

# New Zealand: Lessons on economic reform from a distant relative

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*Navigating Economic Change  
Lessons from abroad and history*

## Navigating Economic Change

As the UK is buffeted by the economic shocks and challenges of the 2020s, The Economy 2030 Inquiry, a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics (LSE), funded by the Nuffield Foundation, is publishing a series of essays examining how policy makers from a range of advanced economies, including the UK in the recent past, have managed periods of disruptive economic change. As we seek to reformulate the UK's economic strategy for new times it is vital that we learn the lessons of these comparative and historic perspectives.

Some consider the trajectory of a national economy following a major shock – for instance, Germany after unification, New Zealand after the UK joined the European Community, Estonia post-USSR and the UK during the tumultuous 1980s. Others examine the experience of particular cities – for instance a group of post-industrial ‘turn-around cities’ - or the adjustment of key features of a national economic system, such as Danish ‘flexicurity’. Together they offer a powerful and timely set of insights on the successes and failures of economic policy makers in the face of economic shocks and structural change.

The essays are written by a range of leading economists and national experts and reflect the views of the authors rather than those of the Resolution Foundation, the LSE or The Economy 2030 Inquiry.

They have been commissioned and edited by Gavin Kelly (Chair of the Resolution Foundation and member of the Economy 2030 steering group) and Richard Davies (Professor at University of Bristol and fellow at the LSE's Centre for Economic Performance).

## The Economy 2030 Inquiry

The Economy 2030 Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics, funded by the Nuffield Foundation. The Inquiry's subject matter is the nature, scale, and context for the economic change facing the UK during the 2020s. Its goal is not just to describe the change that Covid-19, Brexit, the Net Zero transition and technology will bring, but to help the country and its policy makers better understand and navigate it against a backdrop of low productivity and high inequality. To achieve these aims the Inquiry is leading a two-year national conversation on the future of the UK economy, bridging rigorous research, public involvement and concrete proposals. The work of the Inquiry will be brought together in a final report in 2023 that will set out a renewed economic strategy for the UK to enable the country to successfully navigate the decade ahead, with proposals to drive strong, sustainable and equitable growth, and significant improvements to people's living standards and well-being.

## 1. Introduction

New Zealand is geographically the most 'distant' country in the world. Its nearest neighbour lies 2,000km away. While having a land mass similar in size to the United Kingdom or Japan, it has only a fraction of their population (approximately 5 million). In these respects, it may be thought to be *suis generis*, with few lessons for geographically closely connected, large countries. In many respects, however, New Zealand's experience can shed light on the processes of economic adjustment to major shocks. It is a liberal democratic country with a Westminster-style government that has had to adjust to major international and domestic shocks, just as the United Kingdom faces today.

From being one of the richest countries in the early twentieth century (along with the United Kingdom), New Zealand's fortunes slipped inexorably relative to other developed countries after the First World War and until the 1980s. It lost access to its main trading partner when the United Kingdom joined the European Communities in the early 1970s and New Zealand was then hit by substantial commodity price shocks in the 1960s and the energy shocks of the 1970s. This major disruption exacerbated the trend of declining relative incomes and led to a far-reaching programme of market-oriented policy reforms between 1984 and 1991<sup>1</sup>. Starting in the early 1990s, incomes in New Zealand began to grow again in relative (as well as absolute) terms, accompanied, however, by greater inequality and massive imbalances in the housing market.

The paper briefly discusses this historical context before giving an overview of the country's major economic reforms – including their effects on economic and social developments. New Zealand's experience provides a useful perspective as to how a range of reforms could affect both economic and social performance in the United Kingdom and elsewhere. More broadly, it provides lessons in some of the benefits, and risks, of seeking to shift the economic model of a country in the face of external shocks and ongoing relative economic decline.

## 2. Context: Decline

New Zealand was first settled in the 13<sup>th</sup> century by Māori from the Pacific islands. European (mostly British) settlers began arriving in the 19<sup>th</sup> century, and a formal connection with Britain was formalised through the signing of the Treaty of Waitangi in 1840 between the British Crown and Māori tribes. While New Zealand did not gain full independence until 1907, it was largely self-governing from the late-19<sup>th</sup> century. New Zealand became a social laboratory in terms of public policy, which reflects that it was settled in the 19<sup>th</sup> century by Brits seeking to escape their class-bound society. Large infrastructure works began in the 1870s, and the Liberal government of 1891-1912 introduced old-age pensions, minimum wages, votes for women and industrial arbitration legislation. The 1935-1949 Labour Government created the first welfare state (before Beveridge). A large state (public) housing programme was launched, most health services became free, a new universal pension was introduced at age 65, and other welfare benefits (including family allowances, and benefits for war veterans and the unemployed) were extended.

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<sup>1</sup> L Evans, A Grimes, B Wilkinson & D Teece, Economic reform in New Zealand 1984-95: The pursuit of efficiency, *Journal of Economic Literature*, 34(4), December 1996.

This Labour government also introduced a *dirigiste* style of economic management.<sup>2</sup> Import substitution industries were promoted through subsidies and trade restrictions (quotas and tariffs) and the government ran significant commercial services. A monopoly purchaser of dairy products was created while agricultural production was heavily subsidised (especially following commodity price falls). This broad agenda was followed by both Labour and National (conservative) governments from the mid-1930s to the mid-1980s.

These policies, which retained resources in declining industries and stifled private sector innovation, resulted in a gradual decline in New Zealand's GDP per capita relative to other advanced countries. New Zealand committed resources to industries that were not internationally competitive (for example, car assembly) or which were not competitive at the margin (such as through subsidising wool production). Figure 1 demonstrates New Zealand's long-term decline in GDP per capita, on a purchasing power parity (PPP) basis, relative to other developed countries (Western Europe plus Canada, Australia, and the United States – labelled 'West' in the figure).<sup>3</sup> The United Kingdom's similar, but less drastic, relative decline is also shown. For the first two decades of the twentieth century, New Zealand's GDP per capita was 25 to 40 per cent above that of the 'West'; by 1980 its GDP per capita was approximately 20 per cent below comparator countries.

This relative decline in living standards was exacerbated by three major shocks hitting the New Zealand economy in the 1960s and 1970s. The price of wool (New Zealand's major export commodity) collapsed in 1966,<sup>4</sup> Britain (New Zealand's major trading partner) entered the European Economic Community in 1973 with consequent reductions in agricultural export quotas, while the two oil crises of the 1970s exacerbated the reduction in New Zealand's terms of trade which fell by 35 per cent in the decade to 1975.<sup>5</sup> At the time, conventional wisdom was that the terms of trade were 'exogenous' to a small open commodity-producing economy (i.e. arising externally and therefore out of domestic control). Later experience shows that this is only true in the short term – if resources are free to move out of sectors with declining profitability into other more promising areas of economic activity, then export prices are in part determined within the domestic economy through this process of sectoral adjustment. Prior to the mid-1980s, the *dirigiste* policy settings had stymied the necessary resource flows to prospective new sectors.

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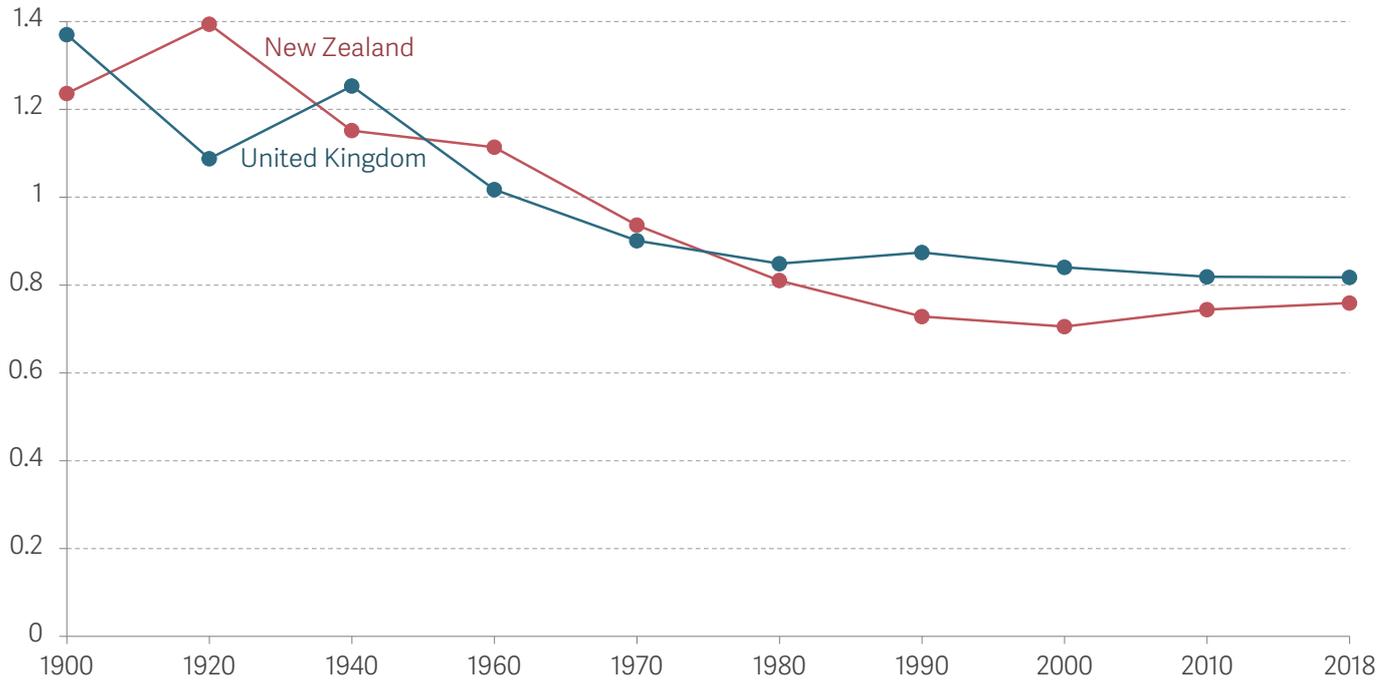
<sup>2</sup> W Sutch, *The Quest for Security in New Zealand, 1840 to 1966*, Oxford University Press, 1966.

