NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE BUDGET POLICY STATEMENT 2009

JANUARY 2009

1 Introduction

1.1 This submission on the Budget Policy Statement 2009 (BPS) is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The Business Roundtable believes New Zealand is facing grave economic problems, many of them the result of policy errors in recent years. They are both of a short-term nature due to the international crisis and longer term due to the slump in productivity growth. In our view Treasury advice to the government since the election has understated the seriousness of the problems and we agree with the minister of finance that a greater sense of urgency is needed. We strongly support the government's aspirations for radical improvements in New Zealand's economic performance, which will require major changes in policy directions.

2 Catching up with Australia by 2025

2.1 ***This goal is challenging***. The government's prime economic goal is to achieve income per capita parity with Australia by 2025.[1] According to figures produced by the Organisation for Economic Cooperation and Development (OECD), it would require income per capita in New Zealand to grow by *more than* 1.5 percentage points per annum faster than Australia.[2] In turn, as the National-ACT Confidence and Supply Agreement notes, "This will require a sustained lift in New Zealand's productivity growth rate to 3% a year or more."

2.2 New Zealand's productivity growth rate rose substantially following the economic reforms of the 1980s and early 1990s – labour productivity growth averaged between 2.5 and 3 percent a year during the 1990s (see Annex I). Assisted by this improvement and favourable external circumstances, New Zealand's growth rate of real gross domestic product (GDP) per capita marginally exceeded

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1 Of course high material living standards should not be the only aspiration. But countries with high incomes are also likely to have a cleaner environment and a better quality of life. The *Economist Intelligence Unit* ranked Australian's quality of life at 6th in the world in 2005. New Zealand's rank was 15th. Overall, Australia was ranked 4th in the world in 2006 in the United Nations' Human Development Index, whereas New Zealand was ranked 20th.

2 The OECD's *OECD in Figures 2008* puts New Zealand and Australian gross domestic product per capita for 2007 at US$27,100 and US $37,100 respectively using purchasing power parity

Australia's for a period up to 2005.[3] However, Australia has been improving its competitiveness relative to New Zealand in recent years.[4] During the last decade Australia's growth in real GDP per capita has averaged 2.2 percent per annum compared to 2.1 per cent per annum for New Zealand.[5] This comparison understates the magnitude of the improvement required because New Zealand's productivity performance has been slowing during this period. According to official estimates, recent productivity growth has been inferior to that in Australia (a reversal of the situation in the 1990s) and, indeed, to the OECD average.[6] The high rate of net emigration from New Zealand to Australia in the last decade is another indicator of New Zealand's relative malaise.[7] The International Monetary Fund's October 2008 *World Economic Outlook* projections to 2013 foreshadow significantly faster income per capita growth for Australia through to 2013.[8]

2.3 ***Goals are not credible if policy settings are inconsistent with them.*** The Clark-Cullen government set a challenging goal,[9] but never had a credible strategy for achieving it.[10] The Business Roundtable pointed this out from the beginning and it gives us no satisfaction to observe that events proved this assessment to be correct. Far from getting to better than 15th as the 'top half of the OECD' goal required, New Zealand's OECD ranking for income per capita dropped from 21st in 1999 to 22nd in 2006.[11] Instead of building on the much improved economic performance of the 1990s, policies emphasised income redistribution rather than wealth creation, and led to the slump in productivity and economic growth. The economy was in recession by the beginning of 2008, well

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exchange rates. To close this 33 percent gap in 18 years (ie starting in 2007) would require a faster growth rate for New Zealand of 1.7 percentage points per annum.

3 See figure 4 in Part B of the New Zealand Business Roundtable's *Economic Fact File*. A copy can be accessed at http://www.nzbr.org.nz/documents/publications/Economic_Fact_File.ppt.

4 Australia moved ahead of New Zealand for the first time in the Heritage and *Wall St Journal*'s 2008 Index of Economic Freedom. It is now well ahead of New Zealand in the World Economic Forum's *Global Competitiveness Index*. (See figures 6 and 7 in Part B of the *Economic Fact File*).

5 Australian Bureau of Statistics series A2336372T to the year ended June 2008. Statistics New Zealand series SNCA.S6RB01NZ to the year ended March 2008.

6 From 2000-2007, measured or market sector labour productivity growth averaged 1.2 percent per annum in New Zealand and 2.0 percent per annum in Australia. The OECD's 2008 comment on New Zealand's slowing productivity performance can be viewed at http://www.oecd.org/dataoecd/29/43/40201820.pdf. See Annex II, which also includes comparisons for multifactor productivity growth.

7 See figure 11 in Part A of the *Economic Fact File*.

8 See figure 4 in Part B of the *Economic Fact File*.

9 The goal was to get New Zealand's rank for real GDP per capita into the top half of the OECD, initially by 2010. Figure 1 of Part B of the *Economic Fact File* shows New Zealand's ranking in 2006 relative to this goal.

10 Surveys of business leaders by the *New Zealand Herald* repeatedly identified this problem.

11 See figures 1 and 2 in Part B of the *Economic Fact File*. The ranking for 2006 was also 22nd.

before the effects of global financial crisis were felt. Looking back, the last several years can be seen as a period of gross economic mismanagement.

2.4 The previous government's policies were centred on major increases in real government spending and taxation per capita,[12] ideological opposition to greater competitive private provision of goods and services,[13] and an endless stream of intrusive state regulation. Too often they seemed to assume that politicians can spend taxpayers' money better than taxpayers. Legislation was seen as the only way to protect employees from employers,[14] customers from suppliers, shareholders from managers and 'the environment' from businesses. The World Economic Forum's *Global Competitiveness Report 2008-09* found that 52 countries out of 140 had less waste in government spending than New Zealand and 64 countries out of 140 had a lesser burden of government regulation.[15]

2.5 ***Credible policy actions are needed to facilitate wealth creation***. To turn the new government's aspiration for a vastly improved performance into reality will require institutions and policies that are much more supportive of wealth creation. Requirements include the need for:

- much improved provision of core government public good functions − such as the courts, prisons, law and order and the protection of persons and property;
- greater reliance on competitive provision of private goods and services currently being provided by state monopolies. The list should include prisons, accident insurance, much health care and education, and much infrastructure;
- reduced government spending as a percentage of GDP.[16] This should be achieved progressively by much greater spending discipline and a stronger

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12 Core Crown revenue and expenses per capita, deflated by the consumers price index, rose 21.2 percent and 26.3 percent respectively between 1999-00 and 2008-09 (BPS data).

