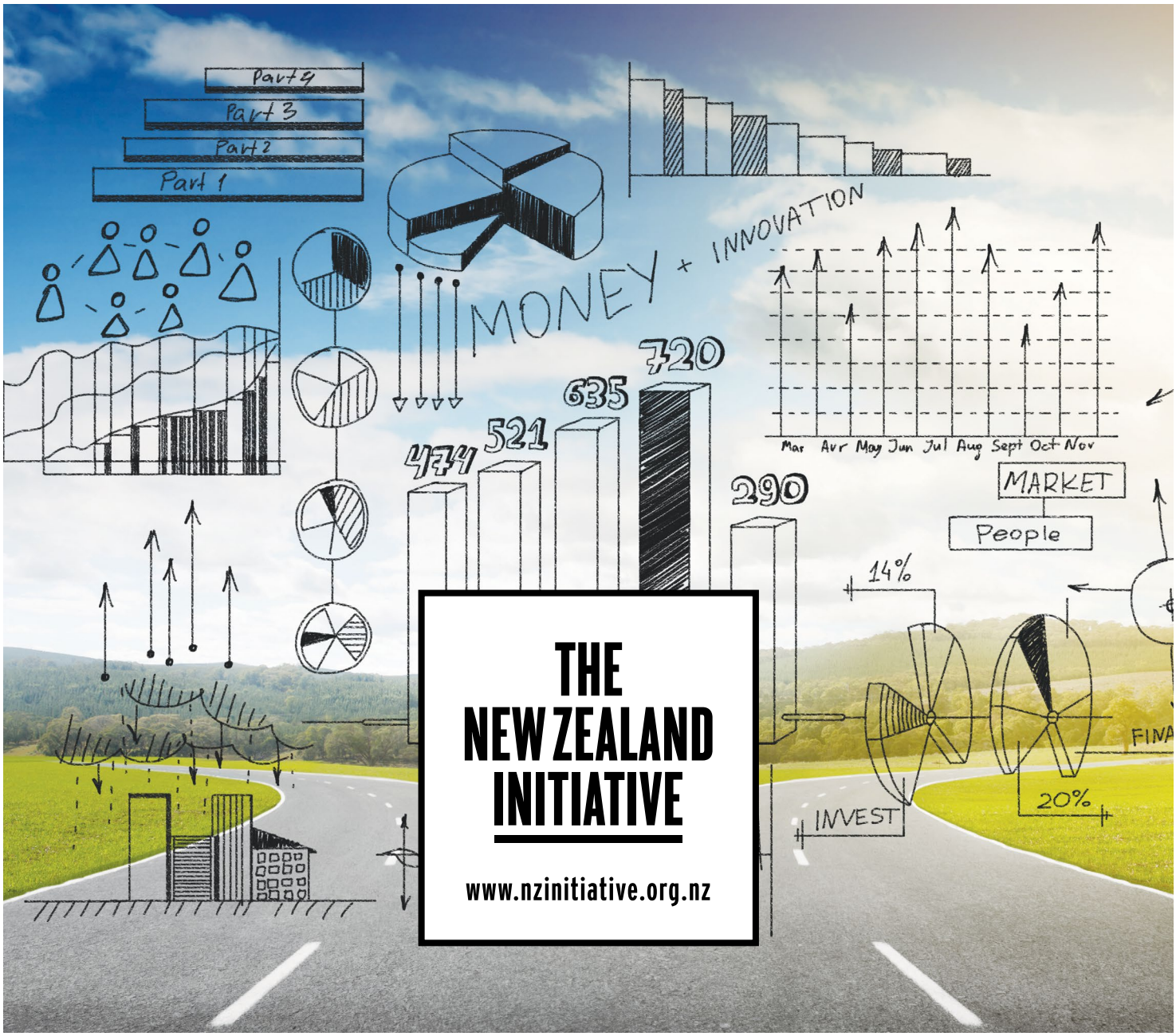
GOVERNMENT & POLITICS

ROADMAP FOR RECOVERY

Briefing to the Incoming Government

The New Zealand Initiative
2020



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About the New Zealand Initiative

The New Zealand Initiative is an independent public policy think tank supported by chief executives of major New Zealand businesses. We believe in evidence-based policy and are committed to developing policies that work for all New Zealanders.

Our mission is to help build a better, stronger New Zealand. We are taking the initiative to promote a prosperous, free and fair society with a competitive, open and dynamic economy. We are developing and contributing bold ideas that will have a profound, positive and long-term impact.

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Executive Summary

New Zealand faces its worst recession in nearly a century. Unfortunately, the economic response to the challenges of Covid-19 leaves much to be desired. Most new policy initiatives proposed in the run-up to the 2020 general election range from trivial at best to economic sabotage at worst. New Zealanders deserve better.

The scale of the problem is immense. The OECD predicts our collective income or Gross Domestic Product (GDP) could fall by as much as 10% in 2020 alone. While Treasury's Pre-election Economic and Fiscal Update forecasts are more optimistic (with GDP falling by 3.1% in 2020), GDP figures released by Statistics New Zealand for the June quarter reveal our collective income fell by 12.2% compared to the previous quarter. Even before Covid-19 New Zealand struggled with long-standing productivity problems, with productivity growth being crucial to raising living standards in the long-term.

Employment has been supported by $14 billion of wage subsidies which are now coming to an end. Unemployment is now on the rise. Indeed, in the final week of June the unemployment rate was 6.2% with 11,000 fewer employed people than the previous quarter. The OECD predicts New Zealand's unemployment rate could climb as high as 8.9% in 2021.

Finally, public debt is projected to balloon from 19% of GDP in 2019 to 28% in 2020. After peaking at over 56% of GDP in 2026, it is only projected to modestly fall to 48% in 2034. This will place a huge burden on future New Zealanders.

This country desperately needs sensible policies to protect the livelihoods of all New Zealanders, now and in the future.

New Zealand's labour market settings are performing well overall, delivering relatively high participation rates, job creation and low levels of unemployment before Covid-19. Labour market settings do not require a radical overhaul, although flexibility in the labour market should be further enhanced to support employment. Recent and proposed reforms to the labour market, however, threaten employment and the flexibility required to deal with the aftermath of the Covid-19 crisis.

Raising or introducing new taxes would hurt growth and is not necessary for getting the public debt back under control. Instead, there is ample scope to reduce public spending through greater efficiency and scrutiny and ending wasteful spending on costly programmes which do not deliver on their objectives. Health, education and welfare need not be affected by these changes and may even improve. Changes to retirement income policy alone could return the public debt to about 30% of GDP by 2034.

Productivity performance could also be improved with key changes to education, regulatory settings affecting investment, monetary policy and climate change.

Promoting employment, growth and productivity, and a credible path back to sustainable debt levels is critical. The New Zealand Initiative has developed a number of key recommendations, outlined in this report and summarised in the table below, which will help achieve these goals, facilitate recovery, and safeguard our future prosperity.

Key Recommendations for Recovery

ISSUES	KEY RECOMMENDATIONS
Labour market settings are performing well, but flexibility should be enhanced to boost employment. This is important for vulnerable groups (young, low-skilled, Maori and Pasifika) who's employment is disproportionately affected in recessions.	Proposals to introduce Fair Pay agreements (FPAs) should be abandoned. Abandon "contractor" law reform proposals. Instead, enforce the existing regulatory settings more effectively. Amend unjustified dismissal procedures of the Employment Relations Act 2000 (ERA) so they do not apply to highly paid employees. Roll back recent minimum wage increases, which will hurt employment, and re-introduce lower youth minimum wage rates.
Public debt will increase significantly over the next 6 years due to Covid-19 and poor-quality spending choices. This will place a huge burden on New Zealanders in the future who will need to pay higher taxes or enjoy less government expenditure.	Avoid increasing or introducing new sources of tax revenue, which would further dampen economic activity. Reform retirement income policy for significant fiscal savings including: • Abolish subsidies to KiwiSaver; • Amend indexation of NZ Superannuation and raise age of eligibility by two years, linking further changes to health adjusted life expectancy; and • Suspend NZ Superannuation Fund contributions. Undertake a comprehensive expenditure review to identify and reduce low quality expenditure. Stimulus, such as "shovel-ready" investment projects, must pass standard cost-benefit tests. Establish an independent fiscal council to keep spending decisions under close scrutiny.
The Resource Management Act (RMA) exacerbates resource problems by undermining private property rights and failing to internalise costs.	Replacement legislation should protect private property rights in respect of resource use. Objectors should be confronted with the cost to the community of the foregone use and compensation for regulatory takings should be permissible.
The Overseas Investment Act (OIA) is amongst the most restrictive in the OECD. Kiwis must be able to access overseas capital and know-how to enable productivity growth.	The OIA should be repealed. Any replacement legislation should focus on genuine public good problems, such as national security. If not repealed, screening provisions in the OIA should be reduced, if not removed entirely. Sensitive land should be restricted to land that is identifiably sensitive and the cost-benefit test should be amended to confirm with something recognisable as a public interest test.
Putting a price on greenhouse gas emissions is the single best way of reducing New Zealand's emissions. Measures undertaken outside the ETS, even if carefully designed, risk being less effective and far less cost-effective than working through the ETS.	Use the ETS as primary regulatory instrument for reducing GHG emissions. Non-ETS measures should be assessed on the cost-per-tonne of GHG reductions, with that cost reported for each. Rather than distort the ETS to achieve desired distributional outcomes: • Grant ETS credits within the cap to existing emitters; • Transfer revenues earned through government auction of ETS credits to lower-income households; and • Supplement those transfers through other additional payments to targeted households if necessary.

ISSUES	KEY RECOMMENDATIONS
Recent monetary policy developments depress savings are potentially highly inflationary, initially for asset values, and risk the independence of the Reserve Bank of New Zealand (RBNZ).	Amend the RBNZ Act to specify a single objective – long-term price stability. Shift the RBNZ's regulatory role to another institution to improve governance and reduce politicisation of the monetary policy role. Limit the RBNZ's budget to cover its monetary policy role and restrain it from getting deeper into matters related to ethnicity and climate change. Return the inflation target to 0–2%. Stop the implementation of deposit insurance. Limit RBNZ's discretionary ability to purchase securities to government paper. Ensure a credible timetable for reducing its balance sheet to pre-Covid-19 levels.
High educational achievement has fallen for two decades due to malign influence of discredited "child-centred learning."	Create a new national curriculum based on disciplinary knowledge, not competencies. Create an evidence-based profession, including designing standardised national assessments to highlight effective schools and approaches. Reinstate and extend the partnership schools model.

Introduction

New Zealand is in the midst of what could be its worst recession in nearly a century. So far, the response to the economic challenges of Covid-19 has primarily focused on new spending and most new policy initiatives proposed in the run-up to the 2020 general election have ranged from the trivial at best to economic sabotage at worst. New Zealanders deserve better.

More public holidays, ending payWave fees, electric cars, wealth taxes and a guaranteed minimum income are not a prescription for recovery and long-term prosperity. The lack of sound economic policy and vision at precisely the time when we need it the most is deeply concerning. The wrong policy prescription now could see New Zealand transition from a relatively high-income country to a failed state.

The scale of the problem is immense. The OECD predicts our collective income or Gross Domestic Product (GDP) could fall by as much as 10% in 2020 alone.[1] While Treasury's Pre-election Economic and Fiscal Updata forecasts are more optimistic (with GDP falling by 3.1% in 2020), GDP figures released by Statistics New Zealand for the June quarter of this year show our collective income has fallen by 12.2% compared to the previous quarter.

Even before Covid-19, this country faced long-standing problems with productivity. Successive governments have largely ignored this issue despite productivity growth being crucial to raising living standards in the long-term. In 1970, our GDP per capita was 84.5% of Australia's. Last year, it was only 78.2%.

Our low unemployment rate, at 4% for the June quarter, will not persist. Employment has been supported by $14 billion in wage subsidies, which are now coming to an end. Labour participation rates have already begun to fall, while the number of benefit recipients has increased significantly. In the final week of June the unemployment rate was 6.2% – with 11,000 fewer employed people than in the previous quarter. The OECD predicts that New Zealand's unemployment rate could climb as high as 8.9% in 2021. This would most hurt the young, low-skilled and vulnerable, likely scarring their employment outcomes for many years to come.

Based on policies and circumstances to 7 September, Treasury's central forecasts see the public debt balloon from 19% of GDP in 2019 to 28% in 2020.[2] After peaking at over 56% of GDP in 2026, it is only expected to modestly fall to 48% by 2034. This will place a huge burden on New Zealanders in the future. We will need to use a greater share of our incomes to service this debt, pay higher taxes or enjoy less government expenditure than we otherwise would have, further dampening our economic potential. High levels of debt will also place us in a far weaker position to respond to future crises such as natural disasters, with which New Zealand is all too familiar.

Unfortunately, the policy response to the economic challenges of Covid-19 has been woefully inadequate. We desperately need sensible policies to protect the livelihoods of all New Zealanders, both now and in the future. This is why The New Zealand Initiative has put together the following key priorities to promote employment, growth and productivity, and a credible path back to sustainable debt levels.

This report proceeds as follows. In the context of labour market settings, which have by and large delivered good outcomes, Chapter 1 discusses

key priorities for employment, including those related to minimum wage settings and proposals to introduce Fair Pay Agreements. Chapter 2 outlines our fiscal priorities and argues that getting better value for money from government expenditure, rather than increasing taxation, is the best approach to keep debt under control. Finally, Chapter 3 discusses key priorities for productivity, including those related to education, regulatory settings affecting investment, monetary policy and climate change.

CHAPTER 1

Priorities for employment

Labour market settings should be evidence-based and support the goal of improving productivity and overall wellbeing. Judged by their results, New Zealand's labour market settings are performing well overall and do not require a radical overhaul. Evidence from both domestic and international research strongly suggests the incoming Government should:

- not introduce the former Coalition Government's proposals to introduce Fair Pay agreements (FPAs);
- keep the current regulatory settings in relation to the popular contractor model used to govern workplace relations for many occupations, but *enforce* the existing regulatory settings more effectively;
- modify the unjustified dismissal procedures of the *Employment Relations Act 2000* (ERA) so they do not apply to highly paid employees (mirroring the approach taken in Australia); and
- re-introduce lower youth minimum wage rates while rolling back recent minimum wage increases – or at least not further increase New Zealand's already relatively high minimum wage rates. If the Government wishes to provide greater income support for families on low income, doing so through in-work transfers is more efficient.