<sup>3</sup> J Bolt & J Jan Luiten van Zanden, [Maddison style estimates of the evolution of the world economy. A new 2020 update](#), The Maddison Project, October 2020. 2018 is the most recent available year in the Maddison dataset. GDP data from 2020 onwards are substantially affected by Covid-related responses so do not illuminate longer term trends.

<sup>4</sup> B Easton, *Not in Narrow Seas: The Economic History of Aotearoa New Zealand*. Te Herenga Waka University Press. 2020.

<sup>5</sup> Source: Stats NZ, Infoshare.

FIGURE 1: New Zealand and United Kingdom GDP per capita (at PPP) relative to the 'West'



NOTES: 'West' is defined as the weighted average of Maddison's groupings for 'Western Europe' and for 'Western Offshoots' (including USA, Canada, Australia, NZ).

SOURCE: Analysis of Maddison Project Database.

Migration flows reflected the decline in economic fortunes associated with the wool price and oil price shocks. Annual net (inward) migration, which had been positive in every year from 1946 to 1967, turned negative in 1968-1969 and again from 1977 to 1982, with the annual net outflow averaging 0.8 per cent of the population.<sup>6</sup>

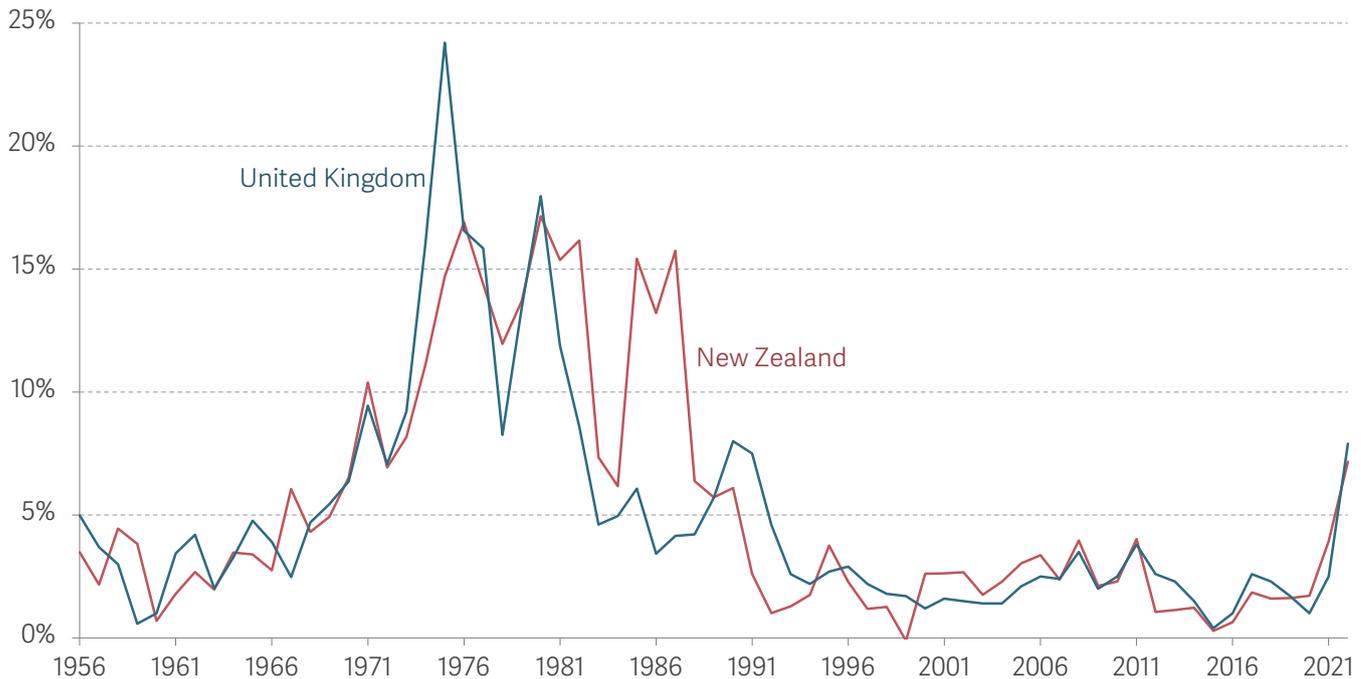
At the macroeconomic level, New Zealand governments increasingly ran fiscal deficits that led to a large increase in government debt. By 1984, net government debt reached 40 per cent of GDP, the fiscal deficit stood at 6 per cent of GDP while the balance of payments current account registered a deficit of 8 per cent of GDP.<sup>7</sup> Lax monetary policy,<sup>8</sup> that accompanied the expansive fiscal policies, led to inflation that exceeded rates in most other developed countries from the late 1960s to the early 1980s. Figure 2 shows that New Zealand inflation rate exceeded that of the UK in the 1980s, for example.

<sup>6</sup> By contrast, the average net inflow per annum over 1946 to 1976 was 0.5 percent of the population. All migration statistics in this paper are derived from: New Zealand Productivity Commission, *Immigration by the Numbers*, New Zealand Government, May 2022.

<sup>7</sup> L Evans, A Grimes, B Wilkinson & D Teece, *Economic reform in New Zealand 1984-95: The pursuit of efficiency*, *Journal of Economic Literature*, 34(4), December 1996.

<sup>8</sup> Under the legislation at the time, the central bank had to follow the instructions of the Minister of Finance; see: J Singleton, A Grimes, G Hawke & F Holmes, *Innovation and Independence: The Reserve Bank of New Zealand 1973-2002*, Auckland University Press, December 2009.

FIGURE 2: New Zealand and United Kingdom annual CPI inflation rate



SOURCE: Analysis of OECD, CPI database.

### 3. Reform agendas

In response to these declining economic fortunes, the Labour government elected in 1984 announced a comprehensive suite of reforms. The programme of measures included: financial market deregulation, floating of the exchange rate, central bank independence with inflation targeting, removal of agricultural subsidies, removal of export assistance, reduction of import tariffs, reduction in regulation of goods and services markets (including occupational licensing), privatisation and corporatisation of government trading entities, reduction in the top personal income tax rate (from the previous peak of 66 per cent), introduction of a comprehensive value added tax, reductions in government expenditure, introduction of user pays for many government services, and resource management reform. The succeeding National government (elected in 1990) deregulated the labour market and cut social security benefits. The political system also changed with a shift from a first-past-the-post (electorate-based) system to a proportional representation system based on Germany's mixed member proportional (MMP) representation model.

The scale and pace of reform was unprecedented in New Zealand and, perhaps, internationally.<sup>9</sup> Almost every sector of the economy had subsidies and other protections withdrawn: for instance, agricultural subsidies were almost completely removed within two years (with farm prices collapsing by up to 50 per cent). International trade was further liberalised with free trade agreements being signed, *inter alia*, with Australia and several countries (both bilaterally and multilaterally) in East Asia including China. New Zealand's concentration on extending international trade to East Asian

<sup>9</sup> O Williamson, The new institutional economics: Taking stock, looking ahead, *Journal of Economic Literature*, 38(3), September 2000.

countries reflected the growth prospects in those countries and their relative – but not absolute – geographic proximity. (The distance from London to Beijing, at 8,142km, is 2,000km shorter than that between Auckland and Beijing.)

Following the major reforms of 1984 to 1991, successive (Labour and National-led) governments have generally adopted only minor economic policy changes. The change in approach reflects both ‘reform-fatigue’ of the populace and the shift to a proportional representation system of government which, with one exception, has resulted in coalition or minority governments since 1996. Nevertheless, in response to growing inequality, there have been some significant policy shifts particularly the Working for Families package (similar to the UK’s Working Tax Credit), introduced in 2004, which supports the incomes of low and middle-income (employed) families with children.