13 The ideological opposition was evident in policies towards private prisons, competitive accident insurance, private schools, competitive private provision in health, and to the sale of state-owned commercial enterprises.

14 New employment laws during this period illustrate this point. Of course, some of these beliefs are of longer standing, as illustrated by other legislation including accident insurance and workplace safety.

15 See figure 8 in Part B of the *Economic Fact File*. These rankings reflect in good part surveyed executive opinions. Note that New Zealand's overall ranking for economic freedom is much higher than these rankings would suggest.

16 Sustained high rates of economic growth are implausible for any prosperous country that has government spending of 40 percent of GDP or more. In its briefing papers since the election the Treasury has once again failed to make this basic empirical point. Figure 9B of Part A of the *Economic Fact File* shows that this ratio rose well above 40 percent after 2004.

focus on value for money than in the past. A large number of government programmes, and indeed government entities, are unnecessary and should be eliminated;

- lower and flatter taxes in conjunction with a return to a simpler tax system; and
- reduced government regulation of the business and household sectors.[17]

2.6 ***Economic flexibility is critical***. A current imperative is to shift resources from low-productivity non-traded goods activities (which includes the government sector) into the internationally exposed traded goods sectors. In general the higher the level of economic freedom (the freedom to transact and exchange) the more resilient and flexible is an economy. Greater labour market flexibility in particular is needed to minimise the rise in unemployment.

2.7 ***Several proposed initiatives are heading in the right direction***. The Confidence and Supply Agreement between National and ACT rightly emphasised the need to address the burdens of government imposed by wasteful and unnecessary spending and regulation. It proposed, *inter alia*, spending reviews, a Taxpayer Rights Bill and a Regulatory Responsibility Act. It was weaker on measures to increase the size of the private sector and capital markets such as selling government commercial activities in order to reap further efficiency gains. Research indicates that systems of proportional representation weaken spending disciplines and the government is to be commended for its commitment to hold a referendum on MMP.

3 Assessment of the current economic situation

3.1 The BPS projects two years of declining export volumes, during which real GDP per capita falls by almost 1 percent, while the rate of unemployment (March quarter, seasonally-adjusted basis) peaks at 6.4 percent. The deficit in the current account of the balance of payments is 9 percent (rounded) in each of these years. Core Crown spending rises above 35 percent of GDP (up from 30 percent in 2005), previously projected operating surpluses become deficits, and

17 This covers transactions between employers and employees, customers and suppliers, and firms and investors. It excludes harms to third parties. Some of these may be better addressed through tort remedies and other private rules than through government legislation. The domain for specific government regulation would still be significant.

net core Crown debt rises sharply and keeps rising through to 2013. About the only positive features of the projections are the much-reduced rate of inflation and the projected resumption of growth in 2010-11.

3.2 If these forecasts are right, this would be one of the ***least*** severe recessions in New Zealand since World War II in terms of the fall in income per capita. Cumulative falls in real GDP per capita of 6-8 percent are much more common.[18] After the first oil shock in 1973-74, real GDP per capita fell for six of the next seven years while government spending rose from 25 percent of GDP to 37 percent.[19] In 1933 real GDP per capita was 14.3 percent lower than in 1930.[20]

3.3 Successive Treasury forecasts in 2008 of the path of the economy were too optimistic. So too was the Reserve Bank's view that the economy would turn up from the end of the year. Given the daily international news about a continuing banking crisis and plummeting industrial production, we suggest that a sensible strategy would be to plan on the basis that New Zealand is just one year into a much worse recession than the BPS forecasts suggest. This implies much larger operating deficits and increases in public debt with unchanged policies.

3.4 ***New Zealand is very vulnerable to external developments***. Although the international crisis poses the greatest immediate threat to New Zealand's short-term economic prospects, New Zealand's vulnerability to it has been greatly increased by policies that have led to the decline in productivity growth and a loss of competitiveness.[21] This was a prime cause of the big increases in current account deficits in recent years (which former finance minister Michael Cullen wrongly attributed to a deficiency of savings by New Zealanders, for which there is little evidence.) Annexes III, IV, and V illustrate the massive loss of competitiveness, as measured by relative unit labour costs, the increase in imports while exports flatlined relative to GDP, and the current account trends.

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18 According to Statistics New Zealand's long-term series (March year basis), real GDP per capita fell 8.4 percent between 1951 and 1953, 1.0 percent between 1956 and 1958, 4.3 percent between 1966 and 1968, 7.7 percent between 1974 and 1976, 6.2 percent between 1977 and 1982, and 7.0 percent between 1989 and 1992.

19 See the Treasury's Financial Net Expenditure statistics at http://www.treasury.govt.nz/government/data

20 Most of these estimates should be treated as indicative, given measurement problems.

21 The World Economic Forum's *Global Competitiveness Report* ranked New Zealand 13th in the world in 1999 and 24th in 2007-08 for international competitiveness. New Zealand's balance of payments deficits, the recent credit rating watch put on New Zealand by Standard and Poor's and the large net migration loss to Australia further illustrate the competitiveness problem.

3.5 The crisis makes the funding of New Zealand's current account deficit more problematic and costly. The sharp fall in the New Zealand dollar in recent months indicates the need for adjustment. A lower real exchange rate is necessary in order to shift resources from the non-traded goods sector (eg much of government) to the traded goods sector (the sector in which firms are directly exposed to international competition). For a sustained gain in competitiveness, tax and regulatory burdens need to be reduced and real wages need to fall in the short term relative to productivity. Policies have been so bad for so long in relation to productivity that the government could do much to ease the necessary resource transfer by productivity-enhancing measures.

4 Overall response

4.1 ***Making the boat go faster****.* The touchstone question for all government economic initiatives should be whether they are focused on the short-term need for adjustment and the longer-term need to raise productivity. Such a strategy will only build sustained investor confidence if the government's specific policy initiatives are consistent with it. We endorse the notion of a 2025 Commission to set out a detailed programme for closing the income gap with Australia by that year.

