REPORT

Lifting export performance

Actions to drive growth in exports

nzier
authoritative analysis

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NZIER report to Export New Zealand, a division of BusinessNZ

EXPORT NEW ZEALAND
A division of BusinessNZ

BusinessNZ

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About NZIER

NZIER is a specialist consulting firm that uses applied economic research and analysis to provide a wide range of strategic advice to clients in the public and private sectors, throughout New Zealand and Australia, and further afield.

NZIER is also known for its long-established Quarterly Survey of Business Opinion and Quarterly Predictions.

Our aim is to be the premier centre of applied economic research in New Zealand. We pride ourselves on our reputation for independence and delivering quality analysis in the right form, and at the right time, for our clients. We ensure quality through teamwork on individual projects, critical review at internal seminars, and by peer review at various stages through a project by a senior staff member otherwise not involved in the project.

Each year NZIER devotes resources to undertake and make freely available economic research and thinking aimed at promoting a better understanding of New Zealand's important economic challenges.

NZIER was established in 1958.

Authorship

ExportNZ commissioned NZIER to provide an independent view on options for New Zealand firms, business organisations and government to boost export growth. While ExportNZ posed the question, the views contained in this report are those of NZIER.

This report was prepared at NZIER by John Stephenson and John Ballingall.

About ExportNZ

ExportNZ, a division of BusinessNZ, operates in the main centres and exporting regions of New Zealand.

At a regional level ExportNZ provides networking events, training and other services including seminars, exporter capability assessments, trade missions, local sponsors and professional advisors. At the national level it provides advocacy, analysis and promotion of exporter issues.

ExportNZ's executive director is Catherine Beard, cbeard@exportnz.org.nz or 027 463 3212.

Key points

Boosting exports is vital to lift economic performance

Export growth has been below par in New Zealand in recent decades, raising questions about what might be done to improve performance.

The most important rationale for doing anything at all is that the New Zealand economy has underperformed in general and there are reasons to believe this is because of geography i.e. smallness and isolation. Exporting is a means by which distances can be reduced and scale can be achieved.

Export success can create a virtuous cycle

Export performance also suffers from the effects of smallness and isolation but it might be more amenable to a boost than overall economic performance because export success begets export success. There may be an opportunity to break the vicious cycle of weak economic performance and weak export performance if ways can be found to initiate a virtuous cycle of export success.

Determining precisely what should be done is another question altogether. It is also confused by the existence of a range of government initiatives which have been put in place over the years while ignoring the fact that we are starting from square two. It seems like policies and programmes have been heaped upon one another without regard for whether the last set of policies has done the job or not. The same intervention logic is used and re-used as if it were new.

Existing initiatives may be doing the trick – we just don't know

Serious effort needs to be put into evaluating and rationalising all existing initiatives aimed at boosting firm capability – export-related or otherwise. New Zealand policy should aim to do a few things well and then to stay the course on those policies to see if they are working.

Questions also need to be raised over whether it makes sense to promote exports on one side of the ledger when foundational regulatory and fiscal policies run counter to economic and export success on the other side of the ledger. It is tempting to focus on finding the next big idea when many of the old ones will work fine.

Businesses need to collaborate to build export capability

As long as New Zealand remains small and isolated it is going to be expensive for firms to enter export markets on their own and more expensive still to establish local presence and build local market knowledge. Businesses should look towards strategic alliances that build on the resources or expertise of others to establish export brands and exporting know-how. Government has been supportive of such alliances but successful collaboration requires careful identification of mutually advantageous relationships. This is something that only firms can work through for themselves.

Our tax, welfare and investment policies need to be first rate

If New Zealand faces fundamental geographical penalties and constraints to international competitiveness then we can ill afford to have policies and regulations which are not first rate. For example, we cannot afford to have company tax rates above those of comparable countries.

And we need to be clear that, as much as we might enjoy the services that the welfare state provides, these come at cost which may be born disproportionately by the export sectors of the economy.

We need to treasure areas where we have scale but firms need to protect against reactionary regulatory change

Neither should we forget the natural advantages that New Zealand already has in sectors such as agriculture where we already have scale.

The primary sector itself needs to be acutely aware, if it isn't already, that regulatory risks to their businesses are unlikely to go away. More needs to be done at the industry and individual business level to manage these risks. Firms and farmers need to get onto the front foot.

Minerals and Māori businesses offer opportunities for scale

Other natural advantages that could be leveraged, though success is not guaranteed, are in the minerals sector and in Māori owned businesses. These both offer opportunities to create new sources of scale in the New Zealand economy.

You can't fake scale: population debate needs to be had

Ultimately, the best way to overcome problems associated with smallness and isolation is to do away with smallness. This means boosting population through immigration. We are already on record starting the bidding at 15 million people in New Zealand in the next 50 years. This, we argue, is a more economically meaningful target for helping boost exports than a target focussed on exports as a share of GDP.

Rewards for high performers warrant investigation

Finally, we caution against policy focussing too much on increasing the export capability of firms: grants, government assistance programmes and the like.

The logic behind these kinds of interventions is that entrepreneurs, investors and exporters don't have sufficient incentive or opportunity to build and maintain capability to export.

Policy needs to strike a balance between incentives for building export and business capability in New Zealand and retaining that capability. Our policy settings do not extend to retaining or rewarding proven performers. One option for providing incentives for building capability and then retaining capability, though by no means perfect, would be a system of rewards for high performers, accessible after a period of, say, 10 years. This warrants serious investigation to see whether it would be more effective and efficient in lifting export performance and productivity growth than existing capability-oriented schemes.

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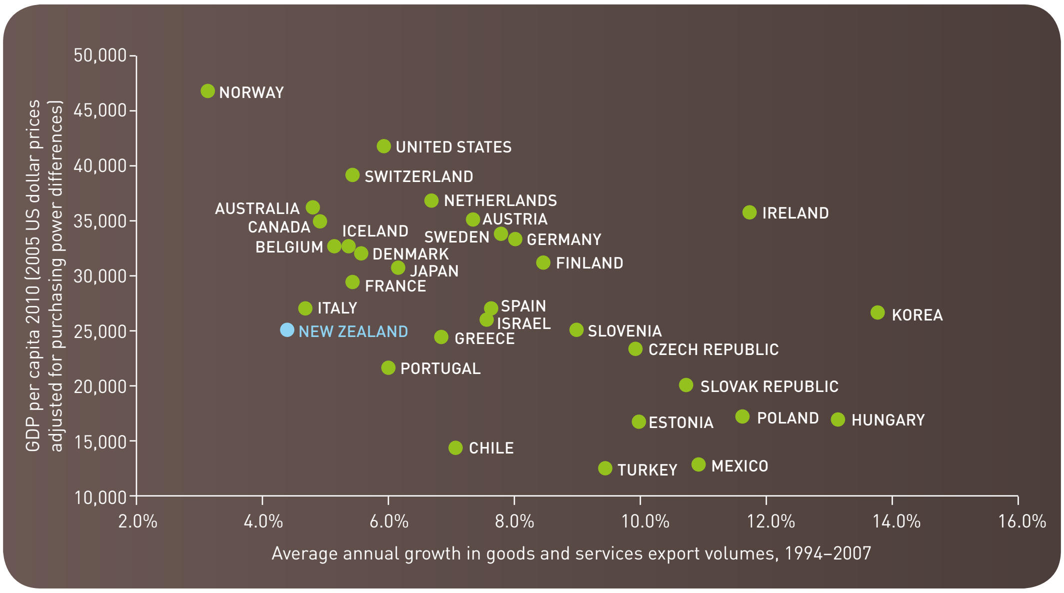
1 Exports and economic prosperity

1.1 Export performance has been below par

A dynamic export sector is essential to the health of a small economy like New Zealand's but on most measures New Zealand isn't performing as well as it might. New Zealand stands out amongst economies in the lower half of the OECD income distribution for having experienced slow growth in exports in recent decades.