The 2008 to 2017 National-led government introduced what it termed a ‘Social Investment Approach’ to policy (which ostensibly took a long-term approach to government policy choices). A Treasury paper foreshadowed this approach outlining how policies could be ranked according to their long-term present discounted value of benefits relative to costs, rather than focusing on short-term outcomes.<sup>10</sup> The intention was to highlight policies that had inter-generational benefits. Implementation of the policy, however, mistakenly focused on the long-term fiscal calculus which meant that policies which had societal, but not fiscal, benefits were downplayed. The same government introduced a set of Better Public Services Targets (BPS) that set ten time-bound targets for social outcomes. Progress towards achieving these targets were rigorously monitored; in one case where the target was not being achieved (rheumatic fever) extra resources were channelled to address the issue through the introduction of a Healthy Homes programme.

More recently, the Labour-led government scrapped the BPS targets while introducing a ‘wellbeing approach’ to policy in 2017.<sup>11</sup> This reflected the Treasury’s adoption of a Living Standards Framework (LSF) closely modelled on the OECD’s Better Life Index.<sup>12</sup> The LSF comprised 12 ‘domains’ (such as health and housing) with 60 associated indicators.<sup>13</sup> This indicator approach has been of little assistance, however, in helping to prioritise policies. Indeed, major fiscal expenditures (e.g. the Winter Energy Payment and free tertiary education fees) have been initiated with benefits accruing to large numbers of wealthier households, contrary to the intentions of the wellbeing approach.<sup>14</sup>

One area where the LSF has been useful is in relation to child poverty where, in contrast to other policy areas, government set specific, time-bound (three-year and ten-year) targets for child poverty.<sup>15</sup>

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<sup>10</sup> V Jacobsen et al., Investing in Well-being: An Analytical Framework, New Zealand Treasury Working Paper 02/23, December 2002.

<sup>11</sup> Government of New Zealand, Budget Policy Statement 2019, December 2018.

<sup>12</sup> Treasury, Our People, Our Country, Our Future. The Living Standards Framework: Introducing the Dashboard. New Zealand Government, December 2018. The LSF has since been updated in: Treasury. The Living Standards Framework 2021, New Zealand Government, October 2021.

<sup>13</sup> The approach is similar to the ONS ‘Measures of National Well-being Dashboard’ that is used in the United Kingdom.

<sup>14</sup> A Grimes, Budgeting for Wellbeing, in B Searle B, J Pykett, M Alfaro-Simmonds, A Modern Guide to Wellbeing Research, Edward Elgar, 2021.

<sup>15</sup> Three child poverty measures were adopted – the share of children: (i) in households with less than 50 per cent of median household income (before housing costs), (ii) in households with less than 50 per cent of median household income (after housing costs), and (iii) in households suffering from ‘material hardship’ (defined according to lack of access to a range of necessities). To illustrate the government’s scale of ambition, the first measure had a baseline (2017/18) proportion of 16.5 per cent (of children in poverty) with a three-year target of 10.5 per cent and a ten-year target of 5 per cent. Baseline, three-year and ten-year targets for the second indicator were 22.8 per cent, 18.8 per cent and 10 per cent respectively; for the third indicator, the corresponding figures were 13.3 per cent, 10.3 per cent and 6 per cent.

This self-imposed pressure encouraged government to increase benefit levels for parents with children to alleviate child poverty. While progress towards the targets has been hampered by the Covid pandemic and accompanying lockdowns, the moves to increase support demonstrate the positive effects that explicit time-bound targets can have.

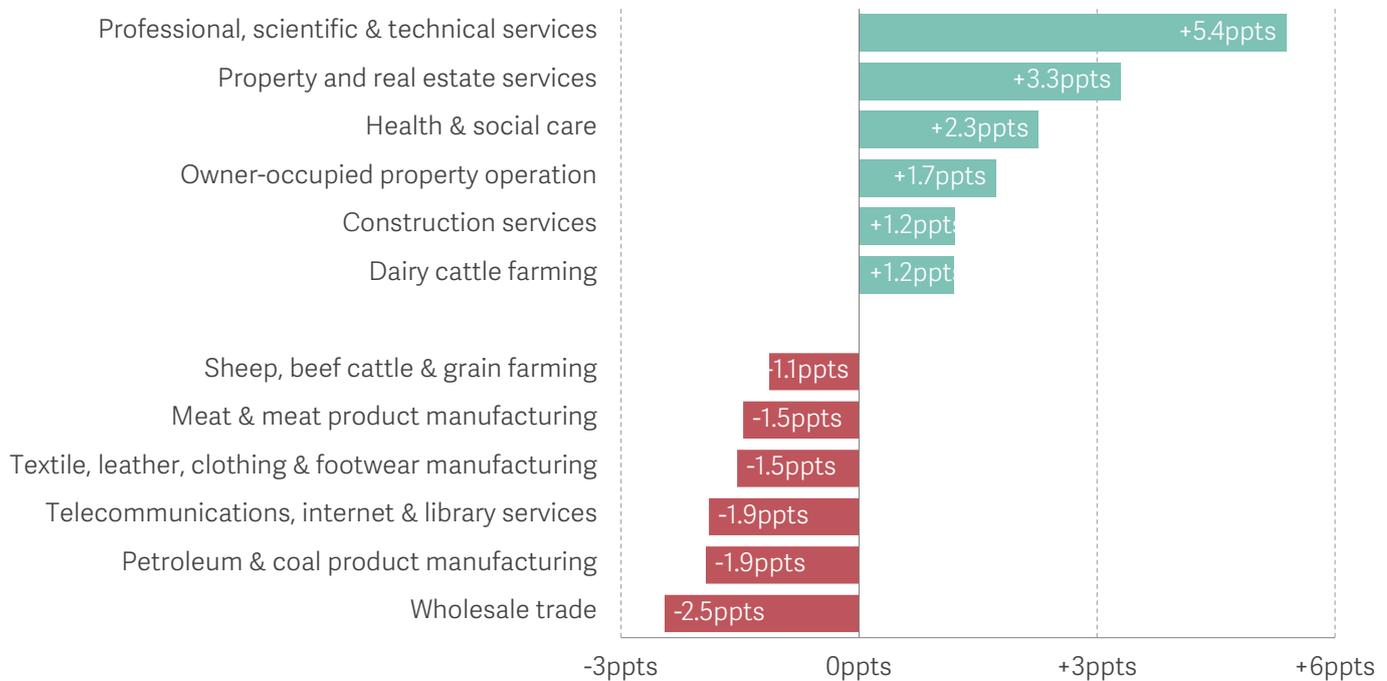
## 4. Did the reforms work?

The comprehensive reforms of 1984-1991 did not immediately reverse New Zealand’s relative decline in GDP per capita (see Figure 1). In fact, the period of decline continued until the mid-1990s as previously protected firms and sectors shrank or disappeared entirely. Net migration was again negative from 1985 to 1990 (averaging an annual outflow of 0.4 per cent of the population) as people lost jobs in previously protected industries. The unemployment rate rose from 4.2 per cent in 1986 to a peak of 11.2 per cent in 1991.<sup>16</sup>

### a) Reallocation towards higher-return sectors

Since the mid-1990s the country’s per capita production has been on a gradual upward trend compared to other developed nations (see Figure 1). These production statistics do not, however, tell the whole story in relation to income trends. If resources move to sectors with higher returns, then incomes can rise even if (physical) productivity does not increase, which is indeed what happened in New Zealand.

**FIGURE 3: Percentage point change in the industries’ share of gross value added: 1986-87 to 2020-21**



SOURCE: Analysis of Stats NZ, Table SNE048AA.

<sup>16</sup> The official Household Labour Force Survey definition of unemployment is consistent with the standard ILO definition. The survey was introduced in October 1985 so prior comparable figures are not available.

Figure 3 highlights some of the significant changes in industrial structure that occurred between 1987 and 2020 in terms of the percentage point change in industry shares of nominal value added.<sup>17</sup> Of the six industries with the largest increases, three are property-related sectors, in part reflecting strong inward migration increasing demand for housing over the period. The health share also increased markedly, consistent with trends in many developed countries with ageing populations. The industry with the largest increase (a rise of 5.4 percentage points) is 'Professional, Scientific and Technical Services', a high-income sector. The other major growth industry is 'Dairy Cattle Farming' while another important feature of the table is that 'Sheep, Beef Cattle and Grain Farming' (and the related 'Meat and Meat Product Manufacturing' industry) were amongst the six largest declines in industry share. Resources shifted within the agricultural sector (to those with higher returns) as well as between sectors towards high-income activities (Professional, Scientific and Technical Services). Within the agricultural sector, land use change facilitated this switch to higher-value agricultural production. With respect to services, inward flows of skilled migrants assisted the move towards professional and technical activities.<sup>18</sup>

### *b) Rising incomes*

Changes in New Zealand's sustainable consumption levels over time can be ascertained by referring to trends in per capita Real Adjusted Net National Income (pcRANNI)<sup>19</sup> which is an aggregate measure of income (discussed in more detail in Annex 1).<sup>20</sup> New Zealand's pcRANNI began increasing relative to most other developed countries from the early 1990s. From 1994 to 2018, New Zealand grew faster on this measure than Austria, Belgium, Canada, Denmark, France, Germany, Greece, Italy, Japan, Netherlands, Portugal, Spain, Switzerland, the United Kingdom and the United States. Figure 3 shows the compound annual growth rate of pcRANNI for New Zealand and the United Kingdom for each decade from 1970 to 2018 (with the final 'decade' covering eight years).