4.2 ***Orthodox policies are required****.* There is no need to look beyond conventional economics for productivity-enhancing measures. Confidence was sustained after the 1984 economic crisis by embarking on a programme of orthodox, market-oriented reforms. Pump-priming and short-term expedients are not the right response to the current difficulties. ***They have been caused in considerable part by excessive government spending, and more spending overall can only worsen them.***

4.3 A list of sounder initiatives that builds on paragraph 2.5 would include: replacing unjustified and wasteful government spending by productive (private or public) spending; eliminating unnecessary and unjustified regulations; undoing the distortions introduced to the tax structure in the last decade and adopting a lower, flatter tax structure; improving the governance of infrastructure (eg electricity, water, roads and telecommunications); exposing Crown entities to greater competition and privatising commercial enterprises; and refocusing the role of local government on core public good functions.

4.4 ***Don't return to spend, borrow and hope****.* A considerable risk around the world currently is that governments will fail to take such orthodox measures and instead increase future tax burdens and public debt by massively expanding wasteful public spending while revenues fall. Japan suffered the 'lost decade' of the 1990s as a result of such policies, including spending on infrastructure. The Treasury's 'fiscal impulse' indicator shows an overall expansionary effect of around 5 percent of GDP for 2009 and 2010 combined, which is already very large. Calls for even more ill-justified spending should be resisted. Many noted economists internationally are questioning the recent 'Keynesian' responses. Some are arguing that tax reductions such as New Zealand is implementing are a better response than higher spending, particularly if they are structured to improve incentives for growth.

4.5 One point that is particularly pertinent for New Zealand is that it is a small, open economy with a flexible exchange rate. Keynesian arguments mainly relate to a closed economy. For countries like New Zealand there can be no deficiency of aggregate demand for production − the world market remains huge. By shifting enough resources into the production of tradables, and given labour market flexibility, New Zealand can achieve full employment. Since there is no deficiency of aggregate demand, increased government spending would be likely to increase the already dangerously large current account deficit in the balance of payments rather than increase domestic employment.[22]

5 Government spending

5.1 ***Protect bureaucracy, shed exposed firms?*** The path of core Crown spending inherited from the previous government is projected to run to over 35 percent of GDP without any focus on its productivity. (Total government outlays on the broader OECD measure are set to rise to 45 percent of GDP.) The government is saying it will maintain public service numbers while firms exposed to international competition are shedding staff. This means the burden of adjustment will be largely borne by the private sector and the necessary shift of resources will be impeded.

5.2 ***Consistent policy signals are required***. The immediate need is to stop wasteful spending and the previous government's regulatory juggernaut (eg its emissions trading scheme). The government has commendably been cutting back on minor expenditure items (eg conferences), emphasising to senior public servants the lack of funding for new policies and reviewing some capital projects (eg IT, Waterview and rail). However, the signal of greater fiscal prudence risks being undermined by plans to maintain public service numbers and for big increases in spending on 'infrastructure' before any systematic case has been made.[23] The BPS expressed the view that cuts to government spending that reduced aggregate demand "would simply push the economy deeper into recession".[24] This overlooks both the balance of payments point and the tax implications of the spending increase. Because people can generally spend their own money better than can politicians, the quality of national spending overall should rise if public spending declines. At the same time, indebted households would be better able to service their debt.[25] Increased spending at the present time will deprive the private sector of labour and capital and crowd out the expansion of internationally competing activities.

5.3 ***Low-hanging spending fruit****.* We have no objection to increases in public spending where competent analysis demonstrates that the benefits to the community can be confidently expected to exceed the costs. But such spending could easily be funded by dropping unjustified spending, the absence of much of which the public would never miss. Examples include:

- the host of ministries, agencies and commissions whose purpose is to promote the interests of a particular constituency, rather than the overall community interest;[26]

- the many paternalistic agencies who see their role as being to exhort adult New Zealanders to change their behaviour. Examples include the agencies that try to induce people to be more 'energy efficient', more environmentally

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22 See, for example, p 270 in Robert Mundell, *International Economics*, 1968.

23 Infrastructure should normally not require government spending. See the speech by Roger Kerr Reducing the Barriers to Investment in Infrastructure, at http://www.nzbr.org.nz/documents/speeches/speeches-2004/041130rk_reducing_barriers.pdf

24 The big spending increases after 1974 were associated with stagflation. In contrast, strong output and employment growth followed the 1991 Budget cuts and the freeing up of the labour market, despite the public claim at the time by 15 Auckland university economists that "the deficit-cutting strategy is fatally flawed. It can only depress the economy further … " Similar predictions by UK economists when the Thatcher government was cutting spending were just as awry. As already noted, the assumption of limited aggregate demand is a large country/closed economy concept.

25 It is telling that supporters of high government spending (former finance minister Michael Cullen was one) were opposing tax cuts prior to the recession on the grounds that households would only spend them and are opposing them now on the grounds that households would only save them. Just whose money is it?

'sustainable', smoke less, drink less, eat better, exercise more, or to be more politically correct in their language or advertising;

- other regulatory agencies that harass firms for 'harms' that are not long-standing common law harms. Many SMEs have to 'fly blind' through the regulatory morass (such as employment law) that now surrounds their activities. Large firms spend a great deal on advice from lawyers who may well themselves be unclear about just what a law or regulation means 'in practice';

- major diversions of capital from the private sector such as the 'Cullen Fund' (the New Zealand Superannuation Fund) and the Reserve Bank's $1 billion capital injection in July 2004 "to absorb any losses that may occur as a result of foreign exchange intervention".[27] There has been a very poor average rate of return in recent years on the Fund and other government investments such as Air New Zealand. At the very least payments into the Cullen Fund should be suspended pending a first principles review of it;

- the failure of a number of state-owned enterprises to meet their cost of capital in recent years (which indicates a misallocation of resources and a drag on economic growth). SOEs are poorly monitored by the Treasury's Crown Company Monitoring Advisory Unit. For many years we have urged the Treasury without success to report publicly in a systematic way on the financial performance of SOEs, as is done in Australia. The Commerce Committee of parliament did likewise following an inquiry last year. Its recommendations should be adopted, and the poor use of capital in SOEs adds to the case for privatisation.

- spending that has not been seen as inconsistent with the Treasury's poor quality spending guidelines.[28] These have no focus on value for money or the opportunity costs of public funds. The deficiencies have been

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26 The number of ministerial portfolios also illustrates the proliferation of unnecessary and distracting government activities. There is no good national interest case for a Minister of Racing, Sport and Recreation, or Veteran's Affairs.

