

Raising New Zealand living standards

The productivity taskforce is charged with recommending ways to improve productivity and close the income gap with Australia. Raising productivity means increasing the amount produced per hour of work, which can be a good way of lifting a country's average standard of living.

We do caution that maximising measured productivity does not necessarily coincide with maximising income. Productivity is difficult to measure, especially when comparing the "amount" produced of two different goods. When the price of a good increases, resources should be devoted to its production, even if doing so reduces productivity. For example, following increases in the price of dairy products relative to wood over the past twenty years, New Zealand has converted some forest plantations to dairy land. These conversions have raised New Zealand's living standard by utilising the available land in the way that generates more income (at today's prices). But each conversion has reduced New Zealand's measured labour productivity, because dairy farming has lower labour productivity than forestry. Similarly, mining and manufacturing have higher productivity than agriculture. But increasing the amount of mining or manufacturing in New Zealand would only increase our income level if we actually had a comparative advantage in those industries.

We recommend that the productivity taskforce interprets "improving productivity" as increasing productivity *within sectors*. Attempting to skew the allocation of resources towards sectors that have higher measured productivity should be avoided. New Zealand should concentrate on exploiting its comparative advantages in the most efficient manner possible.

New Zealand's low level of productivity compared to Australia and other OECD countries is often pinned on the following factors. The first two are "facts of nature" that are not practical to change. The remainder are key weaknesses that could be addressed by policy.

- Our economy specialises in agriculture, which has comparatively low value-added per worker (even though our agriculture industry is more productive than other countries').
- We live on an extremely isolated and sparsely populated island group that has challenging internal geography.
- We spend very little on research and development. Our research is concentrated in academia with low commercialisation of innovations.
- We have low capital intensity. Despite a high return on capital, New Zealand has persistently low investment.
- We have inadequate infrastructure.

Unfortunately there is no silver bullet for improving productivity; it's about doing a lot of small things well. Below we discuss some of the policies that we think would be helpful. The two key areas we identify are taxation and infrastructure.

Improving labour productivity

- **Focus on effective marginal tax rates, not just average tax rates.** Reducing effective marginal tax rates would be even more productivity enhancing than reducing New Zealand's average tax burden. Some New Zealand families currently face effective marginal tax rates of 70% or more, once abatement of benefits like Working For Families and the Accommodation Supplement are considered. This is a huge work disincentive. Similar distributional outcomes to Working For Families could be achieved with a tax *rate* reduction for those on low incomes with children. This would have the side benefits of cutting down on administration and reducing effective marginal tax rates.
- **Focus on policies encouraging labour market flexibility.** Maintaining skills of temporarily inactive workers has an important contribution to make to labour productivity. As the New Zealand population ages, it will be crucial for both economic growth and the fiscal position to encourage workers to stay in the labour force for longer in some capacity (e.g. job-sharing, working

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from home). This won't increase productivity, but it would increase living standards.

- **Focus on lifting the bottom.** In our view the cheapest gains are to be made by lifting the productivity of the lower end of the workforce. For example in education policy we would advocate increasing spending on early childhood/primary education rather than increasing funding for tertiary education (where numbers of students have been steadily increasing anyway).
- **Maintaining social cohesion.** Marginalising and/or alienating groups within society may prevent members of those groups from realising their full productive potential. In New Zealand's case, policies to prevent marginalisation may include allowing the Maori language to flourish and assisting with the integration of immigrant groups while allowing their distinct cultures to flourish.
- **Embedding a productivity focus.** The quest for enhanced productivity/living standards will be ongoing. The work of the taskforce could usefully be augmented by the establishment of a Productivity Commission.

A disciplined, strategic approach to public infrastructure investment

- **Use existing infrastructure more wisely before building new infrastructure.** For example, building new roads simply encourages more car use and can actually worsen urban congestion by clogging key choke points. By contrast, better public transport reduces commuting times and alleviates congestion for other road users. Similarly, user charges for publicly provided services may encourage wiser use, reducing the overall financial burden of providing said services.
- **Have a national, productivity-based approach to investment.** The new land transport Government Policy Statement and the associated NZ Transport Agency's Investment and Revenue Strategy for allocating the roading budget with an efficiency and economics focus are a good start. We would argue that the same type of analysis should be applied at a higher level in determining how much resource should be allocated to public infrastructure overall, and how it should be divided up between different types of infrastructure. At the moment it appears to be largely philosophy-driven, and assessed on a project-by-project basis. A key factor that must always be considered is how much private investment will be driven out through competition for resources. "Think Big" type projects can be net negative. A work programme aimed at assessing the most appropriate discount rate to apply in the provision of public investment would be a useful addition.

