NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE
1999 BUDGET POLICY STATEMENT

FEBRUARY 1999

1999 BUDGET POLICY STATEMENT

Executive Summary

- Starting with its submission in 1995 on the first Budget Policy Statement (BPS) issued under the Fiscal Responsibility Act 1994, the New Zealand Business Roundtable (NZBR) has expressed increasing concerns about trends in fiscal policy. These have run counter to the improvements in fiscal discipline achieved during the 1990–93 parliamentary term, which were a major factor in the strong economic recovery of the mid 1990s, and to the intentions of the Fiscal Responsibility Act.

- In the NZBR's view the Coalition government's 1997 and 1998 budgets were risky to the point of imprudence. The Asian crisis has merely served to expose dramatically the underlying weaknesses in fiscal and growth strategies adopted during the last and current parliamentary terms. The present weak and unbalanced state of the New Zealand economy (with a large current account deficit) owes much to inadequate fiscal discipline.

- We believe that the 1999 BPS represents an inadequate response to New Zealand's problems and thereby compounds the earlier errors. This is notwithstanding our longstanding and very public support for many of the government's specific growth-enhancing objectives and proposals.

- In our view the government's strategy for economic growth is inconsistent with its growth objectives (see section 2 of this submission). The strategy is too narrowly conceived, too many policies are being pursued that conflict with growth objectives, and too little is being achieved in important areas that would contribute to growth. Partly as a result of its failure to admit to underlying problems in a timely manner, the government also has major communication problems with its growth and fiscal strategies. Some important statements in the BPS simply lack credibility.

- We argue in this submission that much greater emphasis is needed on cutting government expenditure and taxes, privatisation and deregulation (particularly of the labour market) if New Zealanders' living standards are not to continue to fall relative to those in comparable countries.

- The BPS fails to consider an alternative medium-term strategy of vigorous government expenditure and tax cuts, reverting instead to a discussion of short-term fiscal stabilisers that appears to have no relevance to the issue of economic growth. In our view the fiscal strategy in the BPS is little more than a strategy of 'spend and hope'. It does not appear to be informed by an awareness of a growing amount of empirical research into the negative relationship between the size of government and economic performance (see sections 1 and 3 of this submission).

- This submission also argues that the government's long-term objective of reducing expenses below 30 percent of gross domestic product (GDP) is both too modest and no longer credible. The government's short-term intentions for government spending are at odds with its long-term targets, and the 'spend and hope' fiscal strategy fails to reconcile the difference satisfactorily, contrary to the requirements of the Fiscal Responsibility Act 1994. We urge the Select Committee to express a clear view on this issue.

1 Introduction

1.1 This submission on the 9 December 1998 Budget Policy Statement (BPS) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 This is the fifth BPS issued under the Fiscal Responsibility Act 1994 (the Act). In our submissions on the first two BPSs, we expressed our support for the Act and for the government's intentions at the time to use increased revenue from economic growth first and foremost to generate operating surpluses, reduce debt, build net worth and reduce taxes. As successive budgets have used a substantial part of the increased revenues to fund additional spending (see the attached chart) we have become increasingly concerned about the impact of fiscal policy on the economy.

1.3 Since 1995 we have criticised the growth in government expenditure and expressed the view that real expenditure reductions would better serve the government's economic growth and social cohesion objectives. In our view, major reductions in government expenditure and much-reduced government regulation are essential both for the sustainable achievement of the government's objectives and to avoid seeing New Zealand's standard of living fall further below its potential and the levels achieved by comparable countries.

1.4 The NZBR's submissions on earlier BPSs documented the growing empirical evidence of an adverse relationship between the size of government and economic performance. We have argued that the government would better meet its growth objectives if government spending were progressively reduced to below 20 percent of gross domestic product (GDP) (the precise figure depends on the quality of the spending, not the percentage of GDP).

1.5 Section 2 of this submission discusses the inconsistency between the government's growth strategy as outlined in the BPS and its objectives for economic growth. Section 3 critically examines the BPS's fiscal strategy. Section 4 discusses the issue of the consistency of the BPS with the Fiscal Responsibility Act 1994.

2 The government's economic strategy

2.1 The Summary of the BPS maintains that the government has a comprehensive strategy for economic growth. It also asserts that during the last eight years it has "made substantial progress" towards the goal of creating "an environment that generates income and employment and promotes trade and social opportunities in which all New Zealanders can participate". In our view this is a claim that the 1990-1993 National administration could fairly have made. However, substantial slippage occurred during the 1993-1996 National administration[1] and, notwithstanding some important initiatives, the overall fiscal strategy pursued by the 1996-98 Coalition government and the current National minority government has been highly negative for growth and employment. In this section, we look first at the growth record and then at the government's "comprehensive strategy for economic growth".