New Zealand's labour market settings are working well

The 1991 labour market reforms dismantled the national awards system, under which most workers were represented through a system of collective bargaining. In its place, the *Employment Contracts Act 1991* (ECA) (the predecessor to the ERA) introduced individual employment contracts (now individual employment agreements) prevalent in workplaces today.

Judged by its record since 1991, New Zealand's labour market has performed well.

- At 80.9% (pre-Covid-19), our labour market participation rate is among the highest in the world. Among developed countries, we sit behind only Sweden, Switzerland and Iceland. New Zealand's position in the front ranks compares favourably with Australia (78.5%), the EU average (74.2%) and the OECD average (72.8%).[3] Labour force participation matters. The link between work and wellbeing is incontrovertible. Joblessness harms not just material wellbeing but also mental and physical health.
- Since 1991, the labour market has had the third highest rate of job creation in the OECD.[4] While this ranking is no doubt influenced by high levels of immigration, the country's employment growth record shows that labour market settings have enabled the economy to absorb high immigration flows.
- Matching the high labour force participation and employment growth rates is a relatively low unemployment rate. At 4% for the last pre-Covid-19 quarter ended 31 December, 2019,[5] the country's unemployment rate was well below Australia's (5.1%) and compared extremely favourably with the OECD average (5.2%) and the EU average (6.5%).[6] New Zealand's current employment rate

also compares favourably with our past employment performance. Before the ECA transformed the country's domestic industrial relations landscape, labour market participation was languishing at a low 73% and unemployment exceeded 10%.[7]

- Over the past three decades, average real hourly wages have increased cumulatively by about 30%,[8] with average real wage rates rising in all wage deciles.[9] This is at a time when wages for low-income workers were stagnating in some OECD countries for decades.[10]
- Recently, the OECD singled out New Zealand – along with Denmark – as countries in which real median wage growth has closely tracked productivity growth.[11] In other words, our labour market has increased wages in line with increases in productivity, notably among other OECD countries.

Many other countries have either emulated – or are looking to emulate – aspects of New Zealand's flexible approach to labour market regulation. Most notably, French labour laws were changed in 2017 to permit workers and employers to negotiate at the enterprise level, instead of (the formerly compulsory) sector-wide collective bargaining.[12]

Abandon FPA proposals

The former Coalition Government proposed to introduce a system of compulsory, centralised collective bargaining called Fair Pay Agreements (FPAs). The reforms would take New Zealand back to the awards system that dominated industrial relations before the 1991 reforms.

In promoting FPAs, then-Minister of Workplace Relations and Safety Iain Lees-Galloway said FPAs were needed to repair the damage to labour markets caused after abandoning compulsory unionism and collective bargaining in 1991. But, as The Initiative showed in *Work in Progress: Why Fair Pay Agreements would be bad for labour* (2019), each of Lees-Galloway's claims about the 1991 reforms is flawed. Contrary to his claims:[13]

- Employees' share of GDP has trended upwards since 1991;
- Unlike in other countries, market income inequality has *fallen* in the past three decades;
- Wage growth has closely tracked productivity growth, not lagged it;
- Wages were not driven down by a "race to the bottom" with "bad" employers undercutting the wages paid by "good" employers. Average real hourly wages have *risen* in every wage decile.

Lees-Galloway said New Zealand's poor productivity record was due to the 1991 reforms.[14] While he correctly identified poor productivity as the Achilles' heel of the economy, the evidence shows he was wrong to blame the 1991 reforms. The country has had poor productivity growth for more than 50 years; periods of fast productivity growth occurred only *after* labour market regulations were relaxed in 1991.[15]

While the case for FPAs is weak, the case against FPAs is strong – and it is even stronger with the New Zealand economy on its knees due to the global pandemic. Industry- or occupation-wide collective bargaining – like the proposed FPAs – risks lowering the country's already tepid productivity growth.[16] FPAs will reduce the flexibility of labour markets and increase their operational complexity.[17] They also risk locking in inefficient practices. Kiwi workers and firms can ill afford these risks with the economy struggling to find its feet.[18]

At the same time, if compulsory collective bargaining forces wages to rise (as unions no doubt hope it will), even more job losses would occur in firms unable to recoup the costs of

higher wages from customers. Higher wages would likely disproportionately hurt the unskilled and the unemployed – particularly young workers trying to enter the workforce.[19]

Abandon "contractor" law reform proposals

In 2019, the previous Government commenced consultations on whether changes are needed to regulate the "contractor" model for working arrangements between firms and workers.[20] The Ministry of Business, Innovation & Employment (MBIE) sought feedback on 11 "options" to provide contractors with "better protection." The options include improving enforcement powers for the Labour Inspectorate and re-classifying some categories of contractors as employees – or as a new intermediate category of "worker" (with some but not all the rights of employees).

MBIE's discussion paper was primarily in response to the rise of the "gig economy" and challenges to full-time employment from technology (commonly termed the "future of work").

It is true that contracting is popular in many sectors of the economy to govern arrangements between firms and workers. From truck drivers to tradesmen, and from cleaners to couriers, contracting is preferred over employment.

Yet in 2019, the Productivity Commission separately reported that the gig economy was small and showed no signs of rapid growth, either in New Zealand or in the 30 countries for which data was available.[21]

The Productivity Commission's findings suggest that before considering solutions (like the "options" in MBIE's discussion paper), we must ask, "Is there a problem that needs solving?"

The discussion document's "Message from the Minister" (from Lees-Galloway) repeated the discredited claim supporting his FPA reform proposals – that the deregulation of the labour market in 1991 created structural problems and increased inequality.

The body of the discussion paper (no doubt correctly) identifies instances of exploitation by unscrupulous employers treating their workers as contractors when the law requires them to be treated as employees. Anecdotes aside, no evidence of systemic problems requiring wholesale changes to the status of contractors was presented.

The problem of workers not receiving their entitlements is a problem of enforcement. It does not require contractors to be reclassified as employees (or into some hybrid, halfway house as suggested in one of the "options").

The OECD recently warned that in this area, policy makers should be careful to base any decisions they make on evidence rather than anecdotes. Lees-Galloway failed to heed this warning.

The incoming Government must also be mindful that non-standard forms of work such as contracting emerge in response to the real needs of both firms and workers. As long as labour markets are working well, the Government must resist the urge to find solutions to non-existent problems.

Relax unjustified dismissal provisions in ERA for high-income earners

The unjustified dismissal provisions add safeguards to protect workers from being unjustifiably dismissed.[22] Originally designed to protect low-paid, vulnerable workers from the arbitrary conduct of "bad" employers, the unjustified dismissal provisions were extended to all workers when the ECA was enacted in 1991.[23] These provisions prevent an employer from dismissing an employee by simply following

the notice terms of the employment agreement. Instead, for a dismissal to be "justified," the employer is required to show "cause" and exercise "due process" by acting fairly.

In extending the unjustified dismissal provisions to all workers, New Zealand's industrial relations legislation extends beyond the equivalent Australian legislation. Australia's *Fair Work Act 2009* excludes employees earning above a defined "high-income threshold" from the protection of Australia's unfair dismissal laws.[24] The threshold is adjusted annually and is currently $AU153,600.[25] Consequently, an Australian employer can fire an underperforming but highly paid manager simply by complying with the notice provisions in the manager's contract. "It's not working and we want to try someone else" is enough justification for dismissing Australia's high-earning senior managers.

Good reasons exist for New Zealand to follow Australia's approach. The common rationale for protecting workers is the inequality of bargaining power between employers and low-skilled, low-paid workers and the financial vulnerability of low-paid workers in the event of dismissal. This logic is weaker for high earners, who generally have the economic nous to negotiate their employment terms. They are also more likely to have the financial and human capital needed to protect themselves if they lose their jobs.

Just as the rationale for protecting high- and low-paid workers is asymmetric, so too are the potential distortionary effects on productivity. Protecting an unskilled worker against dismissal without cause is less painful to a firm's productivity – or its viability – than constraining its ability to dismiss an underperforming senior manager whose performance may be poor, but not so poor as to justify dismissal.

Indeed, putting barriers in the way of a firm trying to dismiss underperforming senior managers has the potential to put the jobs of low-paid, vulnerable workers at risk. The difference between the success or failure of a firm – or of a division within a firm – may, at the margin, depend on the quality of its senior management. Consequently, using unfair dismissal laws to constrain a firm's owners from dismissing underperforming senior management may be counter to the interests of low-paid workers, whose welfare the unjustified dismissal provisions are designed to protect.

These concerns are amplified in the post-Covid environment. With the economy struggling, we need firms to be led by able senior managers.

In 2017, a private members' Bill, the *Employment Relations (Allowing Higher Earners to Contract Out of Personal Grievance Provisions) Amendment Bill*, reached the Select Committee but failed following the change of Government the same year. The Bill had its flaws, including its reliance on a cumbersome "contracting out" mechanism.[26]

The incoming Government should resurrect the reform proposal and follow Australia's lead by narrowing the ERA's unjustified dismissal provisions so they do not cover highly paid senior management.

Reform minimum wages for more employment

Most OECD countries have some form of statutory minimum wage. However, minimum wage levels and setting mechanisms vary markedly across countries, as do their coverage and level of employer compliance. During the global financial crisis and recovery, countries relied heavily on the minimum wage either to boost (or sustain) the wages of the (working) poor and other low-paid workers, or to cut labour costs as a crisis-related measure (depending on the most pressing issue).

Minimum wages have both potential advantages and disadvantages. They can improve equity by lifting the incomes of lower-paid workers and encourage those on the edge of the labour market, such as the low-skilled, to find work. If set too low, they lose this usefulness. If set too high, minimum wages will stop employers from hiring lower skilled workers and may end up protecting the "insiders" who already have the jobs. For some firms, the cost of taking on extra staff can be a hurdle, even at minimum wage.

Minimum wages are also a relatively blunt tool for tackling poverty even if they were not to have any negative effects on employment. Many poor families have no working member. At the same time, many workers at minimum wage live in households with above-average incomes. Also, minimum wages do not guarantee that workers will be able to work enough hours to lift them out of poverty.

For instance, a study using New Zealand data and previous minimum wage changes estimated that a 10% increase in minimum wages, even without a loss in employment or hours of work, would only lower the relative poverty rate by less than one-tenth of a percentage point.[27] For this reason, in-work transfers are likely to be a more effective mechanism for poverty reduction than minimum wage increases.

Evidence suggests that small increases in the minimum wage at reasonable levels are unlikely to cause substantial job losses. However, the evidence also suggests that vulnerable groups, such as the young and low-skilled, are more adversely affected. Furthermore, what constitutes a "reasonable" minimum wage is inevitably country-specific and depends on how the minimum wage interacts with other policies, as well as on the coverage of minimum-wage legislation, compliance, and macro-economic and labour market conditions.[28]

In 2019, the minimum wage in New Zealand was among the highest in the OECD, at 66% of the median wage for full-time workers, and significantly above the OECD average of approximately 55%.[29] Minimum wages were increased in April this year when the country was in lockdown and there are calls now to lift them further still.

Today's macro-economic environment and labour market conditions are far from ideal for absorbing minimum wage increases. Indeed, we could be facing the worst recession in nearly a century, and unemployment is projected to more than double. Ill-timed minimum wage increases will ensure fewer jobs are created.

In fact, as part of its annual minimum wage review in December last year, the MBIE forecast that this year's increase in the minimum wage to $18.90 would come at a cost of 7500 jobs. MBIE further predicted a loss of 19,000 jobs if the minimum wage were increased by an additional dollar to $19.90 – more-or-less the level of minimum wage the Labour Party is promising for 2021.[30]

These predictions were made on the assumption of "limited but steady" overall employment growth, an assumption that no longer holds. Indeed, the latest available employment data from Statistics New Zealand shows employment down by 11,000 in the June quarter. MBIE's predictions of the costs to employment from minimum wage increases now appear optimistic.

The disparity between employment and unemployment should be of primary policy concern, rather than differences between those who are lucky enough to be employed at this time. To ensure employment levels remain as high as possible during the Covid-19 crisis and recovery, the minimum wage increase implemented earlier this year should be rolled back. At the very least, further increases in the minimum wage should be avoided.

Further, as a high minimum wage disproportionately hurts the job prospects

of the young and vulnerable, multiple minimum wage rates should be considered – including a youth minimum wage for those under 25. This is common practice in countries with relatively high rates and can help alleviate the potential harm to those struggling to enter the workforce.

CHAPTER 2
Fiscal priorities

The policy response to the economic challenges of Covid-19 has, so far, focused on increased spending. As a result, net core Crown public debt, excluding New Zealand Super Fund assets, is expected to increase from 19% of GDP in 2019 to over 56% in 2026.[31] Moreover, debt will remain high for decades to come, only falling to 48% of GDP by 2034 on this commonly cited measure.[32]

The changes in total Crown borrowing and Crown net worth provide a fuller picture of the increased risk to taxpayers from the weakened fiscal position. Between the 2019 and 2024 fiscal years, total Crown borrowing is set to rise from 36% of GDP to 79%, while total Crown net worth attributable to the Crown drops from 45% of GDP 10.4%. A drop of 35% of GDP amounts to almost $60,000 per household and is more than a full year of tax revenue.

Borrowing to this extent comes at a significant cost. To restore the net worth position, future spending must be reduced and future taxes raised in some combination by about 35% of one year's GDP. To the degree that national net worth is also weakened, the country is now more vulnerable to further economic crises or coping with natural disasters. Another risk is when global interest rates rise relative to income growth. When that happens, the fiscal positions of New Zealand and Europe could quickly become perilous.

Burdening future generations with the cost of Covid-19 is an unworthy option. Instead, governments can increase revenue or reduce spending. Each has its advantages and disadvantages. For example, raising taxes in the midst of a recession would likely further dampen economic activity. Similarly, reducing expenditure in certain areas, such as unemployment benefits, could lead to significant hardship. Nevertheless, it is prudent to consider whether the country's policy priorities should remain the same.

