BUDGETARY STRESS

Why New Zealand needs to reduce government spending deficits and debt

NEW ZEALAND BUSINESS ROUNDTABLE

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Contents

	Executive Summary	**i**
1	**Introduction**	**1**
2	**Fiscal Policy and Economic Performance**	**4**
2.1	Medium-Term Fiscal Targets	6
	Expenditure Target	8
	Financial Balance Target	11
	Revenue	13
	Should the Deficit be Reduced During a Recession?	14
	Debt Target	16
	Conclusion on Fiscal Targets	19
3	**The Government's Fiscal Projections**	**21**
4	**Expenditure Reduction Programme**	**24**
4.1	Outputs	24
	National Superannuation	24
	Unemployment and Training Benefits	27
	Domestic Purposes Benefit	29
	Other Benefits	32
	Housing	33
	Accident Compensation	34
	Health	35
	Education	37
	Defence	39
	Other Outputs	40
4.2	Inputs	41
	Labour Costs and Productivity	41
	Debt Servicing	42
	Other Inputs	43
4.3	Public Sector Management	43
4.4	Privatisation	44
4.5	Revenue	45
	Taxation	45
	User Charges	46
5	**Conclusion**	**47**
	Bibliography	**49**

This report incorporates data available up to 20 March 1992.

Executive Summary

- This report examines New Zealand's fiscal policy in the context of wider policies aimed at restructuring the economy in order to raise income and employment levels, and outlines the desirable directions of fiscal policy over the medium term.

- Excessive levels of government spending, taxation and borrowing impair the performance of any economy. With growing international mobility of capital and labour, they impose an increasingly severe penalty.

- Fiscal policy has been the consistently weak feature of the economic reforms pursued since the mid-1980s. Insufficient progress has been made in lowering the level of net government expenditure relative to GDP, in improving the fiscal balance relative to GDP and in reducing the ratio of net public debt to GDP.

- Fiscal policy is at the heart of the coherent economic policy which needs to be implemented and adhered to over the medium term. It is now the main threat to the programme which the government is putting in place. While adjusting to living within our means is hard, failure to do so in the past has brought about the cumulative economic and social stresses which the country has been .experiencing and continuing failure would compound them in the future.

- The progress made by the government since late 1990 with its financial position has taken the pressure off monetary policy and financial markets and made room for private sector expansion. The benefits of lower government spending and an improved fiscal outlook have contributed to the recovery in economic activity.

- To capitalise on this progress, the government should adopt explicit fiscal targets for government expenditure, the financial balance and public debt to be achieved by the year 2000. This would improve the credibility of its fiscal policy.

- The share of government expenditure in national income should be reduced to between 25 and 30 percent by 2000. To achieve this target, the ratio should be reduced by an average of between 1 and 2 percentage points a year.

- The financial balance as a percentage of GDP should be improved by around 2 percentage points a year on average.

- Net public debt relative to GDP should be reduced to the average ratio for OECD countries by 2000.

- The government should continue to improve its underlying financial balance throughout economic cycles. Concerns about the impact on the level of economic activity of changes in the financial balance should be reflected in the speed at which it is improved.

- Expenditure reductions rather than revenue increases are needed to improve the financial balance. There is ample scope to reduce low value expenditure and New Zealand is already a heavily taxed nation.

- The government's three year fiscal projections, released in December 1991, show an insufficient reduction in the level of expenditure and an insufficient improvement in the financial balance – both relative to GDP – and no improvement in the ratio of net public debt to GDP.

- Substantial policy changes are required to achieve the desirable targets.

- The focus of expenditure savings necessarily includes the large expenditure items – social services, including health and education, and significant inputs such as labour and other operating costs.

- Significant expenditure savings in welfare spending can be realised by lowering the ratio of some benefits to wages, tightening abatement and eligibility rules, and applying a means test to assets as well as income.

- Greater reliance should also be placed on private insurance markets to manage the risk of income losses and additional costs from retirement, sickness, accidents and natural disasters.

- Consumers should bear a higher proportion of the costs of at least post-compulsory education. In addition, steps should be taken to promote choice and competition on a competitively neutral basis among educational establishments.

- The ease or difficulty of recruitment and retention for particular jobs in the relevant locality should generally determine state sector remuneration policy. Excess demand for many positions is clear evidence that remuneration should decline in the interests of promoting employment in both the public and private sectors. There should be a move from national awards to local collective and individual contracts.

- The public sector has not yet achieved the productivity improvements which have been realised by leading private sector firms. Operating grants should be cut by around 5 percent on average in 1992/93 with further negative adjustments in subsequent years to force productivity improvements.

- Public sector management needs to be strengthened to improve efficiency. The establishment of advisory boards to assist in monitoring the performance of major administrative departments is suggested.

- The privatisation programme needs to be reactivated to realise efficiency gains and to reduce debt.

- A private sector advisory group should be constituted to assist the government with its annual review of expenditure programmes.

- The proposals outlined in this report would enable the fiscal targets to be achieved and would enhance the benefits that are now becoming apparent from the structural reforms of recent years and the better balance of policies achieved by the government.

- The adoption of such a programme by the government would reduce the economy's vulnerability to adverse external events, create a platform for solid growth and put within reach the goal of restoring a triple A credit rating which it is committed to achieve.

1 Introduction

This report is part of a programme of work undertaken by the New Zealand Business Roundtable on public policy issues. Its purpose is to promote policies in a vital area of economic management which will contribute to the well-being of all New Zealanders.

The economic reforms of the past few years, such as moves toward price stability, the liberalisation of labour and capital markets and many markets for goods and services, and the corporatisation and privatisation of some state businesses, have helped to establish the conditions necessary for sustainable non-inflationary growth. Competition has increased in the private sector and this is spurring productivity growth and innovation. The international competitiveness of producers has recently returned to around the levels briefly recorded following the 1984 devaluation, largely as a result of higher productivity growth and tighter controls on labour costs in comparison with our main trading partners. In addition, the fall in the rate of inflation during 1991, in response to a firm monetary policy in recent years and weak demand, has enabled monetary pressures to be eased, resulting in lower nominal exchange and interest rates. Improving export volume growth reflects the rise in international competitiveness.

On the other hand, fiscal policy, which is the focus of this report, has been a persistently weak link in the reform programme. Insufficient progress has been made in eliminating low quality government expenditure. This was acknowledged by the Treasury (1990) in its briefing for the incoming government where it stated:

> "The root of our persistent fiscal problem is that expenditure continues to rise steadily as a proportion of GDP. The more government spending can be held in check and the pressures on our tax system reduced, the more our economic performance will improve."

There has also been inadequate progress in improving the financial balance (reducing the fiscal deficit) and in reducing debt levels. Earlier gains were allowed to erode in the previous government's second term. The privatisation programme stalled in 1991. As a result of these factors, New Zealand remains a highly taxed and heavily indebted nation, and these characteristics will constrain future income and employment growth. They contribute, for example, to the relatively high real interest rates which New Zealand continues to experience.