2.2 The BPS is based on the economic projections in the 9 December 1998 Economic and Fiscal Update. These confirm the pattern of recent updates – a lowering of growth expectations, a weaker fiscal position, and a worse outlook for unemployment.

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1 Government expenditure increased markedly during this period, and by 1996 business and consumer confidence had fallen and growth was slowing. The sharp fall in unemployment has been reversed, partly due to court decisions which have re-regulated the labour market to a significant extent.

2.3 Based on these projections and actual growth to date, real GDP is expected to grow by a mere 3 percent during the government's 1996-1999 term of office. This would be a deplorable performance. When the government took office in 1996 it projected that the economy would grow by more than 10 percent in this period. The government's performance should also be measured against National's 1995 target range for annual economic growth of 3.5 to 5 percent to the year 2010. Given the under-performance to date, the growth rate for the remainder of this period would need to be 4-6 percent per annum in order for National to achieve its target. Even assuming an upturn in Asian and world economic growth after 1999, the latest economic projections do not envisage that New Zealand will achieve even the bottom end of this range before 2001/02. Moreover, Annex 3 of the BPS discloses that the central scenario is based on average growth of just 3 percent per annum beyond this period, with the low growth scenario being only 2 percent per annum. There is no indication of any action that National intends to take to raise the rate of growth to its target range.

2.4 In telling contrast, GDP in Australia grew by 5 percent in the year to September 1998 alone, despite that country's greater exposure to Asia than New Zealand's. Australia's medium-term outlook is now better than New Zealand's, contrary to the position a few years ago. Clearly New Zealand cannot primarily blame economic turmoil in Asia for the woeful growth record of recent years. In public policy terms, Australia has moved ahead of New Zealand in a growing number of areas, and it is continuing to show more momentum in this respect. Recently, for example, the federal government announced that small businesses would not be subject to regulations governing unjustified dismissals, a reform that, while much too limited, is not even being talked about by the government in New Zealand. Extensive privatisation is being implemented or promoted in Australia by federal and state governments of varying political persuasions.

2.5 The government's strategy for economic growth does not look credible in the light of the gap between its growth objectives and actual and expected outcomes. Useful growth-enhancing measures, such as the elimination of tariffs (albeit on an extended timetable) and the limited introduction of competition in accident compensation, have been offset by negative factors. These include increasing social and economic regulation, increased regulation of the labour market by the courts and under the Human Rights Act (eg the new age discrimination provisions), the undermining of the rule of law (as evident in the electricity and Taranaki Maori land lease decisions), and the increasingly predatory approach to taxing productive activity. This last point is variously illustrated by the increases in government expenditure, the government's proposal to impose border charges on ports and airports, and its decision to fund the ACC tail by a particularly distortionary payroll tax (we submit that this decision should be reversed). Similar measures are being proposed by other political parties, eg the Labour/Alliance proposal to increase the top personal tax rate.

2.6 A fundamental problem is that the government's growth strategy continues to presume that big government is necessary and desirable. Many of the seven overarching goals and the eight strategic priorities in the BPS presume that the government can determine what outcomes diverse New Zealanders desire. They are highly dirigiste. A more credible growth strategy would put greater emphasis on providing institutional structures that allow people to better pursue outcomes of their own choosing.[2] The BPS places too much reliance on concepts derived from central planning.

2.7 In our view, the essential elements of a more credible growth strategy would include:

(i) the pursuit of a more comprehensive set of growth-enhancing measures – notably free contracting in labour markets and much more vigorous privatisation;

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2 For example, the government could allow individuals much greater scope to determine how much of their own money they wish to spend on health and education, how much to spend on local heritage, and what aspects of New Zealand identity they value, while respecting the freedom of others to choose differently.

(ii) much more action on – as opposed to talk about – deregulation, particularly in relation to the producer boards, the labour market including the professions, resource management, network industries, health and education, and on a meaningful Regulatory Responsibility Act that reduces the cost of regulations on business activity;

(iii) a reversal of the current fiscal strategy in favour of a credible medium-term programme of expenditure and tax reductions (see next section);

(iv) much greater focus by the government on its core public good activities (which are not even mentioned in the BPS as overarching goals or strategic priorities), including respect for and enforcement of the rule of law and private property rights, and on approaches that would persuade foreigners that New Zealand is a desirable place in which to live and invest; [3] and

(v) much improved government communications concerning the need for ongoing adjustments in policy and business practices if New Zealand is to be a dynamic and competitive economy.

