Answering the $64,000 Question

Closing the income gap with Australia by 2025

Summary Report

First report of the 2025 Taskforce

2025 TASKFORCE

November 2009

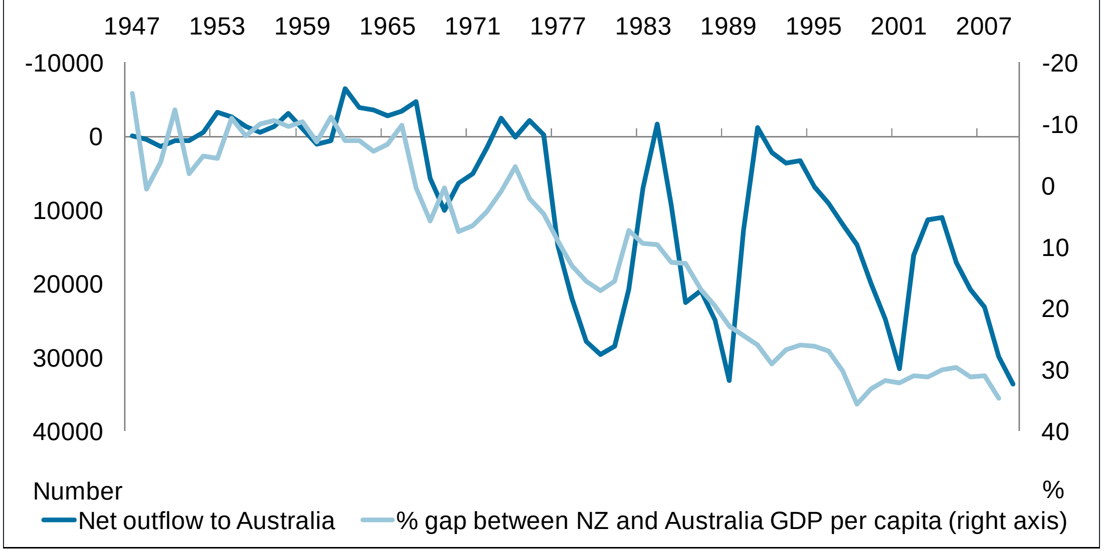
978-0-478-33098-4 (Print) 978-0-478-33099-1 (Online)

New Zealand Government

Executive summary

Over the last four decades, living standards in New Zealand have fallen far behind those in Australia. The gap is large. Measured in terms of real Gross Domestic Product (GDP), average Australian incomes are around 35 percent higher than those in New Zealand. For a family of four, that gap is worth around $64,000 a year. The gap matters. Being poorer means those of us living here have fewer choices than our peers in Australia do. And more and more of our friends and families have chosen to leave New Zealand for the better opportunities, higher incomes, and richer range of choices abroad – a net 260,000 New Zealanders have left in the last 10 years alone, mostly to Australia.