27 The Cullen Fund essentially borrows in order to invest. However, it is economy-wide productivity growth, not a state 'cookie jar', that ensures a more prosperous future and the supply of the real goods and services that retirees will depend on. The cabinet paper in support of the Reserve Bank capital injection made no case that the Bank could outperform private persons in judging exchange rate movements. Nor did it identify the problem of reduced monetary policy credibility arising from increased confusion as to whether the Bank was targeting the exchange rate or inflation.
See http://www.rbnz.govt.nz/finmarkets/foreignreserves/intervention/0148108.html.

acknowledged in discussions we have had with the Treasury and the guidelines should be urgently upgraded. The Treasury's guidelines on user charges are also economically flawed and should be redone.

5.4 We disagree with the Treasury's advice that the previous government's R & D tax credit and Fast Forward programmes should be retained. The 2001 McLeod Tax Review recommended against the former and no serious economic analysis was presented in favour of the latter. We also disagree with the Treasury's criticism of the government's decisions on KiwiSaver. The Treasury's briefing papers showed little recognition of the economic mismanagement of recent years, the gravity of the present crisis, and the need to fundamentally reshape policy if the government's 2025 goal is to be achieved. They tend to support the previous minister of finance's view that Treasury's advice on government spending has been weak. Although the Treasury claims to be giving 'free and frank' advice, it had little or nothing to say about the previous government's poor quality policies in areas such as interest-free student loans and Working for Families and about privatisation. (A Business Roundtable Study suggested that privatisation of SOEs could boost GDP by around 1 percent a year.[29])

5.5 The government has said it will keep within the previous government's provisions for new spending. We believe such an approach is insufficiently rigorous, given the massive increase in government spending in recent years. However, across-the-board reductions in department votes are not desirable since they have no regard to the quality or necessity of spending: no household would reduce its budget in this way. We believe the overall baseline provision should be reduced and that the government should prioritise within it. In some cases, however – for example, the Treasury – we believe there is a need for more and higher quality resources and funding to support the government's ambitious goals, as well as using the existing vote allocation better.

5.6 The previous government raised the long-term target for core Crown expenses from 30 to 35 percent of GDP (and spending is on a path to overshoot it). As noted, total government outlays on the OECD measure (which includes local government and some capital spending) are heading to 45 percent of GDP. Far lower ratios, more like those in Hong Kong and Singapore where the figure is below 20 percent of GDP, are needed if New Zealand is to achieve fast growth.

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28 The Treasury, *Demonstrating Performance: A Primer for Expenditure Reviews*, August 2008.

Even Australia, which has an extra layer of government and spends more on defence, has a much lower ratio (and hence tax burden) at around 35 percent of GDP.

5.7 ***Undertake detailed spending reviews***. In addition, a systematic approach is necessary to improve accountability for value-for-money from major spending areas, such as retirement income support (including KiwiSaver and the Cullen Fund) education, health and welfare. In all these areas there are endless problems and irresolvable confusion about objectives and priorities. The current structure lends itself to professional capture, for example in relation to hours of work and rewards for performance. Meanwhile state intervention is suppressing private provision and choice and creating state dependency. Working for Families has exacerbated the problem of high effective marginal tax rates which discourage work effort over very wide income ranges. The spending task forces mentioned in the National-ACT agreement are a logical way to proceed to work through these areas. The ministerial group to review the performance of the public health system is a good start.

5.8 ***Long-term fiscal targets***. The Public Finance Act requires the government to determine targets for key fiscal aggregates. The most important decision is the operating spending target since this largely determines the tax burden. In its fiscal briefing paper, the Treasury has suggested that another long-term target in the form of a ratio of operating spending to GDP could be set. We do not believe such a move would greatly improve fiscal discipline – such targets have been ineffective to date. Governments can always say they are committed to achieving them but were not able to make progress "this year". We favour an expenditure limit to which governments can be held accountable on an annual basis, and propose that annual spending should not be allowed to grow by more than the rate of inflation plus population growth, unless taxpayers approve higher increases in a referendum.[30] Over time, the application of such a rule would reduce the government spending share of the economy. The Taxpayer Rights Bill which is to be introduced into parliament as a government measure under the National-ACT Confidence and Supply Agreement incorporates such a constraint. There is no reason why the government could not include it in the 2009 Budget

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29 Phil Barry (2002) *The Changing Balance Between the Pubic and Private Sectors*, New Zealand Business Roundtable.

30 Such a rule is applied in a number of US states. See Bryce Wilkinson (2005) *Restraining Leviathan*, New Zealand Business Roundtable.

Fiscal Strategy Report. We favour a similar constraint on local authority spending.

5.9 As regards the operating balance and targets for debt, the BPS forecasts a string of deficits and potentially large increases in net and gross debt. Moderate operating deficits are acceptable for a period in present circumstances but persistent deficits stand to threaten the government's credit rating. Given the current prudent levels of total debt, the Public Finance Act requires the government to ensure that "on average, and over a reasonable period of time, total operating expenses do not exceed total operating revenues", ie that the deficit should be eliminated. We believe that "a reasonable period of time" should be interpreted as being within the budget forecast period, say, 2012, and that a tight debt target should be set to reduce credit rating concerns. Achieving it would require disciplined spending plans.

5.10 As regards the Crown's balance sheet, the productivity case for putting commercial assets into private hands, subject to competition, is overwhelming. If the political constraint cannot be relaxed, the alternative of divestment by direct distribution of shares to households should be seriously considered. Regardless, the government should seek to maximise the degree to which new spending on infrastructure (eg broadband) leads to competitive private ownership rather than more state ownership.

6 Taxation

6.1 ***Its the spending, stupid!*** The burden of taxation on an economy is best measured by the current government spending burden. What the government spends largely has to be met from current or future taxation because any borrowing must be repaid. Tax cuts not funded by spending cuts are future tax increases. The projected core Crown operating spending ratio of 35.5 percent of GDP in 2010 is a better indicator of the ongoing burden of taxation than the revenue ratio of 32.4 percent. The chart in Annex VI provides more details.

6.2 It follows that the recent 'tax cuts' − in conjunction with spending increases − are really a net increase in the future tax burden. They are largely funded by the reductions in operating surpluses. People's consumption plans are mainly based on their expected permanent income, so the higher tax burdens they will expect to face are likely to dampen any increases in household consumption.