Figure 1 Export growth and national income per capita



Source: NZIER, OECD

Exports are the only way that people living in a small economy can get access to a variety of products and services and having access to a wide and increasing variety of products is a mainstay of economic and social progress. While there is some popular scepticism over the need for increasing diversity of consumer products and services the benefits are unmistakable – from improved health thanks to new pharmaceuticals and medical procedures or the simple pleasures of talking to friends and family members on a cell-phone.

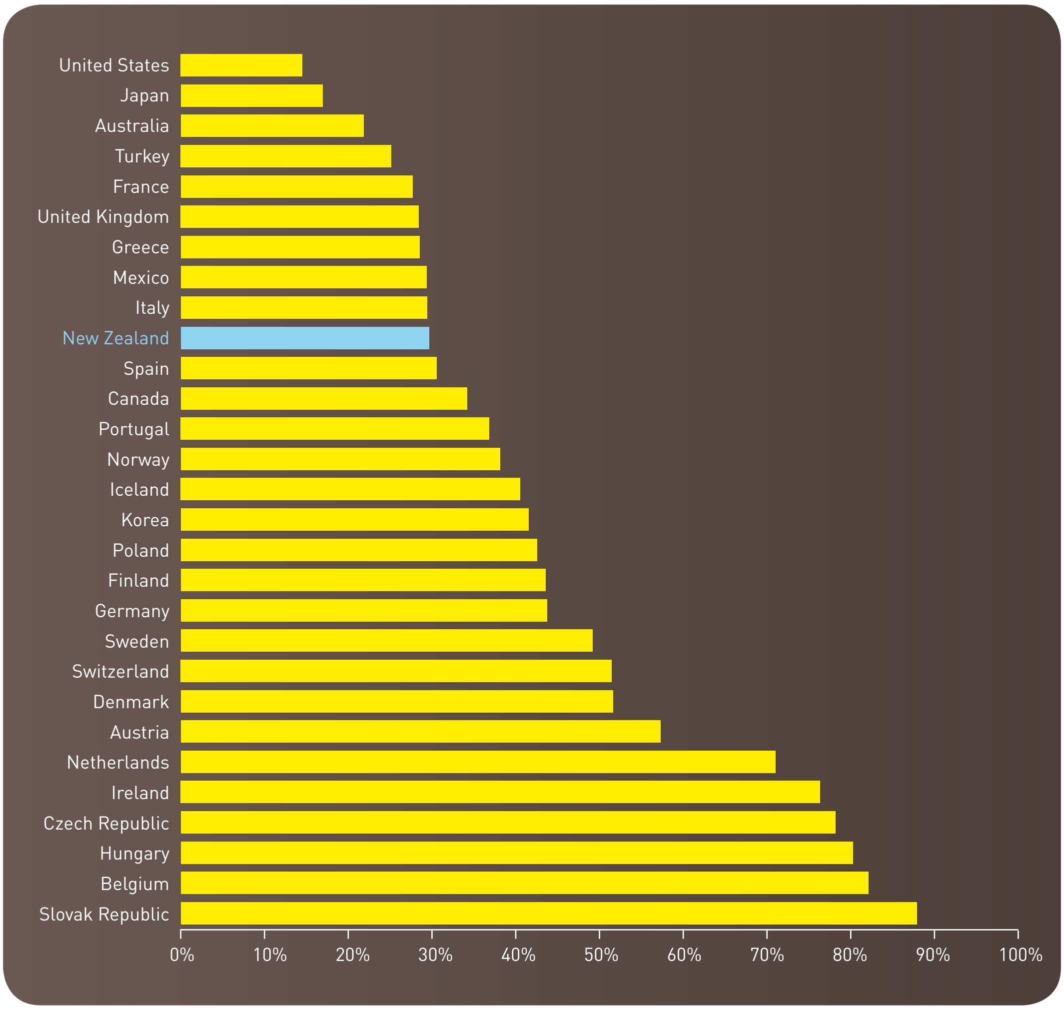
To access a growing range and quality of products and services, something needs to be given in exchange. In a large country this exchange can take place within national borders. In a small country, making this exchange means exporting.

Low or slow growing exports can be a symptom of underperformance of New Zealand companies, or a relative scarcity of high performing companies. There is, for example, good evidence that better performing firms are more likely to choose to export and existing exporters become more productive the more they export (Fabling and Sanderson, 2008). Thus, if exports are sluggish it may reflect a relative absence of competitive companies.

New Zealand stands out as having a generally low rate of trade (trade as a share of GDP) relative to many other similar sized countries (see Figure 2). We also have a fairly concentrated portfolio of exports compared with roughly similar sized countries (see e.g. Figure 3).

Figure 2 Trade as a share of GDP

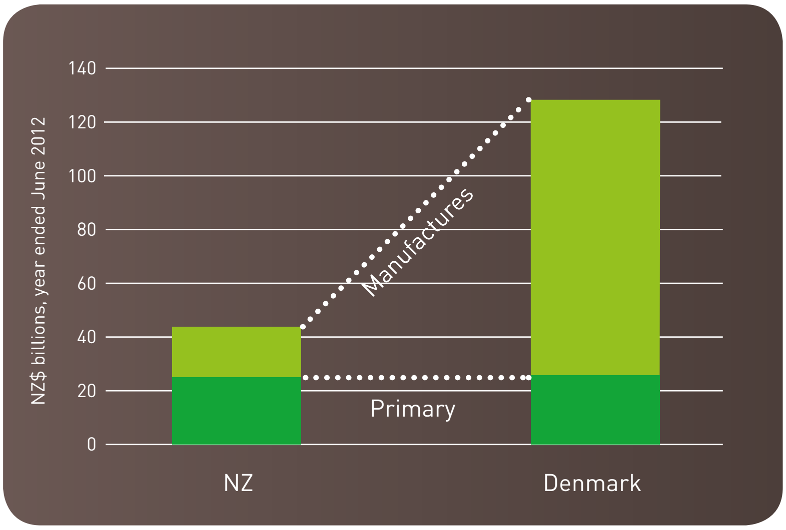
Average of imports plus exports as a share of GDP, 2007[1]



Source: NZIER, OECD

1 *Figures 1 and 2 omit data post 2007 so as to focus on structural trends and avoid any misrepresentation due to the effects of the global financial crisis.*

Figure 3 NZ and Danish export profile comparison



Source: NZIER, StatBank Denmark, Statistics New Zealand

The government has set a target of boosting exports to 40% of GDP by 2025. There is no way to tell if that is the right target. There is no ideal amount of exports for an economy. A large trade surplus (high exports and low imports) can be a sign of weakness and a trade deficit can be a sign of strength (Krugman, 1994).

What we do know is that when exports are growing slowly or are at a level that is significantly below that of comparable countries, then there is reason to worry about the health of the economy.

1.2 Deep connections to economic performance

New Zealand's economy needs high performing exporters more than other countries to make up for deeper problems which come from being small and isolated. Being small and isolated means reduced access to new ideas and expertise, reduced competitive pressure, fewer options to specialise, and higher costs of infrastructure (O'Connor, et al 2012).

