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Why Economic Growth Matters and Policy Priorities for the new Government

The case for growth

Economic growth is crucial for the prosperity and well-being of a society. It drives improvements in living standards by increasing the production of goods and services, creating jobs, and boosting income levels.

Growth generates the resources needed to invest in critical areas such as education, healthcare, and infrastructure, enhancing human capital and overall quality of life. Moreover, it provides the resources for a necessary social safety net. A growing economy can reduce poverty and income inequality, providing opportunities for social mobility.

It also fosters innovation and technological advancement, which can lead to increased productivity and sustainable development. In essence, economic growth is a cornerstone for achieving a higher standard of living and ensuring future generations' welfare.

The problems of not having enough growth

Economic growth doesn't solve everything. It alone cannot address deeply rooted societal issues such as systemic inequality, environmental degradation, and mental health crises.

However, it's a good start. Not having it presents a host of challenges. First and foremost, it results in sluggish job creation, leading to high unemployment and underemployment rates.

Low growth also hampers income and wage increases, affecting the living standards of citizens. This, in turn, exacerbates income inequality and poverty.

Insufficient revenue generation makes it harder for governments to invest in critical sectors like healthcare, education, and infrastructure, further impeding long-term development. Additionally, low growth may discourage innovation and foreign investment, hindering a country's global competitiveness.

In sum, sustained low economic growth can undermine a nation's social stability, prosperity, and overall quality of life. The results often find negative political expressions, such as populism and attempts to distract the population from a stagnating economy by ramping up nationalist rhetoric or even by starting conflicts.

Per capita GDP is a better measure for assessing prosperity

Per capita GDP growth is a superior metric for assessing a country's prosperity compared to total GDP. It considers the distribution of income within a nation, providing a more accurate reflection of the average citizen's standard of living.

It also highlights changes in individual wealth over time. This measure emphasises the well-being and living conditions of a nation's people, making it a more meaningful gauge of true economic progress and the equitable distribution of resources. While a high total GDP may indicate economic activity, it can mask disparities and inequalities.

Per capita GDP accounts for population size, allowing for a fairer comparison between countries of different sizes. It was reported earlier this year that India had overtaken the UK as the world's 5th largest economy according to the International Monetary Fund using GDP in current prices data in 2022. However, on the same data basis, India's per-capita GDP is only around 5% of that of the UK.

Recent New Zealand economic performance

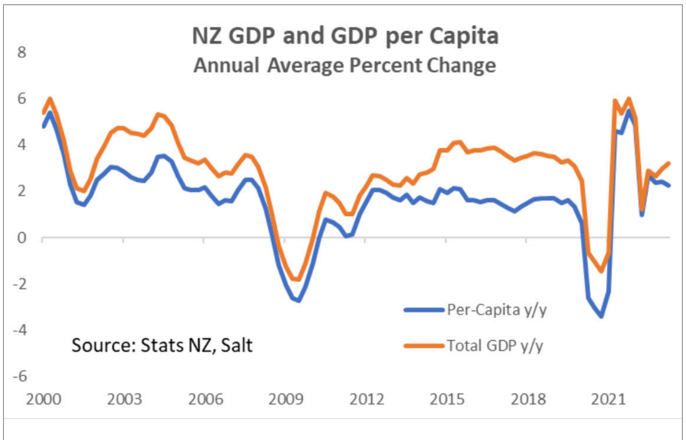
The long-term decline of New Zealand relative living standards is well understood. In the 1950s we enjoyed the status of the third wealthiest country in the world. We remained in the top five until the late 1960s. Since then, while we have made absolute gains in GDP per capita, our relative performance has seen us slip to around 22nd.

This has been due to several factors, some of which we can't do much about. Challenges, such as a small domestic market and geographic isolation, limit opportunities for growth.

Additionally, historical policy decisions, including trade protectionism and agricultural subsidies, hindered competitiveness and led to a misdirection of capital into low value-adding industries.

More recently low investment in innovation and education has contributed to a skills gap, impacting productivity. Demographic shifts, like emigration of skilled workers, further strain the workforce. Environmental concerns, notably in agriculture, pose sustainability challenges.

While we have enjoyed relatively strong GDP growth in recent years, our growth in per capita GDP has been insufficient to provide the quality of life we aspire to, taking constant calls for better public services as a guide. Since 2000, our GDP growth has averaged 3.0% per annum, but per capita GDP averaged only 1.6% per annum.

