Panel: The economic challenges of the future. How should Social Democrats respond?

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I'm glad to have Anna, Brian and Rod with me on the panel because in 15 minutes no-one can cover this huge subject. I want to focus on incomes, but other challenges – such as those of limited resources which Rod will talk about – are of course also vitally important. I don't think incomes are sufficiently part of our political debate. It is almost as if they are not to be spoken about in polite company. But it is vital that all people have a fair and adequate share of the income our economy generates and of course income distribution underlies many of our most urgent problems such as inequality, child poverty, educational attainment, and health, and becomes an even more crucial topic when we consider resource limitations rather than endless growth.

Thinking about incomes raises many other important policy issues. I will briefly cover productivity and globalisation.

As Brian mentions, a crucial characteristic of Social Democracy is how it responds to "the market" and capitalism. On the right, neoliberalism at least pretends to put full trust in markets and the owners of capital to get things right. On the left, socialism wants to do away with capitalism (though not necessarily a market) – in other words, private ownership and control of the means of production. Social Democracy accepts capitalism but realises that things can go badly wrong if markets and capitalism are not moderated by government intervention. That can be through laws, regulations, and so on (I'll just call it regulation), through the tax system, or by taking ownership or control of parts of the economy. Just how far we should go in these things is always a matter for debate, but it is abundantly clear that this is a good political place to be in the light of current events.

The global financial crisis showed with great clarity how markets and capitalism – particularly financial capital – can impoverish whole nations if not properly regulated. We also see how in the end they depend on the state – which in the end means from your and my pockets and limits on the policy choices we can make – for their survival. But New Zealand has further destructive examples to add to this. The principles of the structural reforms of the 1980s and 1990s were aimed at greatly increasing the power of the market in determining the shape of the economy and society. By reduction of regulation and effective regulators, market forces would be unleashed and the owners of capital would self-regulate, with their own commercial interests preventing misbehaviour. But misbehave they did, in hugely expensive, socially divisive and dangerous ways. Consider these examples of regulatory failure. I am indebted to the Fabian Society series which Brian mentions and which he brought together for some of these.

- A finance sector that lost investors and taxpayers billions of dollars through its own incompetence, irresponsibility and fraud

- A vocational training system that left us with a long term skills deficit as employers failed to take up the responsibility to train their workers
- Workplaces which, compared to fatality rates in better regulated countries like Australia and the U.K., have killed 500-800 more people from fatal injury in the last decade alone, and possibly 7 to 10 times that number from occupational disease
- A building regulation system that has cost the country a comparable amount to the Christchurch earthquakes in leaking buildings.
- A wages system that saw wage rates fall far behind labour productivity increases.

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Did this unleash the forces of growth? No. Our growth has fallen behind the rest of the OECD.

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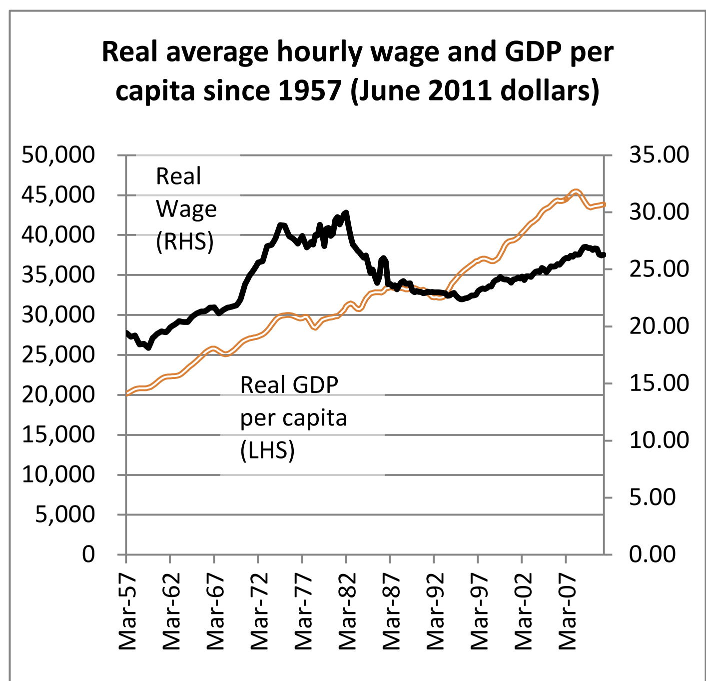
Did it make us internationally competitive? No, our international liabilities have grown almost constantly over that period reflecting inadequate exports, speculative rather than productive investment, high levels of low quality overseas investment, and international short-term borrowing rather than domestic saving.