Figure 1: Net migration and the income gap



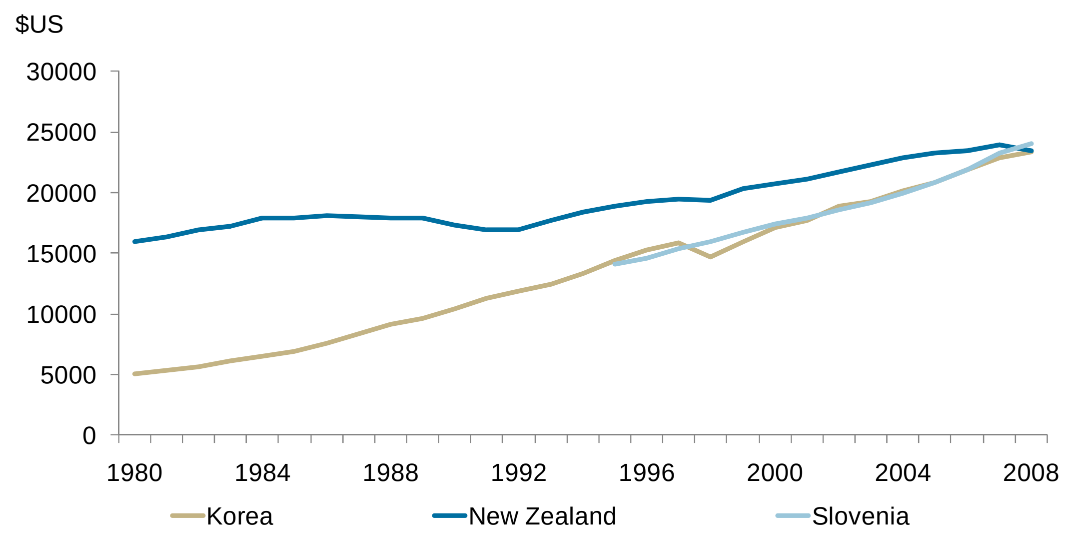
Source: Statistics NZ, GDP per capita from Maddison for 1947-1970, constant prices, 1991 Int. GK$, OECD for 1971-, US$, constant prices, constant PPPs, reference year 2000

The Prime Minister has articulated his vision of closing the gap with Australia by 2025. We share that vision. New Zealand has vast potential: strong institutions, hardworking and creative people, a degree of trust and integrity second to none in the world, and abundant natural resources. So of course the gap can be closed. But it won't close of its own accord. And if nothing is done the gap could get worse, with increasingly serious long-term implications for our country's future. Starting from here, closing the gap will require far-reaching policy reforms. That will take bold courageous leadership over at least the next decade.

The 2025 Taskforce has been established to help answer New Zealand's $64,000 question: what can and should be done to reverse the slide? Following an extensive discussion of various factors that help shed light on the New Zealand story, this report culminates in a wide-ranging set of recommendations. We hope they will stimulate extensive public debate. Policy reform along these lines would give us every chance of meeting the 2025 goal.

High living standards in New Zealand in the past were no flash in the pan. For 100 years, incomes in New Zealand – and Australia – were among the very highest in the world. But from the second half of the 1960s, a marked deterioration began to become increasingly apparent. Today, once-poor Asian countries such as Korea and Taiwan are moving ahead of us, and recently the first of the former Communist countries of eastern Europe passed us.

Figure 2: GDP per capita: Slovenia, South Korea and New Zealand



Source: OECD, US$, constant prices, constant PPPs, reference year 2000

Why is the income gap to Australia, and other advanced countries, so large? New Zealand's small size doesn't explain very much. Nor does the Australian mining industry. Nor does the pattern of ownership of the housing stock. Our monetary policy is run just the same as in other similar countries and our exchange rate is not obviously more volatile than those in many other developed countries. Of course, New Zealand is a long way from world markets, but our distance hasn't changed, we can't do anything about it, and it should not be an insuperable obstacle: Australia continues to show that. Given the opportunity, New Zealand firms and entrepreneurs will take on the world's markets with as much drive and commitment as businesses anywhere else in the world.

The critical long-term issue for economic success is getting the "rules of the game" right. Excellent policies and institutions create an environment in which people find it attractive to make the most of their talents and resources, building for the future and providing for themselves and their families. Such frameworks mean that firms – whether owned by New Zealanders or by foreign investors – find it rewarding to innovate and to invest here, in new products, new markets, and new and better ways of doing things. For the most part, firms and individuals don't have different interests: we all need strong competitive businesses in New Zealand, and successful businesses are built substantially on the skills and talents of their people and the savings accumulated over time by people here and abroad.

Our assessment is that New Zealand simply has not consistently made the effort to get and keep these policy frameworks and institutions right. New Zealand has made serious economic policy mistakes for decades. The full adverse impact of the protectionist regime put in place in the 1930s and of measures such as producer board monopolies was masked for a long time by the high commodity prices of the post World War Two period. But the costs were substantial. Of course, we can't blame the mistakes of the 1930s for the problems of today, but we've gone on making policy choices that have repeatedly undermined our chances of turning things around. Periods of good policies, strongly oriented towards improving New Zealand's economic performance, have been offset by much longer periods in which policies have headed in the wrong direction, or simply gone nowhere.