The case for raising or introducing new taxes is relatively weak and highly problematic. For instance, in their 2019 book, Alberto Alesina, Carlo Favero and Francesco Giavazzi found that, on average, while a drop in spending by 1% of GDP reduced GDP by a quarter of a percentage point for less than two years. By contrast, a comparable tax-based austerity measure reduces GDP by more than two percentage points – eight times more – and for a longer period of three to four years.[33]

However, numerous possibilities exist for reducing public spending, in particular, by increasing efficiency or by cutting expenditure where policy programmes fail to deliver. Furthermore, a clear path exists to identify additional opportunities to reduce low-value public spending and ensure future spending initiatives are of high value.

Value for money expenditure, not more tax

European countries are high tax countries. They are the outliers globally, not the norm. Outside Europe, New Zealand's tax burdens are right at the top end of the spectrum for relatively prosperous countries with populations of at least 2 million.

Specifically, on the Heritage Foundation's database for its 2020 Index of Economic Freedom, 69 countries in the world with populations of at least 2m were relatively

prosperous with GDPs per capita of at least $US15,000. Their tax revenues ranged from 1.4% of GDP for Kuwait to 46.2% for France. Singapore and Hong Kong were at 14.1%.

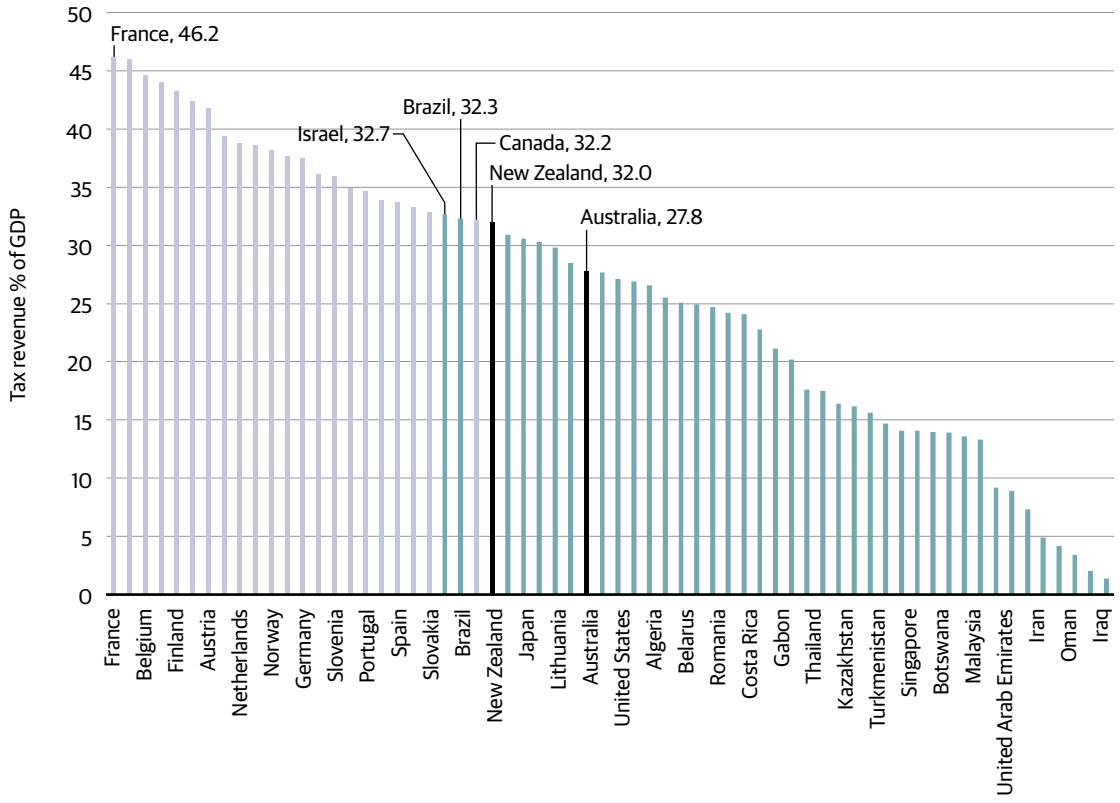
Only three non-European countries had tax revenues greater as a percent of GDP than New Zealand's 32%. (The dappled lines in Figure 1 show European countries with ratios exceeding New Zealand's.) The ratios of the three countries that are similar to New Zealand's are Israel (32.7%), Brazil (32.3%) and Canada (32.2%).

The prosperous Asian countries had incomparably lower tax burdens than New Zealand. The ratios for Japan, Australia, Switzerland, China, Ireland and the US were all appreciably lower than New Zealand's. In all, 79% of the 3.6 billion people who live in the countries in Figure 1 experience a lower average tax burden than Kiwis.[34]

Further increasing tax revenue would be challenging. Even if it were possible, it would come with significant drawbacks. Increasing tax revenue is not straightforward because when faced with higher tax rates, people tend to change their behaviour by reducing the amount they work, save, invest in physical and human capital, or innovate since the returns on all these activities are reduced. This leads to reduced output and growth.[35] People may also try harder to avoid paying tax, and overall, increasing certain taxes may reduce the total revenue collected. This appears to have occurred when the top marginal income tax rate was 39%.[36]

Sources of tax, such as land, capital gains and wealth, as recently proposed by the Green Party,[37] can be similarly problematic. Land taxes under the right circumstances can encourage land to be put to its highest value use, but regulations and restrictions on land use in New Zealand limit

Figure 1: Tax revenue as a share of GDP



Source: Heritage Foundation, "2020 Index of Economic Freedom," Website.

this benefit. Land taxes can also seem unfair because they apply to only one component of wealth, and relatively asset rich but low-income groups may struggle to pay.[38]

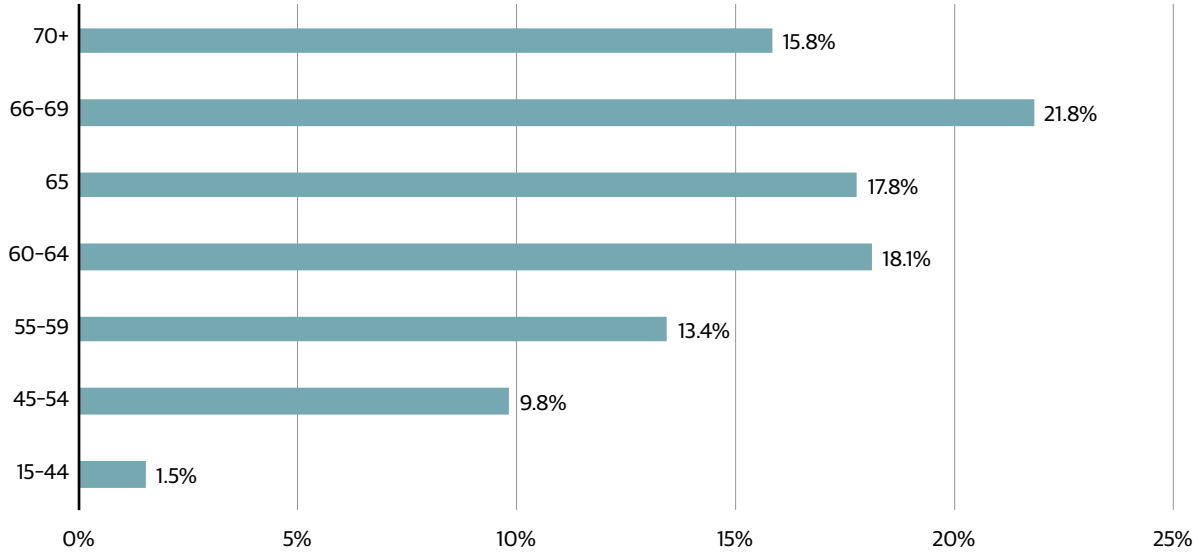
Capital gains taxes, which Prime Minister Jacinda Ardern ruled out, have additional problems as typically implemented. To avoid difficulties in paying a large annual tax bill on property for those who do not necessarily have high incomes, such as the retired, taxes on homes and rental properties are often deferred until the point of sale. This can encourage lock-in and limit people's mobility, which can be particularly problematic during a recession and recovery when people may need to relocate for new jobs. For similar reasons, capital gains taxes also often exclude the family home, which can distort investment decisions and excludes a large part of the tax base.[39]

Wealth taxes go further, covering a much wider set of assets. The Greens, for instance, are proposing an ongoing 1% tax on net assets over $1 million and a 2% tax on net assets over $2m. Unfortunately, as well as generating little revenue and being costly to administer, such taxes typically provoke emigration; disincentivise work and saving; and stifle investment in education and skills, capital, enterprise and innovation. For these reasons, few countries now have annual wealth taxes, and the 2017 Tax Working Group (TWG) recommended against them for precisely these reasons.[40]

Such taxes are often proposed for their apparent benefits in reducing inequality, but proponents seldom offer much information about current wealth inequality or what the optimal level might be. For instance, the Greens say only 6% of Kiwis would be subject to its new wealth tax. But this misses an important point about wealth distribution: wealth is different from income – it takes much longer to accumulate. Most 25-year-olds will have little wealth, but most 65-year-olds would have built some sort of nest egg before retiring.

A look at the data on wealth from the Household Economic Survey (HES) confirms this point (Figure 2). In fact, at any one point in time, 8% of Kiwis would be subject to the wealth tax. However, many more would be hit by the tax at some point during their lives – most likely when

Figure 2: Proportion of individuals subject to the Green Party's wealth tax proposal, by age



Source: Household Economic Survey and Statistics New Zealand.

they retire and are least able to afford it. Indeed, 21.8% of 66 to 69 year-olds would be subject to the tax, according to 2018 wealth data from HES.

Improving value for money in retirement income policy

One area where evidence suggests significant expenditure savings could be made, with little impact on public policy objectives, is retirement income policy.[41] In particular, contributions to KiwiSaver, New Zealand Superannuation (NZS) and the New Zealand Superannuation Fund (NZSF) are going on the country's credit card – and warrant serious attention.

Introduced in 2007, KiwiSaver is a voluntary, defined contributions savings scheme. Its goal, according to the *KiwiSaver Act 2006*, is to encourage Kiwis to form a "long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement" – the target population.[42] In 2019, government subsidies to KiwiSaver totalled $951m.

KiwiSaver's performance has been rigorously evaluated against its stated objectives by two major studies.[43] One used a survey designed specifically to evaluate KiwiSaver and found that only a third of the contributions to KiwiSaver were new savings. KiwiSaver was also found to be highly inefficient at reaching those it was intended to help. For every success, 14 other KiwiSaver members were merely along for the ride.

The second study looked at KiwiSaver's effect on wealth accumulation. A large group of individuals were followed over eight years and changes in their assets and liabilities were measured. KiwiSaver membership was found to have no effect on wealth accumulation on average. This was the case even after controlling for other wealth accumulation factors such as income, age, gender, ethnicity, family circumstances, home ownership and previous levels of wealth.

Overall, KiwiSaver has performed poorly – as have many similar schemes overseas.[44] Government subsidies to KiwiSaver represent poor value for money. With the current economic context forcing the government to borrow heavily, subsidies to saving through KiwiSaver should end. If this were to happen in 2021, government debt as a share of GDP in 2034 would be approximately 4.5 percentage points lower, all else being equal.

NZS, a universal government-funded pension scheme intended to ensure a basic standard of living for the elderly, is an even bigger ticket item. The eligibility age for NZS is 65 and payments are linked to wages. NZS contributes to low old-age poverty rates but comes at a considerable cost. In 2019, spending on NZS was approximately $14.6b, or 4.7% of GDP, but its costs are projected to increase to 7.9% of GDP by 2060 due to population ageing.[45]

Many OECD countries have already reformed their superannuation systems to account for increases in life expectancy and continued population ageing.[46] Since the last changes to NZS (lifting the age of eligibility from 60 to 65 between 1992 and 2000), life expectancy has increased by about two years and will continue to rise.

Fortunately, analysis using long-term population projections from Statistics New Zealand suggest that even relatively modest changes to NZS can lead to significant fiscal savings over time.[47] If, for example, the age of eligibility for NZS were increased by two years from 2025 and the growth of individual payments were reduced slightly from 2021, government debt as a share of GDP in 2034 could drop by 12.4 percentage points.

Linking the age of eligibility to further changes in health adjusted life expectancy would also reduce the need to periodically re-evaluate NZS settings,

providing greater certainty to future NZS recipients. Of course, making people rapidly plan for an additional two years before retirement would be a challenge. But phasing in increases to the eligibility age over a longer period could help manage the transition and achieve similar reductions in debt over the medium term.

Taken together, ending subsidies to KiwiSaver and making some relatively modest changes to NZS could reduce government debt to about 31% of GDP in 2034, instead of the projected 48%. Before Covid-19, debt of 15–25% of GDP was what the government considered prudent.

Further, the government is diverting resources that could be used to deal with the clear and present Covid-19 economic crisis to the NZSF for a rainy day far in the future. The NZSF is a public savings vehicle created to help meet the future cost increases of NZS due to population ageing.

While it is true superannuation costs as a share of GDP are expected to rise over time, they will remain much lower than the OECD average.[48] Amending NZS now, as described above, would further weaken the case for keeping the NZSF.

The NZSF holds about $44b now. Despite Covid-19, the government still plans to borrow an additional $7.7b over the next four years to make further contributions to the NZSF.[49] A the least, contributions to the NZSF should be suspended as it was during the global financial crisis.

However, serious consideration should be given to winding up the fund early. The expected balance of the NZSF in 2024 is approximately $60b, which would go a long way towards paying for the Covid-19 recovery.

More ways to reduce expenditure

Given the scale of the fiscal challenge ahead, it is prudent to consider further opportunities to reduce current and future government expenditure, and to ensure the spending that does occur is of high value. Identifying programmes and initiatives that fail to meet their objectives or provide poor value for money is not necessarily straightforward. However, strong contenders include KiwiBuild, Fees Free tertiary education and the Provincial Growth Fund (PGF).

KiwiBuild was a flagship 2017 election promise of the Labour Party and entailed building 100,000 affordable homes over 10 years. Since it was introduced, the programme has fallen far short of meeting each of its targets, delivering only a handful of homes so far – homes that likely would have been built anyway.

Similarly, Fees Free tertiary education for first time learners, providing either one-years' study or two-years' training fees-free does not appear to have induced greater enrolments. The scheme likely benefits those who would have continued their learning anyway and who will benefit directly from that education.