Encourage private investment

- **Respect for property rights is paramount.** One of the key ingredients for good productivity growth is secure property rights. On-the-fly rule changes for private transactions undermine property rights and discourage future investment. If restricted ownership of certain firms is deemed appropriate, then they should be identified within a disciplined framework and a register maintained.
- **Maintain law and order.** It is important to adequately fund basic public infrastructure such as justice and police, as insecurity in any form hampers investment.
- **Maintain macroeconomic stability.** New Zealand's disciplined macroeconomic framework and public institutions have held the economy in good stead during the global financial crisis. Additional effort to minimise the size of government spending, public debt, and taxation will reduce any 'crowding out' of private business, reduce deadweight losses of taxation, lower interest rates, and increase the incentive structure for individuals to participate in the economy.
- **Re-commit to inflation targeting.** Over the past decade there have been two inquiries into monetary policy and two adjustments to the Reserve Bank's Policy Targets Agreement in the direction of higher inflation. The best way to help the Reserve Bank achieve its inflation target would be to publicly reaffirm the Government's commitment to the inflation target. Commitment to inflation targeting is an important pre-condition for infrastructure investment, since it would reduce borrowing costs and help to create more macroeconomic certainty. Cyclical monetary policy settings are not an appropriate tool to try to stimulate the long-term level of investment. But making the inflation-targeting job easier for monetary policy through less price intervention could have a virtuous circle effect of meaning less volatility in interest rates is required, improving certainty about funding costs (and potentially macroeconomic volatility), thereby encouraging investment.
- **Use Public Private Partnerships (PPPs).** PPPs have been shown to produce better infrastructure at less cost and with fewer delays than traditional contracts. NZ's aversion to PPPs is an international oddity.
- **Tax advantages for R&D.** Such policies can lead to rent-seeking, but it's a case of "if everyone else is doing it...". More generous depreciation rates would also be helpful, as would a generally lower rate of company tax.
- **Reducing business barriers.** Minimise or reduce legal, tax, and regulatory barriers to business, especially when it comes to integrating with larger economies. These policies include looking at financial integration with

larger economies, and adopting trading partner standards and practices where reasonable.

- **Reduce anti-competitive elements of the Resource Management Act.** We are encouraged by the changes to the RMA aimed at reducing its abuse as an anti-competitive tool.
- **Ensure price signals are clear.** Government policies can mask price signals, causing misallocation of resources. For example, ACC premiums could be more tightly tied to risk. Electricity prices could more closely reflect the marginal cost of new generation.
- **Reduce the tax advantage for housing.** The current tax structure encourages the allocation of capital into housing investment. A broader (e.g., introduction of a land tax) and flatter tax regime, accompanied by more tightly targeted government expenditure, would help reduce the distortion in the allocation of capital.
- **Increased competition.** Increase competition in key markets, including the provision of labour, education, health, and social insurance. This also includes removing barriers to immigrants rapidly being subsumed into the labour force.
- **Free trade.** NZ has made substantial income gains through the pursuit of free trade agreements. Given the snails pace of progress in multilateral trade agreements, energy should continue to be focussed on bilateral agreements.
- **Celebrating success.** Develop an environment that celebrates commercial success and entrepreneurial behaviour.

Enhancing public sector performance

Central and local government makes up a considerable share of the NZ economy and both are fertile areas for 'quick wins' on productivity enhancement.

Both central and local government could usefully:

- enhance evaluation of existing government spending;
- focus on outcomes rather than outputs;
- increase central stewardship to coordinate priorities across the literally hundreds of government agencies; and
- Identify and address duplication of functions (e.g., accounting, procurement).

In order to raise the quality of government spending decisions the outputs of specific policies must be aligned with the desired outcomes of the government. Performance should be measured against outcome targets.

The OECD proposed some basic 'rules of thumb' that could usefully be employed to assess if the government's outputs are best aligned with the desired outcome of raising living standards.

These 'rules of thumb' can be run over current government spending and any proposed future initiatives to assess their merit.

- Does the programme serve a clearly defined purpose that matters?
- Is this an appropriate role for government (i.e. does it address a specific market failure)
- Would we establish a programme today if it did not exist?
- Is it desirable to maintain spending at its current level? And,
- Can it be delivered more effectively or efficiently?