Government spending as a share of GDP is much larger than it was when we were much further up the international league tables (and is well above government spending in Australia). As we've become relatively poorer, New Zealand extended the welfare system in ways that allow an increasingly large proportion of the working age population to opt out of working, fully financially supported by the state. That is a large cost, both to the government directly and in terms of wasted talent and skills. We've hugely increased public subsidies to tertiary education, even though the private returns to a good education have never been better. And we've gone on providing a very generous universal pension that leaves many people quite rationally concluding that there is no particular reason to save for themselves.

The New Zealand economy is much more open and competitive, internationally and domestically, than it was. Almost every country's economy has opened up. The reforms of the 1980s and early 1990s represented a very significant step forward. But liberalisation and reform are not some sort of one-off exercise. While we have stood still in some areas, and made serious reversals in others over the last decade, most other countries have continued to improve their regulatory systems. On internationally comparable measures, we now typically score no better than the middle of the pack.

To close the income gap with Australia, our per capita GDP growth rate over the next 16 years will need to be twice what it was over the last 16 years. But the actual choices that New Zealand governments have made continue to go directly counter to what is required to close the gap. Over the last decade, New Zealand has:

- Increased effective marginal tax rates (quite materially in many cases)
- Increased government subsidies and concessions in a range of areas
- Increased direct state ownership in business, and
- Imposed heavier regulation on the labour market (one of the very few countries to do so).

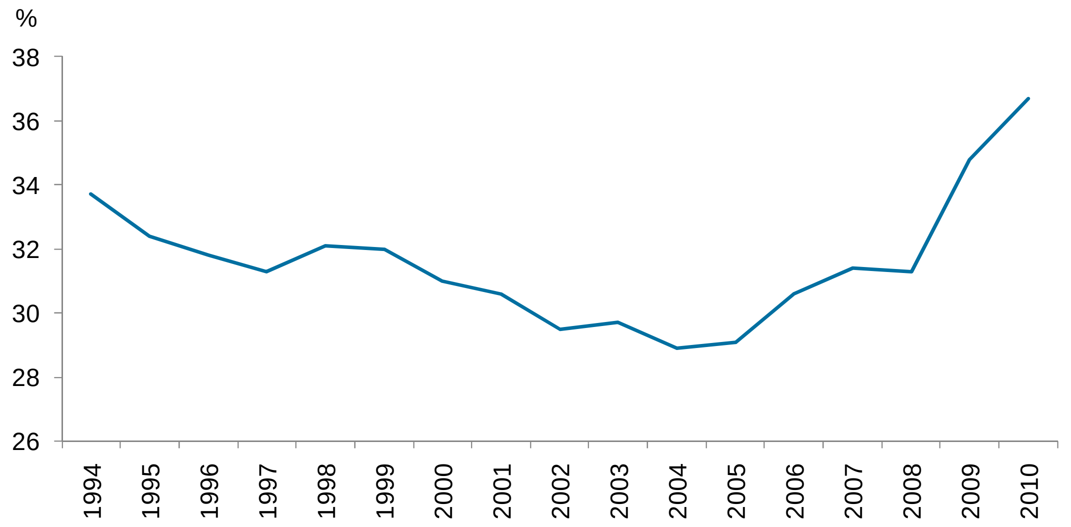
In addition, the problems of planning legislation, and the mindsets of the local authorities and officials involved in the administration of that legislation, have become increasingly apparent and increasingly constraining.