This shows New Zealand's (and, to a lesser extent, the United Kingdom's) slow growth in aggregate real income over the 1970s. Unlike the United Kingdom's spurt in real income over the 1980s and 1990s, however, New Zealand's aggregate real income continued on a low growth trajectory through these decades (although a rebound began later in the 1990s). Since 2000, New Zealand's aggregate real income growth has increased markedly to average around 2 per cent per year whereas the United Kingdom has been stuck in an era of low growth for fifteen years. This strong increase in real incomes in New Zealand since the early 1990s contrasts with the somewhat weaker picture for real GDP per capita growth shown in Figure 1 (though even on this score there has been some modest catch up with leading economies over the last two decades). A key difference is that the pcRANNI measure includes relative price gains flowing from the redirection of production towards sectors with rising output prices whereas real GDP ignores such gains.<sup>21</sup> Real GDP measures therefore do not adequately reflect the benefits of reforms that facilitate the reallocation of activity to higher return sectors.

<sup>17</sup> The figures are from the production based national accounts published by Stats NZ, covering 55 sectors. Dates are for years ending March, so 2020 is largely unaffected by the Covid pandemic; 1987 is the first available year for the data.

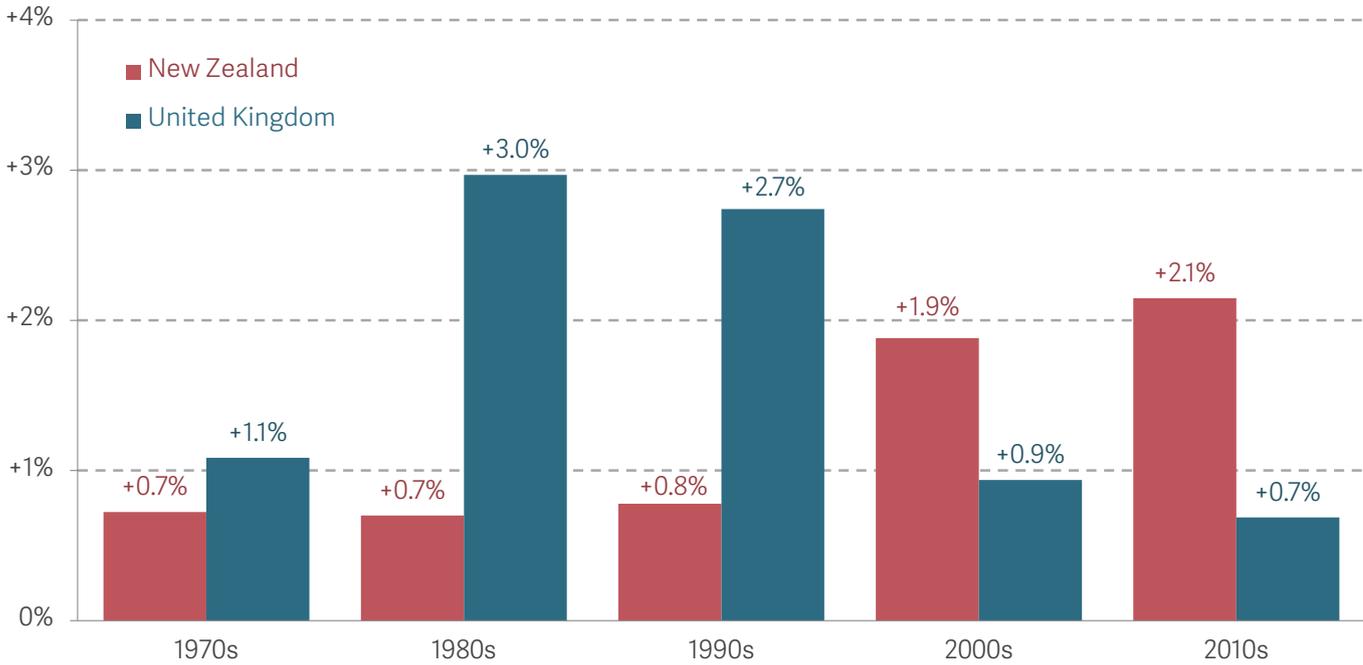
<sup>18</sup> See Figure 5.1 in: New Zealand Productivity Commission, *Immigration by the Numbers*, New Zealand Government, May 2022.

<sup>19</sup> Annex 1 describes the derivation in Grimes and Wu, 2022, of pcRANNI and how it compares with GDP. It also includes discussion of New Zealand Treasury analysis (from 2023) decomposing trends in pcRNNI (per capita Real Net National Income) relative to GDP per capita since the turn of the millennium.

<sup>20</sup> The measure is consistent with Hicks' definition of income as the consumption that can be undertaken without reducing a country's capital stock.

<sup>21</sup> See: U Kohli. *Trading gains and productivity: A Törnqvist approach*. *International Productivity Monitor*, 42, September 2022.

**FIGURE 4: Compound annual growth rates of per capita Real Adjusted Net National Income (pcRANNI) for New Zealand and the United Kingdom, by decade, 1970-2018**



SOURCE: Grimes and Wu, 2022.

### c) High employment

Consistent with rising incomes (and production value), the unemployment rate fell back to 4.2 per cent in 2004 and has since remained broadly stable at between 3.5 per cent and 5.0 per cent (other than through the Global Financial Crisis). Notably, this moderate level of unemployment occurred at the same time as the employment rate (i.e. employment / population of working age) increased markedly from 72 per cent in 1986 to 77 per cent in 2019. Reflecting this strong employment growth, net migration was positive every year from 1991 through to the pandemic – averaging 0.4 per cent of population per annum. Furthermore, life expectancy increased sharply between 1985-87 and 2017-19 for both females (by approximately 8 years) and males (by approximately 9 years).<sup>22</sup>

Longer-term monetary and fiscal trends have also been positive. Following Reserve Bank independence in 1989 and the adoption of inflation targeting, the inflation rate fell to low single digits (see Figure 2).<sup>23</sup> In addition, the country’s net foreign liabilities (i.e. net debt plus equity owed to foreigners) fell from 73 per cent of GDP in 2001 (the earliest available data) to 46 per cent in 2022. As described in more detail later, the government ran fiscal surpluses in most years between 1994 and 2018 (excluding the Asian Financial Crisis and Global Financial Crisis years) so government debt also fell over this period.

<sup>22</sup> Life expectancy calculated in 2017-2019 was 83.5 and 80.0 (for females and males respectively); the corresponding figures for 1985-87 were 77.1 and 71.1. Source: Stats NZ, <https://www.stats.govt.nz/topics/life-expectancy>, accessed 31 October 2022.

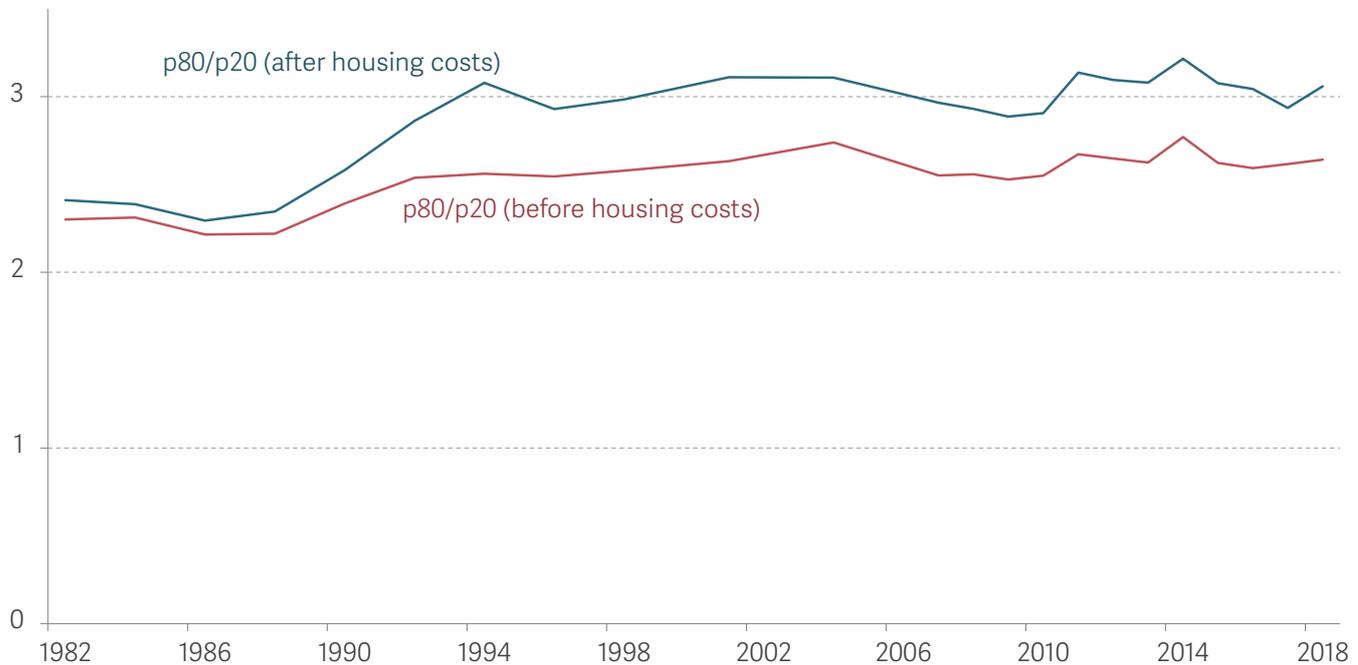
<sup>23</sup> With a legislative change in 2018 to return to a dual mandate (price stability and full employment) CPI inflation has once again risen, together with marked instability in house prices (discussed further below).