2.8 In respect of point (v), the government has failed to acknowledge the deficiencies in its growth strategy and the magnitude of the problems the country faces. The government's basic position has been to deny that weaknesses exist, as the extract from the BPS cited in paragraph 2.1 demonstrates. The Coalition government was slow to recognise the seriousness of the Asian situation, and when it did its initial response was to deny that any adjustment in its spending programme was needed (implying that all the adjustment should be borne by the private sector). The government has now conceded that the situation is serious enough to warrant a slower rate of increase in expenditures, but the proposed adjustments are not material. The BPS continues to over-emphasise the role of uncontrollable factors such as the Asian crises and the drought. It largely ignores the negative implications of the increased tax burden implicit in the major increases in government spending in recent years, and it puts far too much emphasis on ephemeral events such as the pending APEC conference to lift the economy. It is also arguably placing too much hope on forecasts that the Asian economies will recover quickly after 1999.

2.9 The government is still not acknowledging in the BPS the gap between growth outcomes and projections and its own growth objectives. The public cannot be expected to accept the need for policy adjustments to improve growth and living standards unless it understands that New Zealand's economic potential is not being achieved. It is hard to see how any growth strategy can be credible as long as the government remains in denial about its policy errors and the under-performance of the economy.

3 The government expenditure problem

3.1 In our view, the greatest single fiscal problem facing New Zealand is the rise in government expenditure. The attached chart highlights the very limited nature of the recent spending reductions in relation to the overall trend. The most dramatic failure of fiscal control occurred in the election-year budget of 1996, but the upward trend was established in the budgets that followed the 1993 general election.

3.2 Government operating expenses are now projected to peak at 36.4 percent of GDP in 1999/2000, up from 34.3 percent in 1996/97. This is a rise of 2.1 percent of GDP. Excluding finance costs, the rise is even greater – at 2.8 percent of GDP (from 31.1 percent to 33.9

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3 The government's decisions in respect of electricity and Taranaki Maori land leases send a strong negative signal to all investors, as have statements at various times by influential politicians about Asian immigration, foreign investment and tax rates for society's most productive people. More rapid progress with reform of the international tax regime would be helpful here.

percent). With the notable exception of Japan, New Zealand stands out amongst OECD countries for the sharp rise in government spending projected in the latest (December 1998) OECD *Economic Outlook* – in most other countries the ratio is expected to continue the declining trend of recent years or stay flat. The BPS projects operating revenues to hold at around 34.5 percent of GDP to 2001/02. The net effect is that the operating balance is projected to be in deficit in each of the three years from 1998/99 to 2000/01. A further disturbing feature is that net debt is now rising again and is expected to peak at 27.8 percent of GDP in 2000/01.

3.3 We acknowledge that the rise in government spending as a percentage of GDP compared with the 1998 budget arises primarily from downward reductions in forecast nominal GDP rather than a further rise in government expenditure. What has driven the forecast operating balance into deficit is a fall in forecast receipts as a result of lower nominal GDP. Our fundamental disagreement is with the government's premise of recent years that it is desirable to increase government expenditure as long as total spending is falling relative to GDP. The critical issues are the quality of all government spending and the tax burden it imposes on the productive sector of the economy.

3.4 When, as is the case in New Zealand, spending by all levels of government is around 40 percent of GDP, the quality of that spending is critical for standards of living. In our view, the quality of much central and local government spending is very poor. Governments have expanded far beyond their proper roles and levels of competence in many, if not most, areas. The NZBR has presented the government with specific spending reduction proposals on many occasions, for example in the 1996 report *Moving Into the Fast Lane*. Page 19 of the BPS asserts that:

> *The government will continue its rigorous examination of new and existing expenditure to ensure that money is spent only where justified.*

This assertion is little short of astounding in the light of persistent demonstrations by the business sector of ways in which the government could cut unjustified spending. It can only serve to reinforce the feeling that the government long ago stopped listening to the business community about this aspect of its growth strategy.

3.5 Naturally elected governments are free to put the interests of the beneficiaries of specific government expenditure programmes (including the public service itself) ahead of the goal of promoting greater economic growth to lift the living standards of New Zealanders at large. But they cannot then maintain that they have ambitious growth strategies, such as annual growth targets of 3.5 - 5 percent of GDP. Moreover, they cannot claim that many such programmes are justified on equity grounds when, as is often the case, they are poorly targeted. For example, given the overarching goals in the BPS, how does the government justify taxing relatively well-off New Zealanders in order to buy health and education services for the same group? Overarching goal 4 expresses the sound view that high taxes should not be used to support high-income New Zealanders in respect of social assistance in welfare and housing. Why does the government not apply the same principle then to other government 'social spending'? For example, how does it justify not reversing the decision to provide New Zealand Superannuation on a universal basis, with the result that high-income superannuitants are now being supported by lower-income taxpayers? Many of the policies of the Coalition government had much more to do with the special interests of better-off constituents than with equity. They should be revisited as being inconsistent with the goals outlined in the BPS.

