NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE BUDGET POLICY STATEMENT 2001

JANUARY 2001

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1 Introduction

1.1 This submission on the Budget Policy Statement 2001 (BPS) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily 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 We have made submissions on successive governments' Budget Policy Statements since their inception. This is because we believe that fiscal policy and the disciplines introduced by the Fiscal Responsibility Act 1994 are important for sound economic management and the quality of the communications between the government and the wider community, particularly the investment community.

1.3 We remain concerned that the BPS process is not fully achieving the purposes intended by the Fiscal Responsibility Act. There is little evidence that governments have used the opportunity of submissions and select committee deliberations to test and modify their thinking on budgetary strategies. Under previous governments, fiscal outcomes varied substantially from announced targets yet no significant corrective actions were taken. The select committee and the media have not held governments to account for such failures. Currently the government seems to be unable to engage in open-minded debate about issues such as the case for continuing government ownership of commercial businesses. Rational dialogue is impossible if major issues are simply off the agenda for ideological reasons. Perhaps because of disenchantment with the process, in recent years few submissions have been made on the BPS, which should be one of the most important consultation documents put out by the government each year.

2 Economic growth

2.1 The BPS is important first and foremost because fiscal policy, in particular levels of government expenditure, taxation, borrowing and debt, has a major impact on economic growth. New Zealand's long-term economic growth performance has been poor. Living standards have risen only slowly, and have not kept pace with rises in other countries.

2.2 By the early 1980s, average growth rates had become mediocre and were based on unsustainable borrowing: we estimate that the economy was incapable of delivering more than 1-2 percent annual growth on a sustained basis (and close to zero in per capita terms). Following the reform periods of 1984-88 and 1991-92, annual growth averaged 4 percent up to 1996. Deteriorating policies since then have seen the sustainable growth rate fall back to an average which we would estimate to be 2-3 percent per year. This is a marked improvement on the pre-reform period, and is confirmed by studies showing a major increase in total factor productivity growth following the reforms.[1] The cumulative effect over the average New Zealander's lifetime of this improvement would, if sustained, be large. However, it falls far short of New Zealand's potential economic performance and means other countries would continue to outstrip us.

2.3 The BPS figures confirm this assessment. The projections up to 2005 show average growth of under 3 percent on an annual basis and do not take account of the recent signs of weakening in the world economy: some forecasters are projecting growth of only 2 percent for New Zealand in the year to March 2002 compared with the BPS figure of 3.7 percent. For the period 2004/05 to 2009/10, the 2000 budget projected average annual growth of only 2.3 percent and 1.5 percent beyond that point. Since the mid-1990s, New Zealand has fallen markedly in international rankings of its relative competitiveness, which are a pointer to future growth performance.

2.4 This outlook suggests that economic performance will not meet the government's goals and calls for a strategy for more rapid economic growth to

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1 See especially Erwin Diewert and Denis Lawrence, 'Measuring New Zealand's Productivity', Treasury Working Paper 99/5, 1999.

be implemented to attain them. In effect, the government's own projections are saying that such a strategy is not in place.

2.5 A large body of economic research indicates that policies for economic growth are primarily a matter of getting the institutional and policy environment right. The key ingredients are (a) a legal system that provides for secure property rights and enforcement of contracts; (b) monetary arrangements that achieve price stability; (c) free trade and open markets, subject only to necessary regulation; and (d) modest levels of government spending and taxation. The trend to more open economies, lower tax rates, privatisation and deregulation is widespread and continuing. Inevitably, the progress is uneven and the details are unique in each country. But any growth strategy is unlikely to be credible with the international community if it is not in line with mainstream research and thinking and the directions in which successful economies are heading.

3 Size of government and economic growth

3.1 A leading researcher on economic growth, James Gwartney of Florida State University, has concluded that for most countries, government spending and taxation levels in the range of 10 to 15 percent of gross domestic product (GDP) are perfectly adequate for the core government functions of providing a range of public goods and a social safety net (including underwriting access to needed social services).[2] Even spending levels of 20 to 25 percent of GDP may not be too damaging if the spending focuses on core functions and is designed to minimise the adverse impact on incentives to earn, save and invest.