The huge increase in government spending since around 2005, reversing much of the fall achieved over the previous decade, has been particularly stark and troubling. From the year ending June 2004 to Budget projections for 2009/10, annual core Crown operating expenses will have risen by 60 percent (or $32 billion). Expressed as a share of GDP, operating spending rose from round 29 percent in 2004 and 2005 to around 36 percent now. A small proportion of the increase in that ratio is mechanical: GDP itself temporarily fell during the recession. But at least five percentage points of the increase was simply new spending. That means core government operating spending is around $9 billion per annum higher than it would have been if government spending had just kept pace with the underlying growth in the economy itself.

The economic case for much of the new spending was particularly poor: two egregious examples were the move to make student loans free of interest (costing more than $500 million per annum) and the trebling (to now in excess of $1 billion per annum) of subsidies for early childhood education and day-care. There are no apparent economic benefits from either substantial subsidy, the benefits of which are heavily concentrated on the taxpaying middle classes. Increasing spending on that scale meant passing up the opportunity for tax cuts that would have improved our long-term performance. Taxes adversely affect people's choices to work, invest, and save, so without a clear economic rationale such spending leaves the country as a whole poorer. Sharply rising government spending also squeezed out private sector activity, in part by pushing up the exchange rate.

It is all but impossible that New Zealand's per capita economic growth can be doubled – which is what achieving the 2025 goal means – with government spending as large as it is now. Unfortunately, the Government's fiscal strategy announced in this year's Budget in practice largely ratified the rise in the size of government spending, offering no specific plans to reverse the increase to any meaningful extent.

Figure 3: Core Crown operating expenses (percent of GDP)



Sources: Treasury, Statistics NZ, Secretariat estimates

Note: 2009 Budget forecasts of expenses for the 2010 year were used.

Overall, the pattern of policymaking over the last decade defies the well-established international evidence about what works. So it is no real surprise that New Zealand is not doing better. The overall policy environment here is not much better than those in the various other advanced countries that also languish near the bottom of the group of longstanding OECD countries, and our distance does count against us (even if less than it did 100 years ago).

In its recent review of New Zealand, the OECD recommended policy reforms that in many cases are quite similar to those in our Report. The OECD explicitly highlighted that if we want to overcome any disadvantages of distance we need policy frameworks that are consistently among the best in the world. If we are serious about closing the gap to Australia, we shall certainly need such policies. We still have best practice policy in some areas, but that was truer 15 years ago than it is today. Across the whole spectrum of policies that affect the climate for economic performance, we are far from being good enough.

In particular, governments appear to continue to remain confused about what they can and must bring to the table if our economic performance is to be transformed. Governments just don't have the knowledge, the expertise, or the incentives to be picking winners, or tilting the playing field this way or that.

There are lots of exciting opportunities for New Zealand business. New technologies, new products, new markets beckon each year. Competitive markets have proven the best vehicle for realizing these gains. What markets do best is to encourage innovation, reward success and weed out failures. By doing that, markets help to ensure the best possible use of scarce resources: translated, that means we get the most out of what we have, both now and in the future.

It is critical to re-establish the mindset that markets, not governments, create wealth best. The tendency to look to government assistance (tax concessions, regulatory and legislative protections, direct state investment) to particular firms and sectors, as if getting that right offers the answer to our economic underperformance, must be successfully fought. We have tried these sorts of initiatives for decades in New Zealand – and much more so again in the last decade – with outcomes ranging from mediocre at best to disastrous at worst. We see little reason to expect different results this time around.