The PGF is a $3b investment fund announced in 2017 to increase regional growth and development. Again, it is not clear what outcomes consistent with this objective have been delivered by the myriad projects undertaken. Indeed, the Office of the Auditor-General has called for greater evaluation of the fund, which is now overdue. It has also criticised the administration of the fund as it was difficult to tell why and how certain projects were chosen for funding. The Auditor-General also noted that the PGF's spending on "manifesto commitments to the regions" acted as a "fund within a fund" with "no easy way for Parliament to scrutinise the appropriations for the Fund as a whole."[50]

Examples of such policy missteps are not always so easy to identify, yet rigorous evaluation of policy programmes and investment projects is relatively rare in New Zealand. Typically, we

only monitor programme uptake, spending and other high-level indicators. Such information, while useful, is not enough to judge efficacy. Even when rigorous evaluation of actual outcomes against policy objectives and value for money is conducted, there is no clear path to reforms.

Following the global financial crisis many countries, particularly in Europe, undertook comprehensive expenditure reviews to reduce low quality expenditure. A similar exercise should be undertaken in New Zealand to identify and weed out spending that fails to meet objectives or provides poor value for money. KiwiBuild, Fees Free and the PGF would likely make the list, but such an exercise would likely also identify less visible or less spectacular failures.

Looking ahead, while New Zealand has the fiscal headroom to stimulate the economy now, it does not mean the next Government should hastily implement expensive new policy initiatives – and risk policy failure and unintended consequences. Nor should it undertake investment projects where benefits do not outweigh costs. The recent drive to implement "shovel ready" projects to aid the Covid-19 recovery and stimulate employment particularly warrants caution based on history.[51]

For instance, to help stimulate demand, support flailing automakers and fix some environmental concerns, the US introduced the "Cash for Clunkers" scheme in 2009. Washington offered incentives of between $US2500 and $US4500 to US residents when they traded in a gas-guzzling, older vehicle for a newer, more fuel-efficient model.

The programme cost the US taxpayer billions. However, estimates suggest about 60% of the subsidies were claimed by consumers who would have bought a new car anyway. Ultimately, no real difference existed in new car ownership between those eligible for Cash for Clunkers and those who were not. On top of that, since most fuel-efficient vehicles tend to be cheaper (and imported), consumer spending declined.

Australia introduced the Home Insulation Programme (HIP) with similar goals of stimulating demand and jobs. HIP created a $AU2.8b frenzy of activity. Prior to the scheme, roughly 70,000 houses were retrofitted with insulation every year. At the height of HIP, about 180,000 houses were completed in a single month. Because regulation and training had not caught up with the scheme, much of the finished work was unsafe, unsupervised and even fatal.

Another example of a quick-fix scheme was Australia's 2010 Nation Building Economic Stimulus Plan, a two-stage group of 28,000 local government projects costing about $AU52b. Then-Prime Minister Kevin Rudd said the plan would protect against a nationwide recession after the global financial crisis by building stronger future infrastructure.

While many projects were no doubt chosen using sound economic reasoning, there were some bizarre choices too. For instance, Carcoar – a sleepy village in New South Wales of 218 residents and an average age of about 50 in 2006 – suddenly found council workers building an expensive new playground for only 34 children.

Examples of similar poor quality but "shovel ready" funding for investments as part of New Zealand's Covid-19 economic recovery are already evident. For instance, $11.7m of taxpayers' money has been allocated to a private "green" school in Taranaki. This school is not registered and has only a handful of domestic students. But it does host DNA activation seminars, holy ceremonies and crystal plantings.

Such projects get the go ahead because meeting a basic cost-benefit test is not a requirement for funding. It is crucial to subject all projects, "shovel ready" or not, to proper cost-benefit tests or we risk burdening future generations with

massive debt, taxation and even harder choices about cutting public spending.

Longer term efficacy of existing and proposed spending programmes need better scrutiny. New Zealand should establish an independent fiscal council to strengthen the effectiveness of fiscal rules through public monitoring and reporting – similar to what The Initiative has already proposed.[52]

The proposed body would:

- be an office of Parliament to reduce its dependence on the Executive;
- monitor the Executive's compliance with fiscal responsibility principles;
- monitor Treasury's expenditure control, assessment procedures and functions;
- assess the degree to which the Executive has a credible programme for addressing identified fiscal pressures, such as those identified in Treasury's long-term fiscal projections;
- assess the performance of government agencies administering major spending programmes in detecting and avoiding waste through lack of clarity about objectives, failure to adequately consider alternatives, poor administration and diffuse accountability; and
- improve the servicing of Parliament's Finance and Expenditure Committee.

CHAPTER 3

Productivity priorities

The central importance of productivity growth

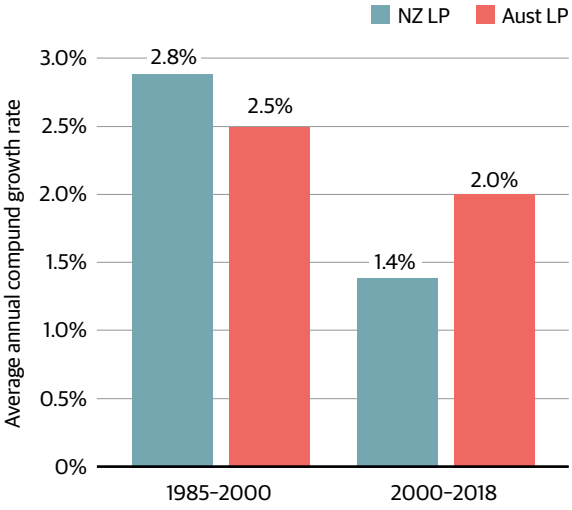
The slowdown in productivity growth since around 2000 has been the Achilles' heel of our economy. This is true both in a "before and after" comparison and relative to overseas benchmarks such as Australia, the OECD average and the best of Asian countries.

Figure 3: "Before and after" slowdown in productivity growth since 2000

Source: Statistics New Zealand, "Productivity statistics: 1978–2019," Spreadsheet (n.d.). "Industrial growth cycles (1978–2018) Former measured sector Tables 5.01 and 5.03.

The relatively poor performance matters because Kiwis overwhelmingly want higher incomes. Governments are lobbied daily to transfer a higher proportion of national income to some interest group or section of the community. Yet, higher incomes per capita overall can only be obtained sustainably by some combination of working longer hours or higher productivity.[53]

Figure 4: Labour productivity growth rates in New Zealand and Australia (1985-2018)



Source: Statistics New Zealand, "Productivity statistics: 1978–2019," Spreadsheet (n.d.), Table 1.1: "Former measured sector"; Australian Bureau of Statistics (ABS), "Estimates of Industry Multifactor Productivity, Australia," Spreadsheet (n.d.), Table 4: "Productivity measures – Selected industries aggregate."

Higher labour productivity can be achieved by raising skill levels, increasing capital intensity per worker, technological change more generally or entrepreneurship in finding more profitable niches. Taxes, subsidies and regulations affect incentives, for better or worse, depending on their quality.

Policy sources of low productivity growth

Policies that reduce labour productivity growth can be grouped into the following categories:

- **Reduced human capital:** Weak incentives to lift human capital skills in education, career training, on-the-job-development and pay scale/income tax structure.[54] The welfare system and the breakdown

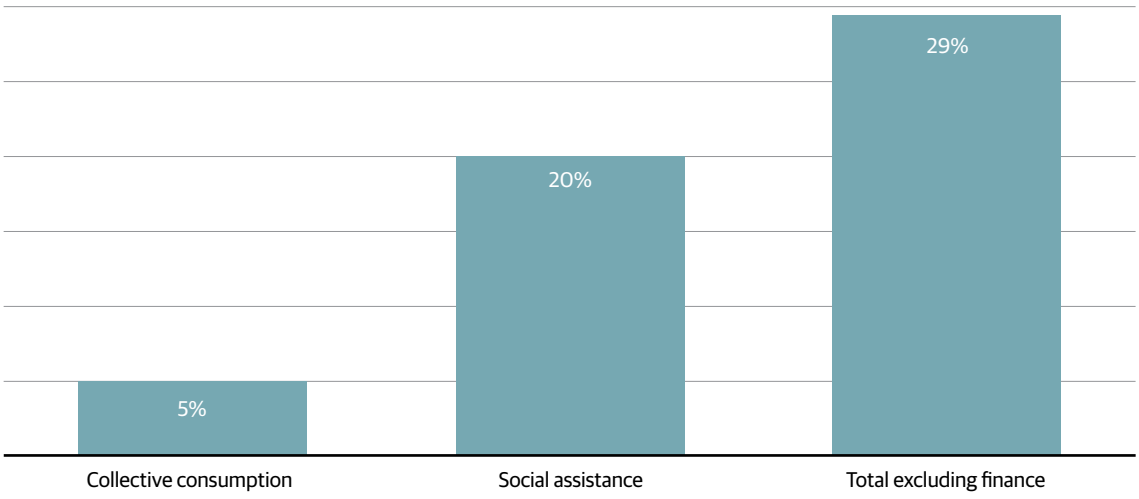
of the biological family unit have been accompanied by the development of entrenched, negative productivity and inter-generational misery.

- **Reduced physical capital per worker:** Disincentives to invest productively have many sources: undue barriers to foreign direct investment (FDI), too much regulatory red tape, relatively high tax rates on income from mobile capital, policy uncertainty in conjunction with predatory tendencies towards taking or impairing private property without due compensation, etc. Predation reduces distrust.[55] Dominant state-owned competitors have weak incentives to efficiently use capital and labour.
- **Inadequate provision of public good infrastructure** (e.g. transport, electricity and water networks and public health) is a source of low productivity.[56] Poor quality of public capital investment, including failing to maintain water pipe networks, also reduces productivity.
- **Discouraging innovation:** Undue disincentives to finding more profitable uses for workers and capital can arise from artificial impediments to competition (or its opposite – predation towards "excess" profits from successful investment in profitable niches), undue red tape that inhibits flexible resource use[57] and the tax system.

On the last point, economic research has established that growth in per capita incomes is likely to be weaker the greater the proportion of national income transferred through the tax system. It is not high in New Zealand compared to European and Scandinavian countries, which as a group are at the high unemployment rate, high public debt and low growth rate end of the developed country spectrum.

Outside Europe, New Zealand has one of the highest ratios of tax revenues to GDP in the world, excluding very poor countries and countries with small populations. New Zealand's ratio is high because transfer spending on welfare assistance and health and educational services of a private nature are high. Spending on providing goods and services of a collective nature is small in comparison. In the year ended March 2019, central government spent $20 on social assistance in cash and in kind for every $5 spent on collective consumption (Figure 5).

Figure 5: Current central government spending as a percentage of GDP (2018–19)



Source: Statistics New Zealand, "National accounts (income and expenditure): Year ended March 2019," Spreadsheet (n.d.).

Political incentives to do little about low productivity growth

For the past two decades at least, the political incentive has been to promise much and deliver little.

All major political parties pay lip service to the importance of income per capita growth – and thereby productivity growth. The initial top economic priority of the Labour-led Government of 2000–08 was to lift per capita income to the top half of the OECD. The 2009–17 National-led Government set up a taskforce to eliminate the income gap with Australia. It also set up the Productivity Commission to advise on productivity matters. Neither Government made any material progress towards achieving its productivity goals.

The political problem is that the pressure to transfer national income from those who earn it to others override the pressure to lift national income. As a result, much government spending and regulation is ill-justified from a wellbeing perspective.

Policy recommendations

The "in principle" recommendation

The central political problem is to raise the quality of government spending and regulation from a productivity (benefit-cost) perspective when so many groups are benefiting from existing ill-justified spending and regulation.

Greater accountability of the Executive to Parliament and the public would help. On the fiscal side, The New Zealand Initiative advocates a fiscal council that would report to Parliament to improve transparency and accountability. Furthermore, voters could be empowered on fiscal matters by allowing strike-down referenda on significant new non-urgent spending or taxes. On the regulatory side are the dormant recommendations of the 2009 Regulatory Responsibility Taskforce.

Recommendations for incremental improvements

Government spending can be made more effective by:

- reinvigorating the former social investment approach focused on finding which spending programmes effectively help people back to self-reliance and wellbeing;
- restoring the transparency introduced by the actuarial liability estimates of spending programmes to complement the social investment approach;
- improving the competence of cost-benefit assessments of proposed and current spending programmes, such as a central government agency hiring expertise rather than the sponsoring spending department;
- giving the Productivity Commission tasks that relate directly to the productivity aspects of government policy actions;
- improving competition in private health and education services, for example, by permitting public schools to become partnership schools; and
- reducing undue red tape from environmental, health and safety, labour market and FDI regulation.

Government regulation and productivity

The pipeline of productivity-reducing laws and regulations emanating from lawmakers is never dry. The problems of haste, expediency and rewarding partisan causes can be guarded against but not eliminated. The question is how best to curtail such pressures.

A well-regulated engine purrs; an ill-tuned machine runs noisily and erratically. The same is true for well- versus ill-regulated societies.

Well-regulated societies are orderly. People can largely predict what part others will play in interactions for mutual benefit. A clear "keep to the left" rule facilitates free-flowing car traffic,

which helps everyone pursue goals of their own choosing. Conversely, not knowing how the burden of public debt from Covid-19 will be distributed makes it harder for people to plan.

Many *legal* rules governing interactions between people have evolved from ancient judge-made law, the common law being the best known in countries with Anglo-Saxon heritages.

Constitutions and statute law are the main source of laws governing interactions between citizens and the state, although much common law has been codified in the 20th century.[58] The common law contains many of New Zealand's constitutional principles.[59]

The road map for well-designed laws and regulations is clear. In New Zealand, the authoritative official document is *Legislation Guidelines: 2018 Edition*.[60] The essence of good law-making is adherence to long-established legal principles and good law-making processes. Chapter 7 of the *Cabinet Manual 2017* sets out the proper processes for developing primary legislation[61] and regulations.[62] *CabGuide* provides further process details.[63] It also prescribes proper policy development processes,[64] including impact analyses.[65]

The very existence of this prescriptive guidance demonstrates the strength of political pressures to pass poor quality laws and regulations, sometimes too quickly. If there were no problems, the guidelines would not be needed. What we need is balance. Parliament must necessarily have the power to pass new laws during urgency. The danger is that this power can be abused to avoid the checks and balances embedded in prescribed policy development processes.[66]

The deep problem with these worthy constraints and guidelines is that the entity with the strongest incentive to legislate and regulate for reasons of political expediency is the one commanding a political majority in the House of Representatives – New Zealand's sole law-making body.[67]

There is widespread agreement that there is a generic problem of poor-quality laws and regulations.[68] In the early 1990s, the then-National Government proposed unsuccessfully to return to a bicameral system by creating a senate. Members would be appointed by MPs.

