



New Zealand firms: Reaching for the frontier

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Frontier firms are vital to lifting national productivity and wellbeing

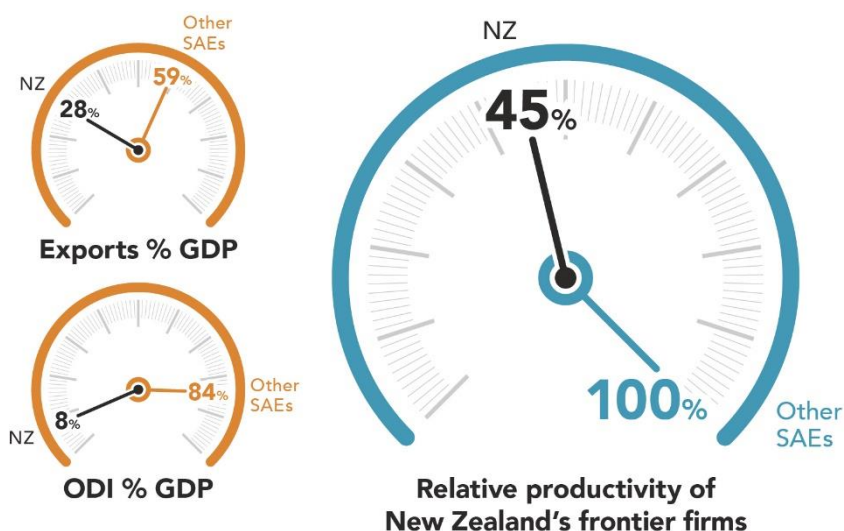
New Zealand's disappointing productivity performance has held back its standard of living, and wellbeing more generally, for many years. It's a decades-old problem that has persisted despite various policy efforts and large structural changes in the economy.

This inquiry focuses on a central but relatively underexplored aspect of New Zealand's productivity performance – the economic contribution of its most productive firms. These "frontier" firms can play vital roles in turning around the country's lacklustre productivity performance. They can improve national productivity by lifting their productivity closer to the global frontier, growing larger and diffusing innovation through the rest of the economy.

Time to learn from other small advanced economies

A striking finding of this inquiry is that the labour productivity of New Zealand's frontier firms is less than half (45%) that of the best frontier firms in other small advanced economies (SAEs). These frontier firms in other SAEs operate at or near the global productivity frontier; in other words, they are world leading. While New Zealand does have some world-leading firms, it does not have enough of them. Firms in successful SAEs are more internationally connected, so these countries also have much higher ratios of exports to GDP, and greater direct investment overseas (ODI).

New Zealand lags behind other small advanced economies



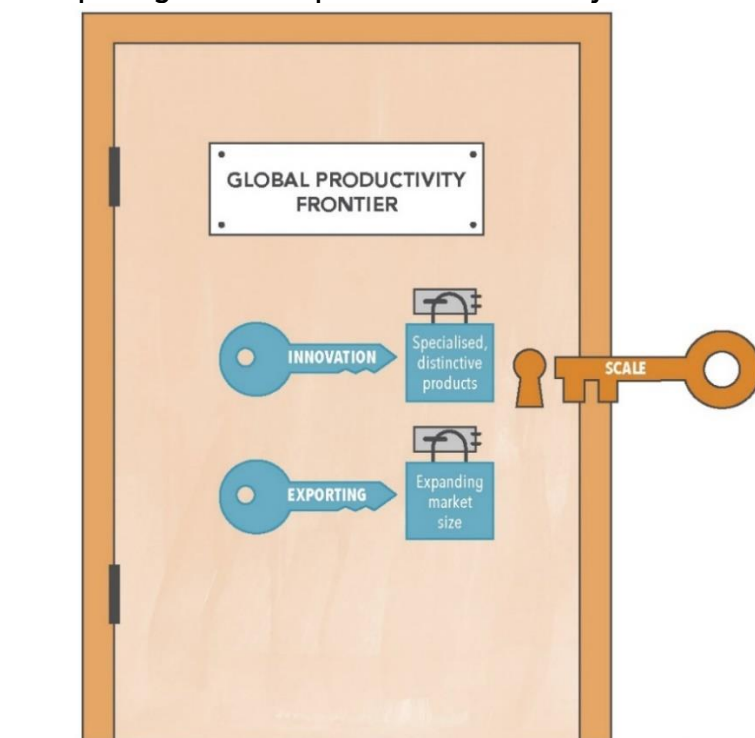
Successful SAEs are located mostly in Europe (eg, Sweden, Denmark, Ireland, the Netherlands) but also in the Middle East and Asia (eg, Israel and Singapore). Like New Zealand, other SAEs face the challenges of small domestic markets and some are also relatively distant from large international markets. This inquiry investigated what it is these countries do differently in supporting their frontier firms to be world class.

