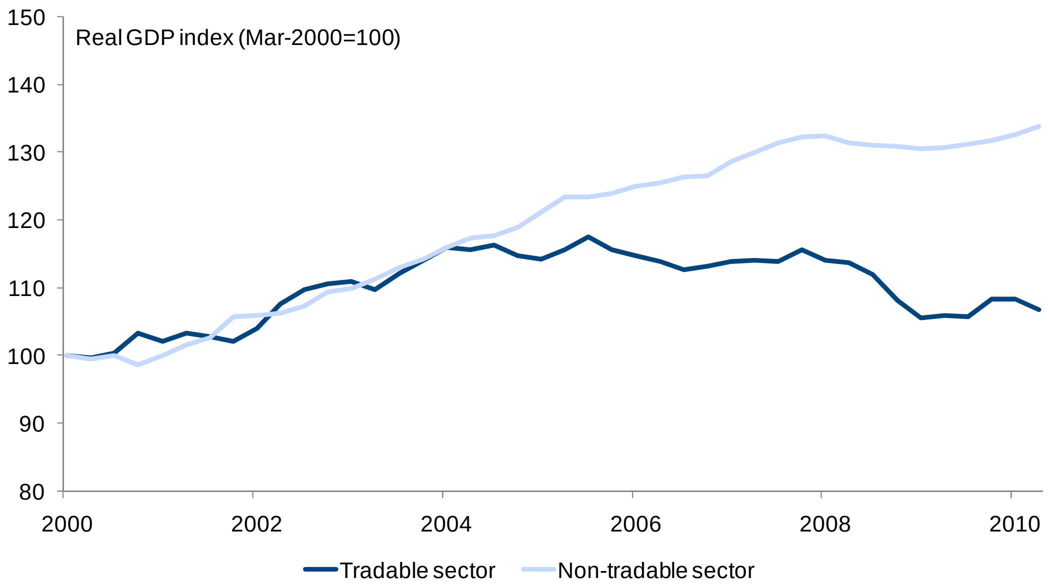
Source: Bank for International Settlements

Figure 6.2: Primary fiscal balance (Crown cash balance excluding finance costs)