Although the government has made significant progress in dealing with the alarming fiscal situation which it inherited in 1990, **on present projections it will still need to borrow an additional $7 billion in the current parliamentary term, or over $2,000 for every New Zealander.** The ongoing outlook for financial deficits of around $2-2.5 billion a year or around 3 percent of GDP in the next 2-3 years means that **a further credit downgrade is likely unless this situation is corrected.**

Unemployment is also a serious problem involving not just economic waste but also great social harm and personal distress. The labour reforms were implemented too late in the programme. They are now making a major contribution to productivity growth which will provide a basis for higher real wages as unemployment comes down. However, in the short term minimum wage legislation and a welfare system which remains generous by international standards have helped to hold wages above the levels at which many of those who are out of work would be employed. The Employment Contracts Act is facilitating more flexible employment arrangements, with employers and employees giving greater attention to local labour market conditions in agreeing wage rates and other employment terms. Reductions in penal rates and in unreasonable constraints on operating practices are occurring which will assist in raising output and employment. These benefits are being attenuated to some degree by the pattern of decisions emerging from the Employment Court and Tribunal, which are failing to reflect the new contractual basis of employment relations, particularly in a number of redundancy and dismissal cases, so raising the costs and risks of employment.

The public sector and some other parts of the non-traded goods and services sectors have yet to emulate the productivity growth and labour cost reductions achieved by many industries which are exposed to international competition. In particular, centralised wage fixing, including national awards, remains the predominant practice in labour intensive areas such as education and health services. **Recruitment and retention information indicates that many public sector wage rates are too high, exacerbating fiscal pressures and inhibiting higher employment in the affected services.** Many unjustified regulations impede competition within the non-traded goods and services sectors thereby adding to costs, placing an undesirable burden on other producers and posing a risk to price stability. The failure of our education system to deliver the high quality educational outcomes necessary to support a dynamic, high employment, high growth economy is equally worrying for the future. Thus ongoing education reform remains a key priority.

The successful restructuring of the economy requires top quality economic management. The business sector has had to face up to meeting international standards of performance and has generally accepted the challenge. It has a right to expect comparable performance from the government in developing and implementing policy. New Zealand's vulnerable economic position allows no latitude for weak decision-making. In addition, the government needs to explain carefully its policy to the electorate as any government is ultimately dependent on community understanding and support for its actions. These requirements have not always been present in the reform programme of recent years, and as a consequence it has at times faltered.

Given the serious and deep-seated nature of our economic problems, it is vital for all New Zealanders that the reform programme continues to be implemented as a matter of urgency. Fiscal policy encompasses a large proportion of the reforms which are now required. Its contribution to the revitalisation of the economy is the subject of the balance of this report.

Since the 1980s governments of many different persuasions around the world have have taken steps to reduce government expenditure, to privatise state-owned enterprises, to reduce the costs of distortionary tax policies and to lower fiscal deficits and debt levels. As Oxley and Martin (1991) noted in relation to OECD countries:

"Concern over the effects of a continuing expansion of the public sector on private sector performance and a greater appreciation of the social costs of higher taxation produced broad agreement that the brunt of this strategy [to reduce budget deficits] should be borne by reductions in expenditure rather than tax increases. This was to be accompanied . . . by a reduction in government intervention, particularly when it distorted price signals."

The policies discussed in this report are comparable with those adopted by many of the most successful industrial countries and the fast-growing Asian economies. **None can be characterised as out of line with mainstream international thinking and practice.**

The next section discusses fiscal policy and economic performance. We examine the case for medium-term fiscal targets for expenditure, the financial balance and debt. Desirable parameters for such targets are proposed. We also consider whether the financial balance should be improved during a recession and why fiscal adjustments should be made through lower expenditure rather than higher revenue.

Short-term official forecasts are reviewed in the third section. These are evaluated against the medium-term fiscal targets and the need for further expenditure and debt reductions and an improvement in the financial balance is demonstrated. The fourth section identifies policies which should be modified to contribute to such a programme. The final section presents our conclusions.

2 Fiscal Policy and Economic Performance

The extent to which New Zealand's national income lags behind that of other countries is evident from the following table which has been taken from the World Bank's 1991 World Development Report.[1] It shows real income (GNP/GDP) per head in 1989 measured in United States dollars, real income per head expressed as an index based on Switzerland=100, and the average growth in real income per head between 1965 and 1989 for high income countries. While such international comparisons involve statistical measurement difficulties, they provide an indicative assessment of each country's relative performance.

New Zealand's real per capita income in 1989 placed it in 19th place on the World Bank's list. However, its income was equal to only 40 percent of that of Switzerland, which topped the list, and 50 percent of that of Japan which was second. In the early part of the post-war period, New Zealand's per capita income was comparable to that of Switzerland and Japan was a low income country. By 1989, Australia's income per head was some 19 percent higher than that of New Zealand, a reversal of its earlier position. Perhaps more noteworthy, the per capita income of two of the more dynamic countries of Asia, Singapore (until recently a recipient of New Zealand aid) and Hongkong, are next to New Zealand at 20th and 21st place respectively. They are likely to overtake us in the near future, if they have not already done so.

The most relevant statistic shown in the table, however, is the relative growth in real income per head over the past 25 years. New Zealand's rate of 0.8 percent p.a. was well below that of all high income countries listed with the exception of Kuwait. It was only half that achieved by the United States which had the next lowest average rate of growth. Among high income countries, Switzerland, Japan, Norway, Finland and Italy all recorded solid growth in real per capita incomes.

Sweden, which has been cited by some critics of New Zealand's recent reforms as an example which we should follow, has performed poorly by comparison with its near neighbours – Norway and Finland. The most striking performance, however, was recorded by Singapore and Hongkong. Their average real income per head grew between 1965 and 1989 by 7.0 and 6.3 percent p.a. respectively.

An increase in New Zealand's rate of growth is necessary just to hold our relative position on the table. An even larger increase is required if we are to raise our material standard of living to the relative position which we held in the early post-World War II period.

1 International Bank for Reconstruction and Development (1991).

Table 1

REAL PER CAPITA INCOME HIGH INCOME COUNTRIES

Rank	Country	Real Income Per Head US$[1]	Index[2]	Annual Avge Growth Rate[3 4]
1	Switzerland	29,880	100.0	4.6
2	Japan	23,810	79.7	4.3
3	Norway	22,290	74.6	3.4
4	Finland	22,120	74.0	3.2
5	Sweden	21,570	72.2	1.8
6	United States	20,910	70.0	1.6
7	Denmark	20,450	68.4	1.8
8	Germany	20,440	68.4	2.4
9	Canada	19,030	63.7	4.0
10	United Arab Emirates	18,430	61.7	N.A.
11	France	17,820	59.6	2.3
12	Austria	17,300	57.9	2.9
13	Belgium	16,220	54.3	N.A.
14	Kuwait	16,150	54.0	−4.0
15	Netherlands	15,920	53.3	1.8
16	Italy	15,120	50.6	3.0
17	United Kingdom	14,610	48.9	2.0
18	Australia	14,360	48.1	1.7
19	**New Zealand**	**12,070**	**40.4**	**0.8**
20	Singapore	10,450	35.0	7.0
21	Hongkong	10,350	34.6	6.3
22	Israel	9,790	32.8	2.7
23	Spain	9,330	31.2	2.4
24	Ireland	8,710	29.1	2.1
25	Saudi Arabia	6,020	20.1	2.6

1 1989
2 Switzerland's real income per head US$ 29,880 = 100.
3 1965 to 1989.
4 N.A. = Not available

Source: International Bank for Reconstruction and Development (1991).

A country's economic performance is not judged only by its rate of growth of output. A temporarily high rate of growth might be achieved, for example, by monetary stimulation and inflation, loose fiscal policy, borrowing and a declining current account position, masking a deterioration in overall performance. However, New Zealand's performance has been an inferior one on virtually all relevant indicators. Our rate of productivity growth has been the lowest in the OECD area throughout the entire post-war period, real wages have been static since the early 1960s, the inflation rate was 50 percent higher than the OECD average through much of the 1970s and 1980s, unemployment (including those on special work schemes) had risen to nearly 130,000 by 1984 and is now above the OECD average, and persistent borrowing has led to a high level of internal and external indebtedness. Many of the social pressures that are currently evident are far more attributable to this long history of inferior performance than to recent attempts to remedy it. It is extraordinary that despite this record claims are still heard, including from some economists, that there has not been a problem with New Zealand's long-term economic performance.

A sound fiscal policy is a basic factor in any country's economic performance for the following reasons:

- government spending and taxation exert a powerful influence on incentives and relative prices throughout the economy and affect the allocation of resources and the generation of wealth. This influence has grown substantially this century as governments have expanded their role in the economy;
- government taxation effectively diverts resources from the private sector for use in the public sector. To the extent that those resources are employed in public sector projects which yield a lower return to the community than they would yield in the private sector, overall community welfare is reduced;
- government spending and taxation decisions affect the distribution of income, which in turn affects spending, savings and investment patterns;
- fiscal policy interacts with monetary policy and thereby influences the level of inflation, and nominal and real interest rates;
- governments, through their spending, taxing and borrowing decisions, may, in the short term, influence the aggregate level of activity in an economy. The direction and strength of such influence is, however, uncertain and any favourable short-term effect may be offset by larger unfavourable long-term consequences;
- fiscal policy affects the level of certainty and confidence in the economy.

The importance of fiscal management to economic performance requires close attention to be given to institutional arrangements which may assist in delivering superior fiscal policies. It is not possible to lay down rules which are applicable to any economy in all circumstances. Decisions may properly be affected by external circumstances (e.g. security threats) or choices which are ultimately political in nature. Nevertheless, in New Zealand's present circumstances it is possible to make judgments about fiscal parameters which, in the forseeable future, would be likely to lead to better economic and social outcomes. **The government has already moved some distance in this direction by establishing goals such as a balanced budget, a commitment not to raise taxes and a declining share of government expenditure and taxation in GDP.** A more extended set of such parameters or targets is discussed in the next section.

2.1 Medium-term Fiscal Targets

The failure of successive New Zealand governments to pursue sound fiscal policies suggests that explicit medium-term fiscal targets are desirable. There is also some evidence in the literature that the choice of fiscal rules affects fiscal outcomes (see Crain and Miller (1990)). Like the present price stability objective of the Reserve Bank, such targets could add greater credibility, certainty and stability to the government's fiscal policy. The more depressed than expected economic conditions which required the government to modify its goal of achieving a balanced budget by 1993/94 do not, in our view, justify the abandonment of firm fiscal goals. **Separate targets should be established for the level of government expenditure, the size of the financial balance and net debt, all relative to GDP**. The case for targets in respect of each variable is discussed below.

The government's powers to tax and to regulate give it a unique ability to spend and to borrow to excess, and thereby to undermine the borrowing ability of its citizens and put their wealth at risk. Moreover, the pressures to which the political process is subject suggest that innovative approaches to improve economic outcomes are worth considering. Sectoral interests are able to secure governmental favours at the expense of the majority because they are better represented politically[2]. Their gains are concentrated and accrue to a limited number of beneficiaries who have incentives to lobby. The costs, however, are spread thinly over the remainder of the population. Such a broad group is more difficult to organise politically and there is less reason for individual members of it to devote resources to lobbying. Electors also face an ongoing problem in controlling their elected representatives, and government officials have incentives to pursue their own interests at the expense of the community. These factors may justify constitutional constraints and conventions which seek to limit a government's ability to spend and to borrow irresponsibly.

An assessment of a country's fiscal position is hindered by conceptual differences concerning the appropriate economic and accounting concepts which should be employed, particularly in measuring its fiscal deficit, by the absence of generally agreed benchmarks against which performance can be monitored, and by the lack of comparable data on the fiscal state of other countries.[3] These difficulties are not intractable in New Zealand's case partly because our fiscal performance, measured by a range of indicators, has fallen well short of that of earlier years and of other comparable countries. Three main fiscal indicators have generally been employed in assessing New Zealand's fiscal performance. These are the level of expenditure relative to GDP, the financial deficit relative to GDP (and prior to this IMF measure being available, the fiscal deficit calculated on a budget table 2 basis relative to GDP), and the ratio of net debt to GDP. This report focuses on these indicators.

The level of government spending measures the government's claim on the private sector. It has a pervasive influence on the economy. The point at which such expenditure is reflected in taxation is affected by the government's borrowing decisions. Thus if the community wishes to control the size of the government, it must set a constraint on the level of government expenditure. Limits on the government's ability to borrow alone would not constrain its ability to spend and tax.

The government, as a borrower, is no different from any other borrower in that the more it borrows in relation to its income potential, the more it puts itself in the hands of its lenders. Furthermore, the more it borrows from non-residents the more severe is the problem. However, should the government default on a loan, the lender cannot take possession of the government's assets and realise them as it would do if an individual or a firm were in default. The prime security for government loans is the power of the government to levy taxes. In the case of default, the government would be forced to come to an arrangement with its lenders and this would undoubtedly result in restrictions on spending, tax increases and, possibly, asset sales.

2 "Since most people are temperamentally uninterested in political life, they let their democracies be dominated by pressure groups. Hence the perennial tendency towards government of the busy, by the bossy for the bully." (*The Economist*, June 1990, in a review of *Capitalism* by Arthur Seldon.)

3 For a discussion of the relevant issues see Blejer and Cheasty (1991) and Buiter (1985).

The government's unique abilities to appropriate the wealth of individuals and businesses through taxation and regulation allow it to borrow beyond the limits that apply to individuals and other entities. While this may be beneficial during a national crisis, such as a war, the cumulative effect of excessive reliance on these powers in normal times puts the wealth of all citizens at risk. This is reflected in interest rates charged on loans to the private sector as well as on loans to the government.

Constraints on expenditure and on the financial balance (with appropriate adjustment in times of national crisis) would automatically limit the growth in debt arising from current operations, other than that caused by changes in exchange and interest rates. The government could, however, influence the level of its debt by engaging in asset sales. Thus to constrain the overall level of debt a debt target is also desirable.

Expenditure Target

In the post-war period prior to the 1970s, expenditure by successive governments commonly accounted for 25-30 percent of GDP. There was a particularly marked expansion in government expenditure in the mid-1970s. Between 1971/72 and 1975/76, government expenditure rose from 28 to 38 percent of GDP (Economic Monitoring Group (1984)). A subsequent attempt to reduce spending and the deficit proved to be short-lived. By 1983/84 spending exceeded 40 percent of GDP and is currently around 42 percent despite a reduction in industry assistance and the establishment of major trading activities as SOEs and their exclusion from the government accounts.

The initial rise in government expenditure as a percentage of GDP by the mid-1970s reflected higher spending on social services and debt servicing costs. Since then the following influences have placed further upward pressure on this ratio:

- a deterioration in the financial balance resulting in growing public debt and increased debt servicing costs. This has been accentuated by the restructuring of major project debt;
- the poor performance of the economy has been reflected in higher numbers of beneficiaries (unemployment benefits, with some spillover to the domestic purposes benefit (DPB) and the sickness benefit);
- real wage increases in the public sector have increased spending on health, education and other government services;
- discretionary policies which have increased the real cost of programmes (e.g. national superannuation and the introduction of the DPB, and higher ratios of teachers to students);
- demographic factors which push up spending on programmes such as national superannuation and tertiary education. A decline in the number of school-aged children has not been fully reflected in a reduction in the cost of education programmes.

The increase in government spending over the past two decades is a serious concern for the following reasons:

- to the extent that public expenditure is of less value to the community than the private expenditure which it replaces, overall welfare is reduced. There is little evidence to support the view that the rise in expenditure has been matched by comparable improvements in the benefits flowing from it;

- the taxation required to fund public expenditure is costly to raise. Taxes distort people's willingness to save, to invest, to work and to bear risks, and influence behaviour in a host of other ways. These costs reduce output and incomes and bias choices. **Overseas studies typically show that the marginal cost of raising an extra dollar of tax revenue is between $1.20 and $3.00.**[4] Even so, such studies do not capture all of the efficiency costs imposed by taxes. Thus the marginal benefits of marginal expenditure programmes need to exceed substantially the costs involved, if the community is to at least break even. Examples of programmes where this test is most unlikely to be satisfied are set out later in this report;

- the government has progressively absorbed a higher proportion of risks which were previously managed privately. Examples include retirement income, ACC, sickness benefit and compensation for natural disasters. There are very few instances where the government has a comparative advantage in managing such risks. In most cases, the risks which it initially absorbs are passed back to individuals via more uncertain expenditure levels, tax rates and financial balances (Gordon (1985));

- the government has generally been shown to be a poor manager of business entities. The evidence on the substantial productivity gains achieved by SOEs and privatised businesses (referred to in section 4.4) supports this view. It is likely that the non-commercial activities of the government have exhibited similar or even larger inefficiencies relative to those found in businesses which have been corporatised and/or privatised;

- many of the government's interventions have been shown to have perverse effects. Subsidies to higher education, for example, largely benefit students from well-off families, or people who go on to earn higher incomes in later life, despite persistent statements to the contrary from students and educators. Government failure – in the form of decisions which yield benefits to narrow interest groups but impose larger costs on the wider community – is a major factor in the poor returns from many public programmes.

This sceptical assessment of the marginal benefits from current expenditure is consistent with the analysis of Brennan and Pincus (1983). They analysed the rising secular trend in government expenditure in the United States. In respect of goods and services which are directly provided by the government, such as health and education services, they concluded that:

"... the connection between an increase in the level of public expenditure on an item and the ensuing increase in the level of aggregate consumption of that item is vague. It depends on whether there is private supplementation of public supply, retarding of publicly provided units and/or the possibility of replacing public consumption with market alternatives. . . The effects of public expenditure increases on aggregate consumption of the items in question are therefore probably small, and may even be negative over some ranges."[5]

4 For a summary of the relevant research see Lindbeck (1986) and references cited therein. Also see Slemrod (1990).

5 Brennan and Pincus use the term 'retarding' to refer to the ability of individuals to sell publicly provided goods and services to others who wish to supplement privately such goods and services.

Brennan and Pincus were also critical of government redistributive programmes:

> ". . . over a significant range, publicly provided redistribution is offset by corresponding reductions in private transfers."

In an earlier report on fiscal policy (New Zealand Business Roundtable (1989a)), we suggested that:

> "In conjunction with labour market, public sector and social policy reform, New Zealand could aspire to the expenditure/GDP ratios of the late 1960s, of less than 30%, with average tax rates to match."

More recently, the Wellington Chamber of Commerce (1990), in commenting on similar trends and developments to those reviewed above, stated that:

> **"An over-expanded role by governments at all levels has been a major cause of New Zealand's poor long-run economic performance. By examining all government functions from a zero base and applying strict cost-effectiveness tests to each, it is likely that – in conjunction with a growing economy – government spending could be cut back to the level of 25-30% of GDP. . ."**

The Chamber went on to suggest that this target could be achieved by cutting expenditure relative to GDP by at least 1 percentage point a year. **We endorse the objective of reducing government expenditure to 25-30 percent of GDP in the present decade but consider that the parlous state of the government's finances requires somewhat faster reductions in expenditure – of the order of 1-2 percent a year.**

The fact that it is realistic to reduce expenditure to 25-30 percent of GDP is illustrated by the following points:

- the benefits of much government expenditure do not exceed the costs involved. This point is elaborated later in this report;
- government expenditure to GDP was generally within or below this range for a long period prior to the early 1970s when the economy generally performed better than it has done over the past twenty years;
- the target could be achieved if the economy were to grow in real terms by an average of 4 percent a year and if government expenditure were held constant at around its current level. In other words, on this assumption the target could be achieved *without any cuts in real government spending* on the condition that all increases in income growth were left in the hands of private sector firms and households. However, there is scope for actual reductions in real expenditure, including debt servicing costs. Thus the target is achievable even if the average growth rate were less than 4 percent a year;
- the rise in income levels means that welfare assistance to support a minimum standard of living should decline over time. It is paradoxical that welfare spending has increased over the last 50 years despite substantial improvements in general living standards;
- Asian economies, which are generally more dynamic than New Zealand's and achieve higher savings and investment ratios, typically contain their government expenditure to below 30 percent of GDP;

- Federal government expenditure in Australia has fallen from nearly 30 percent of GDP in 1983/84 to 25 percent in 1990/91, and is projected to decline to 22.6 percent in 1995/96;

- Sweden is aiming at reducing its expenditure by 15 percentage points from 55 percent to 40 percent of GDP. Several OECD countries have reduced their expenditure to national income ratios from their peaks. Expenditure to GDP ratios for Japan, Germany, Austria, Belgium and Ireland in 1990 were below those recorded in 1979 (Oxley and Martin (1991));

- the relatively high spending and taxation burden in New Zealand is even more apparent when it is recognised that a significant fraction of the national income of many industrial countries (over 6 percent of GDP in the case of the United States and 8 percent in the United Kingdom) is devoted to defence spending, compared with around 1.5 percent of GDP in New Zealand.

Financial Balance Target

Having decided the level of government expenditure, a separate but related issue is the appropriate means of financing it and, in particular, the extent to which the government should run a negative financial balance (and hence borrow) or a surplus (and thus reduce the level of borrowing and debt).

Low negative financial balances were generally a feature of the New Zealand economy up until the 1970s. Between 1969/70 and 1975/76, the deficit (measured on a budget table 2 basis) rose from 1.5 percent of GDP to 8.6 percent (Economic Monitoring Group (1984)). Although it was subsequently reduced, the deficit had grown again to be 8.7 percent of GDP by 1983/84. It would have been even higher in that year if the government's actual expenditure, including industry assistance, had been properly reflected in its accounts. At no stage between 1969/70 and 1983/84 did the government accounts move into surplus.

In recent years, some steps have been taken to reduce the deficit but it is still likely to be around 4 percent of GDP (measured on a financial balance basis) in 1991/92. For the same year the average deficit for all OECD countries, which (as shown below) are on average substantially less indebted than New Zealand, is expected to be 2.3 percent of GDP. The government has indicated that its objective of achieving financial balance in 1993/94 is unlikely to be achieved.

The following are important features of the government's financial position:

- persistent deficits over the last 20 years suggest that cyclical expansions in downturns have not been accompanied by the required correction in buoyant years. To the extent that a cyclical deficit is justified in a downturn as a temporary event which does not require corrective action, the corollary is that on the upswing of the cycle the government should run a surplus;

- a permanent increase in current expenditure must ultimately be financed by an increase in taxation. The government has some choice as to when taxation is increased (Feldstein (1985)). It could, for example, initially borrow to finance such expenditure but it must eventually increase taxes to prevent spiralling debt. The analysis of whether a temporary rise in expenditure should initially be funded by debt or taxation does not lead to a clear-cut rule. There are circumstances, such as where the debt burden of future generations is clearly excessive, which would justify an immediate rise in taxation (Feldstein (1985)). In New Zealand's case most increases in permanent expenditure, such as the introduction of national superannuation, have not been matched by a corresponding increase in tax;
- net investment might be financed by borrowing provided that the expected benefits from it are equal to or greater than the related borrowing costs. This would enable the costs of the investment to be imposed on future generations which benefit. It is not equitable, however, to impose the costs of net investment on future generations if their debt burden is already excessive;
- the Crown balance sheet, which is to be produced in April 1992 for the first time in many years, is expected to show a negative net equity position of at least $10-20 billion as at 31 December 1991[6]. This clearly indicates that past deficits have not been incurred solely to finance worthwhile investments. They have been incurred to finance poor investments and permanent current expenditure.

A deterioration in the trend level of the financial balance is of concern for the following reasons:

- continued fiscal deficits risk an escalating debt and interest payment spiral. We already suffer excessive debt levels. The implications of rising debt are examined below;
- the higher the fiscal deficit, other things being equal, the higher the public debt programme required to maintain monetary control and the greater the risk that interest and exchange rate pressures will unduly discourage investment and the traded goods and services sector respectively. The danger is that this could reduce investment at the expense of future welfare;
- substantial swings in the level of the fiscal deficit, as experienced over the past 20 years, are disruptive to the private sector and add additional risk to firms' investment and employment plans.

The OECD (1991) reflected these concerns when it reported in December 1991 that:

> "the underlying rationale for sustained efforts to reduce, and preferably eliminate, public-sector deficits has not changed: concern about the adequacy of national saving in relation to desired rates of investment in both OECD and non-OECD countries. While there might be some reversal of the sharp falls in household saving ratios experienced in the 1980s, these are unlikely to rise significantly, and the prospects for much higher rates of corporate saving are likewise not good. Under such circumstances, [an] expansion of funds available for investment will depend on improved public sector financial balances."

6 The amount will depend on the extent of coverage of assets and liabilities in the initial balance sheet and on the way in which taxes and social assistance obligations are treated. The Crown balance sheet will expand the range of fiscal indicators available and may, in due course, suggest that net worth should be the subject of a fiscal target.

Regardless of debt levels, there is an unambiguous case to reduce the deficit to the point at which current revenue funds current expenditure, including replacement investment. On the grounds of equity between generations, borrowing to fund consumption, maintenance of capital assets and general debt servicing cannot be justified. In the present circumstances there is also a strong case for reducing the current excessive debt level. This would require sustained surpluses.

The speed at which the deficit is reduced and subsequently turned into a growing surplus should:

- be fast enough to demonstrate that the government is committed to a responsible fiscal policy;
- be economically and politically sustainable over the medium term, thereby avoiding costly policy reversal;
- enable the level of debt to be stabilised and subsequently reduced to lower the vulnerability of the economy to external shocks;
- avoid excessive pressure being placed on monetary policy.

In the 1984 briefing for the incoming government, the Treasury (1984) argued that a reduction in the deficit of at least 2 percentage points a year was a necessary minimum. We believe that that rate of improvement in the financial balance is still appropriate and should be used to evaluate the government's programme.

Revenue

There have frequently been calls for tax rates to be increased in order to finance additional expenditure or to avoid expenditure cuts. **The government has pledged not to raise tax rates. We strongly support this stance.**

Tax increases would have the following detrimental effects on the economy:

- they would run a very real risk of crowding-out high valued private spending. As illustrated below, there are substantial opportunities to reduce wasteful and low priority expenditure thereby crowding-in higher valued private expenditure;
- they would add to the tax burden on the private sector which is already excessive. Recent moves to broaden the tax base have substantially increased the total tax take. With a more comprehensive base for income tax and a broad-based GST, it is simplistic to compare the current statutory rates with the previous ones or to compare statutory rates among countries. **The relevant rates are effective marginal rates** which, taking account of GST, are high in many cases;
- they would (other things being equal) reduce the international competitiveness of New Zealand businesses;
- by calling into question the government's ongoing resolve to control its spending they would reduce confidence, thus impeding the recovery which is now underway.

Frequent changes in the tax system are disruptive for the private sector because they add to uncertainty and thereby discourage investment and employment. This suggests that the major tax changes of recent years should now be allowed to consolidate.

A number of recent tax moves have narrowed the tax base and reversed earlier efficiency-enhancing tax initiatives.[7] This means that in due course rates of tax will be higher than would otherwise have been the case. **We believe this erosion of an approach to tax policy aimed at minimising distortions and treating activities neutrally should be rectified.**

There is substantial scope for allowing people more control over their lives by returning responsibility for some public programmes to the private sector and reducing taxes. As expenditure levels fall, priority in tax reform should be accorded to reducing high effective marginal tax rates, flattening the income tax scale, removing excessively distorting taxes such as excises and maintaining a comprehensive tax base. There are also arguments for allowing a more neutral treatment of tax losses so as to reduce the bias against risk taking, for reducing the effective rate of tax on dividends paid to foreign investors, and for improving other aspects of the international tax regime.

With the increasing integration of the world economy, countries with high tax burdens will find it more and more difficult to attract and retain mobile resources of capital and labour – businesses will relocate to warmer fiscal climates. In New Zealand's case, high taxation, particularly of foreign capital which is internationally mobile, adds to the disadvantages of being a country on the periphery. While the effective rate of tax on foreign investment could be reduced, this would not be a viable response since domestic capital could be expected to migrate to countries which impose lower tax rates. Furthermore, high levels of taxation (in all forms) reduce people's capacity for self-reliance and create state dependency, as Sweden's experience has shown.

With local government taxation and other compulsory charges such as accident compensation coming on top of central government taxation, **spending decisions amounting to around half the level of average per capita incomes are effectively taken out of the hands of ordinary New Zealanders and made by the state.** It is highly unlikely that many of these decisions are as well-informed as if they were made by those who are directly affected by them. In an economy with lower levels of tax and public spending, more decisions about how to deploy resources can be made by individuals and companies, who can respond more sensitively and efficiently to real economic forces. The outcome is a more productive and competitive economy.

Should the Deficit be Reduced During a Recession?

The government sector has become so large in the economy this century that its expenditure and revenue decisions can affect the overall level of economic activity. This leads to the claim that a government should smooth out fluctuations in economic activity by borrowing to finance some proportion of its current expenditure during recessions and by repaying those borrowings out of revenue surpluses in buoyant times. It is this view which is frequently reflected in public criticisms of moves to reduce the deficit during a cyclical downturn.

There are, however, a number of reasons why this argument has been less influential in recent times. These are summarised below:

7 The application of expenditure tax treatment to forestry development expenditure, livestock and exploration expenditure and accelerated depreciation are examples.

- the vast majority of individuals in developed countries do not require governments to undertake their counter-cyclical smoothing as they can achieve the same effect themselves by drawing on savings accumulated for the purpose, borrowing, broadening their skills, diversifying their investments and adjusting their work effort. The liberalisation of capital markets has enhanced these opportunities. Industries which are particularly prone to cyclical fluctuations, for example, tend to be financed by less debt than other industries;

- fluctuations in business activity are unpredictable. Today's conditions may be tough but tomorrow's circumstances may prove to be more difficult. Thus borrowing today on the expectation that tomorrow's conditions will be better may prove to be wrong. The decision by some governments to borrow on the expectation that the adverse impact on incomes of the 1973/74 oil shock would be short-lived is an example. If the government makes such an error, it can cripple the whole country. As we have seen in the recent past, governments are not generally able to make superior judgments about the path of international and domestic economies. It is for this reason that it may be better for individuals to make their own judgments about how they wish to allocate their consumption over time;

- governments have weak incentives to take the counter-cyclical propositions seriously. Often they find it convenient to borrow today for political reasons. The day for achieving surpluses and reducing debt is deferred, with the result that debt levels tend to rise over the entire economic cycle. New Zealand's experience conforms to this pattern;

- individuals will observe the government's actions and will modify their actions accordingly. These behavioural responses to government policy are important. Businesses and individuals adjust their spending on discretionary items like new investment and deferrable consumption according to whether they are optimistic or pessimistic about the future. As a heavily-indebted country increases its debt, people become less confident rather than more confident about the future. If a government is building up debt and people believe that taxes will need to rise in future to service the debt and to reduce its growth, they are likely to curtail consumption and investment expenditure. On the other hand, if a government has credibility for taking difficult decisions, people may be more willing to borrow. The greater the extent of these behavioural responses, the less effective will be the government in altering the course of economic activity;

- whether, and to what extent, reductions in a fiscal deficit have a contractionary effect on economic activity depends partly on the quality of the measures taken. If wasteful government expenditure is eliminated, community income will effectively increase. The decision to convert certain trading activities into SOEs, which subsequently realised large productivity gains, eliminated substantial waste. On the other hand, an increase in taxes to finance low quality expenditure could be expected to reduce more highly valued private expenditure;

- overseas research confirms that economic activity is less predictable than previously thought. Business activity does not appear to fluctuate around a stable trend growth path; rather it appears that the trend itself is unstable and changes unpredictably. Moreover, policy decisions impact on the economy with a variable lag and political rather than economic considerations often influence fiscal decisions. Attempts at fine tuning have often accentuated rather than dampened the business cycle.

It is frequently argued that a reduction (increase) in the discretionary fiscal balance accompanies a decline (rise) in economic activity. However, many factors – such as reduced pressures on interest rates, crowding-in of private sector activity and improved confidence – may offset partly or wholly, even in the short term, the direct effects on incomes and spending of deficit reductions. Deficit reductions may be seen as a return to responsible government in which case nominal and real interest rates may fall and business and taxpayer optimism may rise. This point has particular relevance to a country like New Zealand with high debt levels and a poor record of economic management. The 'expansionary' budget of 1990 did not appear to have a positive impact on economic activity, because it was judged unsustainable and adversely affected confidence.

We believe that a credible programme of improving the financial balance is a crucial element in a coherent economic policy for New Zealand. The progress that the government has so far made is commendable. **In our view the government acted correctly in improving its financial position in 1991 despite depressed conditions.** This has led to a better balance of policies and created a foundation for economic recovery. Any arguments about the wisdom of such action are in any case less relevant now that economic activity is rising. **To strengthen and sustain the prospects of recovery, it is important not merely to prevent any further slippage but to maintain the momentum of adjustments to structural aspects of the government's finances throughout the economic cycle.**

Debt Target

In reviewing New Zealand's debt levels over the last 100 years, the Department of Statistics commented that New Zealand's public debt has never been low by international standards (Department of Statistics (1990)). In the 1991 budget, the minister of finance noted that "New Zealand's high level of public debt continues to burden the economy." At 31 March 1970, gross public debt amounted to 56.1 percent of GDP. In the early 1970s the debt to GDP ratio fell as GDP grew faster than debt (Economic Monitoring Group (1984)). However, between 31 March 1974 and 30 June 1991 gross public debt rose from 40.6 to 61.3 percent of GDP. The main factors responsible for this increase were continuing fiscal deficits, the support of a fixed currency prior to the floating of the exchange rate in 1985 and the restructuring of major project debt. Net public debt (gross public debt less foreign reserves) amounts to around $34 billion or 48 percent of GDP.

A high proportion of New Zealand's debt is owed to foreign investors. At 31 March 1970 the overseas proportion of gross public debt was equal to 18.3 percent of the total. It fell to 12.5 percent in 1974 before rising sharply to 41.4 percent in 1983 (Economic Monitoring Group (1984)). Foreign investors currently account for almost the entire stock of gross debt denominated in foreign currency (46 percent of the total) and around 6 percent of other public debt. Their claim thus amounts to around 50 percent ($22 billion) of total gross public debt. As the government has few overseas assets or sources of income denominated in foreign currency, the heavy weighting of foreign debt exposes taxpayers to excessive currency risks. A key objective of debt management should be to reduce the proportion of foreign denominated debt.

The debt rating agencies focus on private as well as public overseas debt in conducting their assessments. According to the Department of Statistics, New Zealand's total gross overseas debt at 30 September 1991 was $51 billion (see Table 2).

Table 2

GROSS OVERSEAS DEBT

	$ billion
Official government (Treasury and Reserve Bank)	20.7
Other central government (SOEs)	7.9
Private	22.4
Total	51.0
Total overseas debt: GDP[1]	69.0%
Total overseas debt: exports[2]	255.0%

1 GDP for the year to March 1991.
2 Exports of goods and services for the year to 30 June 1991.

Source: Department of Statistics (1991), and NZBR.

The statistics shown in the above table would change marginally if overseas reserves of $6 billion at 30 September 1991 were deducted. The extent to which private sector offshore borrowing is matched by offshore assets is unknown, but it is unlikely that the private sector has a large unmatched position.

New Zealand's credit rating, as assessed by Standard and Poor's, fell from the top rating of AAA to AA+ on 30 April 1983. They cited increasing fiscal and current account deficits and reducing economic flexibility (a reference to the wage and price freeze) as reasons for the downgrade. Subsequent rating adjustments by both Standard and Poor's and Moody's have seen our rating reduced to AA- and Aa3 respectively. In 1991, New Zealand appears to have narrowly avoided a further rating downgrade to single A. This would have had serious consequences for corporate borrowers, removing a number of them from investment grade. **A firm commitment to orthodox economic policies aimed at successfully restructuring the economy will be necessary if a further credit rating downgrade is to be avoided in the near term. Moreover, substantial improvements in fiscal indicators will be required before the government's objective of restoring New Zealand to a triple A rating is achieved.**

A comparison of New Zealand's debt to GDP ratio with that of other OECD countries is presented in the table below. The net debt ratio is the most meaningful basis of comparison. The table shows that New Zealand, along with Belgium, Italy and the Netherlands, is significantly more indebted than other countries.

It is also instructive to note that between June 1983 and June 1991, Australian Commonwealth debt was reduced from 21.6 percent of GDP to 12.8 percent.

Table 3

INTERNATIONAL COMPARISON OF GENERAL GOVERNMENT DEBT TO GNP/GDP (%)[1]

	Gross Debt		Net Debt	
	1984	1990	1984	1990
Major 7 Countries				
United States	45.6	54.6	25.3	31.2
Japan	67.8	66.5	27.0	10.9
Germany	41.7	43.8	21.7	22.6
France	43.8	46.9	21.1	25.0
Italy	77.2	101.1	74.4	98.2
United Kingdom	54.7	35.6	47.4	28.9
Canada	58.7	72.1	26.1	40.3
Smaller Countries				
Australia	24.9	13.1	N.A.	N.A.
Austria	47.9	54.0	N.A.	N.A.
Belgium	118.6	130.1	108.7	120.6
Denmark	65.9	59.2	37.2	23.5
Finland	19.0	13.9	0.7	(4.1)
Greece	49.5	80.7	N.A.	N.A.
Ireland	116.4	116.9	N.A.	N.A.
Netherlands	66.1	81.7	39.9	59.4
Norway	38.7	42.1	(12.5)	(26.8)
Spain	41.8	43.4	23.2	30.7
Sweden	67.2	43.8	12.6	(3.7)
Average of smaller countries[2]	55.4	56.0	34.7	36.5
Average of above countries[2]	53.5	57.9	30.4	31.0
New Zealand				
Central Government	63.6	63.2	32.2	51.6
Local Government[3]	5.3	3.7	N.A.	N.A.
General Government	68.9	66.9		

1 Figures refer to the general government sector (i.e. including state and local government). OECD figures are for calendar years. New Zealand figures are for 31 March 1984 and an estimate for 30 June 1990. N.A. denotes figures are not available.
2 Based on 1987 GNP/GDP weights and exchange rates.
3 Estimated.

Source: 1991 Budget.

The high level of public debt adversely affects economic performance:

- it raises the risk premium embedded in all interest rates, thereby raising the cost of capital and discouraging investment and (other things being equal) diminishing the international competitiveness of New Zealand businesses;
- it increases the country's vulnerability to external shocks, such as a terms of trade decline;
- the cost of debt servicing, at $4.5 billion a year, is a major expenditure item – greater than the total amount spent on health services or education – and a drain on tax revenue. It crowds out other public and private expenditures.

Moreover, the financial security of an indebted country is threatened when interest rates persistently exceed the rate of growth. This has been the case in New Zealand in recent years.

Another reason for reducing debt levels is to promote equity among different generations. As indicated earlier, if current and capital expenditures are excessively financed by borrowings, an unwarranted burden is placed on future generations. The expectation that the Crown's balance sheet will show a massive deficit in net worth will, if confirmed, provide compelling evidence that the debt burden placed on future generations is not matched by comparable benefits.

It is critical that net debt levels are reduced. While a fiscal surplus is required to achieve this on a sustainable basis, the government can also reduce its debt by selling down its assets. Private sector firms which become over-extended are forced to adopt such a strategy. Often drastic action is crucial to their survival. Because of the importance of a large reduction in debt, an explicit target for the level of net public debt is warranted.

Determining an optimal public debt ratio is not a straightforward matter. Previously (New Zealand Business Roundtable (1989a)), we have suggested that New Zealand should be seeking to at least halve net debt levels during the 1990s, in order to be comparable with the better performing OECD nations. A more refined analysis will be possible when information on the government's balance sheet is available. One benchmark that might then be applied is that the government's commercial assets should be financed on a similar basis to private sector norms. Another, suggested by simple prudence, is that in normal times the government should aim to keep public debt within the bounds dictated by saleable public sector assets. In the absence of such data, and given concerns about intergenerational equity and the influence of relative debt levels on credit ratings, **we suggest an interim medium-term target should be to reduce net public debt as a percentage of GDP to the average for OECD countries by 2000.** In 1990 this would have been 31 percent, but as other OECD countries are also moving to reduce their net debt the target by 2000 is likely to be lower.

Conclusion on Fiscal Targets

In this section we have argued that the government should set and pursue three medium-term fiscal targets as an essential element of a coherent economic policy:

- that government expenditure be reduced to between 25 and 30 percent of GDP by the year 2000. This would involve an average reduction in the expenditure to GDP ratio of around 1 to 2 percentage points a year;
- that the fiscal deficit as a percentage of GDP be reduced at a rate of at least 2 percentage points a year until a surplus is achieved, and that subsequent surpluses be accumulated at the same rate for a period;
- that the ratio of net public debt to GDP be reduced to the average for OECD countries by 2000.

We are not persuaded by arguments which suggest that a fiscal adjustment might be deferred when economic conditions are unfavourable. In our view the key arguments for progressively reducing the financial deficit and for subsequently accumulating surpluses are the possibility that tomorrow's economic conditions may be worse than today's and the need to maintain business and investor confidence in the stability of the government's fiscal policy. While the validity of the view that reductions in the deficit would automatically depress economic activity is questioned, we believe that that concern is best reflected in the speed at which the deficit is reduced. The long period of adjustment which we propose extends over several economic cycles, and present conditions are becoming more favourable with an upturn in domestic and international activity in prospect. In our view, adjustment is required on the expenditure side where low priority programmes, which are unlikely to produce marginal benefits which exceed the marginal cost of the taxes required to finance them, continue to be funded.

The government's short-term fiscal projections are evaluated against these targets in the next section.

3 The Government's Fiscal Projections

Recent projections of net expenditure, on a financial balance basis, are summarised in Table 4. The table shows that net expenditure was projected to increase from $33.4 billion to $36.4 billion between 1991/92 and 1993/94 in the Treasury's 1990 briefing for the incoming government (Treasury (1990)). This estimate, which was substantially above that contained in the 1990 budget, implied that (on an existing policy basis) expenditure was growing in excess of 4 percent a year in nominal terms. Largely as a result of the economic initiatives announced in December 1990 and in the 1991 budget, the projections were reduced to around $29-30 billion. The economic assumptions underlying that forecast proved to be too optimistic and, in addition, significant policy changes (particularly in respect of national superannuation) led to the latest projections which were prepared in December 1991. These suggest that net expenditure will rise from $30.1 billion in the current year to $31.0 billion in 1993/94, an average increase of around 1.4 percent a year.

Table 4

OFFICIAL PROJECTIONS OF NET GOVERNMENT EXPENDITURE FINANCIAL BALANCE BASIS 1990/91 TO 1993/94

Source of Projection	1990/91 $m	1991/92 $m	1992/93 $m	1993/94 $m
1989 Budget	29,700	30,700	–	–
1990 Budget[1]	30,000	31,400	31,600	–
1990 Treasury Briefing	–	33,400	34,800	36,400
1990 December Statement	30,759	–	–	–
1991 Budget	–	29,790	28,958	29,554
1991 December Statement	30,298[2]	30,083	30,299	30,954

1 Unadjusted. The budget projection omitted the cost of several new policy proposals which were announced in the budget.
2 Actual.

Source: 1989 to 1991 budgets, press statements by minister of finance and Treasury (1990).