Exporting distinctive products at scale is the way to reach for the global frontier

In successful SAEs, prosperity comes from exporting specialised, distinctive, high-value products at scale. Specialised and distinctive products are knowledge-intensive, and hard for competitors to replicate. This requires innovation.

Innovation entails high fixed costs, and the way to recover these fixed costs when the domestic market is small, is to export to international markets. Unfortunately, getting into exporting creates additional fixed costs for firms. Making an investment that earns a good return over and above the fixed costs associated with both innovating and exporting requires scale.

Exporting innovative products at scale is key to success



SAEs employ three strategies to help firms export specialised, distinctive products at scale.

- Attract high-quality foreign direct investment.
- Support individual companies to meet the fixed costs of innovation and exporting.
- Invest in building “innovation ecosystems” around their frontier firms, in select focus areas.

Innovation ecosystems are made up of entities, their capabilities, and the networks between them. Firms are at the centre of the ecosystem, including larger “anchor” firms, small and medium enterprises (SMEs) and entrepreneurs. The ecosystem also includes workers with the right skills, international links, research bodies, education and training providers, mentors and investors with deep knowledge and understanding of the industry, and enabling infrastructure and regulations.

Successful SAEs focus their efforts on building deep innovation ecosystems in a limited number of focus areas. These ecosystems support and enable firms to innovate and export at scale. The scale comes either through large “anchor firms” or collaboration among smaller firms. Unlike most successful SAEs, New Zealand doesn’t intentionally or to the same degree focus its investment to achieve excellent innovation ecosystems in a few areas.

Upgrading New Zealand's innovation ecosystems

Governments have an important role in innovation ecosystems. They contribute to innovation capabilities through:

- direct support to incentivise and enable innovation – such as funding for basic and applied research and development, business grants and R&D tax credits, intellectual property regulation, and governance and ownership of key research organisations;
- indirect support – such as building workforce skills (through education and training, and migration policy), providing physical and digital infrastructure, and regulating the business environment and financial system; and
- broader policy settings for society to realise and share the benefits of innovation – such as health services and income redistribution (which influence the health and wellbeing of workers and their families).

The evidence considered by the Commission shows that New Zealand's innovation ecosystems are not currently working well for actual and potential frontier firms. For example, the links between firms and public research institutions are mostly poor, and research is too focused on "science excellence" results rather than impact and responding to industry needs.

The Government must develop a clear innovation strategy and take deliberate policy steps to upgrade New Zealand's innovation ecosystems. Industry (firms and workers), researchers, Māori and government must be effective partners on the journey.

Government should focus on areas of the economy with rich potential for innovation

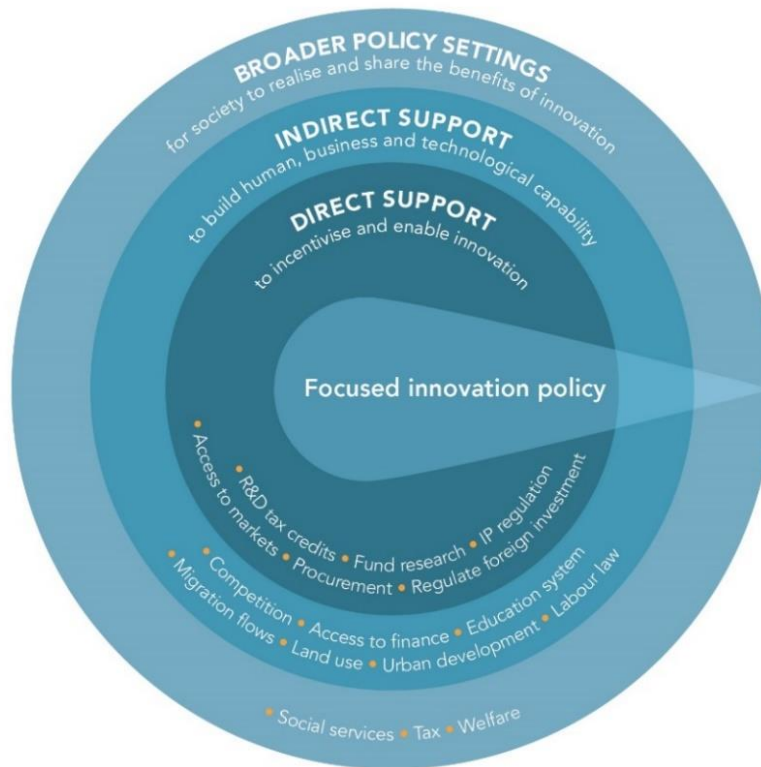
Small economies must choose, as they will have only a limited number of areas that can get to scale and support sustained world-class competitive performance. As a complement to broad-based innovation policies (which benefit all firms), finite government resources need to be deliberately focused on a small number of high-potential areas rather than being thinly spread in what David Skilling terms "sub-therapeutic doses".

Focus areas should reflect existing and emerging strengths and capabilities. They may not align with standard industry classifications; but instead span a range of industries (eg, creative), include upstream and downstream industries (eg, biotechnologies that depend on a supply of primary products) or cover technologies that are used across different parts of the economy (eg, digital technologies). In New Zealand's case, primary industries and weightless industries are logical places to look.

Choosing areas for focus should not be a top-down exercise led by government. Rather government must collaborate with industry and other stakeholders to understand emerging innovation possibilities. Through such processes, stakeholders can identify ways of collaborating and making complementary investments that will get the ball rolling faster and overcome bottlenecks and barriers. Areas of focus will not be set in stone; the process will need to refresh and adapt over time.

Governments can use focused innovation policies not just to achieve higher productivity but a variety of sometimes overlapping objectives. Mission-oriented policies can address societal challenges such as those arising from climate change, technological disruption and social inequalities. Focused innovation policies to enhance productivity will only be durable if they are also consistent with a country's environmental and social objectives.

The Government must make significant investments in innovation ecosystems in focus areas



Implementing focused innovation policy

Many efforts have been made to lift innovation and economic performance in New Zealand. The country has a history of small-scale, sector-focused initiatives that often fade away without any clear idea of what they have achieved.

While the Government has an ambitious draft research, science and innovation (RSI) strategy, this strategy gives little indication of how it will be implemented and on what scale the various initiatives will be resourced. The areas of focus for innovation policy are not consistently defined, and the draft RSI strategy lacks a clear fit with the Government's industry strategy and other policy priorities. The current initiatives risk meeting a similar fate to previous efforts.

To make progress, the right materiality of investment is required. The Government will need to make significant investments in infrastructure, research and people, in a small number of focus areas, to complement the efforts and investments of the business sector. It should also take a more proactive and targeted approach to attracting foreign direct investment that is innovative, oriented to exporting, likely to stay long-term, and a source of spillover benefits.

Smart strategies alone will not be sufficient; execution is critical. The Government should partner with other stakeholders to put in place effective arrangements for governance, resourcing, implementation, monitoring and evaluation to provide confidence that the strategy will deliver on its objectives. These arrangements must involve shared decision making across government, senior industry leaders (firms and workers), Māori interests and research leaders. Senior political leadership is also needed, to unlock resources from across government agencies.

The Government must be patient and stay the course with its innovation investments, as innovative effort requires time to play out and demonstrate success. This means providing funding and policy certainty over long enough time horizons. Securing cross-party support for the strategy would help provide the necessary policy stability. Failure to provide this stability and follow-through will risk wasting the time and effort of stakeholders who participate in the process, and generate disillusionment about engaging in Government processes.

Execution is critical to avoiding the failures of past efforts



Fostering and learning from Māori frontier firms

The Māori economy exhibits many of the characteristics needed for firms to innovate, grow and support higher living standards. Employment in Māori authorities and SMEs has been growing faster than in the wider economy. Māori authorities and SMEs are more likely to export, and have higher rates of innovation and R&D, than New Zealand firms generally.

Māori firms' need to serve multiple bottom lines (eg, commercial, environmental and social objectives) can be a strong driver of ambition, which can also flow through to expectations on suppliers. Further, high shareholder ambition, together with a long-term view, can spur innovation and experimentation, provided the underlying assets are not put at risk.

Māori values help differentiate Māori goods and services and provide added brand value overseas. The values also closely align with the growth in consumer demand for products with strong environmental and social credentials. This presents growth opportunities for kaupapa Māori firms. Common values and features also help bring Māori firms together around shared goals. Formal and informal networks among Māori firms are important mechanisms for diffusing knowledge, exploring innovations and enabling collaboration.

Features of Māori firms can help spur innovation



The successes of Māori frontier firms build the confidence and ambition of these firms, and can help light the way for other Māori firms. Māori firms also offer valuable lessons for other New Zealand firms. Taking a long-term view and managing multiple bottom lines do not need to be traded off against innovation and productivity. Rather, they can be complementary. Long investment horizons are important for supporting experimentation and innovation, and long-term value creation. This contrasts with a short-term focus on financial performance and shareholder returns that can dominate the focus of company boards and management. Further, innovation is key to serving multiple bottom lines, as innovative solutions are required to solve many of the environmental and social challenges facing New Zealand.

Despite their successes, Māori firms face barriers and challenges. The Government should act to reduce these, to unlock the full potential of current and budding Māori frontier firms, and help the Crown better meet its Treaty obligations. The Commission recommends actions to:

- provide greater legislative flexibility for Māori land-based businesses;
- improve the potential of Government procurement processes to stimulate Māori business growth;
- explore how the Māori-Crown relationship can be better utilised or enhanced;
- protect mātauranga Māori and intellectual property; and
- support a Māori-led approach to optimising the Māori business ecosystem.

Supporting inclusive and sustainable economic growth and recovery

New Zealand is experiencing a very significant economic shock from the spread of Covid-19. Such shocks require governments to respond by temporarily supporting businesses and workers in the face of deteriorating economic conditions. Yet, as critical as this is, it is important to keep considering longer-term structural issues that drive productivity – because productivity growth is what will deliver business success, better jobs, higher incomes and improved wellbeing over the medium to long term.

Shocks are also an opportunity for countries to take stock and to “build back better”. This includes preparing for the future known and severe threat of climate change. Productivity and innovation are directly relevant to this challenge because they will influence the nature of the transition and the costs and opportunities that New Zealanders experience.

Frontier firms will be at the forefront of the innovation and productivity improvements needed to transition New Zealand to a low-emissions economy. This makes a lift in their performance all the more critical to delivering sustainable and inclusive prosperity in the long term.

READ ONLINE:

www.productivity.govt.nz/inquiries/frontier-firms/