6.3 Moreover, the previous government's tax cuts, and to a slightly lesser extent those of the current government, are largely focused on income redistribution rather than economic growth. Cuts in high marginal tax rates are the most important in respect of incentives for savings, investment and growth. The top personal tax rate is only falling from 39 to 37 percent. The National, ACT and United Future parties are all committed to achieving a top rate structure of 30 percent for personal, company and trust tax rates. The Treasury has also endorsed such a goal. We believe it could be achieved within this parliamentary term given rigorous fiscal discipline, and that the ceiling needs to be reduced over time to promote faster growth.

6.4 We support the changes the government has announced on provisional taxation and use of money interest rates. However, we do not favour ongoing ad hoc changes which are sometimes advocated, such as allowing accelerated depreciation. We believe funds available for revenue reductions should be applied to moves towards a lower, flatter and simpler tax structure as a priority, and towards removing rather than expanding tax concessions.

6.5 We also consider that the government should be transparent about its tax expenditures, which have grown substantially in recent years (the R & D tax concession and the PIE scheme are examples). These are equivalent to expenditure programmes but are delivered through the tax system and escape parliamentary scrutiny. The Australian government publishes a list of its tax expenditures, with costings where possible, as part of its annual budget. We have been urging the Treasury to do likewise in keeping with its commitment to 'world's best practice' in financial management.

7 Regulation

7.1 ***New Zealand must improve on its 65th ranking in the world for the burden of regulation***.[31] Regulation is crippling economic efficiency, adaptation and flexibility. Claims by the Treasury and the Ministry of Economic Development that New Zealand's regulatory framework is in good shape show no recognition of these burdens on the private sector.

7.2 We suggest a three-part approach needs to be taken to regulatory problems:

(i) **Low-hanging regulatory fruit**

There is a raft of regulatory reform initiatives that would give firms and households quick, visible gains in terms of cost and convenience. They include such things as pharmacy ownership rules, weight restrictions on heavy vehicles, holidays legislation affecting restaurants, cafes and the tourism industry, and compulsory student association fees. We believe a series of "rolling maul" reform packages covering such items over two years or more could make major inroads into regulatory burdens.

(ii) **Reviews of 'big ticket' regulatory issues**

These should include in our view:

- ***The Resource Management Act*** The current review of the Resource Management Act and the longer-term RMA reform programme are top priority issues. The Act is a major burden for firms, households and government, and an obstacle to the necessary switch of resources from non-traded to tradable activities. The initial decisions on short-term amendments are a good start. Desirably the longer-term review should overturn the RMA's anti-growth presumptions[32] and look at options for building a better statute on a common law framework.

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31 The World Bank's *Doing Business* report has ranked New Zealand 2nd in the world for the ease of doing business. However, 'hard' indicators such as the number of procedures required to start a business are of limited value in assessing the burdens imposed on businesses by complex and intrusive regulation. The World Economic Forum's *Global Competitiveness Report* uses some information from the World Bank's report, but it supplements it with information from its worldwide Executive Opinion Survey. It points out that executive perceptions are what matters for decision making. In 2008 its survey had 43 New Zealand respondents.

32 It puts the onus on the productive to obtain a consent. In contrast the common law approach would put the onus on a plaintiff to prove a common law harm.

- ***Building regulation*** This area is again in need of a fundamental review to reverse the over-reactions to the leaky homes problem. As with the RMA, the establishment of a private sector advisory group may be the best way to address this task.

- ***Climate change*** Under the last government, climate change policies seriously impacted on forestry, and were shaping up to damage trade-exposed industries and electricity. This issue remains a serious threat to productivity. Policy seems likely to remain in disarray in the absence of a competent regulatory analysis of the issues. The business community at large supports further actions on climate change now that Australia has joined the Kyoto Protocol, but believes they must not impose undue economic burdens. The Business Roundtable favours a low, revenue-neutral carbon or energy tax with a subsidy for carbon sinks and exemptions for trade-exposed industries, at least until such time as a liquid international trading market develops. The ultimate decisions should not be taken until after this year's Copenhagen meeting and final decisions are taken in Australia, and should be more modest in scope than Australia's given our lower per capita income levels.

- ***Employment law*** The re-regulation of the labour market in recent years – including in areas like holidays legislation – has made the economy less flexible and less well able to handle the structural changes required. As in the 1980s, an unnecessary increase in the level of unemployment is in prospect. The labour market is a key market in the economy, accounting for over 60 percent of the total costs of production, and inflexible arrangements are an obstacle to productivity growth. The government's move to introduce a 90-day probation period for new employees in small firms is a step in the right direction, but there is no logic in the restriction to small firms and desirably any dismissal provisions in contracts should be a matter for voluntary negotiation (like wages and other working conditions). As with other issues, we suggest a private sector task force should be established to recommend additional ways of improving employment law.

- ***Network industries*** The demise of light-handed regulation in electricity and telecommunications has been associated with an enormous growth in bureaucracy, confusion about objectives (efficiency versus redistribution) and problems of governance. Productivity growth is likely to have slumped in these areas. We recommend that the government seek independent advice on improved regulation in these industries and review the need to retain the Electricity Commission, the Telecommunications Commissioner and the Energy Efficiency and Conservation Authority. We also recommend a fundamental review of the Commerce Act and the Commerce Commission.

- ***Transport*** New Zealand transport legislation no longer has the prime goal of ensuring that New Zealand has an efficient transport system. We recommend that economic efficiency be restored as the key criterion for decision making, given the government's emphasis on productivity and growth. We are concerned that the renationalisation of rail will lead to uneconomic investment decisions and major financial losses and recommend that KiwiRail and OnTrack be shifted to the private sector as soon as possible.

(iii) ***Establish a regulatory constitution***

In order to create stronger disciplines on regulatory decision making, we and other business organisations have long advocated regulatory responsibility legislation to complement New Zealand's monetary and fiscal constitutions (the Reserve Bank Act and the Public Finance Act). We were pleased with the outcome of the Commerce Committee's consideration of a Regulatory Responsibility Bill last year and urge the government to give high priority to the task force that is to carry on its work. This is the most important regulatory policy initiative the government could take.

8 Infrastructure

8.1 ***Infrastructure should not become a mantra.*** Infrastructure takes diverse forms. Most infrastructure (ports, airports, rail, telecommunications, electricity, gas etc) is best provided by the private sector. The key issue for roading and water is to treat them like other utilities and establish commercial structures for their operation. There is not a pattern of universal under-investment in infrastructure. In the port industry, for example, there has been over-investment in recent years, with the result that rates of return on investment have been very poor. The current imperative is port rationalisation.