Is the economy better balanced? No, our reliance on low value exports has grown and "the value-added content of New Zealand's exports has been declining over the past 35 years"[1].

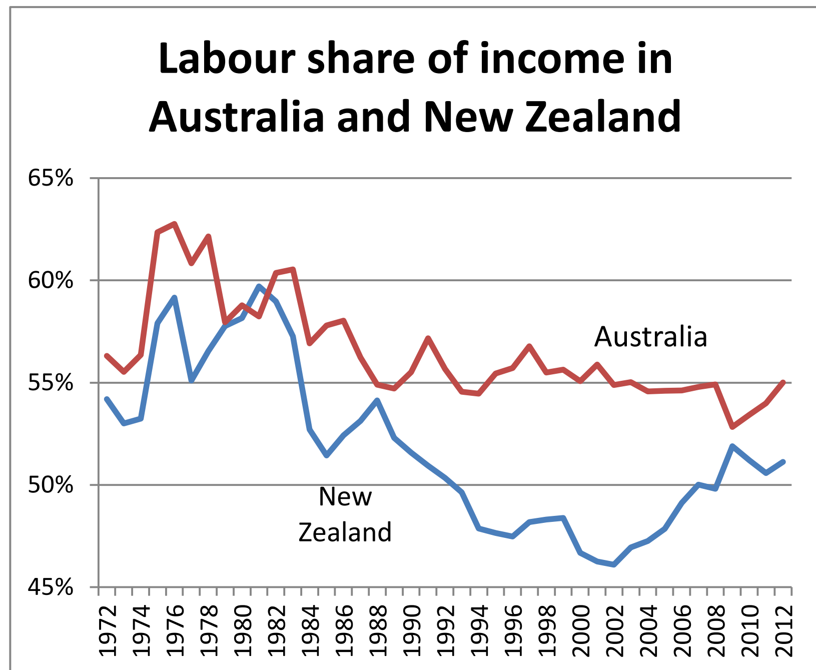


Let's look more closely at wages (in which I include both wages and salaries). Wages are very important. Almost three-quarters (74 percent and rising) of average household income in 2012 was from wages and salaries. Wages and salaries are the main way the great majority of New Zealanders get to share the income this country generates. Wage and salary levels contribute to the very high levels of income inequality that have grown in this country over the last two to three decades. Max Rashbrooke will talk about this in much more detail this evening so I will not go into greater detail, other than to say that it is a cancer on the social cohesiveness of society and that there is increasing evidence that it has damaging economic effects too. We have far too many children living in poverty – a quarter of them or 270,000 by one measure – and two in five are from households where at least one adult is in full-time employment. The rest are children of beneficiaries.

[1] Ralph Lattimore, Przemyslaw Kowalski, and Gary Hawke, "New Zealand's Patterns of Comparative Advantage". NZ Trade Consortium Working Paper. New Zealand Institute of Economic Research, July 2009.

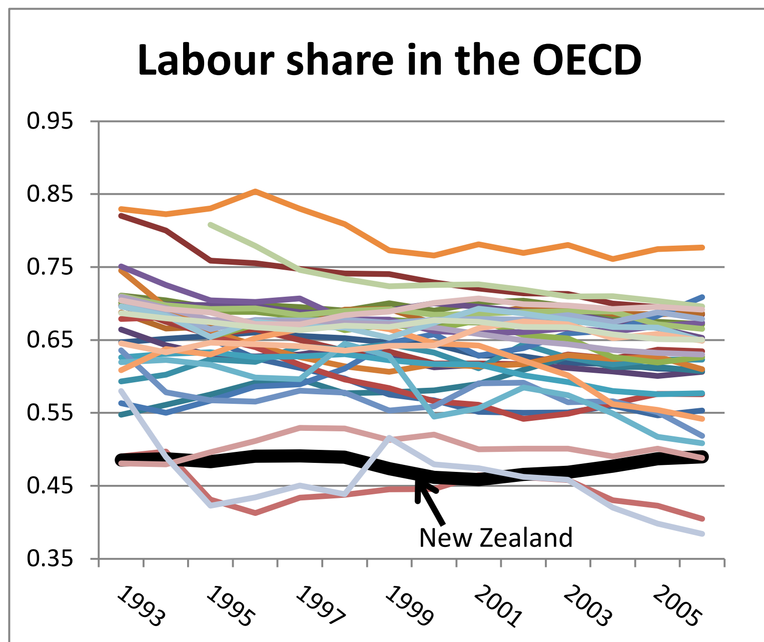
How can we tell that our wages are particularly low?