3.6 The credibility problem is further increased by the claim on page 7 of the BPS that the government's seven overarching goals "are independent and mutually reinforcing". Clearly, policies intended to redistribute wealth or to prevent change that some deem to be harmful to the environment, 'cultural identity' or biodiversity have the potential to conflict sharply with growth-oriented objectives. Denying the existence of such a trade-off is disingenuous.

3.7 It is also disappointing and revealing that there is no discussion in the BPS of the desirability of a medium-term strategy of cutting expenditure in order to cut taxes. The BPS, at the top of page 18, raises instead the issue of the "appropriate level of commitment and limit for *additional* policy spending" (emphasis added), thereby ignoring all private sector and taxpayer arguments for reductions in existing spending. Furthermore, the discussion of this issue is immediately diverted on to the topic of automatic fiscal stabilisers. The BPS concludes that:

> *It would not be desirable for the government to fully counteract the automatic stabilisers by implementing further policies designed to correct the short-term fiscal imbalance. Doing so would risk exacerbating the weaker economic situation. The government's previous actions to reduce public debt mean that short-term action is not required to maintain credibility.*

However, we are not aware of proposals for expenditure reductions "designed to correct the short-term fiscal imbalance". In our view what is required is a vigorous medium-term programme of expenditure and tax reductions. The idea that principled expenditure reductions could exacerbate the economic situation is a throwback to defunct Keynesian notions that have been discredited on many occasions in many countries. This passage represents a reversal of the thinking underlying the cuts announced in National's 1991 budget, which preceded a period of economic growth that was extraordinary by New Zealand and OECD standards. The current National government has made a 180-degree turn on fiscal strategy since 1991 – yet claims in the BPS that it has made substantial progress towards promoting economic growth *during the last eight years*. This inconsistency is startling and further erodes credibility.

3.8 A medium-term programme of reducing government spending to below 20 percent of GDP would enable a resumption of the programme of debt and tax reductions. The return to operating deficits has led to a rise in projected net and gross debt ratios, contrary to the government's stated intentions. Further divestment of government-owned businesses would also contribute to debt reductions. The two recent rounds of tax reductions (1996 and 1998) have benefited low to middle income earners in particular, but they have had the unfortunate effect of widening rather than flattening the income tax scale and hence making the tax system more complex. Also the deferment of the second round of tax reductions was unhelpful in terms of certainty of fiscal policy and the plans of firms and households. The highest income tax rates have the largest deadweight costs and are most harmful to growth. Priority should be given to reducing them in order to reduce the cost of capital to firms and households' borrowing costs, encourage investment and reduce distortions caused by the progressive income tax scale. Given firm expenditure discipline, tax reductions should be programmed in broad terms on a medium-term basis.

4 Consistency with the Fiscal Responsibility Act 1994

4.1 Annex 2 of the BPS summarises the requirements of the Fiscal Responsibility Act 1994. It also tabulates the BPS's long-term and short-term objectives in relation to the principles set out in that Act. The Annex refers readers to the Fiscal Strategy section of the BPS for a discussion of the reasons for changes in short-term intentions and of the government's approach to achieving its longer-term objectives.

4.2 In our view the government's longer-term fiscal objectives are no longer credible in the light of its fiscal strategy for the next three years and the political uncertainties that lie ahead. A key feature of Budget Policy Statements since 1995 has been the objective to reduce operating expenses below 30 percent of GDP. Far from reducing expenses relative to GDP, the ratio will have risen for four successive years to 1999/00 according to the projections in the BPS. Table 2 on page 22 of the BPS indicates that operating expenses will still be 31.1 percent of GDP in

2008/9 – and the reduction to this level depends on the hoped-for economic upturn and constraint in the *growth* in government expenditure.[4]

4.3 Far from instituting a programme of withdrawing government from areas in which it has no comparative advantage, it is clear that the government's expenditure strategy is to increase total spending and to rely on economic growth to reduce the overall expenditure ratio. This makes the credibility of the government's fiscal policy depend on the credibility of its strategy for economic growth. But high spending and taxation burdens discourage economic growth, as New Zealand's experience in the 1970s and '80s and again in recent years clearly demonstrates.