8.2 The case for boosting infrastructure investment in response to the current downturn is not strong. Sound infrastructure planning often requires long lead times, and projects should not be turned on or off like a tap. A similar response led to the Think Big debacle in the 1980s, and to Japan's 'lost decade'. Infrastructure spending is capital spending, as opposed to operating spending, and the only criterion that should matter for investment is profitability or rates of return. Where these are high (eg high benefit: cost ratios for road projects) they should proceed. However, we suspect that some major projects (eg some of the options for Waterview and Transmission Gully) and many rail projects (including rail electrification in Auckland) do not meet economic criteria and if so they should be rejected.

8.3 ***Broadband evaluation?*** The government will demonstrate its approach to assessing value-for-money in government spending when it publishes a detailed justification for its proposed $1.5 billion spending on broadband. We think the broadband issue is in many ways an example of one intervention that was not properly justified (unbundling) begetting another (use of taxpayers' money because the problem remained). We are aware of expert opinion that a much more cost-effective solution would be greater use of wireless and less laying of fibre (which is already extensive in the main cities). The government should make a virtue of shifting to a better option if one is identified.

9 Monetary policy

9.1 ***Inadequate Reserve Bank accountability*** We have long been concerned that monetary policy is no longer achieving the Reserve Bank Act's prime goal – achieving and maintaining stability in the general level of prices. Consumer price inflation in the 5 years to December 2008 has averaged 3.0 percent per annum – which over a decade would compound to more than 30 per cent – and reached 5 percent in 2008. The inconsistency suggests an underlying malaise in existing arrangements. There seem to be no effective sanctions on the Reserve Bank for its failure to achieve its legislated goal. There is not even the requirement to respond to a 'please explain' letter, which is part of the Bank of England's charter. The current recession promises to bring measured inflation closer to the goal, but there is a real risk that the easing of monetary policy will see a subsequent re-emergence of inflation. In our view there has been excessive instability in interest rates and the exchange rate because of over-active monetary policy.

9.2 We also have concerns about the weak accountability arrangements around the Bank's ability to intervene in the foreign exchange market and to provide deposit and wholesale guarantees to financial institutions, which involve massive taxpayer exposures without parliamentary sanction.

9.3 We agree with the general conclusion of the Finance and Expenditure Committee in 2008 that the framework for monetary policy in New Zealand is sound. Nevertheless, we are concerned about the accountability features of the Reserve Bank Act and suggest they be reviewed. One problem appears to be the successive changes to Policy Targets Agreements which have strayed progressively away from a low-inflation mid-point. One option is to give the Reserve Bank board greater ability to influence those agreements. Another is to reduce the room for debate about what level of drift in the measured rate of inflation is consistent with stability in the prices of goods and services by asking Statistics New Zealand or a qualified statistician to review New Zealand price index adjustments for quality improvements and other factors and report on the likely extent of measurement error. Subsequent Policy Target Agreements should make this estimate the mid-point of any target range for achieving the price stability objective. We would also like to see the Reserve Bank's powers to buy and sell foreign exchange and its prudential regulation powers revisited.

10 Conclusion

10.1 The 2009 Budget will be the first major opportunity for the government to demonstrate that it is serious about its goal of achieving parity with Australian incomes by 2025. It will also be a test of its management of the current economic crisis and its resolve to achieve a structural adjustment in favour of the exposed sectors of the economy and avoid a credit rating downgrade.

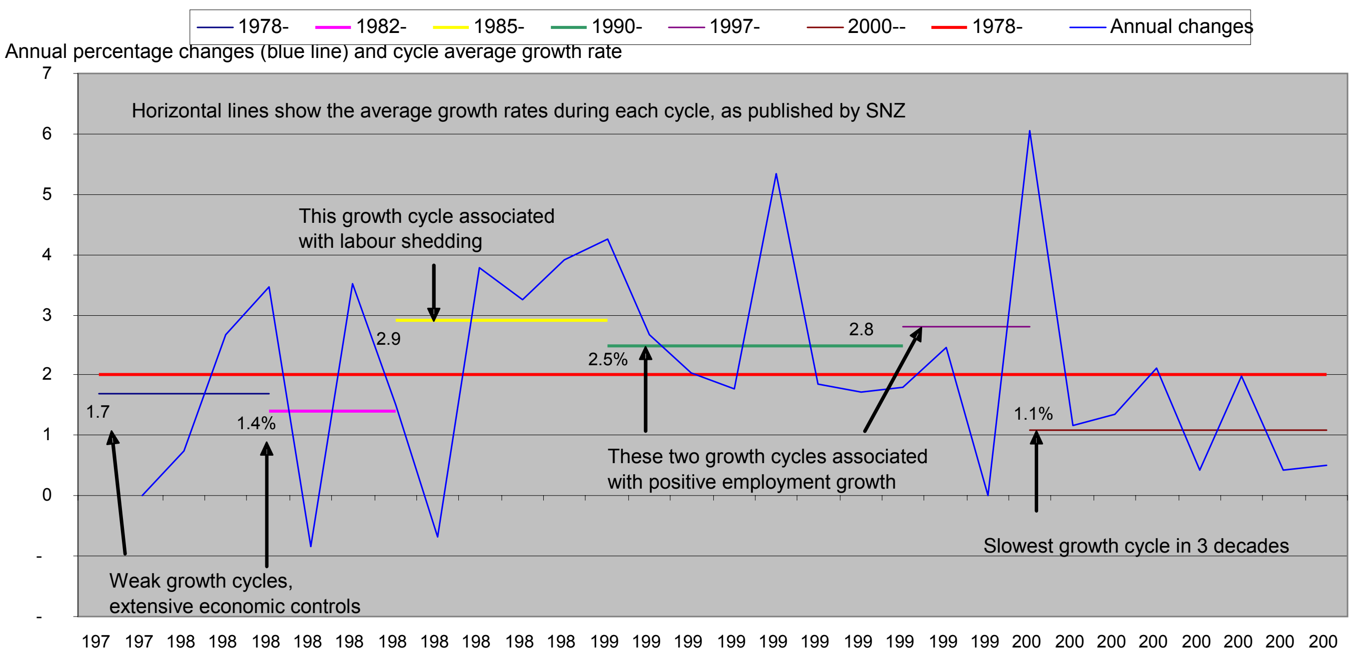
10.2 It took time for data to emerge showing that the previous government was never on track to achieve its goal of getting into the top half of the OECD income range but its policy settings precluded that outcome from the outset, as the Business Roundtable and others repeatedly observed. The big projected increases forecast for the share of government in GDP imply an even worse future performance from the inherited policy settings. The new government is right to signal the need for a new direction, but its measures need to be equal to the task of achieving the 'catching up with Australia' goal.