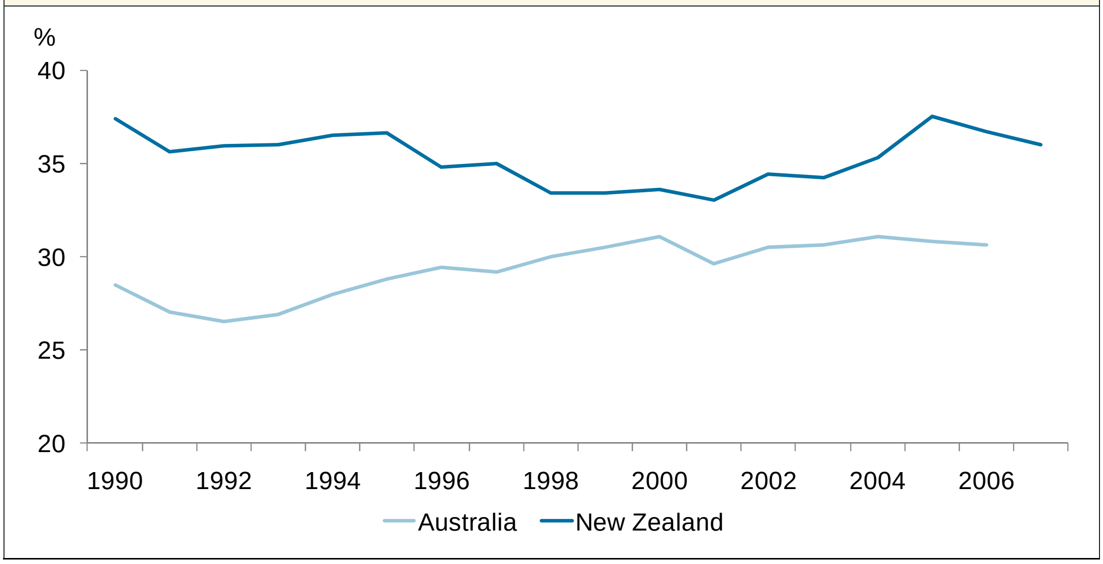
Governments must start doing government excellently, not playing at business. There is more than enough work to do focusing on securing substantial improvements in things only governments can fix (tax systems, welfare systems, core public services, better regulation). Government choices have a vital role in economic success, but that role is not attempting to apply some superior wisdom – of the sort that goes beyond human capabilities – to identifying especially promising sectors or industries, and using taxpayers' money to back such views without effective accountability or discipline.

There is much that can be done relatively readily. The key elements of the Taskforce's approach are:

- Significantly cutting government spending and tax rates.
- Finding better, more effective, ways of ensuring the delivery of services the government does fund.
- Substantially improving the rigour with which government spending proposals are evaluated.
- Substantially improving, across the board, the quality of economic regulation.
- Getting government out of the ownership of business assets.

Take just one example of the scale of what can be done. If government operating spending as a share of GDP could be reduced back to the level that prevailed as recently as 2004 and 2005, the deficit would be closed and there would be scope for deep tax cuts. That would open up a range of far-reaching options that could make a huge difference to our economic performance. For example, for an annual cost of $7 billion the top personal tax rate, the company tax rate, and the trust rate could all be aligned at 20 percent. But there are alternative approaches: for example, the same resources could be used to fund the sort of dual rate system adopted in a number of European countries, in which the tax rate on capital incomes could be set much lower than labour tax rates.

Figure 4: Total tax revenue (as percent of GDP)