A sobering place to start is to look at average hourly wage statistics going back to 1957. It turns out that the real average wage was at its highest in March 1982 when it was $29.97, using June 2011 dollars (purchasing power). In June 2011 it was $26.27[2]. The current level of the average wage is about the same as it was in December 1972. Yet the output of the economy per person (real GDP/capita) is 41 percent higher than it was in March 1982 and 58 percent higher than it was in December 1972.



The obvious question is: so who benefited from that increase in output if wage and salary earners didn't? This is shown by the share that employees get of the income the economy generates – the "labour share". The rest – the capital share – is mainly interest and dividends going to owners of capital.

In New Zealand, the labour share fell from 60 percent in the early 1980s to a low of 46 percent in 2002, having fallen through most of the 1980s and 1990s. In other words, wage and salary earners lost about a quarter of their share of the income the economy generated over that period. It began to rise again but by 2012 was only 51 percent – still well below thirty years earlier. The labour share can fall if production becomes more capital intensive – if employers have invested in plant and machinery to make their firms more productive. In fact that kind of investment was weak in New Zealand.



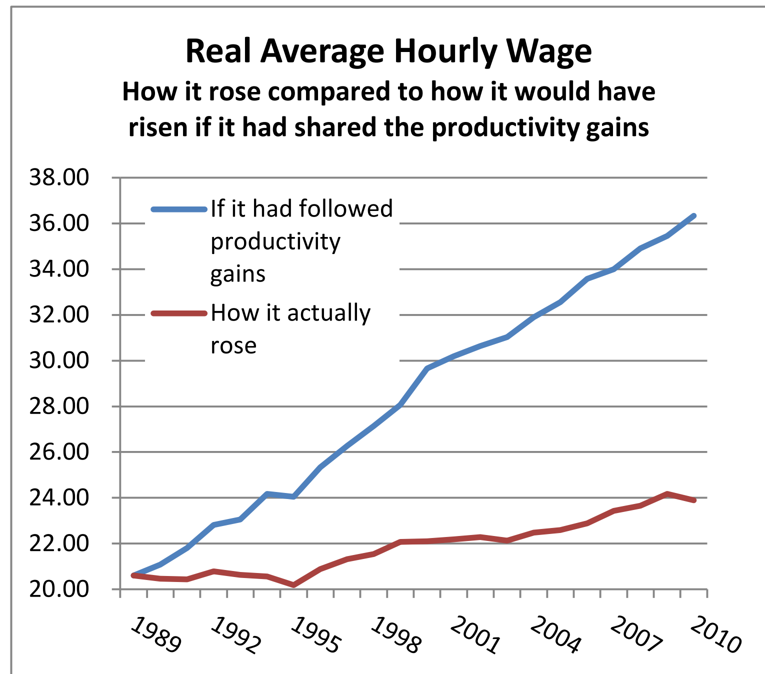
By comparison, Australia's labour share has been higher than New Zealand's for virtually all of this

[2] Data from long term data series published with "The New Zealand Economy: An Introduction", by Ralph Lattimore and Shamubeel Eaqub, 2011. See http://sites.google.com/site/eaqubs/.

period. Its labour share did fall from 63 percent in 1976, but bottomed out around 55 percent in 1989 and stayed around that level while New Zealand's continued to fall. Yet if anything, Australia's capital intensity is higher than New Zealand's.

Australia has thrived with more of its income going to wage and salary earners than New Zealand. That was likely helped by its award system which sets scales of rates that underpin the country's wages. Though the award rates are lower than most actual rates, research has shown that around 80 percent of wages are influenced by award increases[3].

And in fact, New Zealand has one of the lowest labour shares in the OECD. While the individual countries in the graph to the right are difficult to make out, it is clear where New Zealand lies: it is the black line near the bottom. Only Turkey and Mexico trail lower[4].



