NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the 2005 Budget Policy Statement

February 2005

1 Introduction

1.1 This submission on the Budget Policy Statement 2005 (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 In this submission, section 2 reviews the BPS's objectives. Section 3 discusses whether the fiscal strategy in the BPS is consistent with those objectives and touches on problems of regulation. Section 4 focuses on the problem of unprincipled and wasteful government spending. It makes a case for a lower and flatter tax structure and greater taxpayer empowerment. Section 5 makes some concluding comments.

2 The BPS's objectives

2.1 The BPS states that:

> The Government's objective is to increase New Zealand's long-term sustainable rate of economic growth and to ensure that the benefits of growth are spread across society.[1]

Both goals are nugatory unless they are accompanied by a competent analysis of their implications for budgetary policy. Such an analysis is important because New Zealand needs to do better on these fronts. First, New Zealand no longer enjoys the status of being amongst the high income nations in international classifications.[2] Secondly, despite – or because of – general government spending of 35-40 percent of gross domestic product (GDP) and extensive regulation of the labour market and education, far too many adults of working age lack basic literacy skills and are languishing on benefits rather than participating in the community through productive and rewarding work. The latest United Nations Human Development Report ranks New Zealand only 23rd for GDP per capita (US$,

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1 BPS, p 1.

2 For example, an OECD publication on purchasing power parities dated 11 January 2005 categorises New Zealand as being amongst the "low-middle income" group. Australia is in the high-middle income group. Only Ireland, Luxembourg, Norway, Switzerland and the United States make the top category.

purchasing power parity) and only 18th for human development (based on 2002 data). In contrast, Australia ranks 11th for GDP per capita and 3rd for human development. It is clear that New Zealand is still a lagging country, both with respect to per capita incomes and to other social indicators.

2.2 Nevertheless, the New Zealand economy is performing much better than in the pre-reform period. A pleasing feature of the BPS is that it unequivocally states:

> New Zealand's recent growth performance can be attributed to past structural reforms that began in the mid-1980s, which have resulted in a trend increase in New Zealand's growth rate since the early 1990s … a more flexible economy better able to absorb adverse shocks and take advantage of favourable shocks, and sound macroeconomic policy settings.[3]

Given this acknowledgement, the government's references to "the failed policies of the past", most recently in the prime minister's 2 February 2005 statement to parliament, can only be taken as misleading political rhetoric. It is also misleading of the government to suggest that the economy's growth performance has improved during its period of office. The BPS notes (p 13) that over the past five years economic growth has averaged 3.7 percent a year, but it also notes (p 18) that:

> Between early 1993, at about the time when a structural change in New Zealand's trend growth started, to now, growth averaged 3.7% per annum …

So the government has not achieved any improvement in New Zealand's trend growth rate. This is despite the fact that economic conditions for New Zealand have been very favourable in recent years with strong commodity prices, good growing seasons, better terms of trade and easy monetary conditions. This contrasts with economic shocks in the second half of the 1990s, including the Asian economic crises and poor climatic conditions.

2.3 Nor are there any indications of a future lift in New Zealand's economic performance. In its last report on New Zealand, the Organisation for Economic Cooperation and Development (OECD)

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3 BPS, p 18.

confirmed this assessment. The report said New Zealand's markedly better economic performance has been "underpinned by the programme of reforms that began almost 20 years ago". It then added:

> The slide in relative living standards vis-à-vis the OECD average seems to have been arrested, but a further acceleration – necessary if New Zealand is to move back into the top half of the OECD ranking … is not in sight.[4]

2.4 The government has consistently stated that returning New Zealand to the top half of the OECD per capita income ladder is its "top priority" goal. This was reiterated as recently as December 2004 when it stated in its social policy document, *Opportunity for all New Zealanders*, that "[t]he Government's economic objective is to return New Zealand's GDP per capita to the top half of the OECD rankings".[5] It is therefore puzzling to note that the BPS is completely silent about this objective, against which the government has to date been happy to measure its performance. In 2002 the minister of finance stated that it would be clear within the next couple of years (ie by mid-2004) whether New Zealand was on the right track.[6]

2.5 It is now apparent that it is not on track.[7] The December Economic and Fiscal Update 2004 (DEFU) projects that after this fiscal year New Zealand's growth in GDP per capita will average only 1.9 percent per annum through to 2009. This is well below the post-1993 average of 2.5 percent per annum.[8] Professional forecasters are sticking with the widespread view that the underlying trend in labour productivity growth going forward is around 1.5 percent per annum. These growth rates are well below those needed to reach the level of incomes of countries in the top half of the OECD within any reasonable period of time (say a decade or two).

2.6 It is equally clear that the government is not on track to achieve the minister of finance's alternative goal of sustained GDP growth of 4 percent per annum. The BPS projects real GDP growth to be in the

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4 *OECD Economic Surveys: New Zealand*, Organisation for Economic Cooperation and Development, December 2003.

5 New Zealand Government, *Opportunity for All New Zealanders*, December 2004, p 11.

6 Hon Dr Michael Cullen, *Daily Post*, 25 May 2002.

7 For further discussion see our 2004 BPS submission.

8 DEFU, table 1.1, p 15 and the text interpreting Figure 1.4 on p 18.

2.4-3.1 percent range in 2006-2009 (as noted, the average since 1993 has been 3.7 percent per annum). It states that budget decisions assume a "sensible" trend rate of growth of 3 percent per annum.[9] In contrast, the BPS projects Australia's GDP growth rate to be in the 3.3-3.5 percent range and our trading partners' average GDP growth rate to be in the 3.4-3.5 percent range.[10]

2.7 In our view it would be better for the select committee and the public more generally if budget documents compared New Zealand's growth rate with other countries in per capita terms. Differences in population growth between countries can seriously distort such comparisons.[11] Given the importance governments have been putting on New Zealand's international ranking for GDP per capita, it would be useful if tables could be included showing recent and likely trends in this ranking on the basis of plausible extrapolations of growth trends in other OECD countries.

2.8 There is little, if anything, in the BPS to suggest that the government is concerned that it has failed to achieve its earlier growth objectives, or that it will take the current objectives any more seriously. It is also meaningless to set objectives if there is no analysis of what needs to be done in order to achieve them.

3 Do the policies in the BPS support the government's objectives?

3.1 The BPS offers no analysis of the likely effects of government spending, taxation and regulation on either of its major objectives. It ignores the advice the government has received in recent years from New Zealand business organisations, competent economic analysts and the OECD on what might be done to improve New Zealand's growth prospects.[12] The thrust of this advice is that the policies that have brought about the recent economic gains are the ones needed to sustain and extend them. What is required, in particular, are

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9 BPS, p 2.

10 DEFU, tables 1.1 and 1.2.

11 Examples in the DEFU of where this would be helpful include table 1.2 and the comparisons with the OECD on page 17.

12 See our 2004 BPS submission.

further gains in economic freedom, in such forms as lower taxes and less business regulation, to foster entrepreneurship and innovation. Why jettison a strategy that has been manifestly successful? The government's course is widely at variance with that of the re-elected Howard government in Australia, which is committed to further privatisation, tax reform, labour market deregulation and welfare policy changes.

3.2 The BPS does not acknowledge the considerable body of research that finds that excessive government can exacerbate poverty by impairing growth in incomes and through family breakdown and poverty traps. Instead, it baldly asserts that the government has taken a number of initiatives to support long-term growth. It particularly mentions export and business promotion, investments in human capital and large capital investments in infrastructure. It also asserts that it has delivered on its social objectives with initiatives to build safer communities, spend more on the environment and housing, invest in public services and capabilities, and introduce the Working for Families (WFF) package.

3.3 All these 'initiatives' involve raising taxes and government spending compared to what they would otherwise be. The BPS provides no reason for believing that the higher taxes and spending will contribute positively to economic growth, or to alleviating the problems of illiteracy, state dependency or poverty (see below for an assessment of the WFF package). It offers no performance objectives for this spending and no value for money assessment.

3.4 The government's commitment to spending regardless of value for money is also evident in the discussion on page 3 of the BPS under the heading "New information shows we have scope to increase spending … ". All the new information relates to increased discretionary cash pouring into the government coffers; none of it is relevant to assessing the benefit to the public of any new spending, relative to the cost.[13] A *DominionPost* editorial summed up recent cases of government largesse as follows:

> [T]his … simply reinforces the unavoidable truth that Prime Minister Helen Clark and Dr Cullen sit atop a pile of unexpected tax dollars and, true to socialist type, know better than those who earned the money in the first place how to dish it out.[14]

We find it hard to escape the same conclusion.

3.5 The absence of any principles for determining government spending is further evidenced by the statement that the long-term fiscal objective for spending is to: "[e]nsure expenses are consistent with the operating balance objective". The long-run revenue objective is to "[e]nsure sufficient revenue to meet the operating balance objective". Neither of these objectives is based on any principles for determining the proper size of government. The BPS suggests elsewhere that a "constant tax to GDP [ratio]" would be a "sensible" assumption, but it does not say why and is silent on the real issue – the principles that should determine the level. All in all, the BPS proposes to increase core Crown expenses (excluding valuation items) arbitrarily by 2 percent of GDP, from 30.1 percent in 2004/5 to 32.3 percent by 2008-9.[15] Since Treasury projects real GDP to rise by 11.7 percent during this period, the implied rise in real spending (GDP deflator) is 18.4 percent. This is a huge increase.

3.6 The BPS's strategy of 'tax and spend' suggests that the government is ignoring the large body of economic research that supports the view that, beyond some point, higher government spending impairs economic performance without necessarily improving other indicators of economic and social welfare. One reason for this outcome is that public sector intervention can displace private institutions and informal arrangements (for example in health and education) that often do a better job. Another is the deadweight costs of taxation, which rise with the square of the marginal tax rate and hamper growth. The latest OECD *Economic Outlook* indicates that total government outlays in New Zealand (central plus local) in 2004 were

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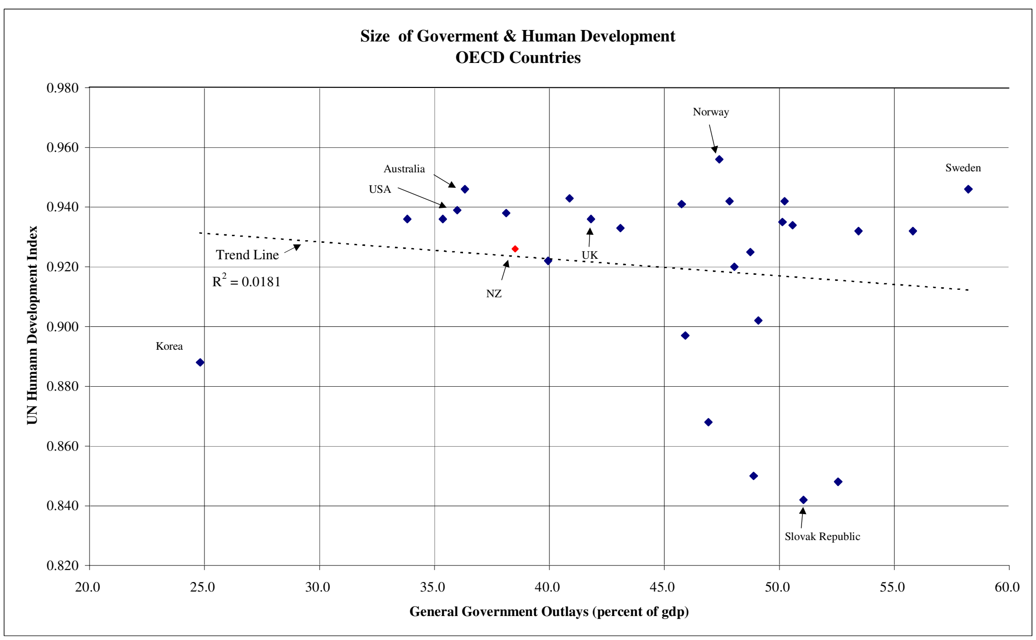
13 This section refers to higher tax receipts and less spending on unemployment benefits as a result of higher economic growth and the boost to revenue from taxing the banks.

14 *DominionPost*, 'State largesse to those not in need', 31 January 2005.

15 The references in this paragraph are to the BPS, pp 9 and 3, and the DEFU, p 40.

38.2 percent of GDP. To add another 2 percent of GDP to government spending, as the government plans, would take the total to around 40 percent of GDP. No OECD country comparable to New Zealand has managed to sustain annual per capita GDP growth of 4 percent a year or more – the rate needed to achieve the government's growth objective – with government spending equal to 40 percent of the economy. It follows that the BPS is almost certainly inconsistent with the government's top priority objective.

3.7 In a recent monograph, former director of the Fiscal Affairs Department of the International Monetary Fund, Vito Tanzi, drew attention to the lack of any identifiable relationship between levels of general government spending (at least once it is beyond 30 percent of GDP) and the United Nations human development index.[16] The following chart (reproduced as Annex I) illustrates his point.



It is obvious from the regression line that the strategy in the BPS of raising government spending as a proportion of GDP cannot be

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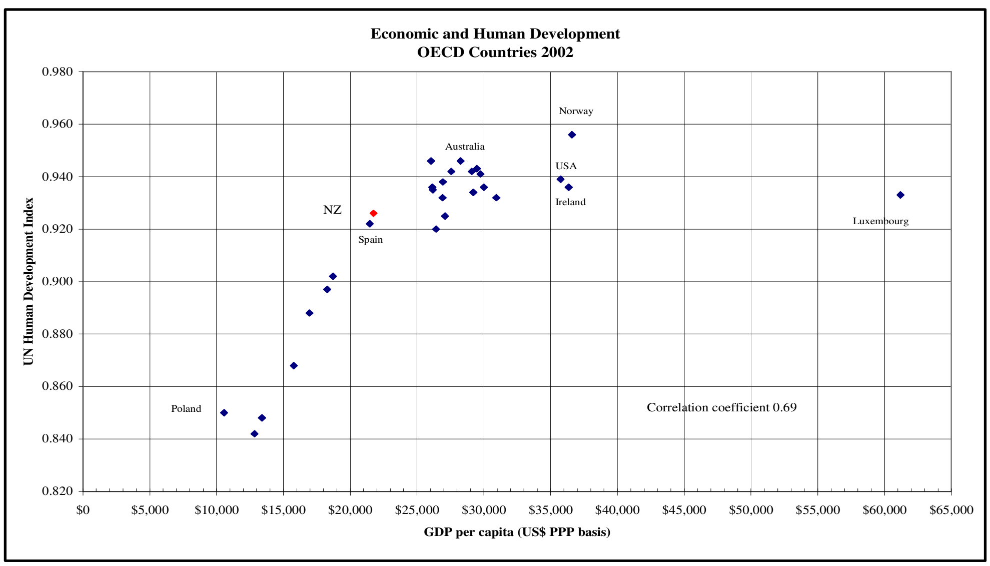
16 Vito Tanzi, 'A Lower Tax Future: The Economic Role of the State in the 21st Century', Politeia, London, 2004. The chart below was prepared using 2002 data from the United Nations and the OECD *Economic Outlook*, December 2004.

expected in itself to improve human development.[17] Note, for example, that Australia has a higher score than New Zealand for human development, along with smaller government. Tanzi observed that:

> All the theoretical reasons advanced by economists to justify the role of the state in the economy, including the need to assist the poor, could be satisfied with a much smaller share of spending in GDP than is now found in most industrial countries if the governments could be efficient and more focused in the use of their resources.

3.8 We would go further. Most policies that are likely to increase economic growth (such as policies to achieve and sustain higher levels of economic freedom) could also be expected to improve the ability of the community to take private initiatives (for-profit or not for-profit) to improve other social outcomes. World Bank research finds that the income of the poor rises "one-for-one" with economic growth.[18] Note also, by way of illustration, the strong positive correlation between per capita income and social indicators in the chart below (reproduced as Annex II).



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[17] The same point could be made in respect of a chart of real income per capita for the same countries plotted against the government spending ratio. The correlation coefficient between the size of government and real GDP per capita is also negative.

[18] David Dollar and Aart Kray, *Growth Is Good for the Poor,* World Bank, 2000.

The BPS appears to assume that policies to facilitate economic growth would somehow impair other indicators of human welfare. We suggest that in the absence of any competent analysis supporting that position, the BPS should adopt the opposite presumption.

3.9 George Mason University economist Tyler Cowen has explained why governments that sacrifice economic growth to other objectives for long periods can seriously harm the interests of future generations:

> The importance of the growth rate increases, the further into the future we look. If a country grows at two percent, as opposed to growing at one percent, the difference in welfare in a single year is relatively small. But over time the difference becomes very large. For instance, **had America grown one percentage point less per year, between 1870 and 1990, the America of 1990 would be no richer than the Mexico of 1990**. At a growth rate of five percent per annum, it takes just over eighty years for a country to move from a per capita income of $500 to a per capita income of $25,000, defining both in terms of constant real dollars. At a growth rate of one percent, such an improvement takes 393 years.[19]

New Zealand's 'experiment' with high levels of welfare spending has been running for over 30 years. It is no surprise to find that 30 years later low incomes in New Zealand, absolutely and relative to incomes in other countries, are a source of concern to many New Zealanders. The government reports that social spending is running at $37.5 billion, or 78 percent of core Crown expenses.[20] A large part of this colossal sum reflects the government's view that it can spend money better than many of the taxpayers from whom it is taken. The most glaring deficiency in *Opportunity for all New Zealanders* is its failure to provide any assessment of whether the government is achieving its stated objectives, let alone whether the spending represents value for money.[21]

3.10 Our concerns that the policies in the BPS will fail to achieve the government's objectives can be illustrated by reference to spending on health and education and on the WFF package. The BPS reports that real per capita health and education spending have been rising by around 5 percent and 3 percent per annum respectively since

19 http://www.marginalrevolution.com/marginalrevolution/2004/08/why_the_growth_.html

20 *Opportunity for All New Zealanders*, *op cit*, p 2.

21 At a rough count, *Opportunity for All New Zealanders* devotes 32 pages to telling readers what the government is doing and none to assessing whether its activities are providing value for money, or indeed any net value for the community as a whole. The implied approach is that the worse the outcomes, the stronger the case for spending even more money.

1999.[22] We are not aware of any evidence that this money is improving outcomes materially, let alone that it is providing value for money. The fundamental remedies for problems in these sectors – competition, choice, and customers who control the purse strings – are lacking. The government appears to oppose private initiatives and voluntary arrangements out of some mixture of expediency and ideology. Yet pouring money into unsound structures is a recipe for waste and for cost inflation (non-tradeable goods inflation is running at close to 5 percent).[23]

3.11 The government's WFF scheme is a major spending initiative. The fiscal cost is expected to be $1.1 billion a year when fully implemented. The government's stated goals are to "make work pay", "ensure income adequacy", and "achieve a social assistance scheme that supports people into work".

3.12 We believe that it will fail to achieve the first objective. It contains few measures likely to reward additional work. Treasury's costing of the package for the 2004 Budget assumed that just 2 percent of sole parents will move off the domestic purposes benefit and into work, with no net change for couples.[24] On this basis we estimate that the cost of each job could be about $84,600. The second objective is meaningless in the absence of any agreement about what level of support is adequate. The claimed reduction in child poverty is an artefact of the arbitrary benchmarks that measure income relativities. It would be a simple matter to restore the original poverty levels by redefining the benchmarks. Arguably, problems of child poverty and income insufficiency amongst adults of working age and their children arise primarily from broken or unformed relationships, teenage pregnancy, inadequate education levels, and an inability to get a job and keep it.[25]

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22 BPS, p 7.

23 DEFU, p 21.

24 Michael Cullen and Steve Maharey, 'Reform of Social Assistance: Working for Families Package', paper for Cabinet Policy Committee (undated), p 22.

25 American researcher Charles Murray has observed that it takes only three things to avoid poverty: finish high school; get married and stay married; and get any sort of job and stay employed.

3.13 As is so often the case with government transfer payments, the package is poorly targeted and takes money with one hand in order to give back with the other, impairing incentives along the way. A third of the funds will go to families earning over $35,000 a year (after tax), including middle and upper income households. A key weakness is the extension of high effective marginal tax rates further up the income distribution. To the extent that the package extends the poverty trap through high effective marginal tax rates, it will exacerbate the problems of state dependency, alienation, family breakdown, and low productivity. All these things would be contrary to both the goals enunciated by the government in the BPS.

3.14 In summary, the BPS makes no case that the government's 'tax-and-spend' policies are consistent with its major objectives. Further, its presumptions run counter to a considerable body of economic reasoning and evidence on the benefits of private enterprise, competition, consumer empowerment and voluntary arrangements.

3.15 Although the BPS mainly focuses on the government's spending and taxation plans, its regulatory policies are also very relevant to its aspirations for faster economic growth. New Zealand has scored well in the indexes of economic freedom and other surveys for the quality of regulation and ease of doing business. However, it is now tending to fall back, which augurs badly for future growth. Business Roundtable member Roderick Deane has recently stated that:

> The most difficult problem facing New Zealand boards is the extent of regulation that's been introduced into New Zealand in all manner of ways over the last few years. Those regulations encompass the capital and security markets, changes in accounting standards, changes to securities law, the Commerce Act, the labour relations area, specific industry regulation and Kyoto requirements. There's been a huge increase in detailed regulatory interventions by this government which are really just starting to accumulate, and I think have become burdensome for boards. In many cases these initiatives are well-meant but they become so overpoweringly detailed they become a distraction from getting on with commercial life … That would be one of the major problems companies face today. Excessive regulation reduces the adaptability and flexibility of the business world, and it's the business world after all that generates growth.[26]

We endorse Dr Deane's observations. We are particularly concerned about the adverse effects of ill-conceived employment, environmental

[26] *Wellington Today*, February-March 2005.

and network industry regulation on investment, employment and growth. In our view, stricter disciplines on regulatory policy-making are needed, in particular much better quality control of Regulatory Impact and Business Compliance Cost Statements and an over-arching Regulatory Responsibility Act.[27]

4 A principled approach to government taxation and spending

4.1 What is required for good government and sound fiscal policies is principled consideration of the circumstances in which governments might be able to spend money better than taxpayers could spend it for themselves. Many researchers have found that the deadweight costs of taxation are significant. At the same time, spending programmes distort behaviour in undesired ways. Both factors usually make government spending more inefficient than private spending. This is why policies that tax middle or higher income earners with one hand and subsidise them with the other (middle class 'churning') are likely to impair community welfare.

4.2 Economists usually postulate that government spending could be more efficient than private spending and voluntary action in the case of a limited number of public goods, most notably defence and law and order, and, more controversially, a basic welfare safety net. Tanzi has observed that:

> *First,* there is now broad agreement among economists that the state should not be engaged in the production of goods and services that can be produced by the private sector or can be imported. Thus, the state should be completely out of such activities …
>
> *Second* … it is unlikely that there are still 'natural monopolies' that justify public ownership and operation for businesses such as airlines, railroads, generation of electricity, communication in its various aspects, and other areas.[28]

There should be a greater role for private and voluntary arrangements in health and education. Tanzi notes that some well-functioning countries do not spend more than 20 percent of GDP on public

27 See *Constraining Government Regulation*, New Zealand Business Roundtable, December 2001.

28 Tanzi, *op cit*, p 20. See also p 9.

programmes and he considers that governments generally need not spend more than 30 percent (central and local) to satisfy fundamental social objectives. In New Zealand's case, history and current spending patterns on core functions (particularly defence) suggest that general government current spending of 10-15 percent of GDP would suffice to cover these activities. Allowing for a modest welfare safety net would increase this, perhaps to around 20 percent of GDP – a figure below that suggested by Tanzi.

4.3 In our 2004 BPS submission we reported OECD advice concerning some commonsense questions about government spending programmes that should be asked and answered in assessing whether they were likely to provide value for money for the community. To the best of our knowledge the government has ignored what the OECD considers to be best practice. We could find no evidence in the BPS of any interest in subjecting government spending to any value-for-money test.

4.4 Since our 2004 BPS submission we have published a report evaluating the first decade of experience with the Fiscal Responsibility Act 1994. A copy of this report, *Restraining Leviathan: A Review of the Fiscal Responsibility Act 1994,* by Bryce Wilkinson is enclosed as part of this submission. Dr Wilkinson found that the Act had played a useful role in helping achieve and sustain fiscal balance. However, it has done little to curb wasteful spending.

4.5 The Report reviewed the recent debate between economists in New Zealand on whether taxes and wasteful spending impair prosperity. It found that there appeared to be agreement with research findings from overseas that reducing taxes (particularly income tax) and wasteful spending (particularly spending on transfer payments) could add perhaps 0.5 percent per annum to the growth rate over a 10 to 25 year period for a spending reduction of 10 percentage points of GDP (eg a reduction in the government spending ratio from 40 to 30 percent.)

4.6 The Report reviewed many measures that have been advocated and tried in various jurisdictions for constraining wasteful spending. We draw the select committee's attention to two options it canvasses: a flat income tax structure and greater taxpayer empowerment over taxing and spending decisions.

A flat tax

4.7 The McLeod Review of the tax system argued for a lower and flatter income tax structure. In April 2004, the Treasury published an assessment of growth policy issues for New Zealand. In a tax context, it considered that:

> … moving to a flat tax rate for both personal and corporate tax rates is likely to have the greatest impact on economic growth as it conforms most closely to the [broad-based – low rate] principle. While in-depth analysis of this option has not been undertaken by Treasury, theory and some empirical evidence suggest a positive effect for economic growth.

It is of considerable concern that such a promising option has not been investigated in detail, since raising economic growth has been at the top of the government's economic priorities since the 1999 general election. A Treasury paper provided to ACT MP Rodney Hide estimated that, on certain assumptions, a tax cut of the type recommended in the McLeod report would, at a revenue cost of about $5.6 billion, add 1.5 percent to economic growth in the medium term.[29] Finance minister Michael Cullen has repeatedly denied that lower tax rates would improve New Zealand's long-term economic growth rate. We suggest the Finance and Expenditure Committee should take the opportunity of Dr Cullen's appearance before it on the BPS to seek a detailed explanation of why he rejects Treasury and other orthodox research findings on the effects of tax on growth.

4.8 The Treasury did not comment on the "other welfare implications" of moving to a flat tax rate. This omission is unfortunate since many think that a single tax rate would benefit the rich at the expense of the poor. In fact, in the very static textbook sense in which this argument is made, a progressive tax rate hurts the poor and the rich compared

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[29] Rodney Hide, 'Treasury report undermines Cullen on tax cuts', media release, 29 December 2004.

with a single rate of tax with a rebate for low income earners.[30] Expressed differently, a single rate of tax with this feature will help the poor and the rich (for the same revenue) relative to a progressive tax rate structure. The current progressive structure also penalises low-income people who aspire to be better off. The McLeod review found that income distribution objectives are best pursued through government spending on social welfare, health and education, not from escalating taxes. As already noted, much government spending goes to those who are already well off. Corporate welfare is a particularly egregious case, but much greater sums are spent on policies such as highly subsidised tertiary education for already well-off families.

4.9 Policies to alleviate poverty need to be assessed in a dynamic context. Economists expect the burden of the tax system to be shifted around by supply and demand effects. The burden may not fall where people think it falls. It may be passed on through higher prices or wages.[31] In particular, economists would not expect the burden of a progressive tax system to fall on people who can readily find equivalent jobs overseas. Another important point in a dynamic context is that people commonly start life on low incomes (eg as students), earn much higher incomes during the peak of their working careers, and rejoin the ranks of low income earners in retirement. A progressive tax structure transfers income over the lives of taxpayers and greatly complicates the tax system, for no obvious benefits for people with such an earnings profile. Perhaps the most important point in a dynamic context is that by fostering economic growth, a flat tax is likely to lift more people out of the ranks of the poor.

4.10 Hong Kong and Singapore are countries with very flat tax structures. Russia has introduced a flat tax of 13 percent, and Estonia, Latvia, Lithuania, Serbia, Ukraine, Slovakia, Georgia and Romania all have relatively low flat taxes. A flat tax is actually progressive when non-financial forms of well-being are taken into account, and it is

[30] See Cathy Buchanan and Peter Hartley, *Equity as a Social Goal*, New Zealand Business Roundtable, 2000.

[31] This is one reason why central planners cannot dictate the distribution of income in a market economy.

constitutionally more desirable than a formal progressive structure in that all those who benefit from spending programmes contribute some amount to them.

4.11 In its submission to the McLeod review, the Business Roundtable said that New Zealand should aim to reduce personal and company tax rates to a maximum of 25 percent in the medium term. We understand that officials have estimated the fiscal cost of such a reduction to be of the order of $3.6 billion, ignoring the likely increase in tax revenue from the faster economic growth and reduced tax avoidance would generate. It is easy to see that such a policy would be readily affordable. Although not all the comparisons are on an 'apples for apples' basis, the sum of $3.6 billion can be compared with:

– new operating spending for 2005/06 of $6.8 billion as a result of decisions in the 2003 and 2004 budgets and the planned $2.1 billion of new spending for that year in the 2005 budget;

– the government's plans for new operating spending averaging $5.1 billion a year over the three years 2007-2009;[32]

– the current operating surplus, which is projected to run at $6.5 billion in the current year;

– the headroom that would be created within a few years by the introduction of a fiscal rule along the lines discussed in the next section; and

– the large boost to GDP from such a reduction in tax rates.

None of these sources would require reductions in government spending, although cuts to wasteful and poorly targeted spending would create room for additional tax reductions. Extra room would be created by ceasing payments into the New Zealand Superannuation Fund, which we oppose for reasons set out in previous BPS submissions. (The Fund's current assets should be used to repay debt.)

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32 DEFU, p 89.

4.12 In our view a general move to a lower and flatter tax structure is greatly to be preferred to selective tax concessions and other forms of government assistance. The government is reported to be looking at measures to assist with retirement savings, home ownership, tertiary education costs and business investment in short-lived assets. There are also perennial calls for tax concessions or the like for health insurance, childcare, R & D expenses and many other 'good things'. All of these reflect the view of interest groups or politicians that 'government knows best' how to benefit the community at large. This is implausible: people have different preferences and needs, and they vary over their lifetimes. Such an approach makes the tax system more complex and costly to administer, and means marginal tax rates have to be higher because of the revenue costs of concessions. Many such concessions (eg for savings or home ownership) benefit primarily those on higher incomes rather than poorer people. They may also be ineffective (eg tax concessions for retirement savings tend to alter the pattern of savings rather than increase the aggregate amount) or have perverse effects (eg concessions for home ownership drive up house prices).[33]

4.13 New Zealand once had a tangled web of tax incentives of this type, coupled with high marginal tax rates to raise necessary government revenue. It was abandoned in favour of a broad-base, low-rate tax policy. This allows people more scope to decide for themselves what is good for them, whether it be home ownership, health insurance, retirement savings or childcare. The best incentive for savings is simply lower income taxes because the income tax, unlike a consumption tax, penalises saving. Similarly, a cut in company (and personal) tax would be of more benefit to businesses than selective tax preferences (eg accelerated depreciation). Such an approach also makes for a much less distorting tax system that does more to encourage economic growth. Other countries have moved in a similar direction. The OECD has strongly advised the government against moving back to selective tax arrangements, and we concur

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[33] In Australia, many well-off families are reported to have obtained grants for first home ownership by buying properties in the names of their children.

with its advice. The coherence and integrity of the tax reforms of the 1980s and 1990s could be greatly weakened by a series of mistaken initiatives over a period of time, as experience in the United States has demonstrated. Getting personal and company taxes down to a maximum rate of 25 percent would avoid this risk, make New Zealand 'stand out from the crowd' relative to other OECD countries, and give a major boost to the economy. The remarkable economic success of Ireland, with a company tax rate of 12.5 percent (half the rate we have proposed) illustrates the power of tax reductions.

Voter empowerment over taxes and spending

4.14 The government shows no sign of commissioning any competent independent assessments of whether it is spending taxpayers' money wisely. This is a worldwide problem, and *Restraining Leviathan* reviews at some length one promising approach to empowering taxpayers that has been tried elsewhere, particularly at state level in the United States. Currently in New Zealand voters get only one chance every three years to influence fiscal policy. Under the proposed approach they would also get a chance to vote if a government wished to increase spending or taxation at a faster rate than inflation and population growth. In addition they would get a chance to vote directly on new taxes or material changes in the tax base. Governments would also be required to return surplus revenues to taxpayers.

4.15 If such disciplines had been in place in New Zealand in recent years, either government taxes and spending would have been more restrained or voters would have had opportunities to vote for higher taxes and spending. The chart below (reproduced as Annex III) was prepared after Budget 2004. It shows that by 2008 tax receipts will be likely to have risen faster than inflation and population growth every year since 1999 and spending seems likely to have risen faster than inflation and population growth every year since 2001.[34]

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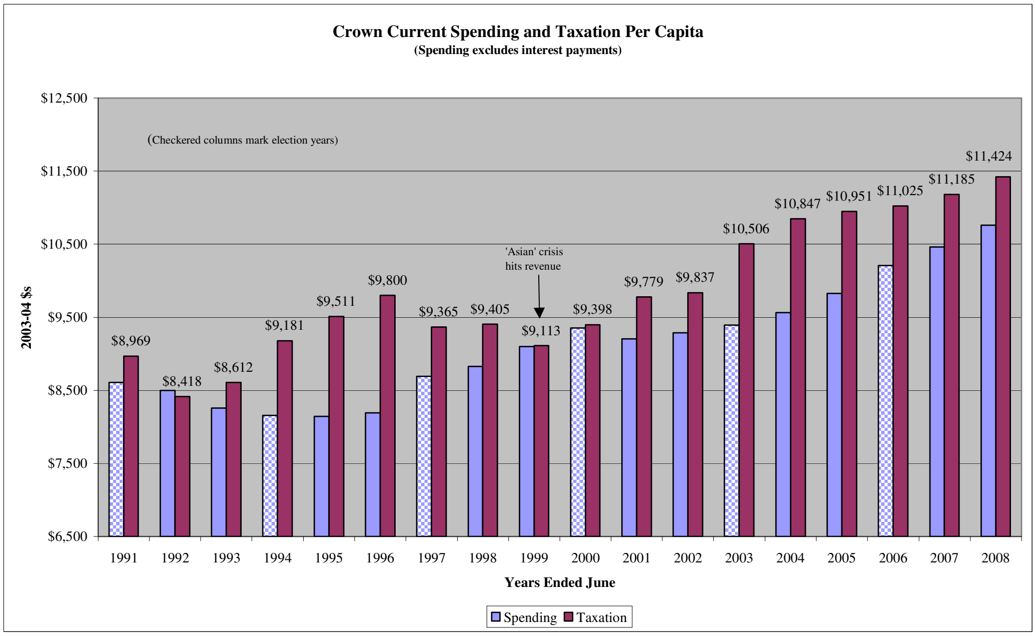
[34] The documents released with the BPS do not allow this series to be updated and extended into 2008-09. We understand that the Treasury hopes to publish the necessary information (which is on a System of National Accounts basis) late in February 2004.

4.16 The above proposal obviously constrains the ability of governments to tax and spend on the unlimited basis that is provided for in the statement of long-term fiscal objectives in the BPS (see paragraph 3.5 above). Households understand the need to live within budgets; governments should be no different.



4.17 The adoption by a number of governments of such fiscal rules is a response to the same conflict of interest that arises in private organisations when people come to vote on matters that could benefit themselves at the expense of others. Governments have acknowledged this problem in the corporate sector by requiring companies to achieve a two-thirds majority of votes for major company transactions. *Restraining Leviathan* suggests that what is sauce for the goose should be sauce for the gander, and proposes that a similar majority should be required when voters are asked to endorse fiscal proposals. It reviews the research that has been done internationally (primarily in the United States) on the efficacy of a fiscal constitution of this type and finds that the outcomes are sufficiently encouraging to warrant serious consideration of the case for introducing one in New Zealand.

5 Concluding comments

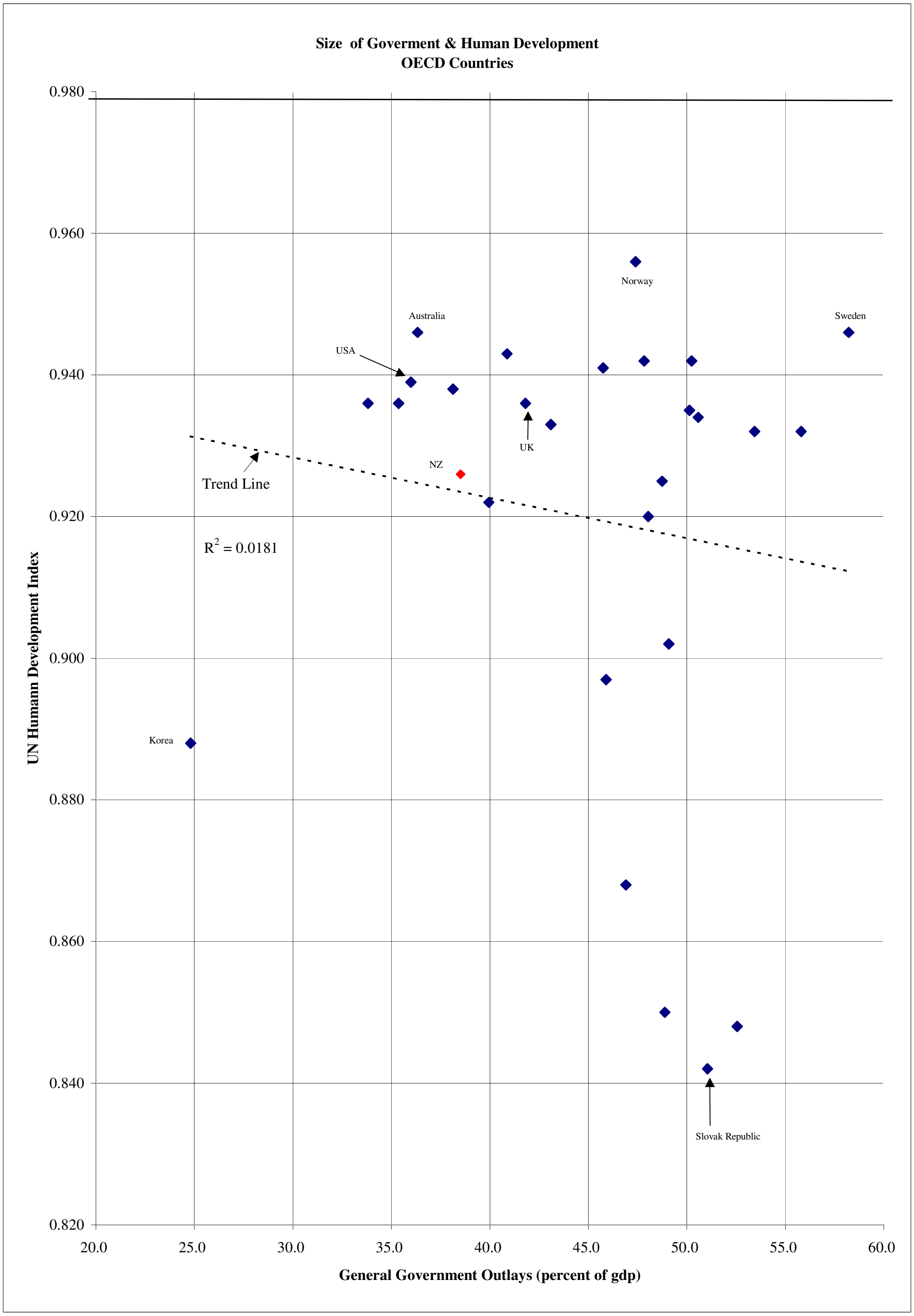
5.1 On our assessment, there is no basis in the BPS for taxpayers to have any confidence that the budget 'tax-and-spend' strategy will contribute positively to the government's stated objectives. On the contrary, a solid case can be made that it is more likely to impair prosperity and thereby put other goals at risk.

5.2 There are two fundamental problems. One is the absence of any analysis of the likely effect of additional tax revenue and spending on the objectives. The other is the failure to put forward any principles for assessing whether new spending is justified or, apparently, to seek any proof that existing spending is achieving the desired results and providing value for money.

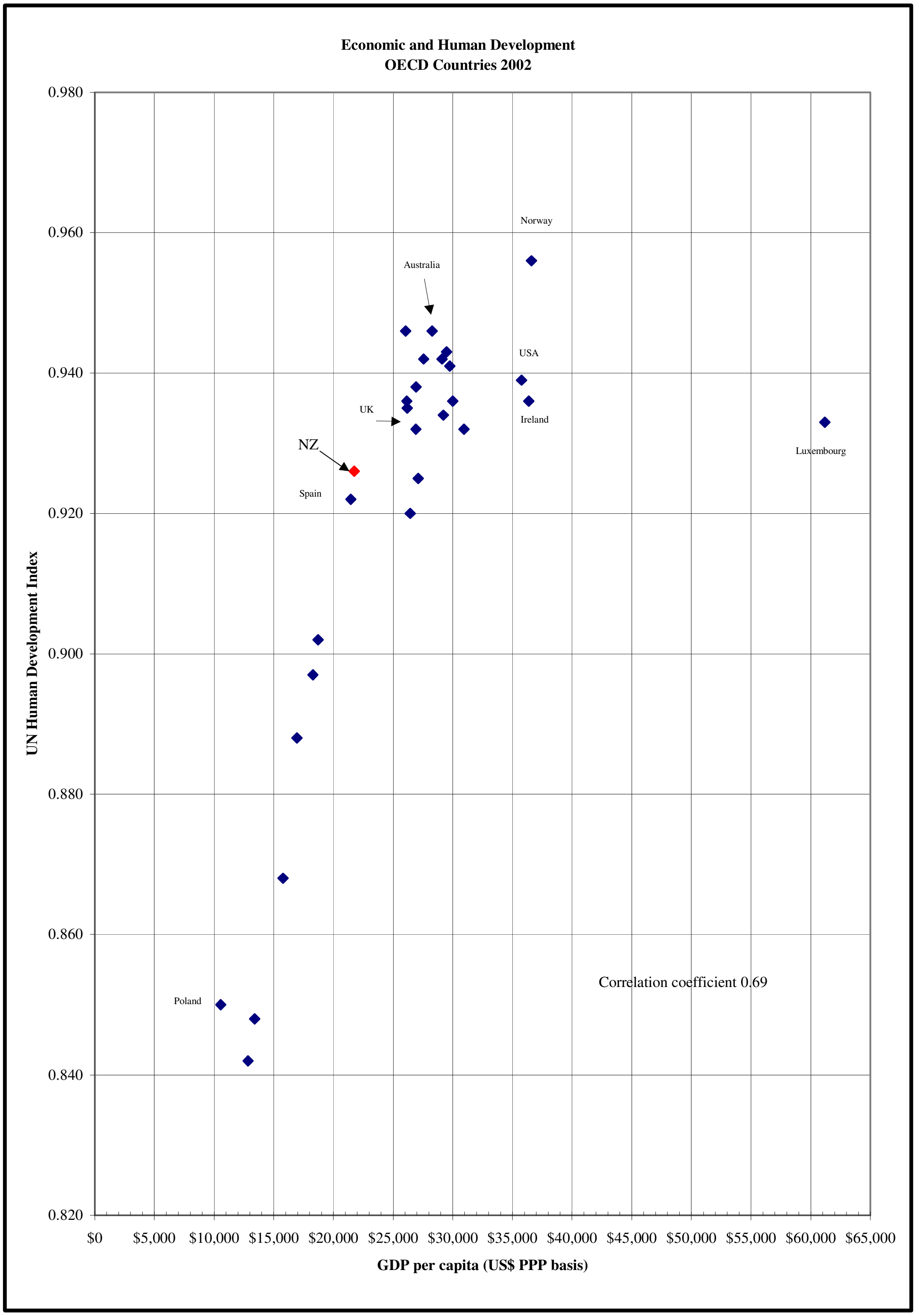
5.3 The Fiscal Responsibility Act was introduced partly to protect both governments and taxpayers against unjustified expenditure arising from special interest lobbying. It has not proven to be robust in this regard. *Restraining Leviathan* suggests, *inter alia*, two main remedies for this state of affairs. First, a single rate of income tax would be more constitutional, promote prosperity and improve equity. It would also slow the flow of funds into the government coffers during periods of inflation or economic growth. Secondly, empowering voters with respect to new or increased taxes, increases in the tax base and excessive revenue or expenditure growth would improve our democracy and help constrain waste in government. The chart in Annex IV illustrates the potential for better control of spending growth to reduce the burden of government when strong economic growth is occurring.

5.4 We also believe the objectives in the BPS require similar disciplines to be imposed on regulatory decisions. Regulation can be as unconstitutional as taxes. Here the principle of compensation for regulatory takings, funded where possible by the beneficiaries of those takings, could improve the incentives of politicians and those lobbying for a regulation to better balance its benefits and costs. Two parties contesting the 2002 general election favoured consideration of a Regulatory Responsibility Act. We would like to see other parties show a willingness to examine the idea in an open-minded way.