Gwartney goes on to say that:

> As government spending moves to 30, 40 and 50 percent of GDP, however, it will undermine both the incentive to earn and the market process. The effects on growth may not be immediately obvious because it takes time for markets to adjust and people to alter their habits and social norms. Modern growth is primarily about gains from trade, discovery and innovation. The adverse effects of government on these activities may not be immediately observable … but

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[2] Government spending was in this range in most countries, including New Zealand, in the early part of last century.

> with time, there will be observable effects on long-term growth.[3]

In response to the question of why growth in New Zealand has not been more robust, Gwartney writes that:

> … while there has been some reduction in the relative size of government (and improvement in performance), New Zealand is still a big government welfare state. Government spending [central plus local] continues at nearly 40 percent of GDP, a figure much too large for maximum growth. I do not know of any country that has sustained per capita income growth of 4 percent or more with that level of government spending.[4]

3.2 Across OECD countries as a group, the share of government spending in national income has been falling significantly in recent years, as can be seen from Annex I which is based on the December 2000 *OECD Economic Outlook*. Since 1996 New Zealand has been one of only four countries that have gone against this trend, which appears to be continuing. Moreover, the ratio for New Zealand will not decline further, given the government's decision in 2000 to raise the previous government's long-term target for central government spending from 30 to 35 percent of GDP.[5] This was by far the most important decision on fiscal policy made by the government, and constitutes an effective 17 percent increase in New Zealand's underlying tax burden (government spending being a better overall measure of the burden of taxation than current revenue given fluctuations in the fiscal deficit or surplus). The divergence between Australia and New Zealand on this measure – the share of government spending in national income – is now marked and growing as the table indicates.

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3 Pers comm. The experiences of Hong Kong, Singapore, Ireland and the United States in recent decades highlight the importance of institutions and policies. These issues are examined further in a forthcoming NZBR study.

4 *Ibid.*

5 The difference between this figure and the OECD figure for total outlays of 40 percent of GDP is explained by the System of National Accounts basis of measurement used by the OECD and by the inclusion of local government spending.

4 The government's priorities

4.1 The BPS states at the outset that "[f]acilitating economic growth will be a priority in Budget 2001". It also states that government initiatives in 2001 "will emphasise the quality of spending, the effectiveness of policy interventions and the relevance of the regulatory environment, rather than any relaxation of the fiscal stance … ". On page 7, the BPS adds that:

> We believe much can be done to improve the value for money that taxpayers … receive from existing government expenditure of over $38 billion per annum at 30 June 2001. Government initiatives in 2001 will also focus on improving the effectiveness of existing policy interventions, managing risks, improving the quality of government regulation, and eliminating unnecessary compliance costs.

4.2 We endorse these sentiments and goals. Our last BPS submission was in agreement with them in stating that "[w]e believe that much current spending is ill-directed and serves to undermine rather than support economic growth and social cohesion." Achieving better overall outcomes is certainly a priority but regrettably the BPS does not provide grounds for confidence that the government is developing a sound growth strategy. For example, the first paragraph on page 5 under the heading "Fiscal policy supports continued economic expansion" suggests the government is relying on the upturn in exports and tourism receipts to flow through to the domestic sector. The buoyancy in the tradeables sector owes much to the real wage cuts that are implicit in the large currency depreciation that has occurred – increased profitability in internationally competing industries will not be sustained if wages rise to match the higher prices of imports and exportables. However, the same phenomenon operates in the opposite direction for the non-tradeables sector which experiences a contractionary impulse due to the higher cost of inputs from the traded goods sector and must lose resources to export and import-competing industries (this is the mechanism by which the current account deficit is reduced). Only if real wages fall relative to productivity – at the margin and on balance – can a sustained overall lift in employment and output be anticipated. In short, the growth forecasts in the BPS appear to be based on the hope that the large and unplanned fall in the New Zealand dollar

will 'stick' in the sense that the effects will not be removed through wage inflation or currency appreciation.