4.4 Currently a major force for increasing government expenditure is the open-ended nature of the government's objectives in many areas. Spending policies intended to improve outcomes in relation to health, education, housing, poverty, safety or the environment have no finite limit. Nor can any finite level of spending satisfy those who would benefit from yet more spending in any of these areas. The widespread community dissatisfaction with health and education services despite large increases in outlays on them illustrates this point. Where there is no principle for determining spending, arbitrary limits do not provide a robust constraint. A credible programme for reducing the size of government requires governments to redefine their role and eliminate open-ended spending programmes where possible. By focusing instead on 'improving' outcomes by additional expenditures, the BPS fails to meet this requirement.

4.5 To conclude, we consider the BPS fails to conform with the requirements of the Fiscal Responsibility Act 1994 to:

- assess the extent to which short-term intentions are consistent with the principles of responsible fiscal management and long-term objectives; and

- state the approach needed to become consistent and the period this is expected to take.

The Act was intended to provide a safeguard against 'spend and hope' fiscal strategies. It was not intended to enable governments to set long-term objectives and claim conformity with the Act merely through successive postponements of the target date for meeting them. The Act intended that governments would take concrete action to remedy departures from sound fiscal plans.

4.6 Given its fiscal discipline in preceding years and fiscal trends at the time, the government's 1995 BPS projection of achieving its long-term expenditure objective by 1997/98 (a figure of 30.5 percent of GDP for that year was projected) was credible. The intention in the 1999 BPS is effectively to defer the achievement of that objective by more than a further 10 years. Given this absurdly extended timetable, the government's demonstrated lack of fiscal discipline in recent years, the fact that the ratio is rising not falling, and the absence of proposed policy responses to the departure from the target, we consider that the government's fiscal strategy is not credible or consistent with the intention of the Fiscal Responsibility Act 1994. In the case of the objective for net debt, which the government reduced to 15 percent of GDP in 1997, the BPS reveals a sharp increase in earlier projections to almost twice that level. In the absence of proposed remedial action, we consider this trend is also not consistent with the intentions of the Act. Accordingly we ask the Select Committee to clearly state its view on whether the BPS complies with these aspects of the Act and if not, what the government is required to do to conform with it.

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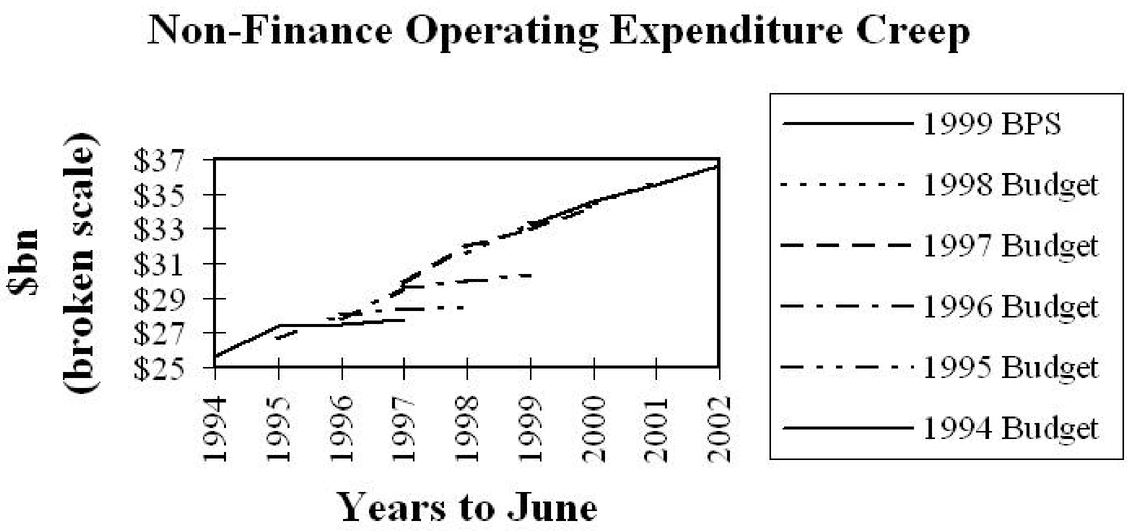
4 The government could have shown greater reductions in the ratio of expenses to GDP by dropping the technical assumption that allows for annual additional spending of $600 million (increased by inflation and "the real growth factor") beyond 2001/02 (see page 33). We commend it for its integrity in thus disclosing its underlying expenditure strategy.


Non-Finance Operating Expenditure Creep
$bn
(broken scale)
$37
$35
$33
$31
$29
$27
$25
1994
1995
1996
1997
1998
1999
2000
2001
2002
Years to June
1999 BPS
1998 Budget
1997 Budget
1996 Budget
1995 Budget
1994 Budget