This all adds up to lower productivity growth than other countries. The OECD reckons that being small and isolated shaves 10% off New Zealand's GDP per capita.

Exporting, so the reasoning goes, can help NZ "Inc." to overcome this geographic penalty by mimicking the effects of scale and providing closer connections to the global economy (NZ Institute, 2005). Exporting exposes New Zealand firms to competition and gives them greater access to new ideas and expertise.

On this reasoning, exports are a means of boosting economic growth rather than an end in and of themselves. We would go so far as to say that this is the only good rationale for targeting export growth.[2]

One wrinkle in the prognosis of using exports as a tool to boost growth is that the logic is circuitous. Smallness and isolation are not only reasons for poor productivity but also good reasons why New Zealand exports less than many other countries.

2 *Pursuing exports purely for the sake of exports can have offsetting negative consequences (King, 2012).*

1.3 Weak economy or weak exports: breaking the loop

Claiming that exporting is a solution to smallness and isolation is like saying "if only we had bacon we could have bacon and eggs if we had some eggs".

At some point though, the loop needs to be broken. Finding ways to boost exports is a good place to start.

1.3.1 Export success can snowball

The reason exports are a good place to start is that there is evidence to suggest that giving exports a boost could have a snowballing effect. Fabling, Grimes and Sanderson (2009) find evidence that path dependency is "a very real force" shaping New Zealand's export performance. This means that a shorter run boost to exports could possibly induce compounding growth in exports.

There is also good evidence that experience or learning matters, whether in terms of learning to deal with the difficulties of exporting (e.g. learning to hedge against currency fluctuations (Fabling and Grimes , 2008)) or in terms well-established connections to a market yielding opportunities to sell other products to that market (Fabling and Sanderson, 2010).

These kinds of findings, where exporting is a cumulative process of learning and adapting are consistent with evidence that paths to success for global firms are incremental (McKinsey & Company cited in NZ Institute, 2006).[3]

If export success begets export success, then it makes sense to find ways to help exporters or potential exporters to overcome some of the hurdles they face in internationalising.

This is not to say that all that all firms will be successful if they attempt to expand export markets. In a comprehensive analysis of export success Fabling and Sanderson (2009) note that four out five new export relationships are destined to end within the first year. Rather, increasing the hit rate and the longevity of firms operating in export markets could have a snowballing effect in driving further growth.

1.3.2 Success has wider benefits

Firms don't only learn for themselves but their success can spill over into improved performance by other local firms. This can happen when high performing firms put more exacting demands on their domestic suppliers. Alternatively, staff from successful firms take their skills to other companies or start their own companies (see e.g. Lerner, 2009). Entrepreneurs who guide their companies towards export success may also take their expertise to new ventures.

1.3.3 Promoting exports isn't risk free

There are a lot of maybes in this rationale for boosting exporting performance. While there are good in-principle reasons to get behind export growth as a tool for driving economic growth there are also a lot of risks. This means that action should not be taken for the sake of it – at least not by those who don't bear the consequences of failure. The existence of a gap between actual performance and potential performance does not justify action unless reasonable knowledge exists about how to cost effectively close the gap.

3 *The view that exporting is incremental and a hit and miss learning process is contrary to the views of others (e.g. Chadwick, 2011; inter alia) who argue that there is a fundamental difference between "traditional" product focussed firms and "global" customer focussed businesses.*

Thus, while there is evidence and intuition giving good reason for taking action to break the vicious loop between low productivity growth and low exports, the question is what should be done and where?

To determine where and what action is needed requires

- diagnosing the main factors holding back export growth
- identifying what is already being done to overcome those barriers and improving on existing initiatives and policy
- spotting any gaps where barriers are not being addressed
- finding fixes that will have positive and hopefully large pay offs in terms of exports and economic growth.

2 Constraints on export growth

Possible reasons for sluggish export growth are a combination of policy problems, market failures and market imperfections – all of which have the effect that entrepreneurs, investors and exporters don't have sufficient incentive or opportunity to build and maintain capability to export. These are well known and widely documented. They are:

- **legacy effects:** expertise has developed in sectors with slow global growth
- **regulatory, fiscal and monetary policy settings,** e.g. government spending which directs resources away from the export sector and drives up interest rates and exchange rates
- **external policy barriers** e.g. tariffs, quotas, subsidies, investment restrictions and the like
- **distance from major markets:** higher costs of doing business – whether in terms of freight, costs of acquiring information about a market, or getting recognised
- **small size:** small home markets reduce competition and reduce the scope and depth of skills in labour and capital markets.

2.1 The primary sector will remain crucial

The perceived problem of New Zealand's legacy of expertise in slow growth commodity production is not a very binding constraint in our view. Or at least, establishing scale in other sectors will naturally diminish, but not do away with, the importance of primary production. Indeed safeguarding the agricultural sector is important given that the primary sector is a sector in which we already have scale and expertise – as long as it is not favoured in policy and at the expense of other parts of the tradable sector.

Furthermore, it is worth reflecting on the extent to which export success is a function of external global innovation and patterns of production. These patterns are not easily predictable but past shifts might have mistakenly reduced policymakers' confidence in the importance of New Zealand's traditional industries.

New Zealand may arguably have been hindered by the gains in overseas agricultural productivity that occurred in the 19th and 20th centuries. These gains have drawn significant numbers of people out of extreme starvation but haven't yet delivered the premiums to protein production that could come with a rising global middle class. Being down in the mouth about growth in demand for animal proteins based on past trends could be a mistake.

By the same token, high tech manufacturing has come with a sting in its tail for economies like Taiwan and Ireland where companies have moved on or previously high end products have become commodities like any other.

2.2 It all comes back to scale and distance

The most binding of these constraints are scale and distance. A range of related hurdles are often put forward to explain why New Zealand exports are below par but these are typically subsets of those issues. They also often confuse symptoms with pathology.

For example, it is claimed that some firms fail to export because they cannot find sufficient numbers of knowledgeable investors, whether banks or angel and venture capitalists, to support their venture. This, it is claimed, is a problem with the thinness of domestic capital markets (Sundakov and Gerritsen, 2010). However the main reason that New Zealand's capital market is less sophisticated than most is that the New Zealand market is small and isolated.

Others point to high start-up costs associated with exporting. Exporting comes with a step change in the costs of doing business and scale of production which adds risk. Consequently there is less scope for incremental growth than there might be in other parts of the world. These issues both point to fundamental constraints on growth coming from scale and distance.

It is entirely appropriate that these things add to the costs of doing business. Investor expertise and capital comes at a premium which reflects New Zealand's distance from major markets and the fact that the New Zealand market is a relatively unknown quantity. It also reflects the higher costs facing a New Zealand firm searching for the right investor(s). Helping firms to overcome this premium by attacking the premium itself won't do away with the actual underlying problem. In this sense, you cannot fake scale. You can reduce its impact a little but you can't fake it. You have to build it.

2.3 Scale in what?

If scale is what is needed this raises the question of scale in what? Government has an expressed interest in focussing on high value knowledge intensive services and manufactured goods. The rationale behind this makes some sense once you can get through the rhetoric about what these things are.

According to Procter (2011) these products are ones which are made by companies which have a technology edge because their products are hard to replicate and they are always innovating for fast growing markets. The products themselves are ones typically made by wealthy economies or similar to those made in wealthy successful economies where there are similar firms doing similar things i.e. others who have a comparative advantage because of a hard to replicate set of knowledge or products who are always innovating for fast growing markets.

It is hard to fault the logic that these attributes make these firms more desirable than ones who produce products that are easily replicated, unimproved and part of slow growing markets.

However, the fact that innovative and hard to replicate products are valuable says nothing about how to identify these firms or their products in practice. Is there any guarantee that today's Apple will be tomorrow's Apple? History suggests that there isn't. Even the history of Apple computers suggests that we can't easily predict tomorrow's successes based on yesterday's attributes. Sure, we can see the seeds of Apple's success now. But that is just wisdom after the fact.

For this reason we cannot see the practical implications of targeting government policy at high-value manufacturing and services. If anything, it looks like a prescription for rewarding already successful companies rather than supporting new ones. Do these companies need more rewards? Supporting one already high-performing firm may come at the expense of the next big thing. It could also mean that today's high performing firm is only a flash in the pan. It does make sense to reward high performance, but the conditions for this should be set before the fact (before they can be seen performing) rather than after the fact. After the fact there is nothing left to entice people – no more incentive effect.

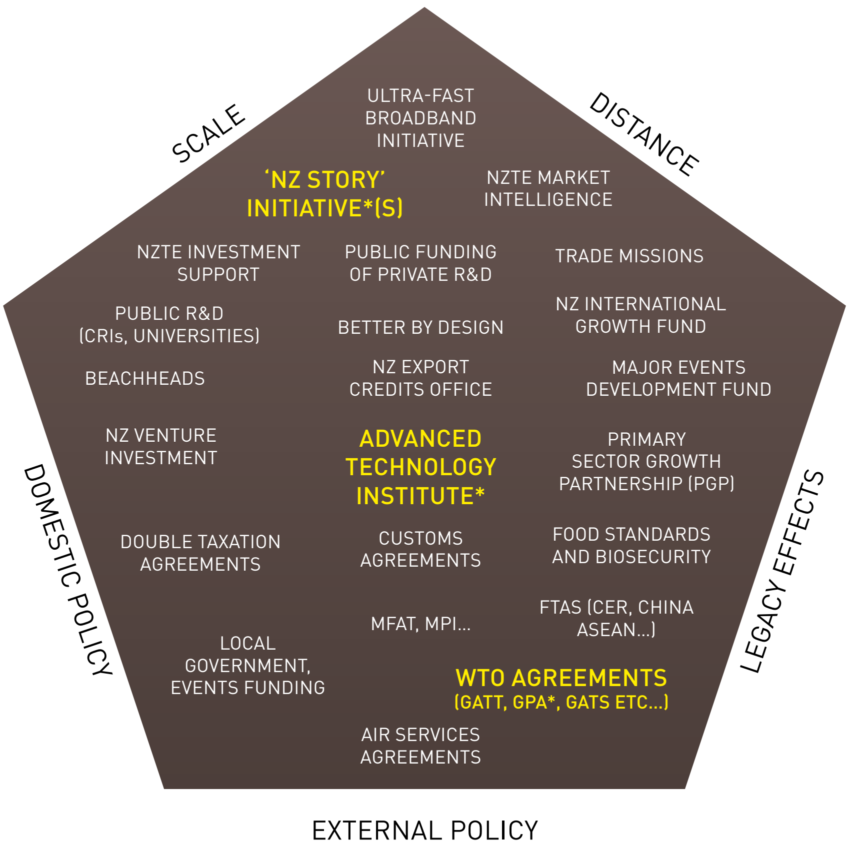
3 Starting from square two

We have to recognise that we are not starting from square one on these issues. Government has been trying to directly lift exports and economic performance for at least a century.

Currently there are a raft of policy initiatives which are aimed at addressing the various constraints to export and economic growth (Figure 4) and it is impossible to tell whether all of these are a necessary or beneficial use of public money.

Figure 4 Examples of existing export-related initiatives

Roughly relative to the barriers they address. Stars indicate new initiatives.



Source: NZIER

3.1 Do a few things well

Existing export-related and business capability boosting schemes need to be rationalised and the ones that remain need to be better evaluated.

The sheer range and mixture of legacy programmes and new initiatives begs the question of whether the same intervention logic is being used time after time to justify new actions to address problems that were supposed to overcome by another initiative which is still in existence. In principle, this may not be a problem. It may be that more is needed; though this seems unlikely.

The problem is, no one knows and there is not a sufficient evidence base to begin to answer these questions. One could always ask current and prospective beneficiaries and administrators of such programmes if they think they are worthwhile. However the answer is not likely to be entirely objective.

A rethink of the effectiveness of existing programmes should also consider important questions about service delivery and institutional effectiveness. To what extent should public organisations be engaged in both funding the development of firms' capabilities as well as actually delivering relevant services? It is not clear what comparative advantage a crown entity has in delivering export promotion services.[4]

3.2 Stay the course and improve evaluation

It may well be that much of the current suite of initiatives is doing its job in terms of building firm capability and lifting New Zealand's skill base and innovation. Policy makers need to give these initiatives time to work; so stay the course. While waiting around for something to happen, more information should be gathered on the effectiveness or otherwise of existing initiatives.

Policy fashions should be treated with scepticism and existing initiatives given time to work as intended before new initiatives take their place. This means being very clear about what it is that a policy or programme is intended to do and the time frame on which it is intended to do it.

'Clusters' are one example of policy that has fallen in and out of fashion. Not long ago it seemed that local and central governments couldn't move quickly enough to plan for and support industry 'clusters', given the scale and innovation that such initiatives promised. While there has been no cluster-led economic revolution in New Zealand, as yet, there are reasons to believe that clusters, built around local capability, can be successful.[5] But, such initiatives cannot be expected to yield fruit in much less than a decadal time frame. Any evaluation of programmes and policies needs to be cognisant of this.

Evaluation needs to start at the firm or the programme level but must end at an evaluation of the overall impact of public initiatives on New Zealand's economic and export performance. A macro view is vital because it is the wider benefits to New Zealand and New Zealanders which are used to justify intervention in the first place.

There is precious little evidence on the effectiveness of existing initiatives which try to help firms to grow their capabilities and to internationalise. The logic behind existing initiatives and new proposals are typically sound i.e. they are serious solutions to fundamental problems holding New Zealand companies back. But no one knows what they all add up to, whether more or less is needed and whether existing resources could be used more effectively.

4 *Although we appreciate that private service delivery could run afoul of international trade rules.*

5 *Support for clusters is not really a policy in and of itself. Rather, it is, or should be, a policy implementation choice which can increase the effectiveness of policy by facilitating scale through cost sharing, joint investment and knowledge sharing. There are many examples of export and innovation successes involving clusters (see e.g. OECD (2010)); though success is likely to cause cluster formation as much as clustering can cause success.*

4 Build a better business environment

There is always room for improving the stock of foundational policy which affects the overall business environment. It is easy to get swept up in the idea that new solutions are needed to the problem of sluggish export growth but, in many cases, conventional policy prognoses remain as valid as ever.

The Government needs to work on getting the fundamentals right and establishing a level playing field for exporters to succeed. This means:

- reducing **regulatory barriers** to economic growth such as staying out of the way of productive foreign investment
- keeping a lid on **government spending**
- setting **tax rates** which do not discourage firms from building capability in New Zealand
- negotiating **trade agreements** which can bring down external barriers to trade and promote the integration of New Zealand's economy with other parts of the world.

Behind each of these ideas is the fact that governments have as much, if not greater, capacity to hamstring exporters and entrepreneurship as they have to boost them.

In New Zealand, policy trends which might be preventing export growth are of concern. Also, if New Zealand faces fundamental geographical penalties and constraints to international competitiveness then we can ill afford to have policies and regulations which are not first rate.

4.1 Barriers to entrepreneurship and investment

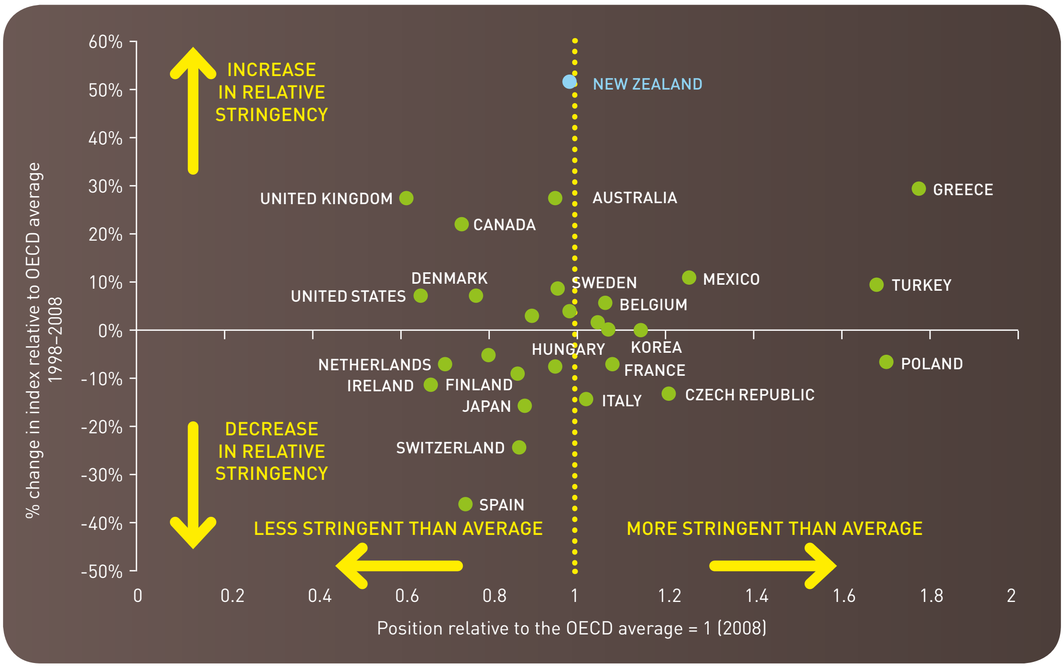
New Zealand has a reasonably high quality policy environment for doing business but this has not improved much in the past decade according to the OECD. At the same time, other countries have improved their position and this threatens a reduction in the relative advantage New Zealand has from a high quality regulatory environment.

Although regulation has improved on a number of counts in New Zealand, the quality of the business environment has deteriorated through some big steps on the part of government to increase its activity in the business sector through, for example, buying assets and engaging in businesses in sectors such as rail or banking.

New Zealand has also recently been scored as having one of the most restrictive FDI regimes in the OECD, alongside Mexico. This is overwhelmingly due to New Zealand's screening requirements for investment which are much more restrictive than other countries.

Figure 5 NZ regulatory environment vs the rest of the OECD

OECD index of product market regulation



Source: NZIER, OECD

This is a poor state of affairs for a small economy which relies on international engagement for both investment capital and trade opportunities.

It is also troubling that public and political debate often rails against foreign equity taking interests in local assets but there is not a second thought for overseas capital funding home mortgages: an egregious double standard.

Furthermore the government has actively promoted the benefits of companies investing offshore, such as opportunities for outward investment in the primary sector, yet questions are raised when offshore firms wish to do the same thing here.

Foreign direct investment is no panacea for export growth. However limiting investment can reduce competitiveness and access to capital. The size of the New Zealand market means that this economy cannot afford to pass up opportunities to access foreign investment.

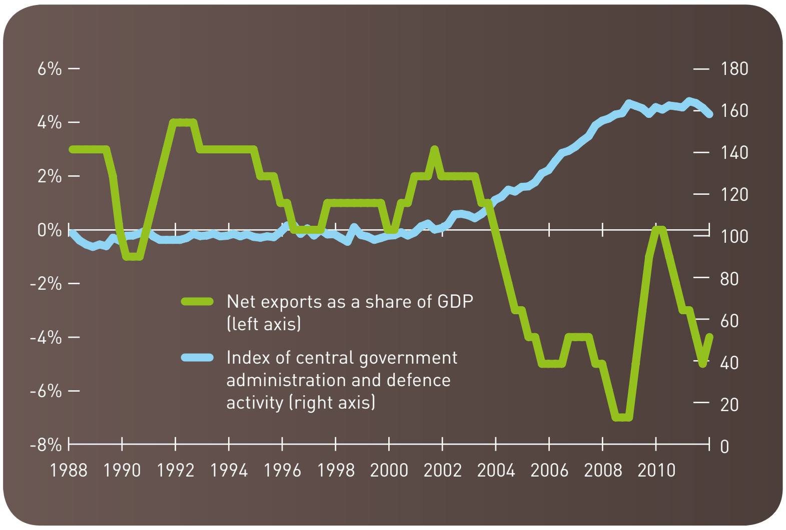
4.2 Public spending: a tax on the export sector

4.2.1 Getting back into surplus must remain a priority

During the 2000s the government administration share of GDP grew by 60% on the back of strong economic growth, higher tax rates and rising revenue. This growth came at a time when there wasn't much slack in the economy with the private sector reporting unprecedented capacity constraints. When government pumped cash into the economy and drove up the demand for labour it sucked resources away from businesses that were already having a hard time growing.

The negative effects of this are compounded by the fact that parts of the non-tradable sector are not subject to very robust competition. As a consequence they have a tendency to be less innovative, less productive and are thus more costly to sustain than other parts of the economy. The public sector is a case in point with evidence suggesting that a person working in the public sector in 2007 received a 22% pay premium over private sector equivalents (Gibson, 2009).

Figure 6 Net exports and central government spending



Source: NZIER

4.2.2 Social spending favours domestic firms over exporters

Growth in social spending also has the unintended consequence of biasing production in favour of domestic-focussed industries. An additional dollar of social welfare spending typically ends up in increased consumption of locally-based non-tradable products and services. This is precisely what social welfare programmes are designed to do – to support costs of living which are mostly local in nature. Nonetheless, it means that an additional dollar of spending goes to consumption, rather than investment, and then to industries which do not export.

These biases in favour of consumption (rather than saving) and domestically focussed enterprise go on to put upward pressure on the exchange rate, downward pressure on the prices that exporters receive on international markets and thus there is less incentive to export (see Savings Working Group, 2011). This is essentially a tax on exports.

4.2.3 Sorting out fiscal policy will help relieve pressure on the exchange rate

Thus, fiscal policy is a major hurdle to export growth. Ongoing concern about monetary policy and its effects on the exchange rate is missing the fact that fiscal policy – tax and spending – is a bigger part of the reason for the higher exchange rates and flat output growth in the export sector.

These observations are not criticisms of public spending programmes. They simply underscore the fact that, on average, an expansion of public spending leads to an expansion of domestically focussed industries and this naturally crowds out the expansion of export focussed firms.

The task for government is to help the rebalancing of New Zealand's economy away from domestic demand, public services and the non-tradable sector and back towards private investment and export growth.

This means staying the current course in tackling New Zealand's public sector deficit and ultimately scaling back government spending even further in the years to come in areas such as interest free student loans and *Working for Families*. It is not necessarily government spending that is an issue, but rather the composition of that spending.

4.2.4 Tough political decisions required

The pay offs from this, in terms of better export and economic performance, are unlikely to be immediate or even achievable in the short term. This clearly makes them unpalatable to a politician. But that doesn't change the fact that rates of return in New Zealand have been skewed for some time thanks to the actions of government. It also doesn't make a great deal of sense pursuing initiatives aimed at pumping up the prospects of exporting firms, only to tax away their profits by pumping up the domestic sector.

4.3 Competitive company tax rates

The tax system, as the counterpart to government spending, also needs continuous questioning. It does not make sense to subsidise early stage innovation and then tax resulting profits at rates higher than elsewhere in the world. That is a signal to firms and investors that they should go elsewhere.

Overall, New Zealand operates a tax system which looks more like the tax system of a country much larger and much richer than it is. Company tax rates, though they have been rationalised in recent years, still stand at rates much higher than for comparable OECD countries.

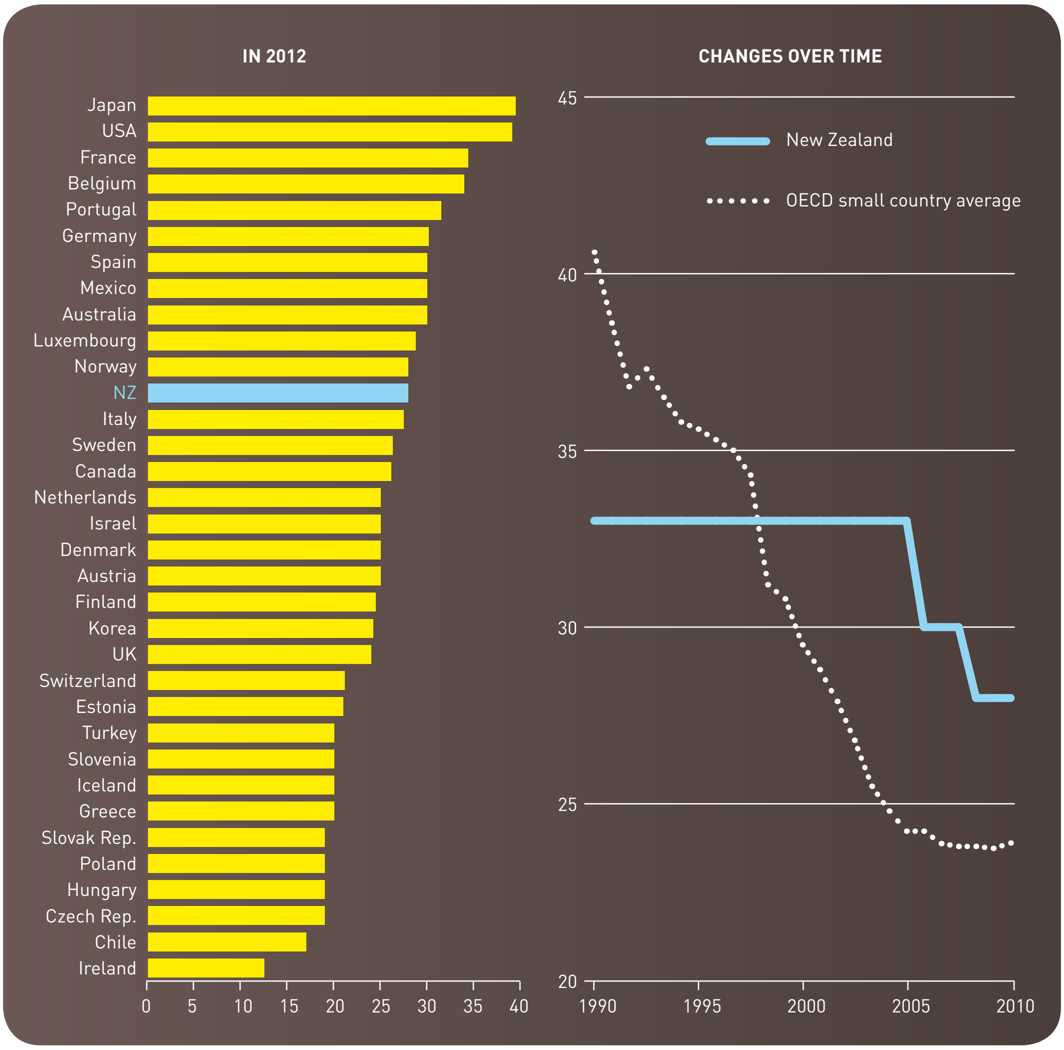
In the short term, pressure on the government's fiscal position may limit the scope for tax rate reductions. Over the longer term, some adjustment is needed. Failure to adjust will limit investment and reduce domestic firm productivity and real wages (Tax Working Group, 2010).

Similar observations can be made regarding other tax rates such as rates of tax on savings and personal labour income tax. Highly-skilled and entrepreneurial people are very mobile and if there is a desire to boost the capacity of the New Zealand economy to generate higher economic growth then these tax rates need to be competitive.

At the moment these issues are not pressing, with New Zealand's top marginal income tax rate below the OECD average – in part due to an absence of social security payments, and reliance on a reasonably high proportion of tax from GST. The issues for New Zealand's tax system in this space are much broader and more closely connected with the incentive problems associated with the structure of transfer payments and subsidies (e.g. interest free student loans) than individual tax rates.

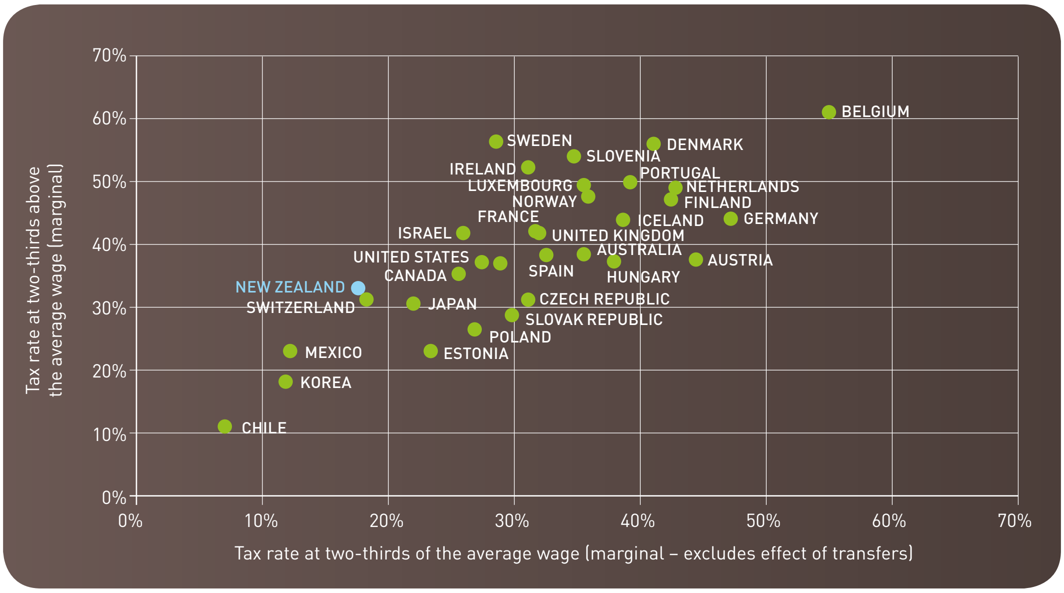
Figure 7 Company tax rates

Percent



Source: NZIER, OECD

Figure 8 Tax rates on wages in the OECD



Source: NZIER, OECD

4.4 Creating opportunities and safeguarding market access

4.4.1 More of the same, but different

A lift in export capability will not come to much if New Zealand is not at the table in the future when governments form agreements on market access and economic integration. Thus, New Zealand needs to remain on the frontier of international and bilateral trade agreements.