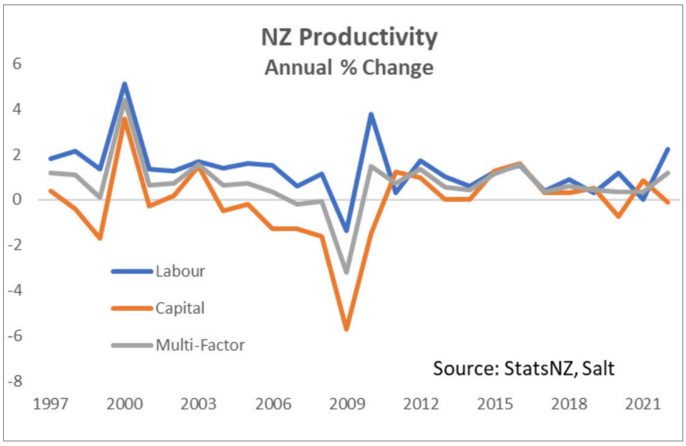


Net Migration and productivity

The difference between the two growth rates is population growth, which has in turn been driven mostly by net gains of migrants, rather than natural population growth.

The labour market has been a key beneficiary as strong net migration has fuelled growth in our working age population at a time when many countries are already or soon will be dealing with declining working age populations.

The downside of (relatively) ample labour supply is that firms can use people to resource the output growth of their goods and services, rather than investing in technology. This has not been good for our productivity growth. Over the last 20-years, labour productivity growth has averaged 1.1% per annum while productivity of capital has averaged -0.2%.



More people simply consume more resource and require more capital being committed to low or no-productivity purposes such as housing and housing-related infrastructure. Only through higher productivity and per-capita GDP growth can we expect better quality services. Furthermore, only through higher productivity can we aspire to the high wage economy we also aspire to.

Shifting the dial on per-capita GDP

Addressing these multifaceted issues requires comprehensive policies fostering innovation, global integration, and sustainable development to reverse the trend and enhance New Zealand's long-term economic prosperity.

Per capita GDP growth hinges on several key drivers:

- First and foremost, productivity gains are paramount, as they enhance the output per worker and lead to increased income levels.
- Investments in physical and human capital, including infrastructure, education, and healthcare, play a critical role in fostering growth.
- Technological advancements and innovation drive efficiency and competitiveness.
- Sound fiscal management and a business-friendly environment, attract investment and promote growth.

- International trade and globalisation can also stimulate per capita GDP growth by expanding markets and opportunities.
- Social and political stability, as well as the rule of law, create a conducive environment for economic progress and overall prosperity.

Policy Priorities for the new Government – Enhancing Productivity

Enhancing productivity in mature developed economies is crucial for sustaining economic growth, improving living standards, and ensuring competitiveness in a rapidly evolving global landscape. Here are several key policies that can help boost productivity in such economies:

- Investment in Research and Development (R&D): Allocating resources to R&D activities fosters innovation and technological advancement. Governments can offer grants to encourage private sector R&D, leading to the development of new products, processes, and technologies that drive productivity gains.
- Education and Skills Development: A well-educated and skilled workforce is essential for productivity growth. Policies that support quality education and training programs, retraining of workers, and bridging skills gaps can enhance human capital and enable workers to contribute effectively to the economy.
- Infrastructure Investment: Efficient transportation, communication, and energy infrastructure are vital for business operations and overall economic performance. Governments should prioritise infrastructure development to reduce bottlenecks and enhance connectivity, thereby increasing efficiency and reducing costs.
- Deregulation and Business-Friendly Environment: Streamlining regulations and reducing bureaucratic hurdles can facilitate business operations, encourage entrepreneurship, and attract investments. Simplified procedures for starting and running businesses contribute to increased productivity by minimising administrative burdens.
- Digital Transformation: In a rapidly evolving digital world, New Zealand should invest in digital infrastructure and technology adoption. Promoting digital literacy and supporting tech startups can fuel growth in this sector, creating jobs and diversifying the economy.
- Incentives for Technology Adoption: Encouraging businesses to adopt advanced technologies, such as automation, artificial intelligence, and digitalisation, can lead to significant productivity improvements. Subsidies, grants, and training initiatives can support businesses in transitioning to technologically advanced practices.
- Promoting Competition: Competition fosters innovation and efficiency by compelling businesses to continually improve and offer better products and services. Effective measures to prevent monopolistic practices can create a competitive environment, that characteristically drives productivity growth.
- Support for Small and Medium-Sized Enterprises (SMEs): SMEs are often engines of innovation and economic dynamism. Policies that provide access to financing, mentorship, and networking opportunities can enable SMEs to thrive, contributing to productivity enhancement.
- Flexible Labor Markets: Labor market policies that strike a balance between worker protections and labour market flexibility can promote job creation and innovation. Reforming rigid labour regulations can encourage firms to hire and invest more readily, boosting productivity.
- Promotion of Entrepreneurship and Startups: Encouraging a culture of entrepreneurship and supporting startups can inject innovation into the economy. Policies that facilitate access to capital, provide mentoring, and reduce regulatory barriers for startups can lead to productivity gains.