MMP was proposed by Sir Geoffrey Palmer as an antidote to "unbridled state power" under FPP. Palmer's hopes about MMP were clear in the title *Bridled Power: New Zealand Government Under MMP* (1997), the book he co-authored with his son, Matthew Palmer.

Twenty years later, Sir Geoffrey's dissatisfaction with this "bridled" power saw him propose with Andrew Butler a written constitution.[69] On Parliament's law-making powers, Sir Geoffrey and Butler proposed that a court or tribunal "must declare that any law or conduct that is inconsistent with the [proposed written] Constitution is invalid to the extent of its inconsistency."[70] Such a declaration would be subject to confirmation by the Supreme Court. If affirmed, Parliament would have one year to pass a validating Act overturning the Court's decision, but it would need a 75% majority of all MPs.[71]

A decade earlier, in 2009, a government Regulatory Responsibility Taskforce published a more modest proposal for greater judicial oversight of regulatory quality. Rather than propose a written constitution, it enumerated a set of principles for good regulations. It also allowed the courts to make a declaration of incompatibility between a government law and those principles. However, it provided no remedy in the event of such a finding.

The taskforce's enumerated principles fell into the following categories:

1. Conform to the rule of law;[72]
2. Preserve individual liberty;
3. Only take property that conforms with enumerated principles;
4. Only tax by or under an Act, and only charge in accordance with enumerated principles;
5. Protect the independence of the courts and their power to interpret legislation. Ensure individuals' right to appeal administrative decisions impinging on liberty;
6. Follow enumerated good law-making processes.

As already canvassed in Chapter 1, too much labour market legislation fails to accord with these principles, particularly the preservation of individual liberty.[73] Laws that stop adults from selling their labour for a low wage if they wish are particularly egregious as they will hurt the least employable the most.

At a time of high unemployment and considerable welfare-related disincentives to work, the costs to Kiwi wellbeing are likely to be high.

The following two subsections evaluate the *Resource Management Act 1991* (RMA) and the *Overseas Investment Act 2005* (OIA)

We highlight these three cases because of their immediate relevance to the problems of replacing lost foreign exchange income from tourism, high house prices and unemployment.

However, the problem of questionable laws and regulations against the enumerated principles is much wider. We recommend creating an expert group to work through the statute book and identify laws and regulations that seem difficult to justify in public interest terms.

Resource Management Act 1991 (RMA)

The RMA has caused endless difficulties and frustrations, particularly relating to high housing costs due to land scarcity. A fresh start is imperative.

The recent *RMA* Review Panel's report,[74] does not provide this fresh start. It fails to identify the wellbeing problems with private arrangements for which its recommendations are the remedy. That indifference to wellbeing leads it to propose a structure empowering partisan politicians to impose their will en masse on citizens in matters large and small. The same indifference allows the report to ignore the flawed incentives and imperfect information that confound the all-encompassing political direction of economic activities. Its proposed over-riding all-compassing national policy statement directives are assumed to be flawless. The report is too disinterested in New Zealanders' wellbeing to consider likely unintended consequences from its proposals.[75]

We consider that the RMA Review Panel's recommendations violate principles 1, 2, 3 and 4 above. Particularly egregious is the anti-development provisions underlying New Zealand's unconscionably high prices for land for residential building.

The fundamental flaw starts with the Act's purpose statement "to promote the sustainable management of natural and physical resources." This means Parliament can manage "the use, development, and protection of [all] natural and physical resources in a way, or at a rate, which enables people and communities to provide for their social, economic, and cultural wellbeing and for their health and safety." This is while purporting to sustain "the potential of natural and physical resources (excluding minerals) to meet the reasonably foreseeable needs of future generations" and safeguarding the "life-supporting capacity of air, water, soil and ecosystems" and "avoiding, remedying, or mitigating any adverse effects of activities on the environment."

Since unanimity in the community to prioritise these matters is unattainable, all resource use

decisions on all-encompassing matters are politicised. This would be the case even without externality considerations that could not be adequately solved by common law remedies or specific statutes (such as earlier laws relating to flood control).

The last provision in the RMA's purpose statement puts avoiding, remedying or mitigating any adverse effects of any activities on the environment before wellbeing. This is consistent with the oft-repeated assertions by the sponsoring Environment Minister in 1991 that the purpose of the Act was to protect fundamental "environmental bottom lines" and being highly permissive of freedom to exercise property rights otherwise.

The reality is utterly different. Private property rights were emasculated from the Act's inception by sections 32 and 85 of the original Act. The former purported to require restrictions on private property to be justified based on net benefits but failed in practice to impose a meaningful test. The second explicitly denied compensation for regulatory takings.[76]

Both measures deprive property owners of much of their use-rights. Evaluations of "social, economic and cultural wellbeing" are essentially political. Dissenters to changes in property use are not confronted with the cost to the community of the forgone change in resource use.

Unfortunately, the bottom lines were to be imposed regardless of the cost to property owners; compensation for regulatory takings was ruled out; and the bottom lines appeared to embrace all changes in land use, particularly subdivision. When "the environment" trumps all, a Minister for the Environment is a Minister of Everything.

Prior to the RMA, there was no pervasive externality. Someone wishing to dictate how private property would be used needed to buy the property or achieve the rightful owner's uncoerced consent. That necessity confronted the objector with the cost to the community of achieving the goal. By removing this discipline for internalising costs and benefits, the RMA became a monumental cause of resource use externalities.

The RMA also essentially abolished common law's "interested party" test of whether an objector was an affected third party. It allowed anyone to object, be they a trade competitor, someone with paternalistic, vindictive or malicious purpose from any region remote from the property in question, or a special purpose hunting and fishing or environmental group that wants a benefit at the expense of the wider community. That provision aggravated the externality problem created by the Act. Anyone could object without being confronted with the costs. Many took advantage of this "free lunch."

The politicisation of virtually all resource use decisions has forced endless changes to the Act and vastly expanded its detail. It now enshrines intrusive central planning at the local and national level. What started as an environment Act that unintentionally aggravated resource use externalities has morphed into a central planning document.

By creating a general prohibition on changes in resource use without a resource consent, regardless of externality considerations, the RMA has created a major barrier to welfare-enhancing changes in resource use.

The 'in principle' remedy

The fundamental remedy is to reverse the general presumption against changes in property use in general and property subdivision in particular. Changes should be permitted unless there is a good public policy reason for preventing them. Injunctive relief under the common law is one mechanism to prevent a damaging change. Another is the knowledge that an owner who makes the change could be subsequently sued for the common law harm imposed on a third party.

At the same time, the RMA cannot simply be abolished. This would create a legal vacuum for resolving specific public good issues, such as those relating to flood control, water use, pollution, unstable land or hazardous substances. Prior to the RMA, there were nearly 50 statutes of a specific nature. Legislation of a specific nature can address an identified problem with private arrangements. Sweeping broad-brush legislation may not.

It took many years to design an RMA to replace more than 50 statutes. It would take many more years to unscramble that work. If the next Government is genuinely concerned with community wellbeing it should set up a process for directing top quality legal and public policy minds to this task.

Partial remedies

Partial remedies must include freeing up the supply of land for subdivision and high-rise residential development to reduce median dwelling values relative to median income.

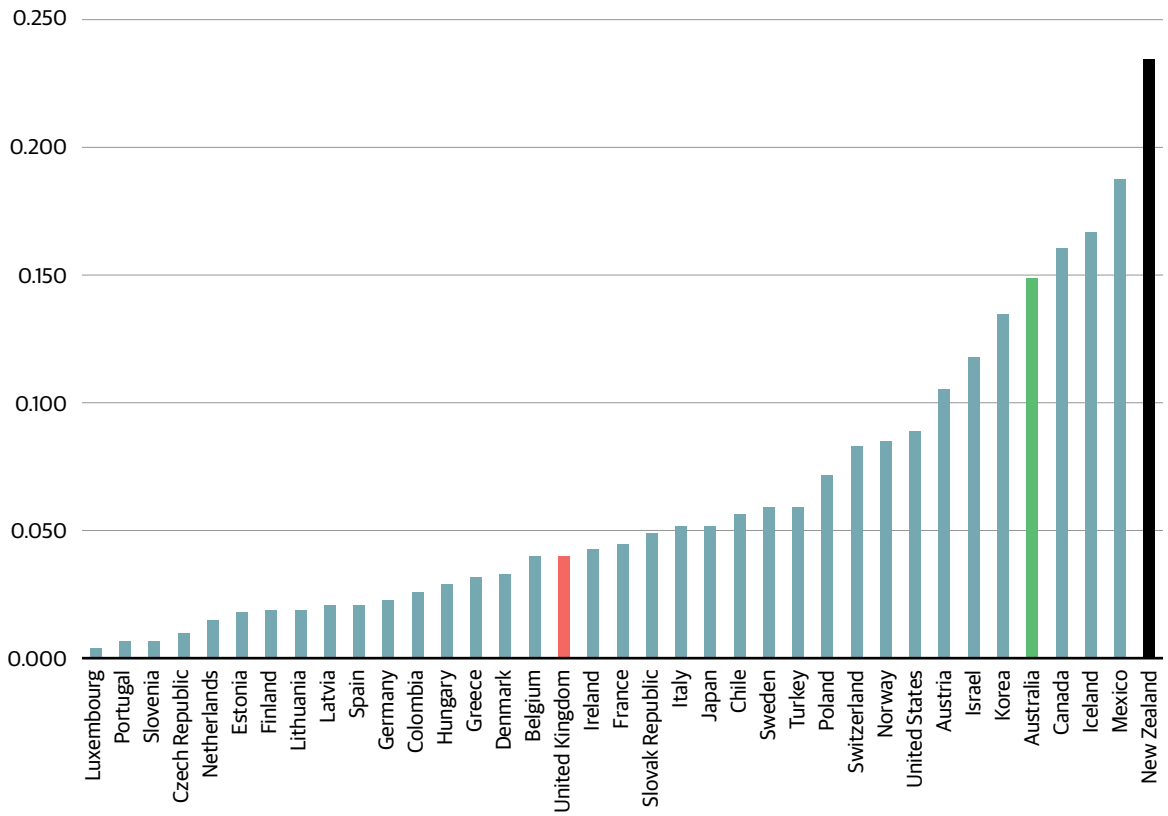
All partial remedies should seek to restore greater disciplines for resource use decisions along these dimensions:

- ensuring cost-benefit assessments of regulatory provisions comply with Treasury guidelines;
- expanding the scope for property owner compensation for takings or property use rights; and
- narrowing the range of people who can object to the direction of restoring the former common law concept of an interested party test.

Overseas Investment Act 2005

New Zealand's resources are miniscule relative to global resources. Through two-way openness to

Figure 6: OECD Restrictiveness Index for member countries (2018)



Source: OECD, "FDI Regulatory Restrictiveness Index," Website.
Note: 1 = closed, 0 = fully open

trade and investment, New Zealanders can tap into the best of what the rest of the world can offer while leveraging off what we can offer other people in other places.

Overseas capital markets provide valuable diversification opportunities for portfolio investors. This is why the next Government should keep such avenues open and undistorted. Nor should the Government put barriers in the way of Kiwis wishing to purchase overseas assets such as land, housing or businesses. These outgoing investment propositions are not contentious.

What is contentious is the question of incoming investment, particularly incoming FDI that involves a degree of foreign control of assets. We have the dubious distinction of being the most restrictive of the 37 member countries of the OECD in this respect. Australia is appreciably less restrictive but is also at the more restrictive end.

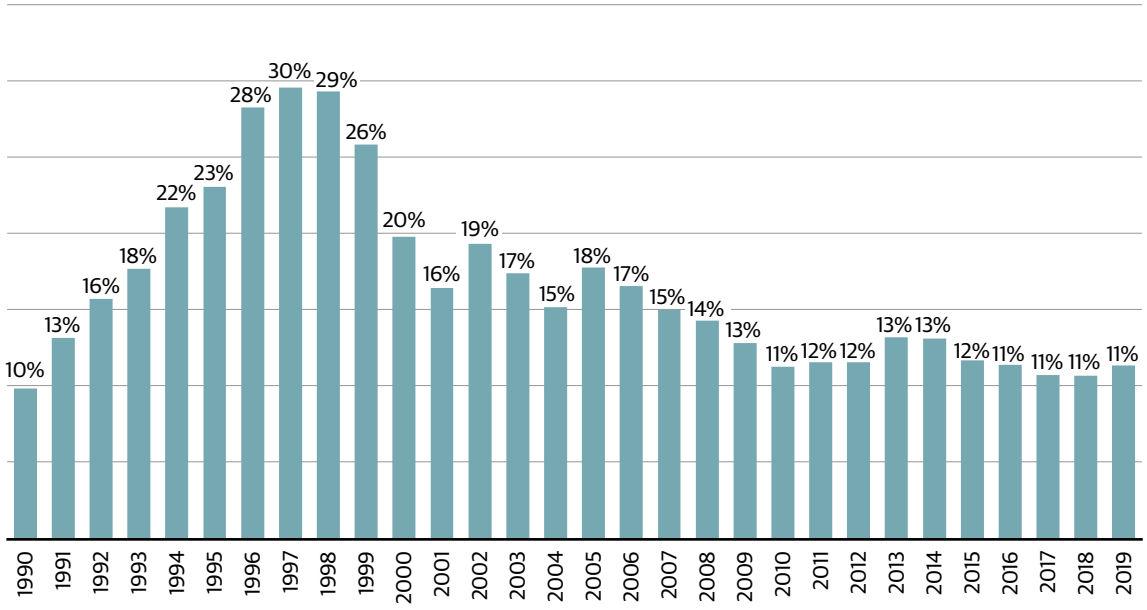
It is a widely accepted principle internationally[77] that policy should be neutral, as between domestic and overseas investors in New Zealand. For reasons that appear to owe much to prejudice and the delusion of a free lunch, the OIA is predatory towards FDI in New Zealand.