4.3 If the government does see currency depreciation as an important part of its economic growth strategy, this is a recent change of position. A little over a year ago (December 1999) the minister of finance stated that a New Zealand dollar below US 50 cents could not be justified by fundamentals and it "should rise again before too long".[6] Nor has the government (publicly at least) made clear to the union movement and workers that a currency depreciation will only have sustained effects if real wages are cut in the short term. (In the longer-term, higher real wages can be sustained by productivity improvements.)

4.4 However, far from being a source of growth, a weakening currency is commonly evidence of economic weakness. For example, any government could depress its currency through foolish policies that scare off investors. But the implied real wage cut is then associated with lowered future productivity rather than with any necessary gain in competitiveness. In contrast, low inflation and rapid increases in productivity tend to be associated with high rates of investment, economic success and currency *appreciation*.

4.5 Fundamentally, real wages in New Zealand will tend to reflect the productivity of the relevant marginal worker in any part of the labour market. The lower that productivity, the lower real wages will be in New Zealand compared with countries with superior policies. A sound growth strategy directed at the budget goal of facilitating economic growth would focus on policies likely to increase productivity and employment across the economy as a whole. The government should not count on a weak exchange rate to achieve a cut in overall real wage rates.

5 Implications for government action

5.1 It is easy to pay lip-service to laudable goals. The real test is credible supportive actions.

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6 *New Zealand Herald*, 15 December 1999, "Kiwi on its way back up soon predicts Cullen".

- The previous government had a longer-term growth target for GDP of 3.5–5 percent per annum, but no credible policy for achieving that target. The minister of finance has targeted a growth rate of 4 percent. We believe such a target is achievable and should be a minimum objective. As noted, however, average outcomes in recent years and the Treasury's December forecasts come in at appreciably under 3 percent. No corrective action appears to be proposed.
- The prime minister campaigned inter alia on reducing the unemployment rate to 3 percent. Unfortunately, many of the government's policy actions point in the opposite direction and the Treasury is forecasting that the unemployment rate will be 5.7 percent in 2005 – effectively no improvement on the rate at the time the government was elected in 1999. Again, no corrective action appears to be proposed.

5.2 The NZBR considers that New Zealand's economic and social performance will remain poor and well below its potential with present policy settings. We believe the government needs to formulate a credible growth strategy to bridge the gap between its goals and projected outcomes. This would involve resuming a reform programme along the lines recommended in recent reports by the OECD, the IMF and *The Economist*, which are in line with NZBR thinking. If the BPS statement that "[f]acilitating economic growth will be a priority in Budget 2001" is to be meaningful, the government must revisit its policy approach which has been redistributive, not growth-oriented, and characterised by higher spending, taxation and regulation. To date the government's priority has been to implement particular pre-election commitments to specific groups. In doing so, it has not established that its policies promote the interests of New Zealanders at large in generally rising living standards, and, indeed, we do not believe that it could do so.

5.3 Although New Zealand has made progress in reducing unjustified government intervention in the economy, it is important to note that the deadweight costs of taxation are still high and rising due to factors such as globalisation and mobility of capital. Skilled labour is also now much more mobile: we believe the government is out of touch with the current experience of many businesses in denying that New Zealand faces a serious 'brain drain'

problem – very different from earlier 'OE' patterns. Average incomes in Australia are now some 40 percent higher than those in New Zealand, as Annex II indicates, and this gap seems likely to widen. As noted taxation as a proportion of national income is also much lower in Australia. The pull to live and work elsewhere is much stronger than in the past, as are the opportunities. Currently the government appears committed to greatly increased expenditure ($5.9 billion over 3 years) and increased marginal income tax rates (the 2000 increase in the top income tax rate to 39 percent). Firms report that the latter are a significant factor in the loss of skilled people. Pressures for additional spending are apparent, yet overall outcomes in areas such as education, health and welfare dependency do not appear to be improving. Along with moves to more extensive regulation and other 'hands-on' policies, this combination of policies is so far removed as a growth strategy from current international expert opinion and prevailing policy directions elsewhere as to call into question its credibility and create major communication problems for the government with businesses and investors.