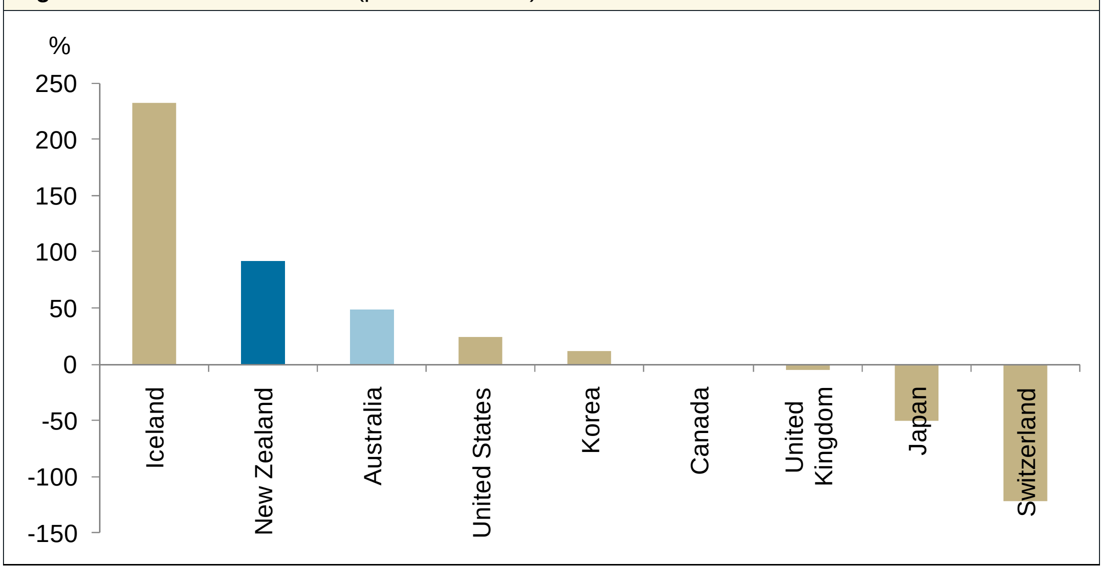


Source: OECD

If, over time, we could reduce government spending still further as a share of GDP, even more substantial cuts in income tax rates would become possible. We know that a well-structured tax system, with low income tax rates, can make a powerful difference in the long run. Tax changes will be even more powerful as part of an overall strategy designed to get much better value from the resources we already have and to substantially improve the regulatory climate in ways that mean that people and firms are keen to innovate and invest for the future.

If we fail to act, or are seduced by strategies that have been proved, over and over again, to have failed, there are substantial risks. For example, New Zealand's firms, farms, and households are very heavily indebted, our foreign debt is at levels that prompt serious questions from credit rating agencies, and much of our growth in the last decade has been in the form of a debt-fuelled consumption binge. There is a real risk that thirty years of increasing domestic and external indebtedness will eventually catch up with us. If that happens, the income gap with Australia could widen further.

Figure 5: Net external liabilities (percent of GDP)



Source: Reserve Bank of New Zealand

We are recommending very substantial changes in the way we do things in New Zealand. We don't make these recommendations, consistent with meeting the 2025 goal, out of some technocratic fixation with particular economic statistics. GDP isn't an end in itself. Higher incomes create better opportunities and more choices across a huge range of dimensions: more health care, better education, a cleaner environment. Better outcomes in these areas aren't just fortunate by-products. New Zealanders expect better health and education, and better roads: what we are proposing will, if implemented, deliver that.

There is a pervasive myth that economic reform of the sort proposed here is about benefiting the rich. That is simply wrong. The rich have options the rest of us don't have and, in fact, are the least adversely affected by New Zealand's relative economic decline. This is a programme to improve substantially the lot of the ordinary New Zealander. We all have a huge stake in its adoption, but none more so than the least skilled, least able, least mobile among us. New Zealanders care about those people.

Serious reform on the scale recommended in this report, to achieve the 2025 goal, is the work of many years. But the first steps need to be taken now – time is short, and early steps will help convince individuals and firms, here and abroad, that real change is coming. By next year's Budget, we would expect that the Government should be in a position to outline the comprehensive approach it plans to take to achieve the 2025 goal.

Getting to the 2025 goal will involve hard choices. There is apparently a sense that far-reaching economic reform means electoral suicide. That hasn't been so here or abroad. It is a standing reproach to successive governments over the last 15 years that so little has been done to tackle the problems. New Zealanders aspire to something better than we have experienced in the last 35 years. Courageous and visionary political leadership is the central element that could give us every chance of delivering on that aspiration and achieving the 2025 goal.