Another way to look at the same data is to compare wages with productivity increases. Neoclassical economic theory says that real wages should rise at the same rate as the growth in labour productivity, and it is commonly used by Treasury and employers as a benchmark. New Zealand's wage rises have fallen far behind productivity growth. In the part of the economy where productivity can be reliably measured (the private sector give or take some subsectors), productivity rose 52 percent between 1989 and 2010. The real average hourly wage rose just 16 percent. It was somewhat better over the period of the Employment Relations Act, but the gap was still large: labour productivity rose 13 percent but real wages rose only 9 percent.

Why have wages fallen so far behind? In part, this has been a trend occurring throughout the developed world. The conservative International Monetary Fund (IMF) has changed its mind on the causes. In 2011 it stated that its conclusions from assessing the research was what many unionists and others critical of the dominant model of globalisation had been saying[5]: international supply chains – the way multinational companies design a product in one country, obtain raw materials in others, assemble them in different countries again, and sell them globally – are intensifying the effect of new technologies, leading to the hollowing out of "advanced" economies. As a result, over the last two to three decades many workers have been moved from medium productivity, middle income jobs (largely manufacturing) to low productivity, low-paid service sector jobs. The result,

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[3] "The significance of minimum wages for the broader wage-setting environment: understanding the role and reach of Australian awards", by John Buchanan and Gillian Considine, in: "2008 Minimum Wage Research Forum Proceedings, Volume 1", October 2008, Australian Fair Pay Commission.
[4] This graphs a slightly different measure of labour share, which includes the labour income of self-employed people (called real unit labour cost).
[5] "World Economic Outlook", September 2011, International Monetary Fund, p.41-46.

they say, is sluggish productivity growth and increasing income inequality. This loss of higher value-added production since the opening of the economy in the 1980s has been documented in New Zealand. So has the growing income inequality.

This doesn't fully explain though why New Zealand wages are particularly low, nor why employees have a reduced share of the country's income. A large part of the explanation must be that the bargaining power of employers has greatly outstripped that of their employees. The rapid opening of the economy encouraged employers to move jobs to low income countries, or threaten to. That was reinforced by the 1991 Employment Contracts Act which made the most effective form of wage bargaining, union-backed collective bargaining, extremely difficult. The most effective collective bargaining to raise general wage levels, national industry bargaining, was impossible. At the same time, the minimum wage was allowed to fall well below current wage levels. The Employment Relations Act which replaced it in 2000 was an improvement, but only a small one. Collective bargaining is still very difficult, and over 90 percent of private sector employees are not directly covered by it. It is not just a union economist saying this: the IMF and the International Labour Organisation agree that loss of employee bargaining power is a cause of growing inequality internationally. Strengthened collective bargaining is recognised in international conventions as the most effective way to address it.

This quote from a study published last year by leading researchers illustrates the grave social dislocation and disadvantage it caused:

> "We … find that controlling for changes in household composition, demographics, education, and employment rates does not explain the increase in poverty that occurred in the 1980s. Taken in conjunction with previous work …, these results suggest that the structural reforms undertaken in the 1980s led to permanent changes in the distribution of resources across households in New Zealand, in particular a reduction in resources for the poorest households."[6]

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A recent Treasury study showed the effect on household income. Market incomes of the lowest 50% of households have been static in real terms over more than 20 years despite the per capita growth in the economy. In other words we have an economy in which the gains are going only to a small minority. Of course this picture looks somewhat difference when taxes, Working for Families and other transfers and government services are taken into account. That reinforces the importance of government in the distribution of income.

But it also emphasises that, given a certain level of income available in the economy we have three choices. Firstly, we could "leave it to the market" and put up with the current situation. We should not then be surprised at continuing and possibly rising inequality, and a continued exodus of people to Australia and elsewhere. Secondly, we can change our

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[6] Stillman, Steven, Trinh Le, John Gibson, Dean Hyslop, and David C Maré. *The Relationship Between Individual Labour Market Outcomes, Household Income and Expenditure, and Inequality and Poverty in New Zealand from 1983 to 2003*. Working Paper. Motu Working Paper. February 2012.