5.4 We believe current approaches are not consistent with a strategy for economic growth and better social performance. We urge the government to consider the following steps:

(i) establish a goal under the Fiscal Responsibility Act of reducing government spending to 30 percent of GDP over the next few years, as a step towards a lower target (Ireland's ratio is projected to be 26 percent by 2002).[7] Some of this reduction could be achieved by holding the rate of growth of government spending below the growth rate of the economy;

(ii) implement significant cuts in wasteful and poorly targeted government spending. Decisions in the budget will be a test of the seriousness of the government's commitment to its 'value for money' programme;

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7 Ireland also has the advantage of being part of the large European Union economy. To offset natural disadvantages such as remoteness form markets, New Zealand's fiscal, regulatory and other policies must be better than those of countries like Ireland to achieve comparable economic performance.

(iii) focus especially on government programmes that essentially involve 'churning' of income by taxing middle and upper income groups only to return resources to them in the form of taxpayer-provided services, either concurrently or at another point in their lives. The deadweight costs of such 'churning' are large – probably in excess of 30 cents at the margin for every dollar of taxation raised. National income is lower as a result. There would be major benefits if such groups faced lower taxes but paid more themselves for some social services (whether provided by the government or the private sector), with taxpayer funding being directed to those in greater need of assistance; and

(iv) reduce high effective marginal tax rates, as these are most harmful to economic performance and growth. There is also a strong case to reduce the burden of taxation on capital income to lower the cost of capital and encourage investment, and to flatten and simplify the income tax scale.

5.5 In addition, we urge the government to halt and reverse the regulatory juggernaut which has led in the past year to more regulation in areas such as ACC, employment contracts, energy, telecommunications and company takeovers. National interest tests as required by Regulatory Impact Statements are not being competently applied in the case of most, if any, of these initiatives, and New Zealand has an enormous amount of regulation (some of it of recent origin) that is stifling business development. We also endorse calls by the OECD and other advisers to resume a programme of privatisation, reduce the generosity of New Zealand Superannuation for future retirees, introduce more competition into health, accident compensation and education, and curb welfare expenditures, particularly by focusing on removing obstacles to employment and restricting the terms of access to welfare benefits. New Zealand welfare arrangements are generally more generous and lenient than those of Australia.

5.6 In summary, we believe that New Zealand's economic performance has been allowed to deteriorate for several years, and that current policy settings risk accentuating rather than reversing this trend. In today's more open international economy, the risks for a remote and under-performing country

with inferior policies are very great. Better policies than other countries are needed to offset natural disadvantages. An accent on redistribution drives capital and people to leave. The government's more recent emphasis on the economy and relations with the business sector is welcome, but must be followed up by tangible action if it is to be meaningful. We consider that the government should see such action as an urgent requirement in formulating the forthcoming budget, and we would be pleased to cooperate in efforts to establish a more successful growth strategy.

Annex II

Australia vs NZ
Key Indicators

	Australia	New Zealand	Difference	
	$	$	$	%
GDP per capita at current prices US dollars. **Purchasing power basis. 1998**	**24,192**	**17,597**	**6,595**	**37.5**
GDP per capita at current prices US dollars. Current exchange rates basis. 1998	**19,900**	**13,936**	**5,964**	**42.8**
	%	**%**	**Percentage Points**	
General government spending as a percentage of nominal GDP 1999	**31.8**	**40.9**	**-9.1**	

Source:
National Accounts of OECD countries, main aggregates www.oecd.org/std/gdpperca.htm

General government total outlays as a percentage of nominal GDP, *OECD Economic Outlook* 68, Paris, December 2000.