While the macroeconomic (and migration) outcomes have been broadly encouraging, other important outcomes resulting from the 1990s reform agenda have been far more troublesome. Two key challenges stand out: trends in inequality and in house prices.

*d) Rising income inequality*

There are many ways of assessing changes in inequality.<sup>24</sup> When it comes to incomes, household inequality (as measured by the ratio of incomes towards the top of the distribution compared to those towards the bottom – the ‘P80/P20 ratio’) rose sharply in the later years of the reform period, especially between 1988 and 1994 (see Figure 5).

**FIGURE 5: Ratio of 80th to 20th percentile (p80/p20) in equivalised household incomes in New Zealand, before housing costs and after housing costs**



SOURCE: Perry 2019, Tables D.2 and D.6.

The economic reforms of the 1980s dismantled supports for low productivity sectors (such as manufacturing firms operating with tariff protection) and inefficient government enterprises (like railways) which were large employers of lower-skilled labour (with particular concentrations of Māori and Pacific Island workers). At the same time, skill-biased technological change reduced demand for low-skilled relative to high-skilled workers. The consequent reduction in demand for unskilled labour was compounded by changes in labour market regulation through the Employment Contracts Act (which led to firm-based or individual-based bargaining largely replacing industry-level bargaining) which reduced wages for lower-skilled workers.

<sup>24</sup> See B Perry, Household incomes in New Zealand: Trends in indicators of inequality and hardship 1982 to 2018. Ministry of Social Development, November 2019. Wealth and wealth inequality is measured less frequently and less accurately than is income, so the focus of the discussion is on income inequality. As in most countries, wealth in New Zealand (however measured) is distributed less equally than is income; in 2003-04 the top wealth decile held approximately 50 per cent of total wealth whereas the top income decile earned approximately 25 per cent of total income. Perry reports that the share of wealth held by the top decile in New Zealand (52 per cent) is similar to that in the United Kingdom (47 per cent).

The trend in inequality once housing costs are taken into account was even starker as house prices (and rents) increased following reform. Beginning in 1991, the National government sold publicly owned housing and introduced market-related rents for the remaining public housing which both reduced options for long-term rented dwellings for lower-income families and increased rents for those that remained in public housing.<sup>25</sup> These sales reflected a long-standing ideological divide between Labour and National governments on the role of the state in providing subsidised public housing.

The introduction of the Working for Families package had the effect of slightly reducing each of the inequality measures between 2004 and 2007; since then, however, the trend has been slightly upward and the ratios are again similar to those recorded in 1994. This long-term outcome likely reflects a permanent change in demand for higher-skilled relative to lower-skilled labour.

#### *e) Entrenched educational inequality*

One factor that feeds through to adult inequality, especially as demand for skilled workers relative to unskilled workers increases, is the high level of educational inequality in New Zealand. In the 2018 OECD PISA survey, New Zealand students had the sixth highest score difference (among 77 countries surveyed) between the top and bottom tenth of students in science.<sup>26</sup> In the 2019 TIMSS survey of science and mathematics for Grade 8 (14 years olds), New Zealand had the 15<sup>th</sup> and 16<sup>th</sup> (out of 39 countries) most unequal scores for mathematics and science respectively.<sup>27</sup> Consequently, the New Zealand Productivity Commission has argued:<sup>28</sup>

*... the Government should urgently address the performance of the school system. Large disparities in achievement between the best and poorest performing students, along with an absolute decline in core skills – reading, mathematics and science – risk leaving many young people ill-prepared to adapt to, or prosper in, the future work environment.*

The existing degree of educational inequality in New Zealand is strongly ethnically differentiated, creating a major challenge for ensuring the prosperity of lower skilled workers in the future. Efforts to try out new approaches to tackling educational inequality have been short-lived or largely ineffective in addressing these disparities in educational outcomes. In 2014, a government led by the National Party introduced state-funded partnership (charter or academy) schools, designed to cater for 'priority' students from more disadvantaged backgrounds. The schools did not have to adhere to the national curriculum and could employ unregistered teachers. These schools, which were designed to facilitate the learning needs of children from target groups, were disestablished by the incoming Labour government.

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<sup>25</sup> B Schrader, *We call it home: A history of state housing in New Zealand*. Reed Books, 2005.

<sup>26</sup> Source: OECD, *New Zealand: Student performance, PISA 2018*, accessed 8 July 2023.

<sup>27</sup> I Mullis et al., *TIMSS 2019: International results in mathematics and science*, Boston college, TIMSS & PIRLS International Study Center, 2020.

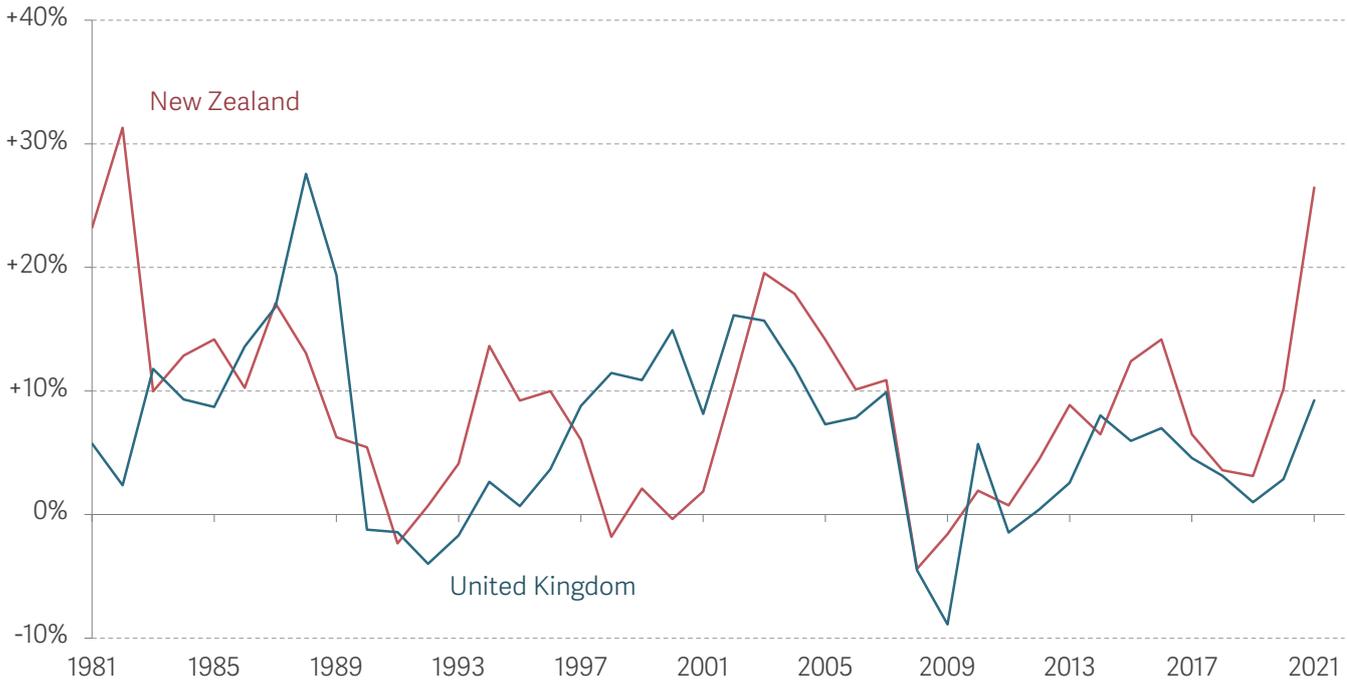
<sup>28</sup> New Zealand Productivity Commission, *Technological change and the future of work*. New Zealand Government, March 2020.

Given the demonstrable failing of the current educational system for many children from priority groups, especially amongst Māori (as shown in PISA and TIMSS data), there remains a strong need to support pilots similar to those offered by partnership schools. At the same time, partial state funding continues to flow to independent (private) schools, whose students mostly comprise children of wealthier families. This suggests an opportunity to reallocate state spending to improve educational outcomes for disadvantaged groups.

*f) A dysfunctional housing market*

Closely related to wealth inequality (see footnote 23) and to income inequality (after deducting housing costs) are developments in house prices, which have been particularly extreme in New Zealand, far surpassing the UK experience. These trends are shown in Figures 6 and 7, showing the annual inflation rate of house prices and the house price index (with 1980=1). In 2021, New Zealand house prices were 29.3 times their level of 1980.<sup>29</sup> (In contrast, the ratio for the United Kingdom was ‘just’ 12.8.) The substantial house price inflation over 2018 to 2021 is likely to have further widened the gap between the after housing cost and before housing cost income inequality measures since 2018.

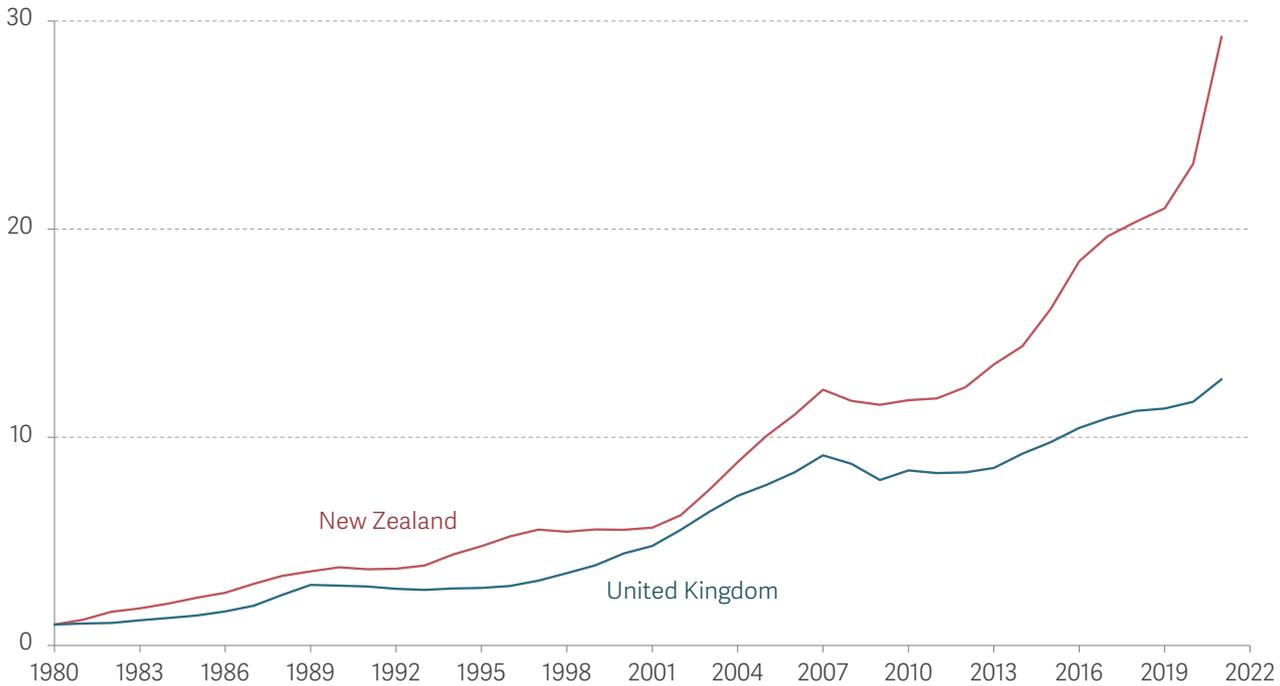
**FIGURE 6: New Zealand and United Kingdom annual house price inflation rate**



SOURCE: Analysis of OECD.

<sup>29</sup> There is no reliable rent index covering the same period, but anecdotal evidence indicates that rents have also increased much faster than have incomes, especially in the main cities.

FIGURE 7: New Zealand and United Kingdom house price index (1980=1)



SOURCE: Analysis of OECD.

Comparisons at both the country and city level demonstrate the severity of New Zealand’s housing affordability crisis. At the country level, New Zealand has the second highest ratio of housing costs to gross adjusted disposable income of the 41 countries in the OECD’s Better Life Index database.<sup>30</sup> At the city level, Demographia’s ‘median multiple’ indicator, defined as the median house price divided by gross median household income, is calculated for 94 markets (cities).<sup>31</sup> Of these, Auckland ranks as the 88<sup>th</sup> least affordable with a multiple of 10.8; by comparison Greater London’s multiple was 8.7 (ranking it as the 83<sup>rd</sup> least affordable).

House prices reflect both demand and supply. Migration and monetary policy are two key factors influencing demand. Positive net inward migration has led to increased demand for dwellings. However, if migration is at a steady rate (with a stable distribution across cities), the construction sector should be able to deliver the required new houses without major price consequences (though see the discussion below regarding ongoing supply constraints). In contrast, surges in migration have a material effect on prices, as the construction sector’s capacity is insufficient in the short term to meet the increased demand.<sup>32</sup>

With respect to monetary policy, both the secular reduction in interest rates since 2008 and the monetary stimulus following the Covid crisis have added to house price pressures. The Reserve Bank of New Zealand’s Official Cash Rate (OCR) stood at 8.25 per cent over the year prior to the Lehman Brothers collapse in September 2008. Over the following two years the OCR fell to 2.5 per cent and since then its peak has been just 3.5 per cent. During the Covid pandemic the rate fell to 0.25 per cent and substantial additional monetary stimulus was pursued through increased banking sector liquidity.

<sup>30</sup> See: <https://www.oecdbetterlifeindex.org/topics/housing/> (as at 12 July 2023).

<sup>31</sup> Source: W Cox, 2023 Demographia International Housing Affordability, March 2023.

<sup>32</sup> A Grimes & S Hyland. Housing markets and the global financial crisis: The complex dynamics of a credit shock, *Contemporary Economic Policy*, 33(2), April 2015.

Despite a fall in net immigration and an upturn in house building in 2021, this monetary stimulus fed through to house prices which surged by 44 per cent between January 2020 and October 2021. The contrary effect can be seen after October 2021 when the Reserve Bank tightened monetary policy in response to rising inflation. The resulting increase in mortgage interest rates contributed to a 16 per cent fall in house prices between from October 2021 to June 2023. Nevertheless, as of June 2023, house prices remained 20 per cent above their pre-Covid levels.

With respect to housing supply, the number of dwellings has needed to increase substantially, not only to reflect an expanding population boosted by immigration, but also in response to a trend towards smaller households. Housing supply, however, has been constrained by regulatory factors and by a shortage of skilled labour.<sup>33</sup> The shortage of skilled labour reflects outward migration of trades people to Australia (where New Zealanders can travel freely and where incomes for most trades are higher) and a shortage of newly trained staff. Immigration flows partially relieved the labour constraint, but this safety valve disappeared for a period when the country locked its borders during the pandemic.

Regulatory constraints reflect local decision-making in which political economy factors (reflecting the interests of existing home owners) encourage local councils to restrict development. In 2010, a government-appointed advisory group recommended that central government be required to sign off on local spatial plans that affect urban development, as occurred then in the United Kingdom, Canada (Ontario) and Australia (Queensland). The recommendation reflected a view that elected local councillors work to protect the interests of local voters, who are mostly homeowners, whereas a Minister could take a counterbalancing 'public interest' stance. However, the recommendation was rejected as ministers were not willing to bear the opprobrium of vocal interest groups.

The 40 per cent increase in house prices that occurred over the first two years of the Covid pandemic led central government to mandate more relaxed rules for development, especially in inner city areas. The legislation was supported by all but one party in parliament (including, at the time, by the opposition National Party), reflecting growing recognition of the chronic social and economic problems caused by high house prices.<sup>34</sup>

An additional factor pushing up house prices relative to incomes is that housing is tax-privileged relative to financial investments. Neither imputed rents nor capital gains on owner-occupied housing are taxed, while capital gains on (long-term) investment housing are also untaxed. By contrast, returns on retirement savings and other forms of financial savings are fully taxed as income.<sup>35</sup> These tax benefits are impounded in the price of houses.

### *g) The growth of cities*

A longer-term trend that is apparent in New Zealand (as elsewhere) is the increasing importance of its major urban area, Auckland. According to the 2018 census, Auckland (with a population exceeding

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<sup>33</sup> New Zealand Productivity Commission, *Housing Affordability*, New Zealand Government, October 2012.

<sup>34</sup> This mandate is, however, being fought by local authorities. Many newly elected councillors and mayors (in October 2022) based their local election campaigns around opposition to the legislation and, in the lead-up to the 2023 general election, the National Party withdrew its support for the policy.

<sup>35</sup> A Coleman, *Housing, the 'Great Income Tax Experiment', and the intergenerational consequences of the lease*. Motu Working Paper 17-09, Motu Economic and Public Policy Research, May 2017.