The Act's opening statement asserts that overseas investors are privileged if the Government permits them to invest here. That essentially tells New Zealanders they are privileged if ministers allow them to sell an asset or obtain funding from an overseas person.

Having denied Kiwis a basic liberty, the Act impairs the rule of law by allowing authorities to extort concessions of various sorts in an unpredictable and opportunistic manner. It does both these things for no good public policy reason.

The "free lunch" fallacy arises from the unexamined belief that the costs of the extorted concessions will fall on the buyer, not the New Zealand seller. But foreigners have plenty of alternative investment opportunities. Unfortunately, the world does not owe

Figure 7: New Zealand inward FDI stock (USD) as a percentage of the Australian inward FDI stock (1990–2019)



Source: UNCTAD, "World Investment Report 2020," Annex Table 3, "FDI inward stock, by region and economy (1990–2019)".

New Zealanders a living. There is no reason for foreigners to invest in New Zealand at an unfavourable price.

Whether the foreigner's buy price is explicitly conditional on the rents governments extract in return for consent is not the point. Just as the bribes for a corrupt regime are built into the cost of doing business in that regime, the cost of rents the OIA imposes on foreigners is also built into their assessment of the value of doing business here.

OECD research shows that countries with more restrictive regimes on its measure tend to attract less incoming FDI. Since 2000, New Zealand has been less successful in attracting FDI than many other countries. Figure 7 shows how New Zealand compares to Australia in this respect. (The corresponding charts comparing New Zealand to the UK and the total inwards FDI for all developed countries (UNCTAD measure) show the same camel-humped shape.)

The OECD estimates that making FDI 10% more open on its restrictiveness measure is associated with a 2.1% increase in a country's bilateral stock of FDI.[78] There is scope for New Zealand to do far more. A 10% improvement in New Zealand's score would still see it ranked as the most restrictive OECD member country.

In The Initiative's 2017 election year Manifesto, we explained the following conclusions:[79]

- Abolish the *Overseas Investment Act*. There should be no FDI regime;
- Subject all investors, domestic and foreign, to the same rules;
- Protect New Zealanders' property rights, including the freedom to sell to whoever they wish. In cases of public interest, appropriate compensation must be made.

Yes, there are security issues with foreign governments, terrorist organisations and the like operating within New Zealand. But OIA legislation is not the best means of dealing with them.

Climate Change Policy and the Emissions Trading Scheme

Putting a price on greenhouse gas emissions is the single best way of reducing New Zealand's emissions. Our Emissions Trading Scheme (ETS) is not perfect but improving it does more good than adding alternative regulatory measures to reduce emissions. Measures undertaken outside the ETS, even if carefully designed, risk being less effective and far less cost-effective than working through the ETS. Worse, regulatory measures taken outside of the ETS that do not account for the effects of the ETS risk being both costly and completely ineffective in reducing total emissions.

Recommendations

1. Use the ETS as the primary regulatory instrument for reducing greenhouse gas (GHG) emissions;
2. Any non-ETS measures undertaken should be assessed on the cost-per-tonne of CO_2 equivalent GHG reductions, with that per-tonne cost reported for every measure;
3. Publish the path for the emissions cap that is consistent with the *Zero Carbon Act* while providing a safety valve tied to prices in European carbon trading markets until New Zealand's ETS is linked to international markets;
4. Deal with undesirable distributional consequences of using the ETS by granting ETS credits within the binding cap to existing emitters, and by transferring revenues earned through government auction of ETS credits to lower-income households. Supplement those transfers through other additional payments to targeted households if necessary, rather than distort the ETS to achieve desired distributional outcomes.

Background: Carbon pricing and emissions trading

Carbon pricing is the most cost-effective way of mitigating GHG emissions. Under carbon pricing regimes where GHG emissions comprehensively draw charges commensurate with the social cost of emissions, individuals and firms have strong incentives to mitigate emissions until the cost of further reductions exceeds the benefit. And, even if the price of emissions is set below the social cost of those emissions, pricing at least still encourages taking up all the most cost-effective ways of mitigating emissions.

If the price of emitting a tonne of CO_2 equivalents is $35, people will find ways to avoid emissions that cost less than $35/tonne. They have the incentive to innovate, develop new technologies and techniques for mitigating emissions, find ways to sequester GHGs and avoid emissions. Instead of the next Government having to choose which sectors need to abate emissions and by how much, those able to do so cost-effectively will self-identify. As US economist Alex Tabarrok puts it, prices are a signal wrapped in an incentive. The price of carbon provides that incentive. Consider what happens when prices change for any other kind of input. If a bauxite mine has an accident, we do not need government commissions to allocate scarce aluminium across different industrial and consumer uses, nor do we need quotas across different sectors telling them how much they need to reduce their use. Instead, the price of aluminium goes up, leading everyone to reassess their use.

Getting a price on carbon does the same thing.

The point of the charge is not to eliminate emissions entirely, but to ensure that emissions only happen when it is cost-effective. If some application costs $350 per tonne to avoid GHG emissions, and the carbon charge was $35, it would be better for society collectively to focus on avoiding the emissions that are the least costly to avoid. If instead we collectively undertook efforts costing $350 per tonne to avoid emissions in the expensive sector, we would have forgone the opportunity to avoid at least 10 times as much GHG emissions through carbon pricing. For example, in the presence of an ETS with a binding cap on total emissions and a current price per tonne of $35, the government could buy and retire credits removing 10 tonnes of emissions for every tonne that would be abated by focusing on the more expensive sector.

Carbon pricing regimes recognise that individuals and firms are the best placed to evaluate the costs they face in abating emissions while recognising the social cost of emissions. Rather than setting reduction targets sector by sector, with officials guessing where emissions reductions are least expensive, carbon pricing regimes encourage everyone and every firm to find the most cost-effective ways to reduce emissions.

As a simple illustration, a carbon charge of $35 per tonne automatically encourages everyone to spend up to $35 to avoid emitting a tonne of emissions. Regulatory measures instead pick activities that may be far from the best buys. We do not need huge regulatory initiatives to encourage people to economise on their use of scarce materials like platinum. The price of platinum does that on its own, ensuring it is only used where it is most cost-effective. Getting a price on emissions has the same effect.

Carbon taxes and emissions trading regimes can yield equivalent results in abating emissions. Both put a price on emissions. Following the theoretical models established by US economist Martin Weitzman in the 1970s, carbon taxes are more efficient than quantity restrictions through cap-and-trade systems in cases, like with GHG emissions, where there is more certainty about the social cost of a tonne of GHG emissions than about the costs of abating emissions.[80]

New Zealand has adopted an ETS rather than a carbon tax regime. Either mechanism can

substantially reduce net emissions and will be generally a more cost-effective way of reducing emissions than other regulatory interventions.

Use the ETS as primary instrument

New Zealand's ETS has matured into a robust system. It sets a binding cap on emissions, with few exemptions. Any desired amount of emissions reduction is generally more efficiently achieved by buying and retiring credits in the ETS, or by using a tighter ETS cap, than through alternatives. When total emissions are capped, as they are in our ETS, buying back credits so they cannot be used means lower net emissions, at a cost per tonne no higher than the current ETS price. Alternative proposals should be carefully costed, noting how they interact with the ETS.

Both carbon taxes and trading regimes also make evaluating the effects of additional regulatory interventions somewhat more difficult.

Domestic transport emissions are covered by the ETS. Because purchasing petrol means purchasing credits in the ETS for those emissions, every tonne emitted from a tailpipe is a tonne not emitted elsewhere when the ETS has a binding cap. How, then, to evaluate the effects of measures like car fuel economy standards? In the absence of an ETS, fuel economy standards reduce net emissions so long as they reduce petrol use.[81] But more substantially, under an ETS, every tonne that is not emitted from a tailpipe leaves room under the ETS' binding cap for someone else to emit.

An automotive fuel economy regulation, under an ETS with a binding cap on total emissions, can reduce emissions only indirectly. Because there would be less demand for credits, ETS prices would be slightly lower than otherwise. Those lower carbon prices may make it politically more feasible for the next Government to tighten the overall cap. But that is a false economy where fuel economy standards are relatively expensive ways of reducing GHG emissions. Corporate Average Fuel Economy standards in the US cost $US48–310 per tonne of CO_2 equivalent avoided, according to estimates published in 2018. Even the lower bound of that range is about twice the current ETS price of carbon in New Zealand.[82]

If abating a tonne of CO_2 emissions through fuel economy standards costs the country, at a minimum, over $70 per tonne avoided, the Government could instead do far better by simply buying and retiring carbon credits within the ETS. It could reduce emissions by, at a minimum, twice as much by working through the ETS. And if costs fall at the upper end of the range, the Government could achieve about 13 times as much reduction in overall emissions by working through the ETS, rather than against it.

The same logic applies to subsidies for electric vehicles. If the carbon price in the ETS is correct, people will already be making appropriate choices between petrol and electric vehicles. If the carbon price in the ETS is incorrect, the solution is not electric vehicle subsidies but strengthening the ETS. If the ETS has a binding cap, reduced transport demand for ETS units simply leaves more units available for others to purchase.

Or, consider the problem from another direction. New Zealand can only afford net emissions equivalent to the ETS cap. How can we best discover which GHG-generating activities are really the most important, given this fixed and declining cap? Sector-by-sector carbon budgets and regulatory interventions are unlikely to get this right. NZU prices through the ETS encourage the least valuable activities to be the first ones to cease.

Because the ETS complicates analysis of the effectiveness of other mitigation policies, getting accurate assessments of the cost-per-tonne of emissions abated by non-ETS regulatory or spending measures is critical.

Find the best buys: Cost interventions

Many different regulatory or spending initiatives might reduce GHG emissions. If one regulatory measure costs the country 10 times more per tonne than another regulatory measure, that suggests avoiding the first measure while scaling up the second. Doing the most good possible requires finding the best buys, as any careful shopper would recognise.

Table 1: Cost of abatement by policy (USD)

Policy	Estimate ($2017/ ton CO_2e)
Behavioral energy efficiency	−190
Corn starch ethanol (US)	−18 to +310
Renewable Portfolio Standards	0–190
Reforestation	1–10
Wind energy subsidies	2–260
Clean Power Plan	11
Gasoline tax	18–47
Methane flaring regulation	20
Reducing federal coal leasing	33–68
CAFE Standards	48–310
Agricultural emissions policies	50–65
National Clean Energy Standard	51–110
Soil management	57
Livestock management policies	71
Concentrating solar power expansion (China & India)	100
Renewable fuel subsidies	100
Low carbon fuel standard	100–2,900
Solar photovoltaics subsidies	140–2,100
Biodiesel	150–250
Energy efficiency programs (China)	250–300
Cash for Clunkers	250–300
Weatherization assistance program	350
Dedicated battery electric vehicle subsidy	350–640

Source: Kenneth Gillingham and James H. Stock, "The Cost of Reducing Greenhouse Gas Emissions," *Journal of Economic Perspectives* 32:4 (2018), 53–72.

Note: Figures are rounded to two significant digits. We have converted all estimates to 2017 dollars for comparability. See Appendix Table A-1 for sources and methods. CO_2e denotes conversion of tons of non-CO_2 greenhouse gases to their CO_2 equivalent based on their global warming potential.

Table 1 summarises various American interventions aimed at reducing emissions, costed in US dollars. Many of those initiatives are more expensive, or far more expensive, than the going price of ETS units. US electric vehicle subsidies, on this measure, cost between 15 and 27 times as much as the $35 early September ETS price of carbon here. For every tonne of emissions abated through electric vehicle subsidies, the Government could instead buy and retire 10 tonnes of New Zealand Units (NZU), reducing the overall cap, and still have the country come out ahead.

But some policies may be better buys than spending the equivalent amount in buying back and retiring emissions credits, or slightly reducing the cap. Table 1 highlights static costs, but some policies have dynamic effects too. In principle, if a network of vehicle charging stations had not been established along major transport routes, government investment could encourage electric vehicle uptake. Investments of that sort could provide dynamic gains if their costing is based on the expected tonnes of emissions reductions.

The Interim Climate Change Commission (ICCC) should produce cost-per-tonne evaluations of every policy it assesses or recommends.

These costings should focus exclusively on the gross cost per tonne of resulting emissions reductions. Some measures may have benefits that go beyond emissions reductions. For example, shifting from diesel to electric vehicles would reduce PM2.5 emission levels, and those reductions have associated health benefits. It would be tempting to include those benefits to get a net cost per tonne measure rather than a gross cost per tonne. But that would spread the ICCC's resources too thinly, and risk introducing additional distortions. For example, suppose a policy encouraging shifting from diesel to electric has a net cost per tonne lower than the current ETS price if the air quality benefits are deducted

from the gross cost. But the policy could still fail to provide the best buy overall: Buying back ETS credits to mitigate GHG emissions while regulating log fires to reduce PM2.5 emissions might be even more cost-effective.

Gross cost-per-tonne measures could feed into broader cost-benefit assessment by Treasury or others.

This kind of costing work matters.

The ICCC was tasked with developing a plan for achieving 100% renewable electricity. Chair David Prentice asked to amend the study's terms of reference to check whether achieving the last few percent would be cost-effective, and if New Zealand might be forgoing larger emissions reductions overall by focusing too strongly on one sector. The ICCC found that the last few percent of emissions reductions would be extraordinarily expensive; pushing up electricity prices would prevent electrification in other sectors and risk increasing net emissions.

Without such costing, counterproductive policies would be pursued too easily.

Set the path, safely

The Zero Carbon Bill sets New Zealand on a path to net zero GHG emissions by 2050, excluding methane, and to reduce biogenic methane emissions on a separate path.

This path should be achieved through reductions in the ETS cap over time, with greater reductions in later years reflecting technological improvements.

A set path makes it easier for market participants to project future ETS prices and guide investment decisions.

But the path also must recognise that global emissions matter most in mitigating climate change.

Most importantly, the next Government must continue to attain international tradeability in carbon units. If it costs $35 to remove the next tonne of emissions in New Zealand, but more cost-effective opportunities for carbon abatement exist abroad, Kiwis should be allowed to buy credible units internationally.