10.3 Major adjustments to current institutions and policies are required to restore short-term confidence and lift longer-term productivity growth. The government's willingness to adopt stronger fiscal and regulatory constitutions, and to adopt a more limited role for government (focused on public goods and a strong safety net, including underwriting access to services like health and education) will be major tests of policy credibility. We think that MMP is an institution that has contributed to lower quality policy making and welcome the government's plan to give voters another say on it.

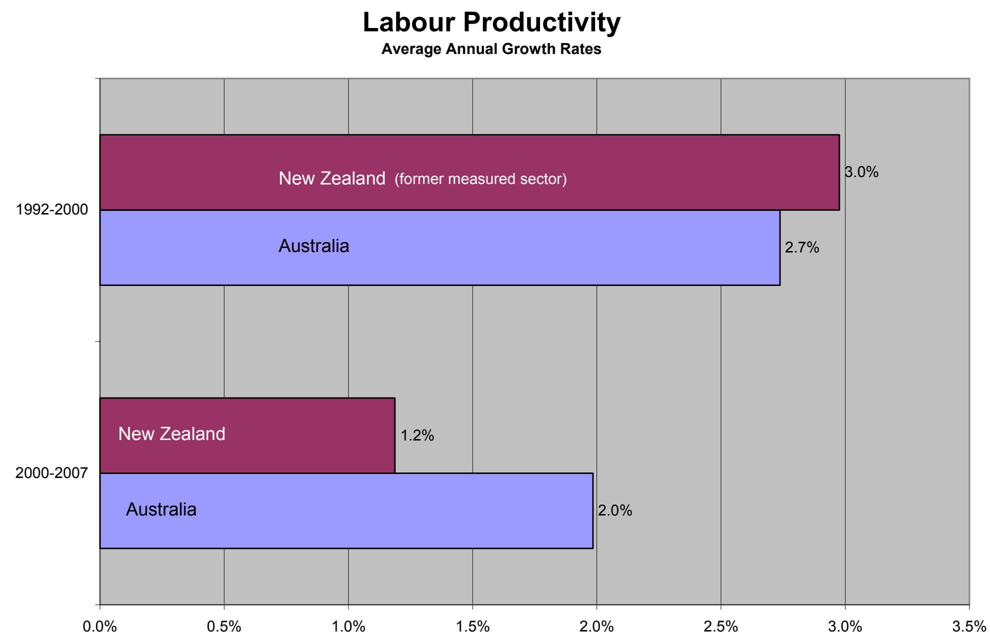
10.4 There has been widespread agreement that the process of submissions and hearings on successive Budget Policy Statements has not been a meaningful one. Important organisations – Business New Zealand for one – have stopped making submissions. We think the process could be improved if the government were subsequently to respond publicly to submissions and engage with submitters on major issues, and we suggest the Committee recommends accordingly.