1.5 million) comprised 33.4 per cent of New Zealand's population (4,700,000).<sup>36</sup> Auckland's share of the national population was similar to that in 2006 (32.4 per cent) but was a substantial rise relative to the 1996 figure of 27.1 per cent.<sup>37</sup> In 1945, Auckland comprised just 17.5 per cent of the country's population.<sup>38</sup>

The forces of agglomeration have been active in New Zealand, as elsewhere, with Auckland having a (small) productivity premium relative to other domestic cities and higher incomes.<sup>39</sup> Since 1991, it also increased its employment share in knowledge-intensive industries (medium/high-tech manufacturing and knowledge intensive services), more so than in other New Zealand cities, and more than in the five main Australian cities.<sup>40</sup> Auckland's development in this respect is consistent with the combined effects of agglomeration of high-tech industries in larger cities *and* the national rise in the share of people working in professional, scientific and technical industries.<sup>41</sup>

At the same time, many rural districts have experienced population decline as people move to the main cities.<sup>42</sup> These trends exacerbate the difficulty of providing services both in declining communities (because of a lack of local taxpayers to fund expenditures) and in Auckland. In the latter, pressure for increased services has outstripped the ability of the local council to fund the infrastructure upgrades required to service the growing population, with resulting congestion. Given the international forces at play, this issue does not appear to be New Zealand-specific but is nevertheless a complicating factor for policy-makers to consider. For instance, it is a particular issue for infrastructure policy when central government is deciding whether to allocate funds to Auckland to deal with its growth or to other lagging regions, to promote development in those areas.

## 5. Fiscal strength and economic resilience

New Zealand has faced three major economic shocks since the mid-1990s: the Asian Financial Crisis (AFC) in 1997, the Global Financial Crisis in 2007-08, and the Covid-19 pandemic starting in 2020.<sup>43</sup> The programme of fiscal consolidation (and debt reduction) that began in the early 1990s enabled the government to respond to each of these crises. According to IMF data, in 2009 (the earliest available year of data) New Zealand's general government net debt stood at 3.1 per cent of GDP (compared with the 40 per cent figure reported in Evans et al., for 1984).<sup>44</sup> Inflation was also well under control, standing at 1.2 per cent, 2.4 per cent and 1.6 cent respectively at the start of each crisis episode.

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36 This ratio of largest city to country population is not unduly high relative to some other OECD countries; larger ratios are found in Korea, Israel, Chile, Ireland and Iceland, while Estonia, Greece, Austria, Hungary, Finland and Portugal each have ratios of at least 25 per cent.

37 Despite Auckland's faster population growth, its house prices have not risen relative to the rest of New Zealand since the mid-1990s, in part due to outflows of residents from Auckland to other parts of the country at times when Auckland house prices have risen above those in other regions.

38 Sources: J Polkinghorn, A New Zealand Local Population Database, RCG Limited, July 2017; and Stats NZ 2018 census.

39 D Maré & D Graham, Agglomeration elasticities and firm heterogeneity, *Journal of Urban Economics*, 75, May 2013.

40 A Grimes, J Le Vaillant, P McCann. Auckland's Knowledge Economy: Australasian and European Comparisons. MED Occasional Paper 11/02, Wellington: Ministry of Economic Development, March 2011.

41 P McCann, Economic Geography, Globalisation and New Zealand's Productivity Paradox, *New Zealand Economic Papers*, 43, November 2009.

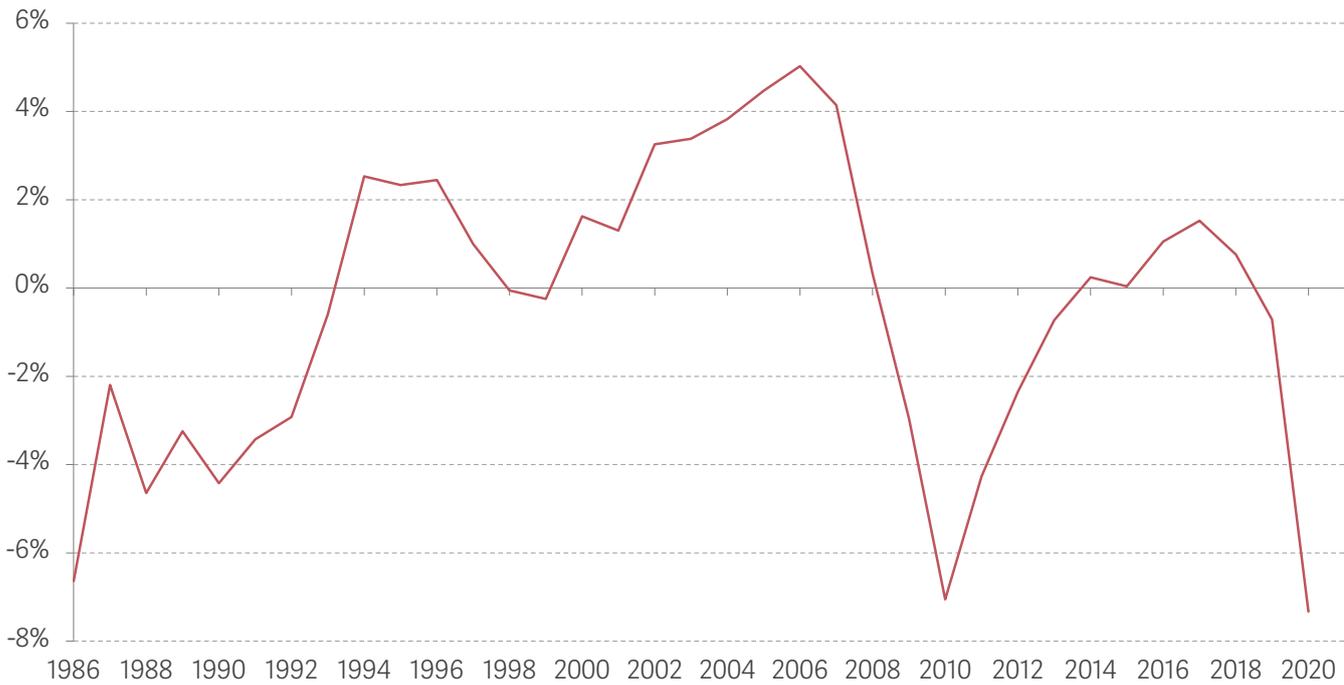
42 N Jackson, Sub-national depopulation in search of a theory – towards a diagnostic framework, *New Zealand Population Review* 40, 2014.

43 The war in Ukraine and associated energy disruptions have not a severe effect on New Zealand's economy other than through global energy and food price increases. For instance, New Zealand's merchandise terms of trade in December 2022 were almost identical to the September 2020 level, indicating that the country's real income has been largely insulated from this source of disruption.

44 Source: IMF Government Finance Statistics data.

The late 1980s and early 1990s was a period in which fiscal imbalances were reduced, with the fiscal balance reaching surplus in 1994 (see Figure 8). Apart from two years of negligible deficits (in 1998 and 1999), when fiscal policy responded to the AFC, the fiscal balance remained in surplus through to the onset of the GFC. The sequence of almost unbroken surpluses from 1994 to 2008 resulted in a low level of government debt when the GFC occurred. This left fiscal policy the room to respond (*inter alia*, through increased expenditure on infrastructure) to the crisis. The fiscal balance returned to surpluses until the Covid pandemic struck, again enabling government to respond through significant fiscal expansion.

**FIGURE 8: New Zealand general government fiscal balance as a share of GDP**



SOURCE: Analysis of OECD, General Government Deficit.

Unemployment, nevertheless, rose during each crisis, with peak rates of 7.9, 6.6 and 5.3 per cent, respectively, following the AFC, GFC and Covid-19 shocks. However, none of these responses comes close to the peak unemployment rate (11.2 per cent) observed during the reform period. The fiscal response, combined with declining peak unemployment rates after each shock, reflects the government’s increased ability to stabilise the economy, due to the significant fiscal space it had available (given government debt was consolidated at low levels).<sup>45</sup>

## 6. Lessons

What are the lessons – positive and negative – from New Zealand’s economic story that can guide future policy decisions and offer insights to other countries, like the UK, considering how to reform their own underperforming economic model? Ten stand out.

<sup>45</sup> While fiscal consolidation helped facilitate resilience to macroeconomic shocks, it was achieved in part through constraining expenditures on infrastructure development. In 2023, the IMD World Competitiveness Centre ranked New Zealand 28th of 64 (mostly developed and middle income) countries in terms of infrastructure quality (UK ranked 20th). See: IMD, 2022 World Competitiveness Ranking, World Competitiveness Center, June 2023.

First, the prioritisation of sound policies during buoyant economic times, including the reduction of government debt, has longer term payoffs. Government fiscal restraint through good times is politically difficult, but its benefits when major economic shocks hit the country are evident.

Second, economies evolve as technologies advance and as competitive positions, consumer preferences and relative prices change. Policy settings need to enable resources to flow to uses with higher returns, raising overall incomes. Stifling of such resource flows turns a process of continuous adjustment (with incremental low-level adjustment costs) into a situation of comprehensive adjustment with large adjustment costs.

Third, an open economy with strong international trade links provides opportunities for domestic firms to expand and for domestic consumers to have improved consumption possibilities. Free trade agreements, particularly, with rapidly expanding economies, can incur initial adjustment costs but increase overall incomes, particularly if they facilitate a shift towards higher value-added economic activity.