An ETS detached from global markets presents substantial risk without international tradeability. If the binding cap results in prices here that are much higher than in Europe, New Zealand could easily suffer substantial economic damage while doing relatively little to reduce global emissions.

When carbon can trade internationally, a law-of-one-price is obtained. If stopping emissions in any one place is much cheaper than elsewhere, then global efforts focus on abating emissions from that place. Everyone works together to ensure that all those 'best buys' are found before moving to the following set of next-more-expensive options.

Without that tradeability, emissions reductions in one country could easily become far more expensive than reductions in other countries facing different opportunities. That difference would undermine support for New Zealand's abatement efforts.

The government has recognised the potential for damaging price surges in the ETS. It set an ETS price cap of $50 per unit in 2021, increasing by 2% per year after that. If prices hit those levels, the government will release further ETS credits at the price cap. Units sold in excess of the cap must be "backed": the government must procure equivalent emissions reductions, either domestically or internationally.

This safety value is laudable.

But European carbon units currently trade at about €25 ($45). If European prices increase by less than 2% per year, New Zealand prices could

diverge from competitor prices overseas. If the government becomes the only agency allowed to purchase backing credits abroad, and only when prices exceed $50 per unit, the government would profit by any price difference between here and abroad. Conversely, if prices abroad exceeded the New Zealand cap, the government could be liable for the difference.

Currently, futures contracts in European Carbon Emission Allowances for December 2024 are €30($53). April 2024 New Zealand ETS units currently trade at $38.42. New Zealand prices are not projected to exceed prices in Europe, or to hit the price cap. If they do hit the price cap, and the government needs to buy European credits to back newly issued NZUs, the government may be forced to cover the difference in price between the local cap and the European price.

The next Government should consider explicitly tying the ETS price cap to trading prices in the European carbon market, setting a ceiling price at a small margin above prices prevalent in Europe. The prices are comparable now but tying the two reduces risk.

Ultimately, the goal should be full international trading in credible carbon units, but international negotiations have proven slow. The price cap and backed-unit mechanism make sense in the interim.

Carbon equity

The First Fundamental Theorem of Welfare Economics tells us that prices in well-functioning markets lead to efficient outcomes – but many other paths can lead to outcomes just as efficient. The Second Fundamental Theorem of Welfare Economics tells us that if there are reasons deriving from equity to prefer one efficient solution to another, it is better to use redistribution to get there than to interfere in the price system.

The ETS is often criticised because industries have been given "free" allocations. But so long as those allocations are tradeable and part of the binding cap, they do not affect efficiency – they rather help ensure equity. Free allocations do not mean it is free to pollute. The price of emitting a tonne of GHGs, if you have been gifted an NZU, is the amount of money you could have received by selling that NZU. Every allocated carbon credit has an opportunity cost for the user of that free credit. Incentives to mitigate emissions are maintained.

Equity issues are sometimes also seen as distorting the ETS. Some argue that relying on the ETS as a primary instrument would raise petrol or other prices. This would have pernicious consequences for poorer Kiwis, and for those in rural areas who need to drive longer distances. Both are questions of equity and can be solved through other policies.

If the next Government thinks living in remote places should be subsidised, it should do so by providing cash to people who live in those places and letting them decide how or whether they want to mitigate their own emissions. If the Government thinks poor people would be disproportionately harmed by higher petrol prices, it should not set complicated systems to hide the cost of emissions reductions in opaque regulatory initiatives, nor should it try to intervene in the operation of the ETS. It should rather provide more money to poor people and let them decide whether to spend it on petrol. Any revenue collected when auctioning off carbon units could be redistributed to communities deemed to be disproportionately affected by carbon charges.

In any case, equity concerns about petrol prices seem highly overstated. ETS charges are a minor component of petrol prices. When New Zealand ETS units trade at $35, a litre of petrol carries a $0.08575 carbon charge. Even doubling the ETS price to $70 would increase petrol prices by less than 9c per litre – well within the normal range of petrol price fluctuations experienced

as the value of New Zealand dollar and oil prices change.

It would be far too easy to wind up in third-best worlds for both the climate change policy and equity by distorting the operation of the ETS to achieve equity goals rather than emissions reductions. Use the ETS instead to mitigate emissions and use other policies – or free allocation of ETS credits within the cap – to address equity concerns. Remember that potential equity concerns will be smaller when the costs of mitigating emissions are lower.

The same principles that lead to recommendations relying on the ETS to mitigate carbon emissions also lead us to recommend building an ETS equivalent for catchment-level water abstraction rights, and for water pollution abatement. The Initiative's report *Refreshing Water: Valuing the Priceless* details how water abstraction markets would keep water catchments within their environmental limits, while ensuring the costs of reducing environmental burdens are minimised and shared equitably. The Initiative's forthcoming report on nutrient management will expand on this.

Monetary policy

What monetary policy can and cannot achieve

The Reserve Bank of New Zealand (RBNZ) says, "monetary policy plays a key role in stabilising the economy through the business cycle."[83]

Charles Plosser, former president and CEO of the Federal Reserve Bank of Philadelphia, has a different take: "monetary policy has very limited ability to influence real variables such as employment. Price stability in the long-run is the goal monetary policy can achieve."[84]

US economist Milton Friedman said in the 1967 Presidential Address to the American Economic Association:

> We are in danger of assigning monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve and, as a result, in danger of preventing it from along the contribution that it is capable of making.[85]

A timeline for swings in monetary policy objectives

During the Industrial Revolution, the UK and other countries were on the gold standard. Retail price stability was achieved along with strong economic growth.

Most prosperous countries abandoned the gold standard after World War I. Germany and Austria experienced hyperinflation in the 1920s. The memory of those costs long made Germans more risk averse towards inflation than other European nations.

The US abandoned the gold standard in 1971. Inflation took off in the 1970s as the world's dominant currency lost its anchor and economists assumed that monetary policy could trade off higher inflation for less unemployment. The stagflation of the later 1970s proved this was chimerical. There was no enduring trade-off, and possibly little exploitable short-term trade-off.

Economists increasingly believed monetary policy was best directed at achieving enduring price stability – and community wellbeing. It took a massive effort and high unemployment in the UK and the US in the 1980s to get inflation back under control. Subsequently, central banks widely targeted monetary policy at predictably and credibly achieving 2% pa inflation. For a time, governments gave them considerable independence to pursue that objective.

That price stability and operational independence is now at risk. Central banks have political incentives to spend trillions of dollars supporting asset prices, while keeping their policy interest rates as low as they think is politically

sustainable. Central bankers have assured investors they will "do whatever it takes" to sustain asset prices. Governments are effectively shifting risks to taxpayers, compounding moral hazards.[86]

There is danger now of central banks believing they can usefully finetune economic activity in the short term. Plosser again:

> The public, and perhaps even some within the Fed, have come to accept as an axiom that monetary policy can and should attempt to manage fluctuations in employment. Rather than simply set a monetary environment "commensurate with the long-run potential to increase production" these individuals seek policies that attempt to manage fluctuations in employment in the short-run. … Most economists doubt the ability of monetary policy to predictably and precisely control employment in the short-run, and there is a strong consensus that, in the long-run monetary policy cannot determine employment.[87]

That danger also exists in New Zealand. The *Reserve Bank of New Zealand Act 1989* has been amended to give monetary policy a dual mandate in place of the original sole price stability mandate.

The degree to which the RBNZ has moved to lower its policy interest rates and flood the banking system with liquidity in pursuit of this dual mandate is illustrated by the charts in the following section.

Institutional background in New Zealand

Governments control the issuance of fiat money. Under a freely floating exchange rate, they also control the amount of banking system cash deposited at the central bank. That power allows them to dictate the interest rates paid on those deposits. (This is one of the rare occasions when the government can dictate both quantity and price as if they are independent variables.)

The RBNZ responded to the 2009/10 global financial crisis by dropping the OCR from about 8.5% to about 2.7%. It had earlier lifted settlement cash from almost nothing to about $9b, but this was to simplify administering the system rather than ease monetary policy. It has responded to Covid-19 by lifting settlement cash by about $20b and dropping the OCR to 0.25%.

Current levels for both statistics are unprecedented, but are not out of line with what other central banks have done, including the Reserve Bank of Australia.

Figure 8: RBNZ's dual monetary policy mandate

Monetary policy

8 Function to formulate monetary policy through MPC

(1) The Bank, acting through the MPC, has the function of formulating a monetary policy directed to the economic objectives of—
- (a) achieving and maintaining stability in the general level of prices over the medium term; and
- (b) supporting maximum sustainable employment.

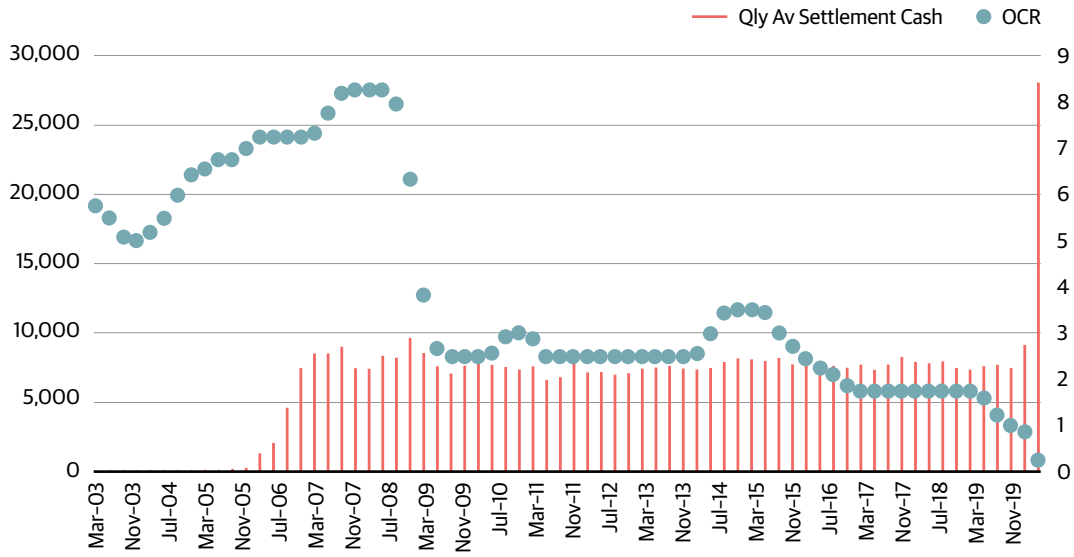
(2) The MPC must, in acting under this section, have regard to—
- (a) the efficiency and soundness of the financial system; and
- (b) any matter provided for in a remit under section 10(3)(d).

(3) The function of **formulating** monetary policy includes deciding the approach by which the operational objectives set out in a remit are intended to be achieved.

Section 8: replaced, on 1 April 2019, by section 8 of the Reserve Bank of New Zealand (Monetary Policy) Amendment Act 2018 (2018 No 59).

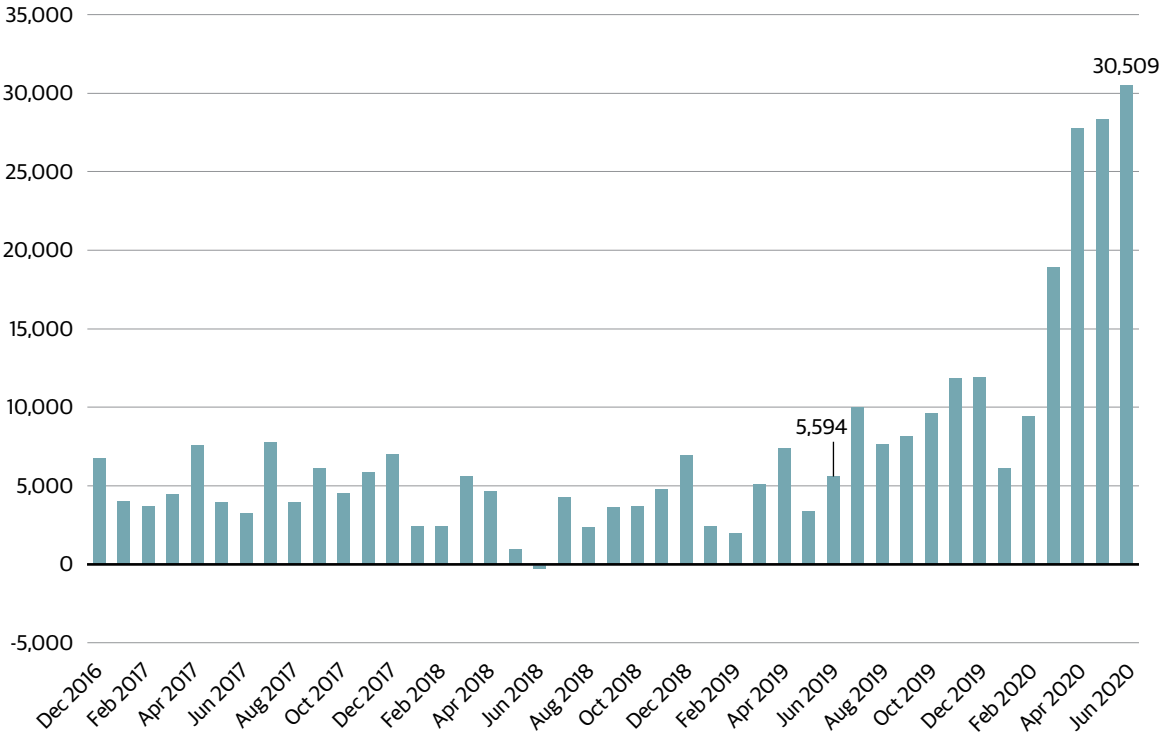
Source: Reserve Bank of New Zealand Act 1989.

Figure 9: Reserve Bank control of quantity and price for settlement cash and OCR (2003–20)



Source: Reserve Bank of New Zealand (RBNZ), "Standing facilities – D12," Website; "Wholesale interest rates – B2," Website.

Figure 10: Net RBNZ credit to central government



Source: Reserve Bank of New Zealand (RBNZ), "Money and credit aggregates (depository corporations) – C50 (December 2016 to current)," Website.

Settlement bank cash is money borrowed by the RBNZ from the banking system. It has mainly loaned the borrowed funds to central government (see Figure 10).

Implications for the incoming government

Central banks around the world, including in New Zealand, are taking on more than they can achieve and creating great potential financial instability by aggravating moral hazard – the incentive to chase risk knowing that losses will fall on others.

We suggest the next Government seriously consider the following seven options:

1. restoring section 8 of the RBNZ Act to its original state. There should be a single objective – long-term price stability;[88]
2. shifting its regulatory role to another institution, as Australia has done, both to improve governance and to reduce the politicisation of the monetary policy role;
3. limiting the RBNZ's budget to what is needed for its monetary policy role and restraining it from getting deeper into political matters related to ethnicity and climate change;
4. returning the inflation target to 0–2% (in the absence of evidence of a social cost to inflation in that range, but clarifying that this is not a target to be achieved every year);
5. stopping the implementation of deposit insurance – some US evidence considers this has exacerbated banking instability through moral hazard;
6. ensuring that the RBNZ's discretionary ability to purchase securities is limited to government paper; and
7. ensuring a credible timetable for reducing its balance sheet to pre-Covid levels.

Raising skills through better education

A well-educated workforce is a prerequisite for high productivity. This means education is critical for a country's prosperity. With the rise of automation, artificial intelligence and migration from developing economies threatening low-skilled employment, it is more important than ever that school leavers are well-educated.

Unsurprisingly, the benefits of good schooling to individual and societal wellbeing – economic and otherwise – are universally accepted.

Yet the performance of New Zealand school students is in long-term decline.

Over the past two decades, the three major international assessments of pupil performance – PISA, PIRLS and TIMMS – have charted New Zealand's decline, both absolutely and compared with our peers.[89]

The OECD's Programme for International Student Assessment (PISA) measures the educational performance of 15-year-olds in reading, mathematics and science. In 2000, out of 32 countries Kiwi students ranked 3rd in reading, 3rd in mathematics and 6th in science. By 2018, against the same 33 countries, absolute declines in educational standards relegated them to the 6th, 19th and 6th places, respectively.[90] In mathematics, students had lost the equivalent of nearly a year and a half's worth of schooling.[91] Similar declines are recorded by the Trends in International Mathematics and Science Study (TIMSS), which measures the performance of Kiwi Year 5 and 9 students in science and maths,[92] and the Progress in International Reading Literacy Study (PIRLS), which assesses Year 5 reading.[93] In all five measures, New Zealand students lagged their peers in the US, Canada and the UK. Australian students significantly outperformed New Zealand in four out of the five categories.

But it is not only the international studies that expose our school system's poor performance. In 2014, research by the Tertiary Education

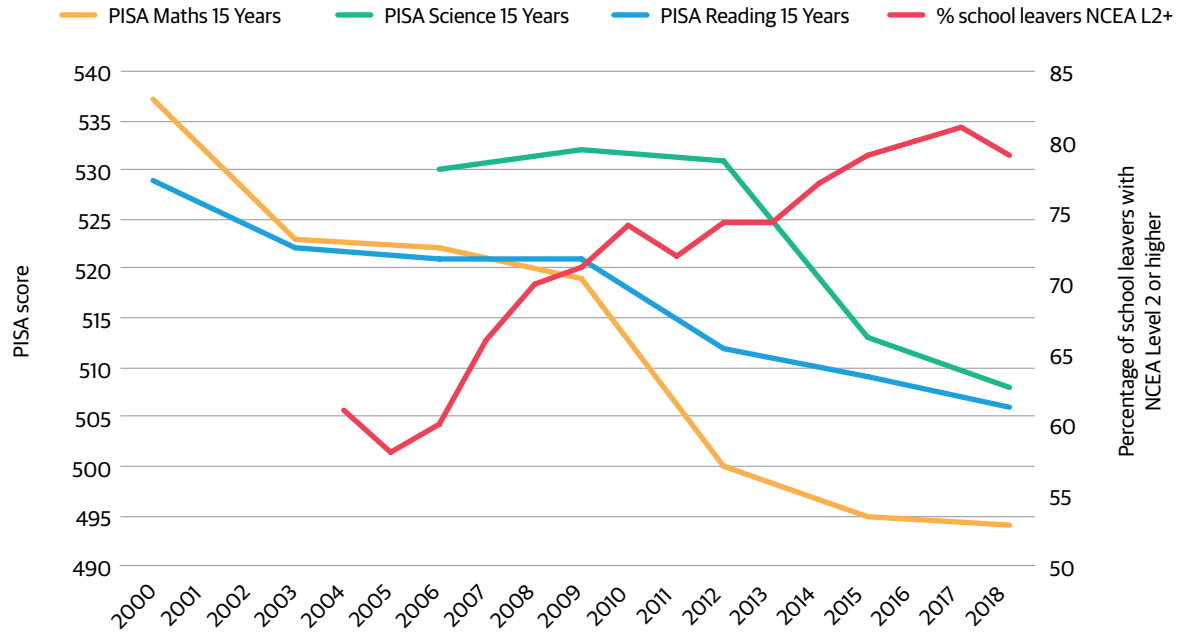
Commission (TEC) found that within a sample of 800 Year 12 students with National Certificate of Educational Achievement (National Certificate of Educational Achievement (NCEA) Level 2, 40% failed to meet an international benchmark for functional reading and 42% failed it for numeracy.[94] The continued decline, since then, of students' achievement in international league tables suggests these findings would be worse today.

Contrary to all this evidence, NCEA data paints an illusion of rising standards, suggesting students are doing better than ever. Only by combining national *and* international metrics can we see the real picture of continual decline in our students' scores in basic literacy and numeracy (see Figure 11).

New Zealand's education system also does a poor job of spreading attainment across ethnic and socioeconomic groups. As the government's own report on Tomorrow's Schools concluded, recent evidence "ranked New Zealand 33rd out of 38 developed countries for its overall educational inequality… the current system has failed to address the persistent disparities in educational outcomes and continues to leave some groups of learners/ākonga underserved."[95]

The most recent PISA tests (2018) confirmed this, with New Zealand recording the strongest relationship between socioeconomic background and educational performance of all its comparator English-speaking countries. Educational inequity is worse here than in the UK, the US, Canada and Australia.[96]

Figure 11: PISA and NCEA Level 2+ performance in New Zealand (2000–18)



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
PISA Maths 15 Years	537			523			522			519			500			495			494
PISA Science 15 Years							530			532			531			513			508
PISA Reading 15 Years	529			522			521			521			512			509			506
% school leavers NCEA L2+					61%	58%	60%	66%	70%	71%	74%	72%	74%	74%	77%	79%	80%	81%	79%

Source: Education Counts, Annual Reports 2004–19, Website; "PISA 2018 – New Zealand Summary Report," Website.

For the past three decades, official policy and discourse about schooling has been dominated by ideological beliefs rather than evidence. These beliefs, all linked to child-centred philosophy, have transformed ideas about *what* is taught, *how* it should be taught and the meaning of accountability.

A major New Zealand Initiative report explores the origins, reach and adverse consequences of child-centred orthodoxy. It demonstrates that by all reliable metrics, child-centred approaches underserve students. This is because explicit instruction is more effective than discovery learning for novices.[97] It is also because skills like thinking and solving problems are not generic but rely on knowledge stored in long-term memory. The Matthew Effect – whereby children with more knowledge find it easier to gain even more – explains why child-centred teaching and skills-based curricula have such dire implications for children who, because of conditions at home, rely mostly on their school to teach them the knowledge and habits they will need to succeed in life.

The Initiative's 2018 report, *Spoiled by Choice. How NCEA hampers education, and what it needs to succeed*,[98] explored how NCEA damages teaching, masks decline and widens disadvantage by hiding it behind an alluring façade. What we need is a fundamental overhaul of the expectations and assumptions underpinning NCEA.

Since 2018, The Initiative has published a series of reports based on empirical research carried out in the Integrated Data Infrastructure (IDI).[99] Having controlled for students' family background characteristics, this world-leading research enables statisticians to identify the most and least effective schools (based on NCEA outcomes).

A previous Initiative report, *Signal Loss: What we know about school performance*, analysed the Education Review Office's (ERO) assessments of schools.[100] The report confirmed performance differences based on ethnicity and socioeconomic status. More disturbingly, it found that some schools remain classified as underperforming for several years despite interventions. In some cases, they were underperforming for more than a decade.

Using the IDI, the Ministry of Education and ERO could identify failing schools swiftly; identify which interventions work and which do not for different groups of students; and match struggling school leaders with those from successful school's serving similar students.

Though this information could be invaluable to the Ministry and ERO in raising standards and equity, the Minister of Education so far has failed to enact the legislative changes that would enable using the insights already available.

The initiative's research has revealed strong evidence of a global shift towards the "professionalisation" of teaching, with the most impressive teaching in countries with high entry qualifications and attractive career paths (Finland and Singapore). Unfortunately, teaching is a career of last resort for many university graduates. This must change. In our 2014 report, *Teaching Stars: Transforming the education profession*, we recommended a range of measures to improve the quality of teachers and rejuvenate the ageing teaching workforce.[101] Some of our recommendations have been implemented. Further attention is still required.

After nearly two decades of decline in student educational attainment, the next Government should look to alternative educational solutions to those provided by the state school system. It should reinstate the partnership schools model, which showed promising results before it was terminated in 2017.

As recommended in our 2017 report, *Amplifying Excellence: Promoting transparency, professionalism and support in schools*,[102] the next Government

should also consider extending the partnership schools model to existing schools. In England, failing schools are converted into state-funded but independently run "academies." The policy has seen failing schools taken over by high-calibre operators running "chains" or "networks" of high-performing schools in low socioeconomic communities.[103] Networks of schools in England have shown greater sustained improvements than single schools due to unified ethos, economies of scale and the benefits of inter-school collaboration.[104]

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21. Productivity Commission, "Employment, Labour Markets and Income: Technological Change and the Future of Work," Draft report (Wellington: New Zealand Government, 2019), 33. Though focusing on the gig economy, the Productivity Commission concluded that this sector was both small and showed no signs of rapid growth, either in New Zealand or in the other 30 countries for which data was available.
22. Employment Relations Act 2000, section 103(1)(a).
23. Employment Contracts Act 1991, section 27(1)(a).
24. Australian Fair Work Act 2009, Part 3-2.
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31. NZSF assets are of the order of 20% of GDP. Net Core Crown debt was 0% of GDP in 2019 and is forecast to rise to 35% of GDP by 2024. In each case the rise is over 30% of GDP.

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53. A lift in export prices relative to import prices will lift incomes per capita, but international prices for oil, dairy products, timber and much else are volatile; any such lift is not necessarily sustainable.

54. A telling pathology is the inability of state schools to identify and reward exceptional teacher performance. The higher the post-tax minimum wage relative to the post-tax median wage, the smaller is the incentive to lift personal skills to the median wage level.

55. The Green Party's proposal that 94% of the population could agree to tax 6% without any consideration of the latter's consent is predatory. Under MMP, it has the potential to create real uncertainty and distrust. A more constitutional democracy would have more checks and balances on the ability of a political majority to oppress a minority.

56. The forced lockdown for Covid-19 because of the lack of public health preparedness was a major source of reduced productivity in the first half of 2020.

57. Much labour market, health and safety regulations, building regulations, the RMA, earthquake regulations, and voluminous banking and financial market regulations in the past two decades will have been inadequately supported by credible cost-benefit analysis.

58. The degree to which common law has been codified in the statute book is a matter for legal experts to debate. One expert, at least, saw statute law as mere archipelagos in the ocean of the common law. David Baragwanath, "'The function of the High Court Judges today and judicial appointments," Address to the New Zealand Bar Association Conference (Christchurch: 1998), cited in Bryce Wilkinson, "Constraining Government Regulation" (New Zealand Business Roundtable, 2001), 80.

59. "The common law is a body of law developed by the judiciary. It consists of both deeply embedded constitutional principles and rules that arise from particular judgments or a series of cases." Legislation Design and Advisory Committee (LDAC), "Legislation Guidelines, 2018 Edition," Website, Chapter 3, 18.

60. Ibid.

61. Department of the Prime Minister and Cabinet, "Process for Developing Bills," Website, [7.23]–[7.67], 103ff.

62. Ibid. [7.89]–[7.95], 112ff.

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66. The checks and balances themselves are subject to partisan pressures. An example is the recent requirement to include in impact analyses a "Climate Implications of Policy Assessment". New Zealand's carbon emissions are too small to have any climate implications. This provision signals that the government does not believe its Emissions Trading Scheme is fit for purpose.

67. New Zealand's parliamentary upper house, the Legislative Council, was abolished in 1951.

68. Our high rank internationally for laws and regulations merely tells us that many countries are worse off.

69. Geoffrey Palmer and Andrew Butler, *A Constitution of Aotearoa New Zealand* (Victoria University Press, 2016). The website relating to the book says: "There is no requirement at all for government to consult with anyone before bringing a Bill before Parliament, and it can prevent a Bill from being sent out for public submissions. All of the usual legislative practices can be, and are, overridden where it suits the government of the day." Geoffrey Palmer and Andrew Butler, *Towards Democratic Renewal: Ideas for Constitutional Change in New Zealand* (Victoria University Press, 2018).

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72. Law should be clear and accessible, not retrospective. It must ensure every person is equal before the law and deal with disputes by applying the law rather than exercising administrative discretion.

73. "The property which every man has in his own labour, as it is the original foundation of all other property, so it is the most sacred and inviolable." Adam Smith, *The Nature and Causes of the Wealth of Nations* (1812).

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84. Charles Plosser, "A Limited Central Bank," *Journal of Applied Corporate Finance* 31:4 (2019), 16–20.

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87. Ibid. 17.

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New Zealand faces its worst recession in nearly a century. Unfortunately, the response so far to the economic challenge of Covid-19 leaves much to be desired. The wrong policy prescription now could prove disastrous. Kiwis deserve better.

The scale of the problem is immense.

We desperately need sensible policies to protect the livelihoods of all New Zealanders. Promoting employment, growth and productivity and a credible path back to sustainable debt levels is critical.

New Zealand's labour market settings should be made more flexible.

Raising or introducing new taxes would hurt growth and is not necessary for getting the public debt back under control. Instead, there is ample scope to reduce low quality public spending.

Productivity performance could be greatly improved by policy and regulatory changes in key areas: education, tweaking regulatory settings affecting investment, monetary policy and climate change.

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