Recommendations

Government spending

General

1. Government operating spending (as measured by core Crown operating expenses) as a share of GDP should be reduced by 2012/13 to 29 percent, the same share as in 2004 and 2005.
2. Beyond 2012/13, government spending as a share of GDP should be reduced materially further. To achieve this, the level of core Crown operating expenses per person should be capped in real terms.
3. The Public Finance Act should be amended to require the Minister of Finance to specify publicly a medium-term target for core Crown operating expenses, either in real per capita terms or as a share of GDP. In each Fiscal Strategy Report, the Minister of Finance should be required to report publicly on steps being taken to ensure that that goal is met.
4. The Government should undertake an in-depth examination of the scope for further institutional changes to strengthen long-term spending discipline. Examples of such institutions could include a Taxpayer Bill of Rights and/or an independent Fiscal Advisory Council.
5. Expert taskforces should be established to scrutinise each major area of government spending, with a view to proposing more effective models for delivering those services that the public sector will continue to fund.
6. Processes for evaluating government spending should be materially strengthened, including greater use of rigorous and transparent cost-benefit analysis for both new spending proposals and periodic reviews of the value that is being obtained from existing spending programmes. Enhancing the quality and rigour of such analysis should be a key priority for the Treasury.

Specific

7. Ambitious welfare reform measures should be undertaken as a matter of priority to reduce the very large number of people of working age currently receiving welfare benefits.
8. Early steps should be taken to lower the actual and prospective costs (as a share of GDP) of New Zealand Superannuation. The eligibility age should be increased progressively, with increases linked to ongoing improvements in life expectancy, and for some years payments should be indexed to the CPI rather than to after-tax wages.
9. Remaining KiwiSaver subsidies should be abolished.
10. Health:
    a. A funder-provider model should be reintroduced in the hospital sector, allowing much greater private sector involvement in the provision of taxpayer-funded services.
    b. Universal (unrelated to income or health status) subsidies for doctors' visits should be abolished.
    c. Subsidies for prescription pharmaceuticals should be substantially reduced, with those in generally good health and not on low incomes paying the full price up to a cap.

11. Education:
    a. The substantial increases in subsidies since 2005 for early childhood education and day-care should be reversed.
    b. A funder-provider model should be adopted for the school sector, allowing new providers to enter, with all-up per student funding equivalent to that for existing state schools.
    c. In the meantime, governance and accountability structures in the school sector need to be reformed to provide better incentives for stronger performance and greater accountability for teachers, principals and schools.
    d. Government-imposed fee caps on university fees should be abolished.
    e. Market-based interest rates should be reintroduced for student loans.
    f. Governance of the public tertiary sector should be reformed, including exploring the rationalisation of the non-university sector and the establishment of universities as independent foundations.
    g. A full review should be undertaken to identify, and recommend reform of, those areas in which various government education agencies (Tertiary Education Commission, Education Review Office, Ministry of Education) have become overly prescriptive, and to explore other, less intrusive, monitoring and accountability options to achieve policy ends that pass a cost-benefit test.

Taxation

12. Average tax rates should be substantially reduced, as ambitious expenditure restraint permits. Cutting core Crown expenses to 29 percent of GDP would, for example, allow the maximum personal tax rate, and the company and trust tax rates, all to be reduced to 20 percent.
13. Serious reforms should be undertaken to reduce the high effective marginal tax rates facing many middle income taxpayers with dependent children as a result of the abatement provisions of the Working for Families tax credit scheme.
14. Reductions in average tax rates should be achieved by reducing income taxes, and doing so having regard both to the importance of administrative simplicity and minimisation of tax avoidance on the one hand, and to the evidence that taxes on capital income can be particularly detrimental to economic performance on the other.

Government assets

15. All businesses owned by central government which are operating in markets where competition is actual or feasible should be sold.
16. Local governments should be strongly encouraged to sell their trading enterprises.
17. To strengthen governance while businesses remain in public ownership, an independent Crown Commercial Appointments Commission should be established, to be responsible for making recommendations to Ministers for Board positions on all Crown commercial enterprises and for vetting and publishing suitability assessments of all appointees to such boards.
18. The New Zealand Superannuation Fund should be wound up and its assets used to reduce gross government debt.

19. Congestion charging should be introduced in central Auckland and in any other cities where a cost-benefit analysis supports doing so. Full road-user charging, differentiated by place and time of road use, should be introduced as it becomes economically efficient to do so.
20. Rigorous and transparent cost-benefit analyses should restored to the prime place in guiding decisions on all public capital spending, including infrastructure spending. All such cost-benefit analyses for projects involving the outlay of more than $50 million should be formally reviewed by Treasury.
21. Mining:
    a. A governance framework should be put in place to facilitate the best economic use of those mineral resources in which the Crown has a direct ownership interest (under both land and sea).
    b. Mining developments on or under sensitive Crown land should generally be permitted provided that they pass a full cost-benefit analysis.
    c. Development of mineral resources should be undertaken by private operators, with the Crown securing its financial interest through appropriate royalty-type arrangements.

Regulation

General

22. A Regulatory Responsibility Bill should be enacted, based on the draft proposed in the recent report of the Regulatory Responsibility Taskforce.
23. Property rights should be added to the list of rights specified in the Bill of Rights Act.
24. Substantially improving the quality of regulatory impact analysis being undertaken before legislation is introduced and/or government regulatory powers are extended should be treated as a matter of high priority by Ministers and central government agencies. Such analysis should be an integral part of all policy development and review processes, to ensure that the full costs and benefits, to all sectors, are appropriately and rigorously factored into government decision-making.
25. An independent Productivity Commission should be established as a centre of microeconomic and regulatory analytical expertise. The Commission should be authorised (and resourced) to undertake reviews of matters referred to it by Ministers, and of issues it identifies as requiring further in-depth analysis and research.

Specific

26. A high quality independent taskforce should be constituted as a matter of urgency to review resource management law from first principles, including identifying the policy goals that should be served by such legislation and assessing the best ways of achieving those goals.
27. When determining the zoning of land for residential purposes, local authorities should be required by statute to take explicit account of any differences between the price of residential-zoned undeveloped land and the price of other undeveloped land in similar areas. These differences should be reported on by local authorities each year, with a strong presumption that scarcity of zoned land, as reflected primarily in price differences, should prompt action to increase the supply of residential land.
28. A system of tradable water rights should be established urgently.

29. Labour market:

    a. Labour law should be amended to strengthen the freedom of negotiation between workers and their employers, including, for example, streamlining provisions governing dismissal of workers, and putting less emphasis on procedural matters.

    b. Statutory provisions allowing enforceable mutually-agreed probationary periods for new employees should be extended, from the current maximum of 90 days for those working for small firms to a maximum of 12 months for employees of firms of any size.

    c. For employees earning in excess of $100,000 per annum, employment relations should be governed by the standard provisions of contract law rather than by the Employment Relations Act.

    d. The youth minimum wage should be reinstated as a matter of urgency, and minimum wage rates should be reduced to the same ratio to average wages that prevailed in 1999.

30. Immediate notice should be given that from 1 January 2011 all remaining tariffs will be removed.

31. Foreign investment restrictions should be further reviewed, starting with a strong predisposition that a much more liberal regime should be introduced.

32. Emissions trading legislation and any future emissions reduction targets the Government adopts should be independently monitored and periodically reviewed. Such reviews should focus on monitoring the economic impact of any carbon abatement goals, and the impact of chosen abatement regimes (here and abroad) on prospects for achieving the 2025 goal.

33. A review of the Commerce Act should be undertaken, with a focus on restoring the primacy of economic efficiency considerations and long-term consumer interests in the design and conduct of competition policy.

34. The Government should strongly encourage the transformation of Fonterra into a conventional company structure with fully-traded outside capital, using any appropriate instruments at its disposal.

35. Zespri's monopoly on the export of kiwifruit to markets outside Australia should be removed.

ISBN: 978-0-478-33098-4 (Print) 978-0-478-33099-1 (Online)

Persistent URL: http://purl.oclc.org/nzt/r-1253