Fourth, tax policies have a major impact on outcomes. Evidence suggests New Zealand's Working for Families package reduced income inequality, especially for the target group of families with children. More generally, tax and transfer policies that support those lower down the income and wealth distributions can make a substantive difference to their lives. By contrast, tax breaks for owner-occupied and rental housing increase wealth inequality, favouring those with housing assets. The design of tax and transfer policies that both support target populations – and combat asset price inflation – needs to be a focus of policy if equitable, as well as efficient, outcomes are sought.

Fifth, sudden adjustment to accumulated imbalances is costly. Unemployment in such circumstances is likely to exhibit hysteresis with a growing number of long-term unemployed people. In these circumstances, government assistance to reduce social costs (for example, through new infrastructure projects) can result in productive investments and cushion the employment and social costs of adjustment. Crucially, to make this option a reality in the presence of regulatory and other constraints, governments need to have *ready-to-start projects in reserve during good times when resources are fully employed*. At the outset of the GFC, for instance, the Government embarked on a substantial national roll-out of fibre for ultra-fast broadband, that included regional as well as urban areas.<sup>46</sup> It also embarked on a large-scale retrofitted insulation programme for older houses. In the midst of the Covid pandemic, government legislated for fast approval mechanisms to enable infrastructure developments to bypass standard planning processes. While each of these examples was successful, success is not inevitable: Australia's retrofitted insulation programme during the GFC had to be cancelled after major problems emerged,<sup>47</sup> and its fibre roll-out programme incurred massive costs. Careful pre-planning is needed.

Sixth, educational inequality is a major issue for New Zealand both in terms of social justice and future economic performance. Here there is scope to redirect resources currently benefiting independent schools, which exacerbate inequalities from childhood onwards, towards schools that are innovating to improve educational outcomes for priority students, while also decreasing societal inequalities.

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46 R Fabling & A Grimes, Picking up speed: Does ultrafast broadband increase firm productivity? *Information Economics and Policy*, 57, December 2021.

47 N Preval et al., Government failure and success: A Trans-Tasman comparison of two insulation subsidy schemes. *Agenda*, 26(1), September 2019.

Seventh, the New Zealand housing 'model' requires far reaching reform. Ensuring an adequate supply of affordable housing is vitally important for current and future equity, as well as overall economic performance. A key aspect of policy that has been lacking at times in recent decades in New Zealand is large-scale construction of public housing. Political views on the role of government in providing public housing have differed sharply between Labour-led and National-led administrations, and this has caused a stop-start (and occasionally a reverse gear) approach to public housing provision. More generally, planning rules that restrict housing development have resulted in constrained supply and hence higher house prices favouring existing homeowners. Tax settings have also resulted in wealth gains for owners at the expense of renters. There is no reason to support the differential tax treatment of housing (whether owner-occupied or investment housing) relative to other assets. The tax system needs to be reoriented so that housing is no longer tax preferred, with imputed rents and (real) capital gains each becoming subject to income tax. A more far-reaching rebalancing of taxation towards a land tax – potentially with reductions in income tax and/or GST – would further reduce the price of dwellings, especially those situated on more expensive land.<sup>48</sup>

Eighth, the problems exhibited in housing and education – and also in mental health (as highlighted in a recent Treasury wellbeing report)<sup>49</sup> – emphasise that economic progress by itself does not necessarily result in a society with sustainably high wellbeing. With these issues being magnified amongst certain ethnic groups (particularly Māori), the effects flow through into other social ills, such as drug use and criminality, which impact the wellbeing of the wider population.

Ninth, resolving these issues requires tax revenues. While New Zealand is likely to maintain a moderately prosperous society over the foreseeable future, the lesson of recent history is that more national resources will need to be allocated to ensure adequate public housing, mental health services (both prevention and treatment) and educational provision (pre-school and school) that meets the learning needs of priority groups. While some redirection of existing resources can help fund these priorities, it is also likely that the overall resources available to government will need to increase (especially with an ageing population), requiring a (mild) increase in tax revenues. Broadening the range of taxes to include a land tax – the most efficient and (vertically) equitable tax available to government – should be considered.

Finally, in terms of policy implementation, a key lesson is that adopting clear targets (whether for macro objectives, such as inflation, or for specific targets, such as rheumatic fever or child poverty reduction) can enhance accountability for achieving policy aims in a way that generic 'indicators' cannot.

Stepping back, New Zealand's economic trajectory provides lessons both in what it has done well – enabling a flexible, open economy to reallocate resources across sectors and having the fiscal space and readiness to respond robustly to shocks – and badly – tackling educational inequality and massive imbalances in the housing market. Other countries, not least the United Kingdom, should learn from both these successes and failures.

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<sup>48</sup> See: A Coleman & A Grimes, *Betterment Taxes, Capital Gains and Benefit Cost Ratios*, *Economics Letters*, 109(1), October 2010; A Coleman & A Grimes, *Fiscal, Distributional and Efficiency Impacts of Land and Property Taxes*, *New Zealand Economic Papers*, 44(2), July 2010.

<sup>49</sup> Treasury, *Te Tai Waiora: Wellbeing in Aotearoa New Zealand*, November 2022.

## Annex 1: Per capita Real Adjusted Net National Income (pcRANNI)

Grimes and Wu compile a measure of sustainable consumption possibilities, per capita Real Adjusted Net National Income (pcRANNI), based on World Bank data for 22 developed countries.<sup>50</sup> The World Bank compiles nominal ANNI which has three key differences compared with nominal GDP: (i) gross national income (GNI) replaces gross domestic product (GDP) so incomes earned by domestic residents are counted rather than production within the country's boundaries; (ii) depreciation of fixed capital is deducted from GNI to give net national income (NNI); (iii) resource depletion is deducted from NNI to give adjusted net national income (ANNI). ANNI is the income available for consumption without reducing the (country's) capital stock (i.e. the Hicksian definition of income).

The World Bank's ANNI series are denominated in US dollars, so are converted to domestic currency at the current exchange rate. This series is then divided by population to convert to per capita (pc) terms, but the resulting aggregate is still in nominal terms. Given that this series measures the income available for consumption without depleting the capital stock, Grimes and Wu use the domestic CPI (consumers price index) to deflate the nominal aggregate to give pcRANNI.

Subsequent work within Treasury adopts a similar approach to deconstruct the sources of New Zealand's real income growth from the late 1990s to 2019.<sup>51</sup> Their work abstracts from resource depletion (which makes only a minor difference) focusing on Real Net National Income (RNNI). They compare growth in pcRNNI with growth in pcGDP and decompose the sources of RNNI growth. Their starting point is the "turn of the millennium" (the average level over 1995-2002). From then to 2019, New Zealand's real GDP per hour worked dipped from 66 per cent of the median of 19 OECD countries to 62%. However, over the same period, pcRNNI increased from 69 per cent to 85 per cent of the median, painting a very different picture to that using the more common reference point of GDP per hour worked.

The Treasury analysis shows that growth in pcRNNI can be decomposed into: changes in real GDP per hour worked, hours worked per capita, terms of trade impacts, net international income, and depreciation as a share of GNI. The key components which explain New Zealand's "excess" growth in pcRNNI relative to GDP per hour worked (in order of impact) are shown to be:

1. An increase in the share of the population in employment (rather than individuals working more hours).
2. A rising terms of trade (with global prices for food increasing relative to manufactures, supported by changes in the composition of imports).
3. A reduction in the net international income deficit (in part due to falling global interest rates, and in part due to a reduction in net foreign liabilities).
4. No material change in New Zealand's depreciation burden (whereas most other countries experienced slight increases).

Each of these aspects is discussed in more detail in the Treasury (Galt, 2023) paper.

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<sup>50</sup> A Grimes & S Wu, Sustainable Consumption Growth: New Zealand's Surprising Performance, New Zealand Economic Papers, October 2022.

<sup>51</sup> M Galt, Examining New Zealand's increased rate of income growth between the late 1990s and 2019, Analytical Note 23/04, The Treasury, June 2023.

### **Navigating economic change: lessons from abroad and history**

As the UK is buffeted by the economic shocks and challenges of the 2020s, The Economy 2030 Inquiry, a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics (LSE), funded by the Nuffield Foundation, is publishing a series of essays examining how policy makers from a range of advanced economies, including the UK in the recent past, have managed periods of disruptive economic change. As we seek to reformulate the UK's economic strategy for new times it is vital that we learn the lessons of these comparative and historic perspectives.

Some consider the trajectory of a national economy following a major shock – for instance, Germany after unification, New Zealand after the UK joined the European Community, Estonia post-USSR and the UK during the tumultuous 1980s. Others examine the experience of particular cities – for instance a group of post-industrial 'turn-around cities' - or the adjustment of key features of a national economic system, such as Danish 'flexicurity'. Together they offer a powerful and timely set of insights on the successes and failures of economic policy makers in the face of economic shocks and structural change.

The essays are written by a range of leading economists and national experts and reflect the views of the authors rather than those of the Resolution Foundation, the LSE or The Economy 2030 Inquiry.

They have been commissioned and edited by Gavin Kelly (Chair of the Resolution Foundation and member of the Economy 2030 steering group) and Richard Davies (Professor at University of Bristol and fellow at the LSE's Centre for Economic Performance).