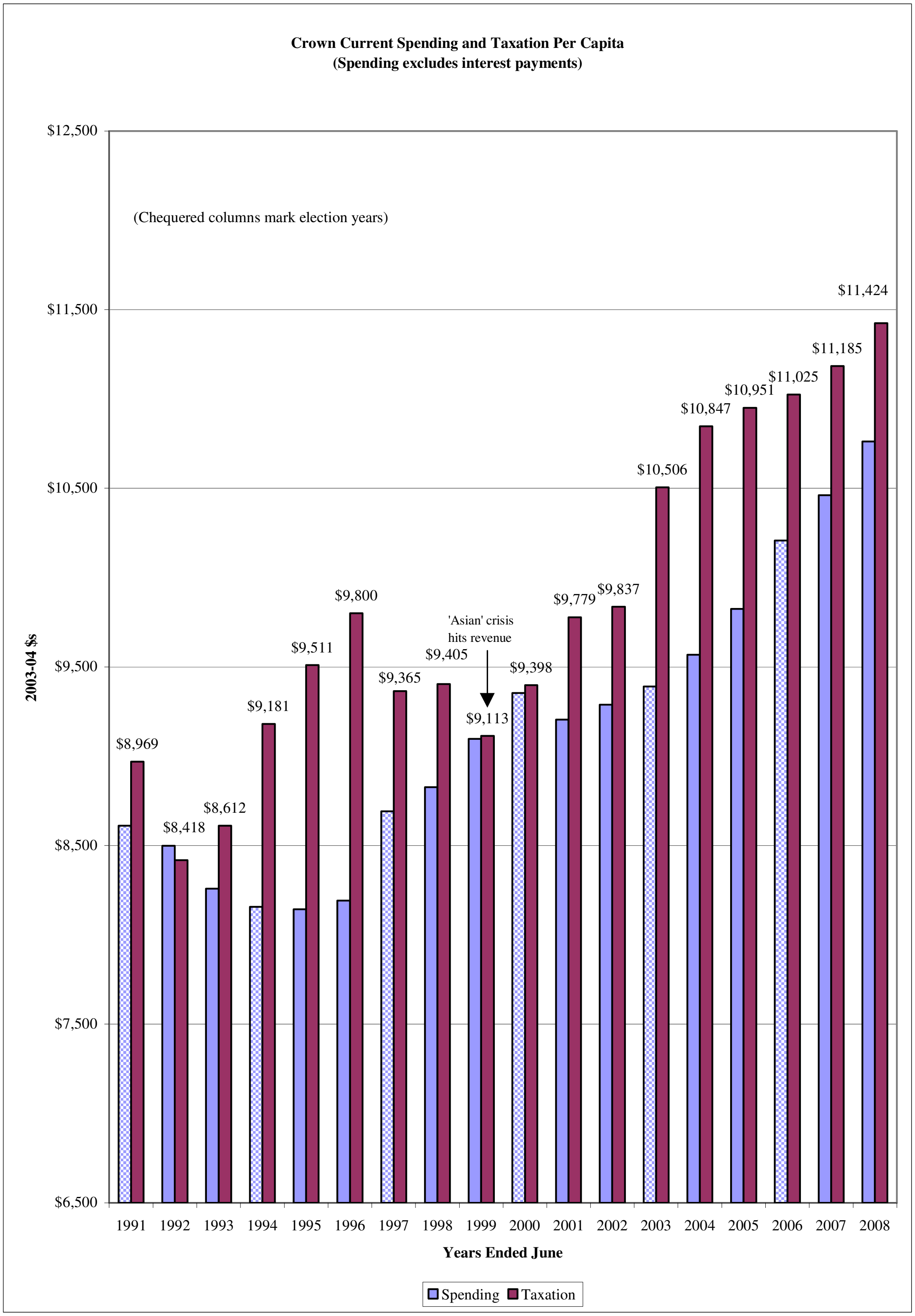
Annex I


Size of Goverment & Human Development
OECD Countries
0.980
0.960
0.940
0.920
0.900
0.880
0.860
0.840
0.820
20.0
25.0
30.0
35.0
40.0
45.0
50.0
55.0
60.0
UN Humann Development Index
General Government Outlays (percent of gdp)
Norway
Australia
Sweden
USA
UK
NZ
Trend Line
$R^2 = 0.0181$
Korea
Slovak Republic

Annex II

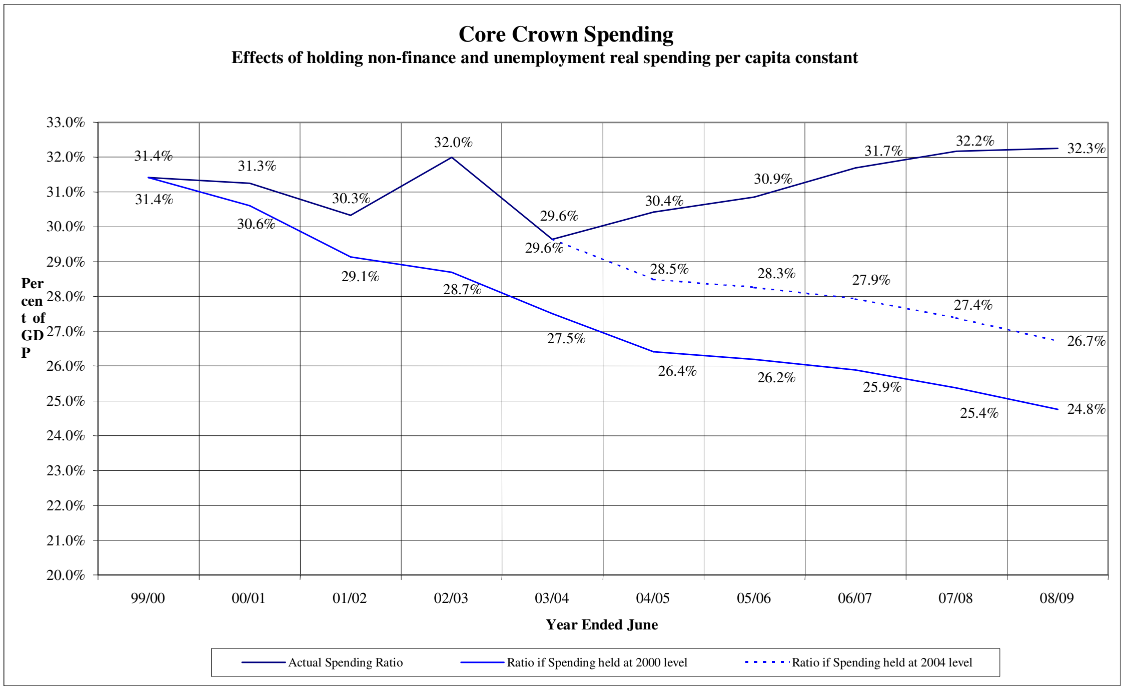

Economic and Human Development
OECD Countries 2002
0.980
0.960
0.940
0.920
0.900
0.880
0.860
0.840
0.820
UN Human Development Index
Norway
Australia
USA
UK
Ireland
NZ
Spain
Luxembourg
Poland
Correlation coefficient 0.69
$0
$5,000
$10,000
$15,000
$20,000
$25,000
$30,000
$35,000
$40,000
$45,000
$50,000
$55,000
$60,000
$65,000
GDP per capita (US$ PPP basis)

Annex III



Crown Current Spending and Taxation Per Capita
(Spending excludes interest payments)
(Chequered columns mark election years)
'Asian' crisis hits revenue
$12,500
$11,500
$10,500
$9,500
$8,500
$7,500
$6,500
2003-04 $s
$8,969
$8,418
$8,612
$9,181
$9,511
$9,800
$9,365
$9,405
$9,113
$9,398
$9,779
$9,837
$10,506
$10,847
$10,951
$11,025
$11,185
$11,424
1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008
Years Ended June
Spending
Taxation

Annex IV


Core Crown Spending
Effects of holding non-finance and unemployment real spending per capita constant
33.0%
32.0%
31.0%
30.0%
29.0%
28.0%
27.0%
26.0%
25.0%
24.0%
23.0%
22.0%
21.0%
20.0%
Per cen t of GD P
31.4%
31.3%
30.3%
32.0%
29.6%
30.4%
30.9%
31.7%
32.2%
32.3%
31.4%
30.6%
29.1%
28.7%
27.5%
26.4%
26.2%
25.9%
25.4%
24.8%
29.6%
28.5%
28.3%
27.9%
27.4%
26.7%
99/00
00/01
01/02
02/03
03/04
04/05
05/06
06/07
07/08
08/09
Year Ended June
Actual Spending Ratio
Ratio if Spending held at 2000 level
Ratio if Spending held at 2004 level