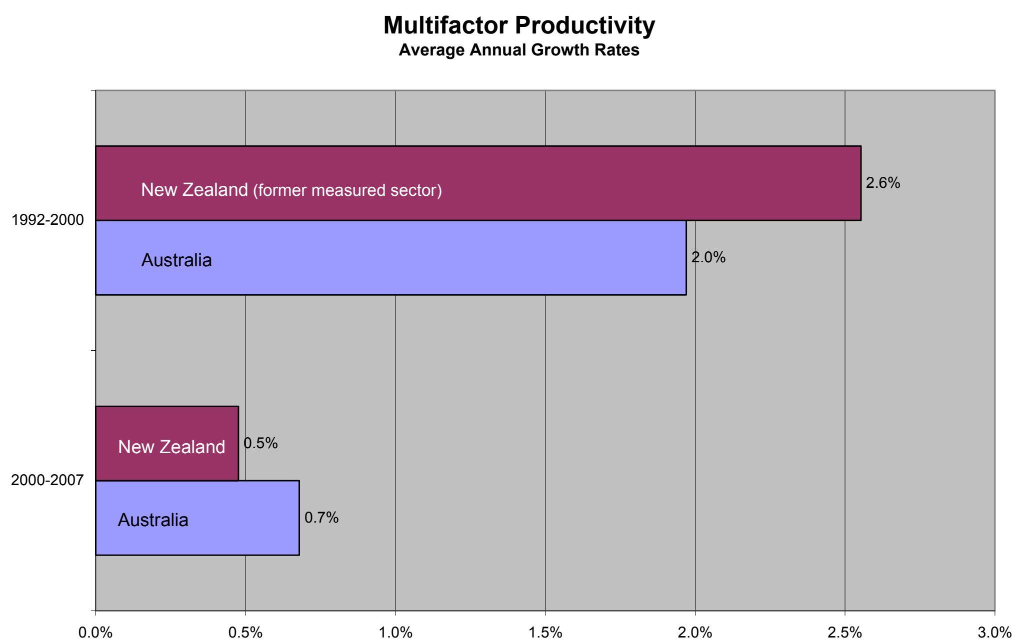
Annex I

Labour Productivity Growth



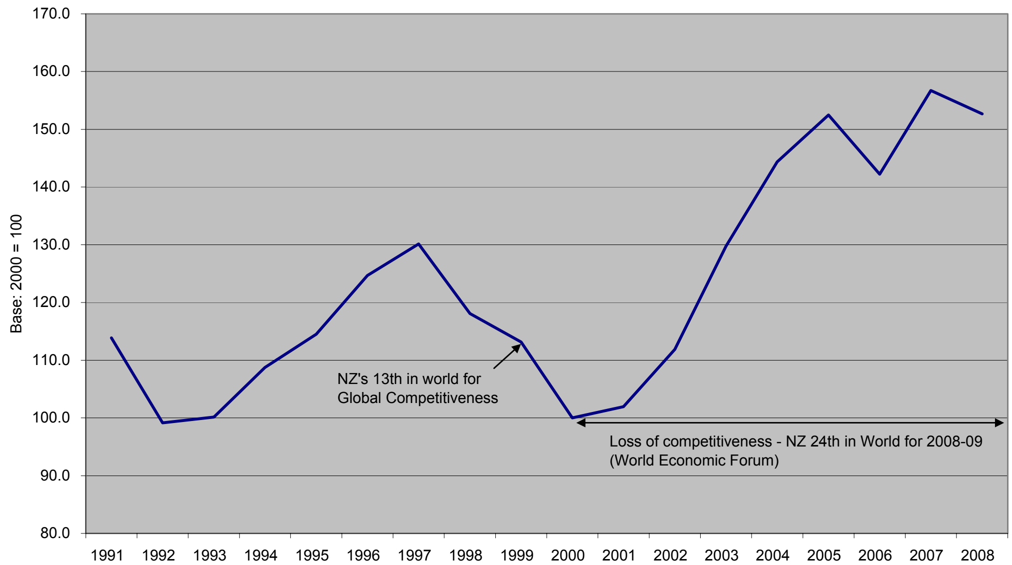
Annex II


Labour Productivity
Average Annual Growth Rates
New Zealand (former measured sector)
3.0%
1992-2000
Australia
2.7%
New Zealand
1.2%
2000-2007
Australia
2.0%
0.0%
0.5%
1.0%
1.5%
2.0%
2.5%
3.0%
3.5%


Multifactor Productivity
Average Annual Growth Rates
New Zealand (former measured sector)
2.6%
1992-2000
Australia
2.0%
New Zealand
0.5%
2000-2007
Australia
0.7%
0.0%
0.5%
1.0%
1.5%
2.0%
2.5%
3.0%

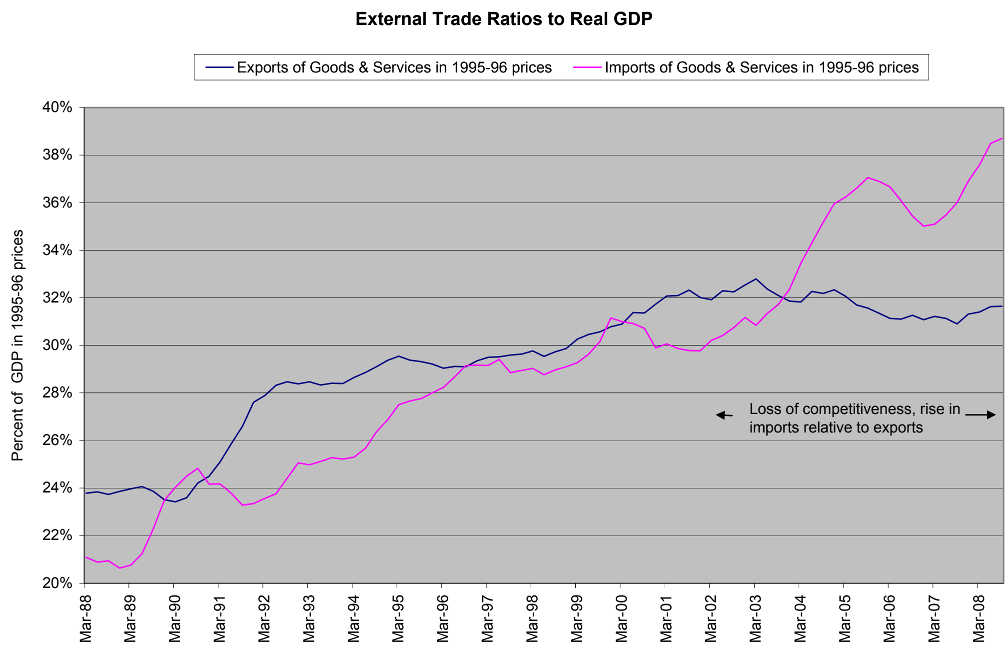
Annex III

New Zealand Competitiveness: Relative Unit Labour Costs
(A rise indicates a loss of competitiveness)



Source: OECD Economic Outlook 84 (2008), Annex Table 43

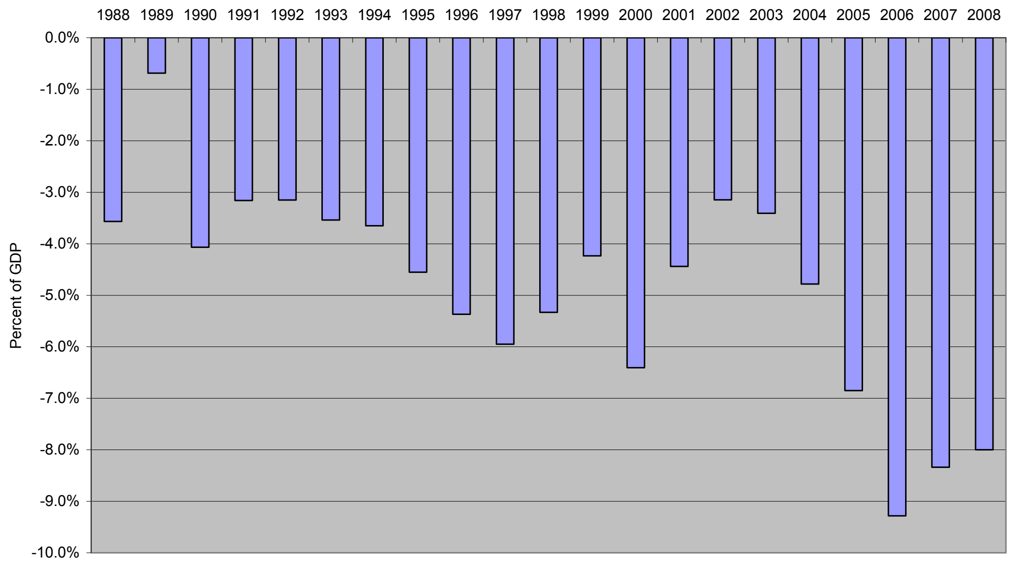
Annex IV



Source: Statistics New Zealand, SNCQ.S4RP60, SNCQ.S4RP61 & SNCQ.S1RB15

Annex V

Balance of Payments Deficits:
Current Account Balance as a Percent of GDP
Years Ended March



Statistics New Zealand: BoP BOPA.S5AC3, GDP (E) SNCA.S1NB15

Annex VI

Appendix: