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The productivity problem: what we can do about it

About us
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At the beginning of 2014, HSBC described New Zealand as a "rock-star" economy, pointing to anticipated short term growth well ahead of most other developed countries. One reason for this optimism is the steady increase in labour output over the last few years, thanks largely to the Christchurch rebuild and some of the best terms of trade we've enjoyed for years.

In the face of that, to publish a white paper that declares New Zealand faces a serious productivity problem may seem like we're raining on this parade. But all parades - the Christchurch rebuild and our current terms of trade - must eventually end. What then?

A hangover, that's what. While we've increased our output recently, and therefore our income, we've barely increased productivity since 2000. Said another way, we're just working longer hours at the same old pay rate.

In the meantime, other countries are taking a smarter approach – increasing the hourly rate of pay. According to the OECD, New Zealand performs about 30% below the OECD average in terms of GDP per capita.

The reasons for the gap have been well documented. They include the so-called tyranny of distance, weak international connections, underinvestment in knowledge, innovation and ideas, and the scarcity of large companies and the opportunities for people to develop serious business skills inside them.

While we'll test some of these reasons, the main question we want to address here is "what can we do about it?".

> **Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.**
>
> **Paul Krugman**
> The Age of Diminishing Expectations (1994)

Is it a policy issue?

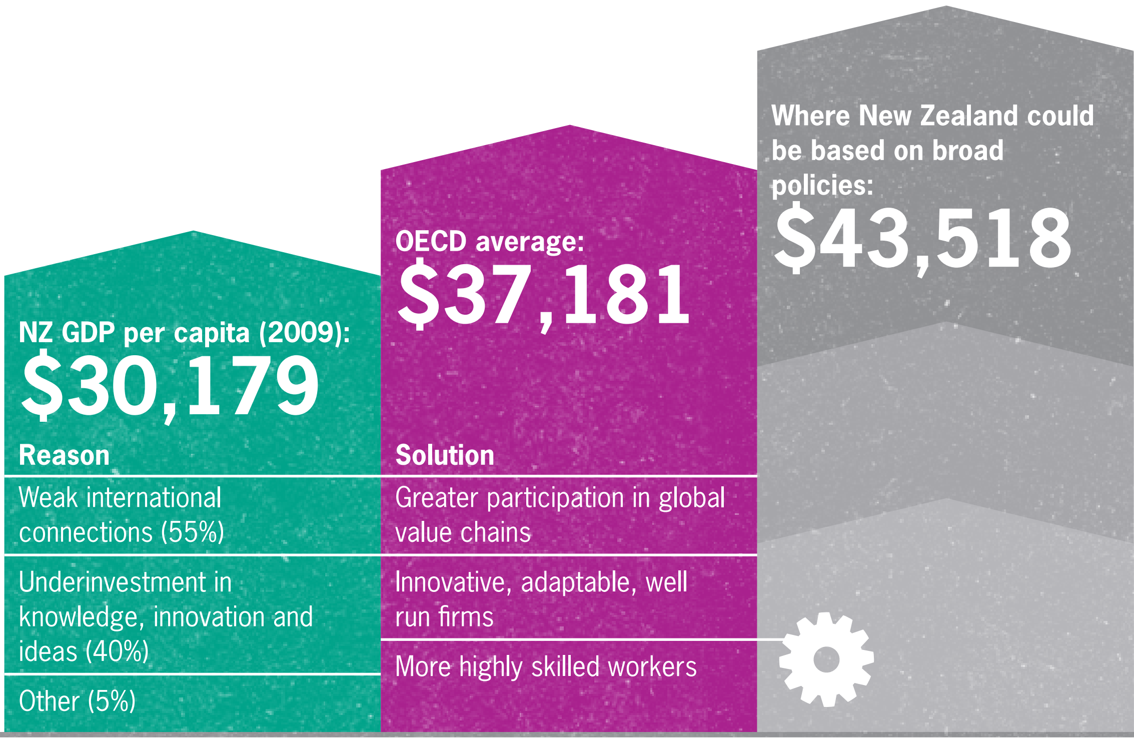
One factor we can confidently rule out is broad government policy – things like market regulation, tax policies and so on. Research by the OECD Economics Department shows that New Zealand's policy settings should generate GDP per capita 20% above the OECD average. So, do we only have ourselves to blame?

In fact, we contend the following:

- New Zealand is a nation of small to medium sized businesses (SMEs).
- The relative scarcity of large multinationals would seem to deprive many of our best people the opportunity to develop the kind of business skills that would allow them to become highly productive.
- But that's a smokescreen. In reality, New Zealand's business culture is – broadly speaking – laid back compared with many other countries. We're not saying New Zealanders aren't hard workers. We're saying New Zealanders lack the business edge that's evident in some other countries.
- One of the greatest opportunities for New Zealand to raise productivity lies in educating the owners and managers of SMEs in the fundamental principles of running and growing a successful business.
- Another opportunity is to break through the notion that SMEs can't compete on the global stage.

We appreciate that this may be a contentious position. Many SME owners are ambitious, financially literate, business literate, hard working and smart. We don't deny that for a moment. Our point is that as a culture – as a nation – those attributes apply less here than they do in other OECD countries, despite individual exceptions. This view is supported indirectly by the New Zealand Productivity Commission's recent report. In outlining the key reasons for our poor performance and the most powerful solutions, it came up with the following data.

Key figures: why New Zealand has low productivity



From "An International Perspective On The New Zealand Productivity Paradox", New Zealand Productivity Commission working paper, 2014/01.

What good is infrastructure without world class businesses?

This report challenges traditional ideas about raising productivity – invest in physical capital, raise education levels and grant tax breaks to companies that invest in research and development (R&D).

Those may be good ideas but thinking they'll make any real difference without a concurrent shift in the way businesses operate at the micro level is simply a delusion.

Let's say we invest heavily in new infrastructure. If the SMEs that make up 95% of New Zealand businesses don't also find a way to create powerful international connections and crack open overseas markets, what difference will that investment make?

'Frontier innovation'

International connections and innovation go hand-in-hand, each feeding off and driving the other.

Shining examples of this virtuous circle include cloud-based accountancy software firm Xero, and Wellington's Weta Workshop. Both companies worked hard from their early days to make it internationally. This ambition drove them to find ways to do things better, more efficiently, and differently from everyone else. At first, you could say they were on their own, but as they gained traction overseas, customer feedback revealed further ways they could innovate – they no longer had to rely solely on their own insights.

In fact, the digital and creative spheres are particularly forgiving of our small size and geographical isolation.

Did the Government drop the ball here, missing an opportunity to make New Zealand the Hollywood of the Pacific? Yes, it did. Is that a reason for New Zealand not to flourish in the digital and creative spheres? No. We mean no disrespect to whoever's in government when we say that any industry that relies on government for its success is doomed to failure.

Governments are meant to govern. Business's job is to succeed with whatever market, regulatory or other conditions it's handed.

How can New Zealand business face this challenge?

We say that for New Zealand to raise productivity – and therefore our standard of living – it's critical that businesses, large and small, stop talking about "working smarter not harder", and actually invest time and money in doing so. That means:

- committing to being technology savvy and driven
- adopting new technologies such as ICT
- adapting business practices in response to new technologies
- upskilling the workforce
- investing in and demanding better managerial skills
- investing in knowledge-based capital (and all the ramifications of that for cutting- edge technologies and a place in global networks)
- trade development with 'nearer neighbour' networks
- measuring effectiveness (three cheers for Xero in this regard. It makes a world of difference when businesses can view their financial information regularly)
- look at the efficiency of the supply chain
- become financially literate. Too many business owners can't read a profit and loss statement, don't fully understand how their business makes or loses money, and don't understand the real costs their business incurs.

A 10 year history of under-performance by New Zealand enterprises (low growth, low productivity and low exports) has constrained national income and our ability to afford the high quality infrastructure that we all wish for.

The result is GDP per capita that is 40% below that of the top 10 countries in the world.

Rather than expecting the government of the day to invest in fibre optic cable, new roads and other big ticket items, what would happen to New Zealand's economy if business took on generating the kind of GDP that would fill government coffers to the extent that it could easily afford everything on the national wish list?

We say it would transform this country and we really have no choice. Here's why.

The tyranny of distance

New Zealanders are all too familiar with the phrase "the tyranny of distance". It costs us more than other countries to get our goods to international markets, and to import goods here.

What's not so obvious to many New Zealanders is a development in international trade over the last decade that threatens to shut us further out of global trade. Trade increasingly features 'global value chains', where production is spread across a range of countries. Because of our isolation, it is not economic for foreign companies to include us in these chains.

This is a double blow for New Zealand. Countries that do participate in these global chains not only receive economic benefits, but knowledge benefits too.

We can't afford to sit and watch this happen. New Zealand must develop and extend links with our nearest markets, Australia, South East Asia and Latin America.

These are big markets. Smaller businesses may need to join larger associations to gain sufficient reach and influence.

What you don’t know can hurt you

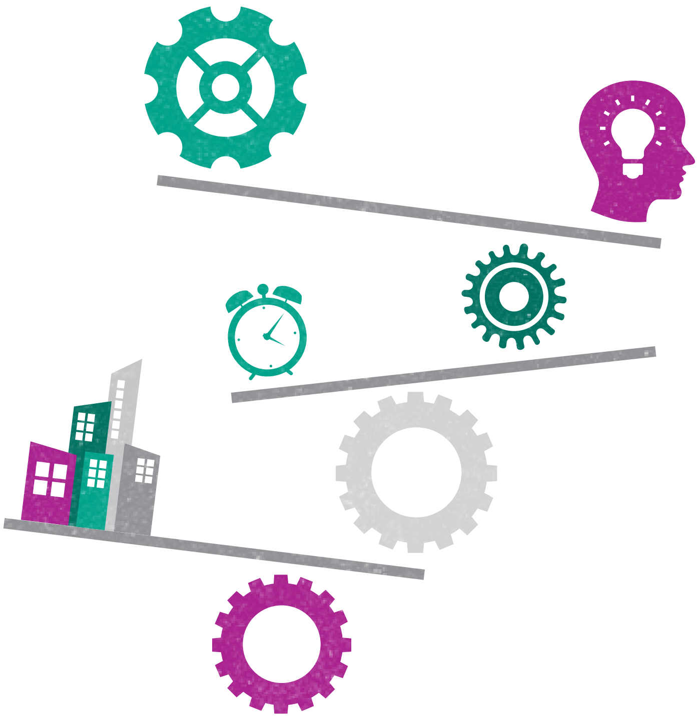
In league with the difficulty of access to technology, cross-country surveys show that New Zealand’s quality of management is below average. That means moribund firms survive for longer than they would in more competitive economies and the ‘clogged’ economy fails to fire.

It’s not enough for firms to invest in R&D and to sign on for new technologies, they also need to adapt their business practices and retrain managers and workers to gain the full benefit in productivity.

What about the government?

Does any of what we’re saying let the government off the hook? Not for a moment. There’s plenty government can and should do, including:

- encourage specialist international industries for whom our isolation is not a negative
- develop our status as a services/skills provider rather than solely a goods producer
- make New Zealand a more attractive trade partner in terms of cost
- encourage capital investment
- invest in business education (especially at the managerial level)
- encourage R&D
- invest more in IT and technological education at all levels
- develop trade relations with ‘nearer neighbour’ networks
- attract skilled New Zealanders living abroad back to the country
- develop policies to include older people in the productivity strategy
- invest in infrastructure.



More about infrastructure

Productivity and infrastructure go hand in hand. Calls for New Zealand to get up to speed with fibre optic broadband are fully justified.

But that's not enough. For too long, we've tolerated a transport network that is not worthy of a highly developed country.

The starkest illustration of this point is Northland – a region rich in natural resources and less than a day's drive from our largest centre, but also one of our poorest regions in financial and social terms.

The reasons are undoubtedly complex, but one of the key reasons isn't. Roads between Northland and Auckland are terrible.

Consider Tauranga and Hamilton, two cities that 'breathe' off Auckland. Look at the roads between them and Auckland, then the road between Whangarei and Auckland. If you had to get goods from one of those three cities to Auckland, which would be the last city you'd base your business in?

The cost to Whangarei and Northland is immense. Where infrastructure is lacking, talented people and businesses drift away and head to the large cities.

It's a little known fact that Northland boasts mines with some of the whitest clay in the world, which produces exceptionally high quality porcelain and bone china. And that's just the start: a study by GNS Science and the New Zealand Institute of Economic Research revealed mineral deposits potentially worth over $33 billion.

The report also states that by world standards the region is "under-explored". Little wonder, given the lack of infrastructure.

We stand by our earlier point that business must take responsibility for generating the funding for new infrastructure. At the same time, government must move roading and fibre optic cable higher on its list of priorities. If that means billions of dollars over the next few decades to build a four lane expressway between Auckland and Whangarei, so be it. The evidence for solid infrastructure driving productivity is simply too strong to ignore.

One place that the money for new infrastructure could come from is overseas investment. But that requires a shift in our attitude towards foreign investors. Right now, xenophobia seems to be playing a big role, as shown by opposition to the sale of Lochinver to Chinese investors.

This is short-sighted and flies in the face of history. New Zealand became a wealthy country on the back of heavy investment in refrigeration in the late 1800s – technology that allowed us to begin exporting meat to Britain in large, profitable quantities. And where did the bulk of that investment come from? Scotland.

When overseas investment holds out the prospect of increasing yields and productivity, that has to be good for New Zealand. Foreign buyers have a history of producing exactly those results. They're not a silver bullet, by any means, but one sign that New Zealanders are serious about lifting productivity and our collective wealth will be a more welcoming stance to investment from any part of the world.

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