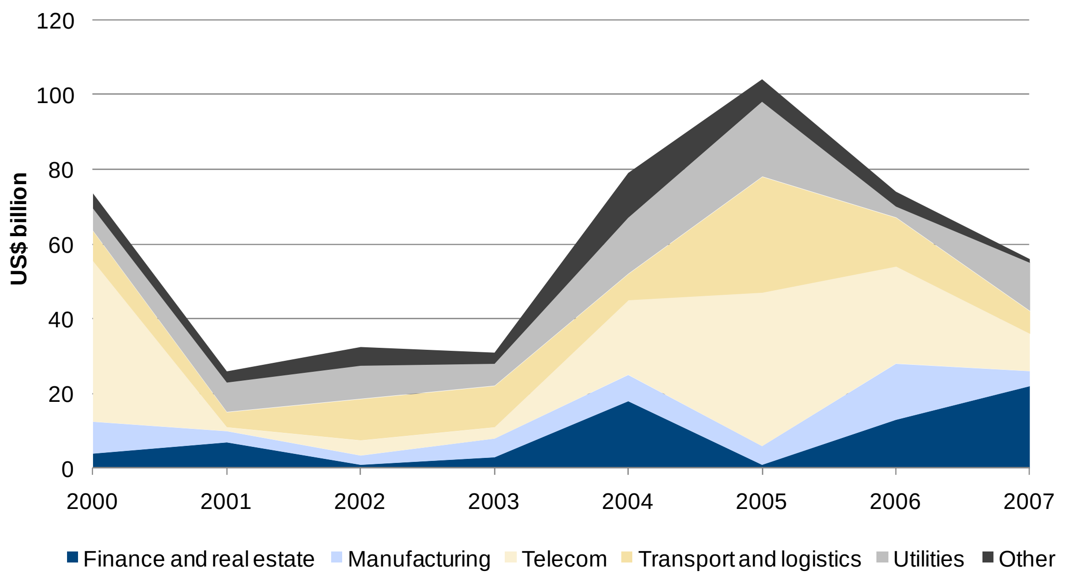
Source: The Treasury

Figure 6.3: Tradable and non-tradable sector GDP



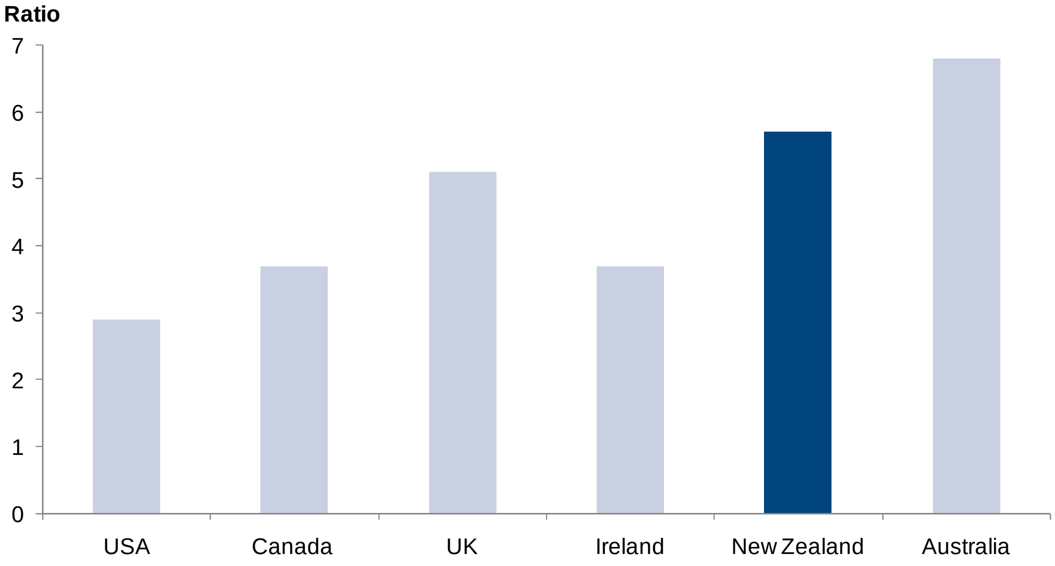
Source: The Treasury

Figure 7.1: The value of privatised state assets in OECD countries, 2000-2007



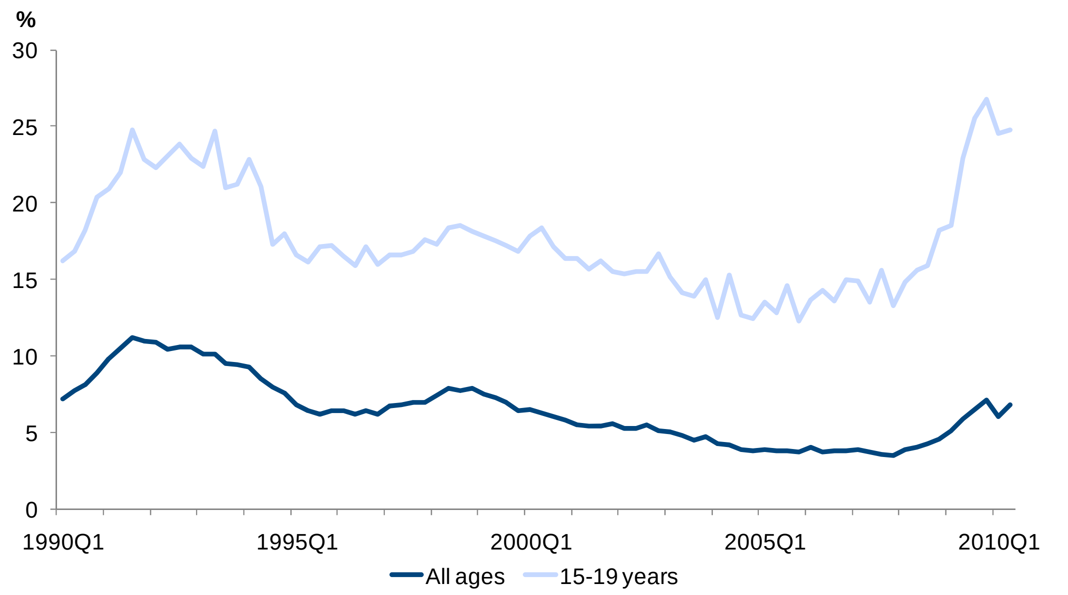
Source: OECD

Figure 12.1: House price to income ratio, selected countries, 2009



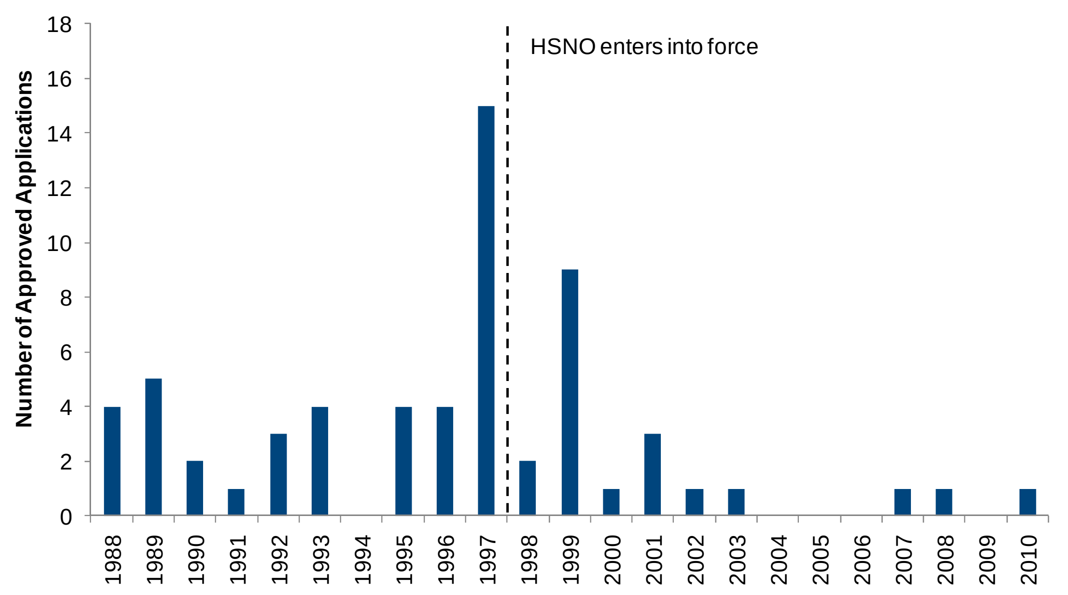
Source: Demographia (ratio of median house price to median household income)

Figure 12.2: Unemployment rates in New Zealand



Source: Statistics NZ, seasonally adjusted

Figure 12.3: Number of GMO field trials and outdoor developments in New Zealand before and after the introduction of HSNO



Source: Treasury using data from the Environmental Risk Management Authority