employment laws – in other words, regulate – to compensate for the imbalance of bargaining power that working people have in negotiating wages and other working conditions. Labour policy is similar to the CTU on this – that we should enable collective bargaining outcomes reached in one part of an industry be extended to the rest of the industry. The Australians have their award system which appears to have been reasonably effective to this end. The awards are in effect a more sophisticated system of minimum wages which most workers are not actually on, but they underpin the wages system and influence it almost throughout. Thirdly we could acknowledge that the wages system is not going to fairly share income and do much more in the tax and transfer system – higher taxes on high incomes, and more transferred through schemes like Working for Families, subsidies and government services. If we reject leaving it to the market, and I think there is a convincing case that we should reject leaving it to the market, then there must be some mixture of the other two. If you reject stronger regulation of employment relations, there are other consequences which I shall come to, but you then must acknowledge that government must spending a lot more than it is currently doing in compensating for the unfairness of the wage system. It means higher taxes, and much more widespread dependency on government for income. If we go further in this direction we should be seriously considering a universal basic income as some people such as Gareth Morgan and Perce Harpham have been advocating.

I am not philosophically opposed, as some might be, to this third option, and it is unquestionable that we do need to increase government income support, particularly for low income families. However careful thought is required as to the consequences of following this path and abandoning, or only weakly attending to the second. In effect it abandons sound employment relationships to the unbalanced relationship between working people and their employers as people become more and more dependent on the state. Many people feel their pay should fairly recognise their effort and would feel resentful that they have to depend on the state to live. The reality is that to get that recognition in their pay, they must have stronger unions and collective bargaining. Unions are fundamental institutions – like the judiciary and a free media – in balancing power in society. This is not only about pay. Many workers – and not only employees, but self-employed as well – are in a position internationally known as "precarious work": short term, casual, labour hire, in their first 90 days, or on a contractual basis with virtually no employment rights (like most in the film industry) – where what rights they have are almost impossible to enforce. Margaret Wilson, former President of the Labour Party and former Minister of Labour, Attorney General and Speaker of Parliament, said this in a recent speech, speaking mainly about precarious workers but more generally as well:

> I believe a legal framework is a necessary but insufficient response to the protection of workers' rights. It is why it is necessary to ensure the representative role of trade unions not only to pursue legal rights of workers but also their role as participants in the policy making process. They provide an essential democratic check on the power of the

> executive, as well as employers. I am aware that trade unions are also capable of abuse of power and must also be subject to democratic process. It is difficult however to ensure how both the legal and policy rights of workers can be delivered without a representative trade union movement subject to law but also supported by the law in this role.[7]

It is for such reasons that the Universal Declaration of Human Rights recognises the right of every person to form and join unions for the protection of their interests[8]. It is why there is a United Nations arm, the International Labour Organisation, to focus on these matters.

What I have covered so far is about distribution of income. It is of course also important to consider ways to increase incomes overall. If we are going to do this sustainably, one way or another it comes down to increasing productivity – how much is produced in an hour of work or with a given investment in knowledge, equipment and technology. In the long run, raising productivity – as long as we also have the social systems to fairly distribute the added value it produces – is the only way to increase incomes across the board. This is a huge area in its own right so I will only make a few points. Raising productivity does not happen overnight. It requires investment equipment and new ideas. It requires investment in people through education and training so they have the right skills, and just as importantly development of participative workplace relationships so that the knowledge that employees have of their own work can be used to increase their productivity. Management that recognises the value of good employment relationships is a vital part of productivity development that is too often lacking. Unions and business worked on such initiatives through the 2000s, but the current government has little enthusiasm for them.

An important way to increase productivity is through increasing the scale of production. In a small country like New Zealand, that is difficult without producers becoming exporters. New Zealand does have scale in some exports – dairy is the prime example. But reliance on low add-value products like milk powder, even at scale, will not create the number of well-paid jobs we need to raise New Zealanders' incomes, nor will it produce sufficient overseas income to begin to reduce the huge private overseas debt that is New Zealand's most urgent debt problem. That is why many people are keen on building our manufacturing capacity, particularly in high value manufactured goods.

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Creating such industries is not easy. Many were killed off in the opening of the economy in the 1980s and 1990s. In a recent study, Dani Rodrik, Professor of Economics at Harvard University found that such changes can *reduce* growth unless actions are taken to replace closed industries with more productive ones. "Structural change, like economic growth itself, is not an automatic process", he wrote. "It needs a nudge in the appropriate direction, especially when a country has a strong comparative advantage in natural resources."[9] Many other researchers have reached similar conclusions. It requires government involvement to support nascent exporters through policies such as research and development assistance, government procurement that helps local firms, marketing

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[7] "Precarious Work: The Need for a New Policy Framework", Professor Margaret Wilson DCNZM, address to the Whitlam Institute, University of Western Sydney, August 2012.