There is no silver bullet or magic wand to achieve higher productivity. Getting it right requires a multifaceted approach encompassing education, technology adoption, infrastructure development, regulatory reform, and support for innovation and entrepreneurship can significantly enhance the productivity of mature developed economies.

By carefully implementing these policies, governments can foster sustainable economic growth, improved living standards, and a competitive edge in the global arena. However, the approach requires consistency and incremental gains which build up over decades.

Reducing our vulnerabilities

More broadly, economic reform priorities for New Zealand in the 21st century should be rooted in a dynamic, inclusive, and sustainable approach that harnesses our strengths while addressing our vulnerabilities.

Climate change and the required energy transition is the greatest challenge of this generation, and probably the next one. Transitioning to a more sustainable economy can stimulate productivity growth through the development of new green technologies and industries. Investment in renewable energy, sustainable agriculture, and eco-friendly practices can lead to economic gains while addressing environmental challenges.

As a country renowned for our natural beauty, New

Zealand must prioritise environmental conservation. Economic reforms should centre on sustainable agriculture, transitioning to renewable energy sources, and reducing carbon emissions. This not only aligns with global environmental goals but also enhances New Zealand's reputation and market access for its products.

For a small economy, focusing on exports can drive productivity by exposing domestic businesses to global competition and expanding market opportunities. Governments can offer support for export-oriented industries through trade agreements, export financing, and market access assistance.

New Zealand's export-focused economy has made it vulnerable to global market fluctuations and rising geo-political tensions. Diversifying trade partners and expanding export markets will reduce dependency on a few key industries. Bilateral trade agreements and efforts to develop high-value exports can help achieve this goal.

The COVID-19 pandemic highlighted the risks of overreliance on tourism. Economic reforms should focus on reimagining the tourism sector by offering unique and sustainable experiences, while also promoting domestic tourism. Low value-added tourism which mainly strains infrastructure and the environment can be de-prioritised and higher-value added eco-tourism capacity can be developed, which should also reinforce an upskilled higher-wage workforce.

Tackling income inequality is a crucial economic reform priority. The government should focus on progressive taxation with appropriate thresholds, ensuring a minimum wage for all, and investing in education and vocational training to provide equal opportunities. This will not only enhance social cohesion but also stimulate domestic demand.

It is important that taxpayers' net income remains high enough for individuals to have free disposable funds left after tax and living costs, to invest in financing industrial and technological improvements. This can create a virtuous circle, whereby the higher-productivity industries are supported to maturity through private capital markets and the domestic investor base benefits through holding equity, which can then lower the pressure building on state-funded retirement income.

Fiscal Sustainability

Fiscal sustainability is being challenged by ever-increasing calls on Governments to meet an ever-rising list of challenges including meeting Net-Zero 2050 decarbonisation commitments, closing infrastructure deficits and building back stronger when existing infrastructure fails during extreme weather events, and closing inequality gaps.

Furthermore, this pressure is coming while ageing populations are already threatening the quality of healthcare provision and challenging commitments to pension entitlements. Higher interest rates are also raising debt servicing costs.

The challenge for politicians is to meet these challenges within the constraints of maintaining prudent levels of debt and a globally competitive, growth-enhancing tax system, not to mention frequent calls for tax cuts.

All around the world, governments are facing into rising deficits, public debt and debt issuance which is underpinning higher interest rates. In many countries, the fiscal windfall from ever lower interest rates is now a burden as interest rates rise and interest costs put the squeeze on core services.

Here in New Zealand, we often comment that our fiscal accounts are the envy of the developed world. That status needs to be maintained as a small, open economy if we are to continue to attract the capital flows required to fund persistent current account deficits. Rating agencies made just this point following the release of Budget 2023.

Hard choices are going to have to be made, and trade-offs will have to be agreed.

We need a plan

Progress towards a more prosperous future will be slow and incremental, but a well-articulated plan from government can give business the confidence that we are heading the right direction. The plan should be guided by a vision of a prosperous, equitable, and environmentally responsible future. By addressing these areas, New Zealand can strengthen its economic resilience and can become a model for sustainable development on the world stage.