The New Zealand government needs to continue to pursue high quality trade agreements with other countries and it needs to continue to be innovative in the way it chooses to participate in the negotiation of these agreements. This means:

- being prepared to take opportunities as and when they present themselves;
- preparing for future (as yet unseen) opportunities by widening the scope of agreements, geographically and substantively;
- being prepared to engage meaningfully in capacity and relationship building that goes beyond setting the architecture and walking away.

Pursuit of trade agreements is not so much about increasing market access anymore as it is about managing risks of losing market access, reducing the transaction costs of trading and, above all, negotiating the option for people to develop well-functioning business relationships with customers and firms in other countries – behind the border.

4.4.2 Business voices needs to be heard to ensure bipartisan trade policy

This changing landscape brings challenges. The beneficiaries of trade policies and the bearers of costs from barriers are becoming more diffuse than what they once were. There is a less vocal and identifiable constituency for reducing behind the border barriers or pursuing further economic integration than, say, reforming agricultural tariffs and subsidies. A key risk from this is that New Zealand loses its invaluable bipartisan position on trade policy; especially in light of shifts already having taken place within the New Zealand parliament.

New Zealand needs the kind of flexibility that comes from a political consensus on the need for free trade agreements and economic integration. If New Zealand is not nimble and perhaps opportunistic in the way that it pursues free trade agreements it may well be left behind. New Zealand simply brings too little to the table in terms of politically saleable gains from free trade agreements.

Another challenge is the increased difficulty that negotiators have constructing and pursuing an agenda which is in the national interest – simply because the business landscape and the issues involved change too rapidly and are, in legal and economic terms, much more complicated. Negotiating the vagaries of audio-visual services in conjunction with intellectual property rights protection is a case in point.

These challenges need to be met by the business community through continued, deliberate and persistent demands for high quality free trade agreements. Exporters, investors, and business organisations would also do well to take steps to ensure that trade negotiators and officials keep getting the information they need.

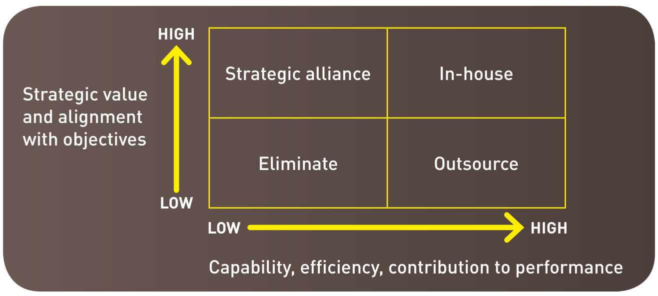
4.5 Collaborating to build capability

Collaboration amongst firms can be a contributor to export success. This includes collaboration by cost sharing or joint investment in offshore marketing, branding or market intelligence. For example, the Pure New Zealand Greenshell mussels brand is held jointly by: Greenshell New Zealand, Kono, Sanford, and Sealord. This collaboration also includes investment in a Shanghai based trading enterprise. This kind of export collaboration can provide a means of achieving scale and boosting in-market capability.

Alongside business, the New Zealand government has taken steps to support exporter and industry collaboration such as through "The Food and Beverage Information project". While government support may be useful, finding opportunities for increased collaboration must lie principally with the business community. Successful collaboration requires careful identification of mutually advantageous relationships and this is something that only firms can work through for themselves.

For many firms, establishing an export market presence will include the need to develop new capabilities and knowledge. For many, this will be achieved most effectively and efficiently by leveraging off the expertise or resources of others. If exporting is core to the strategic objectives of the business then it makes sense to do this with a strategic alliance of some kind, to ensure strategic oversight. When dabbling in a market it is likely to be more effective and efficient to outsource functions such as market intelligence or marketing. In general, when aligning capabilities with important strategic objectives, firms should use in-house capability where possible but form alliances when in-house capability is scarce or hard and inefficient to establish (see Figure 9).

Figure 9 Collaboration: aligning capability and objectives



5 Natural advantages

In key parts of the New Zealand economy there is a natural ability to achieve or maintain economic scale and to build upon export and business success.

These advantages need to be safeguarded and leveraged to the extent possible. Here we highlight three:

- **the primary sector**, where there are firms which already have considerable scale and contribute significantly to the New Zealand economy. This should not be taken for granted – neither by the industry nor by the public at large
- **the minerals sector** where there is also a significant export profile and promise of future export and economic success but this is by no means guaranteed
- the natural advantage that flows from **Iwi-owned assets** and Māori businesses – to the extent that these enterprises are connected to New Zealand for the long haul.

5.1 Primary sector leadership

New Zealand is not without its high performers and large scale industries, mostly in primary industries such as horticulture, viticulture and dairy but also in the extractive (minerals and mining) sectors.

Many of these industries already receive a reasonably high degree of support by way of basic science and public R&D funding, legislated exemptions from competition regulations (to enable scale), and co-funding for public-private R&D initiatives (e.g. the Primary Growth Partnership).

The organisations in these industries are not without their problems but they certainly have scale and more could be done to boost production in primary industry such as through increased use of irrigation. This is unlikely to be a fix for domestic productivity problems which plague other parts of the economy (especially the services sector) but it cannot hurt to boost the productive potential of New Zealand's powerful primary export sector.

5.1.1 Regulatory risks won't go away and need to be met head on

The biggest risk to these industries is regulatory. Existing regulatory processes are not as efficient as they should be. The Resource Management Act and the processes and institutions built up around it seem more an impediment than a boon to sustainable development.

More importantly, these industries risk new regulation reducing their access to or raising the costs of the resources that their businesses depend on. More needs to be done at the industry and individual business level to avoid this. Firms and farmers need to get onto the front foot.

This means accepting that, fair or not, when it comes to primary industry there is a social license to operate and that social license will come under pressure unless the wider public and local stakeholders think it is being taken seriously. To some extent, this is also true in the wider global market where sustainable resource use is increasingly on the radar of markets and mums and dads.

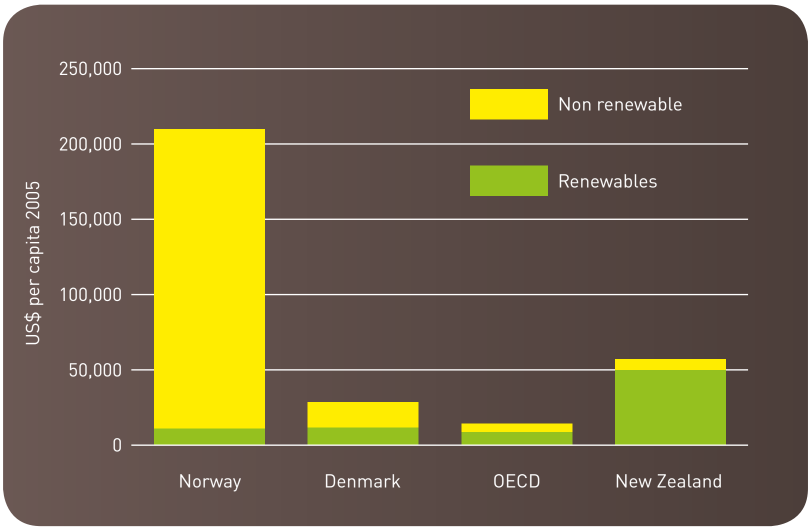
Attitudes are changing and initiatives are afoot which are already making for a more constructive relationship between primary industry and the wider community (e.g. the Land and Water forum). There are also a range of initiatives in place which seek to drive improved performance, especially on the environmental front. It is important that these trends continue. Those best placed to make that happen are those who work at the coal face or the farm gate. Leaving it to government is a poor strategy that is likely to backfire.

5.2 Expanding New Zealand's natural wealth

Increasingly New Zealand policy makers and producers are turning to the non-renewable natural wealth within our borders – mineral wealth that remains to be exploited. A great deal of New Zealand's natural wealth lies in primary production and renewable resources like forests and soil – much more so than countries New Zealand opinion-makers often compare us to (see Figure 10). However, with oil now one of New Zealand's largest exports the question has been raised as to how much further New Zealand should push to increase the rate of exploration and extraction.

Figure 10 Natural wealth

Value of proven and productive natural assets



Source: World Bank, 2010

In terms of increasing export growth, raising the rate of exploration and exploitation of mineral resources in New Zealand is a double edged sword. A large shock to exports from a big mineral find could well put upward pressure on the exchange rate which would crowd out other export industries. This effect looks already to be taking place, in a limited way, from the impact of historically high agricultural commodity prices as well as rising oil exports.

It is also not at all clear that extractive industries would give New Zealand's economy *ongoing* increased scale and improved access to skills. Given that it is a geographically concentrated and capital-intensive industry, boosting mineral exports may not necessarily boost domestic productive and export capability.

5.2.1 The benefits of mineral wealth hinge on how the proceeds are invested

But, with mineral wealth comes the opportunity to invest the proceeds and to build domestic capabilities and increase outward direct investment. This has worked exceedingly well for the Norwegians while the reverse is true for the United Kingdom which consumed most of the proceeds from North Sea oil. As such, increased exports of non-renewable mineral resources could be a boon to the New Zealand economy. For this to happen the use of public resource needs to be carefully managed.

There is little sense in locking away New Zealand's mineral wealth but the government of New Zealand as caretaker of these assets must be clear about what it would do with the rents from a resource boom – should one eventuate. Indeed with oil exports averaging $2 billion per annum in recent years the question might be asked as to why such a strategy is not already publicly available. Governments shouldn't engage in promoting resource extraction if they can't be relied upon to manage those resources, including the accompanying trade-offs in terms of environmental risk and costs, and invest the proceeds wisely.

Getting this right requires the kind of hard-fought bipartisan position that has secured trade policy gains over the years. This is essential for ensuring that governments do not squander New Zealand's natural wealth.

5.3 Iwi assets

A key part of New Zealand's economy which could prove a crucial source of scale and export capability in the future (and already does to some degree) is that part of the economy underpinned by assets owned by Māori property trusts and corporations.

Many Māori-owned businesses have an intrinsically stronger connection to operating out of New Zealand than others. That being so, business success borne by Māori is more likely to be success and capability which remains in New Zealand and upon which scale can be built.

This suggests that there may be higher social returns to a dollar invested in a Māori enterprise than in other enterprises; although this is contingent on the portfolios of property trusts and corporations making returns that are comparable to those of other investors (on a risk-weighted basis). In some areas of the economy there is reason to believe this not the case and in others Māori business is at the vanguard.

Finding ways to ensure that Māori businesses are performing at potential is one of the objectives of the current Māori Economic Development Strategy and it would not make sense to prejudge the outcomes of that. However, the key point is that whatever comes out of that strategy has the potential to be an important part of boosting New Zealand's economic performance and export potential.

6 Pushing the envelope

It is likely that more ambitious policy is needed to help New Zealand to overcome some of the fundamental disadvantages of exporting from a country so small and so remote.

A serious export growth agenda needs to take in potential changes to government policies which are somewhat outside the box. There are two areas of economic performance where this might best apply.

6.1 Immigration policy

If New Zealand's biggest impediment to better economic performance is an absence of scale, there is only one way to overcome this over the long term and that is to grow the population through more migrants.

We are on record suggesting it is feasible to target a population of 15 million in the next 50 years – an annual growth rate of 2.5% per annum. This would bring the size and density of the population to levels closer to more prosperous European countries. Fifteen million – two and a half times current projections – is a good target, too, as it allows for several large cities, fostering competition within New Zealand. Ultimately, this is a more economically meaningful target for helping boost exports than a target focussed on exports as a share of GDP.

The debate needs to be had and it is hard to see politicians picking it up. The private sector, therefore, needs to take the lead.

6.2 Rewarding high performers

Government sponsored initiatives to overcome problems of scale and to promote exporting, innovation and commercial success seem to tackle all of the key hurdles which get in the way of export success except the fundamental disconnect between private return and the wider economic benefits from business or export success.

Interventions to facilitate business success and export performance are predicated on the idea that these wider benefits are being undersupplied by the private sector. The solution should, therefore, be to provide incentives to firms to close that gap, to increase their productivity and grow scale from within New Zealand. Therefore, we need to find ways to better reward high performing firms to operate in or from New Zealand.

Companies in New Zealand reach a point where they cannot grow easily from within the country – when it makes sense to go offshore. At this point exporting from New Zealand is an option but the economic odds are stacked against it. Expertise, investment capital, and customers are all much more plentiful and easier to access from offshore. In many cases the benefits from hanging around are much more likely to accrue to the wider community than to the owners of the company. Something needs to be done to align the private incentive with the wider benefit.

Existing initiatives try to increase the capability and reach of New Zealand firms to help them overcome the odds that are stacked against them. This makes sense but on its own it is insufficient. It could also end up being wasteful. Scale mimicking initiatives like the Advanced Technology Institute may work well in boosting local knowledge but they may not do as much for retention of capability. This means that we might get a step increase in New Zealand's economic and export potential but miss out on a boost in growth rates.

Given that there is good reason to believe there is a gap between the returns which accrue to individual companies and the wider economic benefits of their success it makes sense to ensure that success is better rewarded. With most government sponsored initiatives focussed at the front end of business growth, there is a gap at the back end. Something should be done to close the gap.

There are a range of policy instruments which might be used to close the gap between private and public returns, from tax-related concessions to grants and other payments. The costs and benefits of different methods will need to be considered in some detail.

The concept of rewards for high performance to encourage retention is sound in principle. Indeed, firms use such tools to attract and retain talent. But further evaluation and consideration of implementation detail is needed before we can be sure that any new initiative is commensurate with the size of the problem it is trying to tackle. In particular, the scheme would need to be designed in a way that conditions for success and the size of any reward are set well before the fact and potential perverse incentives are minimised. This is about providing carrots for future business success in New Zealand, wherever that may come from, not a long service payment scheme.

A rewards scheme would also need to reward performance over a sustained period of time, say 10 years.

Rewards for high performers would target a gap in existing initiatives. Existing initiatives focus too much on building the capability of New Zealand firms. This is necessary but not sufficient for improved economic performance.

We cannot be sure what a rewards-based scheme would deliver. But, the idea of rewarding high performers has no less of evidential basis than other existing initiatives. Indeed exploration of the benefits of such a scheme would involve asking hard questions which should help to shine a light on pre-existing initiatives.

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