[8] Article 23.

[9] McMillan, M., & Rodrik, D. (2012). Globalization, Structural Change, and Productivity Growth (Discussion Paper No. 01160). IFPRI Discussion Papers (p. 40). Washington DC, USA: International Food Policy Research Institute. Retrieved from http://www.ifpri.org/publication/globalization-structural-change-and-productivity-growth

and design advice and support, startup finance, and coordination between firms with similar needs or overseas markets.

One of the biggest obstacles for exporters at present is the high exchange rate. One of the largest influences on New Zealand's exchange rate, at least in the short run, are the large financial flows in and out of the country seeking higher interest rates or other returns. Unless we can exert some control over those, we are unlikely to be successful in managing the exchange rate to make life more bearable for nascent exporters.

Higher wages will be attacked as undermining the competitiveness of exporters (and especially so if the exchange rate is too high). Throughout the 1990s, low wages were the government's main policy contribution to competitiveness, leading to a model of reliance on low wage, low skill, low value exports. There is another approach, on which there is a growing research literature. This is that higher wages provide an incentive to firms to raise their productivity through increased investment and innovation. In this sense, while the neoclassical view is that productivity leads to higher wages (which we now know does not necessarily follow), we could have a virtuous circle of higher wages leading to higher productivity.

I spoke recently to a Danish academic , and expert on workplace health and safety, who remarked that he could not see there was much he could recommend to improve our dreadful health and safety record given our labour relations system with low unionisation and little willingness of employers to consider factors beyond their own firm. The relationship between poor health and safety and poor employment relations is very close. He noted that in the early 1990s when it became apparent that Denmark's economy would be opened to the world economy, Danish employers had a choice. They could force down wages and compete on the basis of (low) cost. Or they could foster their employees' skills and work with unions to develop firm productivity in order to compete on the basis of the value and quality of their products. They chose the latter. Denmark has changed from an agriculturally based economy to one with many high value manufactured and service exports – and high wages and unionisation.

This brings me to my last point. Globalisation – the increased international integration of economies – is assumed in New Zealand to be the progressive removal of laws, regulations or practices that get in the way of international trade or investment. This should remind you of something: it is neoliberalism applied internationally. Dani Rodrik has called this model of international integration "hyperglobalisation". It is in conflict with the needs of a social democracy because it removes the policy tools that a social democratic government needs to intervene in markets and capitalism for both social and economic reasons. The Trans Pacific Partnership Agreement (TPPA) is the latest and to date the most extreme example of this. Without the balance of carefully designed industry and social policies, the supply chains it is encouraging are economically and socially high-risk, potentially draining the economy of profits, jobs, corporate taxes, and the reservoirs of knowledge needed to develop and sustain high value sectors such as manufacturing. Yet at the same time it is taking away more tools for "nudging" our economic and social development in the right direction such as local preference and conditionality on government procurement, and the use of our state owned companies and operations for more than short-term commercial purposes. It is proposing so-called transparency and regulatory coherence provisions which give corporations yet more influence over the kinds of health, safety, and consumer rules that we have learned should not be left to the

market. It is inviting more corporate intrusion into economic, social and environmental rule-making through investor-state dispute processes. It is proposing further deregulation of financial markets. It threatens tools such as management of capital flows which are needed to regulate international financial markets and stabilise exchange rates.

International markets are difficult for individual nation states to regulate. International agreements should focus on building collaboration between nation states in regulating these markets: to ensure rapid capital flows do not destabilise economies and distort exchange rates; to fight international tax evasion; to prevent environmental and social dumping.

It is an extreme form which suits some large corporations and the financial markets. It creates winners and losers. Too many New Zealanders, and the balanced development of our economy and society, have been losers. We need a new model of international economic relationships that learns from the past.

I have covered a lot of territory today. But what I want to emphasise is not only that we cannot go on disregarding how people get the benefits that the economy generates, but that how we do that has further consequences that demand a consistency of policy approaches. If we do not maintain that consistency we will find the power of capital and markets driving us far from the directions in which we thought we should travel. These forces are powerful and we have no choice but to adapt to some of them. But if we take that to mean we must simply accept them, there will be no room for social democracy to function.