The latest forecasts imply the pattern for net expenditure to GDP shown in Table 5.

Table 5

PROJECTED NET EXPENDITURE TO GROSS DOMESTIC PRODUCT 1990/91 to 1993/94[1]

Year	Net Expenditure to GDP %
1990/91	41.1
1991/92	41.5
1992/93	39.5
1993/94	38.5

1 December 1991 projection.

Source: Table 4 and NZBR.

Between 1990/91 and 1993/94 the ratio of net expenditure to GDP is projected to decline by 2.6 percentage points compared with our target of at least 3 to 6 percentage points. On this basis alone, a further reduction of between $0.3 and $2.7 billion would need to be made by 1993/94. This does not allow for any further expenditure slippage, new policies or errors in the estimates of output growth. Most of the estimated decline occurs in the final year of the projection when real GDP is expected to grow by 2.5 to 3.0 percent.

The second suggested target relates to the financial balance. Recent official projections of the financial balance are set out in Table 6. The pattern of projections is similar to that for net expenditure. The deficit is now projected to be little changed between 1990/91 and 1993/94 at around $2.3 billion. As a percent of GDP, the deficit rises from 3.2 percent in 1990/91 to 3.8 percent in the current year before falling to 3.0 and 2.8 percent in 1992/93 and 1993/94 respectively. The recent increase in the level of the projected deficit largely reflects low tax collections caused by weaker demand. **Over the three year period, the fiscal balance as a percent of GDP is projected to improve by a marginal 0.4 percentage points, well short of the 6 percentage points which we believe is desirable.** The deficit would need to be some $4.5 billion lower in 1993/94 than currently projected to achieve this target.

Table 6

OFFICIAL PROJECTIONS OF FINANCIAL BALANCE FINANCIAL BALANCE BASIS 1990/91 TO 1993/94

Source of Projection	1990/91 $m	1991/92 $m	1992/93 $m	1993/94 $m
1989 Budget	-1,000	-1,300	-	-
1990 Budget[1]	89	-2,200	-1,600	-
1990 Treasury Briefing	-	-3,700	-4,500	-5,200
1990 December Statement	-	-2,075	-2,189	-2,245
1991 Budget	-	-1,739	-686	-528
1991 December Statement	-2,343[2]	-2,750	-2,300	-2,250

1 Unadjusted. The budget projection omitted the cost of several new policy proposals which were announced in the budget.

2 Actual.

In respect of the third target, net public debt, the Treasury's 1990 briefing for the incoming government projected a decline in net debt from 46.5 percent in 1990/91 to 43.1 percent of GDP in 1991/92 and then a rise to 48.0 percent in 1992/93 and 53.3 percent in 1993/94. The latest projections suggest that net debt will be equal to around 52 percent of GDP from 1991/92 to 1993/94. **Thus a deterioration is forecast from the end of 1990/91 to the end of the forecast period.** On this basis, and on the assumption that other OECD countries continue to reduce their net debt, New Zealand's relative position will continue to decline.

The present projections fall well short of the suggested targets. The financial balance target and the net debt targets are the ones where the greatest improvement is required. Achieving them requires further expenditure reductions and a reactivation of the privatisation programme as a matter of urgency. The considerable scope for action in this regard is discussed in the next section.

4 Expenditure Reduction Programme

The expenditure reductions proposed in this section are an indicative programme for achieving the fiscal targets which we argue would form part of a high quality approach to economic management and yield substantial economic benefits. They are considered under five main headings – outputs, inputs, public sector management, privatisation and revenue.

4.1 Outputs

Modifications to the major outputs of the government sector need to take into account considerations of efficiency, fairness and social opportunity. **While fairness criteria justify a safety net for people in need, it is also important to have regard to fairness to other taxpayers and to ensure that people who are in a position to become self-reliant are not encouraged to remain welfare beneficiaries.** Government spending on social services, education and health is forecast by the government to account for 75 percent of total government spending, excluding debt servicing. It follows that expenditure reductions need to be focused on these major spending items. The key issues in this area relate to benefit levels, eligibility rules and user charges.

In addition, income eligibility rules and abatement rates need to be modified to better reflect the effective income of beneficiaries. A wide range of people have scope to trap income in entities such as private companies and thereby diminish the efficacy of the income test. The introduction of the qualifying company regime will accentuate the problem. Fringe benefits and superannuation contributions which are not taxed in the hands of the income earner also tend to escape the income test. The extension of income testing to health and education will place greater pressure on income tests. A more rigorous approach to the measurement of income for testing purposes is required. While targeting social assistance has drawbacks, the fiscal costs of universal payments are insupportable. The best way of reducing the problems of targeted schemes is to reduce total spending so as to permit a lowering of tax rates, particularly income tax.

National Superannuation

National superannuation (formerly called guaranteed retirement income) is the government's largest expenditure programme. At 30 June 1991, there were about 506,000 national superannuation beneficiaries. In the 1991/92 budget the programme was forecast to cost $5.3 billion (gross) which is equivalent to around 20 percent of the budget forecast of tax collections from all sources. The subsequent changes to the budget policy announcement are understood to have added a further $144 million to its cost in 1991/92.

In recent years, successive governments have taken steps designed to reduce the cost of national superannuation in response to an expected aging in the population and for fiscal reasons. Similar moves have been implemented by other developed countries. Late last year, the government announced that the following changes would be made to the scheme:

- the age of eligibility is to rise from 60 to 61 years on 1 April 1992 and, thereafter, will rise from 61 to 65 years at the rate of three months in age every six months in time. Thus the age of eligibility will reach 65 on 1 April 2001[8];
- benefit levels were frozen until 1 April 1993. On that date, benefits are to be adjusted to reflect the movement in consumer prices during the 1992 calendar year. Subsequent adjustments are to be computed on a similar basis. Provided real incomes rise, these decisions imply a gradual decline in the ratio of national superannuation to real wages;
- the rate of surcharge on superannuitants' other income, which in effect claws back national superannuation, is to increase from 20 percent to 25 percent from 1 April 1992;
- the annual threshold at which the abatement applies is to be reduced from $7,202 to $4,160 for single recipients and from $12,012 to $6,240 for married recipients.

Despite these moves, national superannuation is still a very generous scheme compared with levels of income support for the aged in Australia and other OECD countries, and with comparable schemes such as the invalids benefit. Benefit levels are high in relation to wages. The net of tax benefit payable to a married couple (with no children) is equivalent to 67 percent of average weekly earnings compared with 63 percent payable to a similar couple on the invalids benefit. Furthermore, national superannuation is among the least tightly targeted social welfare schemes. Recipients' income from sources other than national superannuation is subject to the surcharge. However, a high threshold applies and various forms of income are not subject to the test. In addition, some retirees who are in receipt of limited income own significant assets which could be realised to help fund their consumption. An assets test does not apply to national superannuation as it does to the Australian age pension. Hardship is not widespread among the elderly, who in general are well off compared with some other groups[9].

In a previous report, *Retirement Income Provision* (New Zealand Business Roundtable (1989b)), we examined the provision of incomes in retirement in a comprehensive way. The central finding of the NZBR study is that the future welfare of retired New Zealanders is fundamentally dependent on increased output of goods and services from the economy. In the absence of a superior economic growth performance, private financial claims on resources or promised state benefits will be of little avail. **In thinking about retirement income policies, therefore, the need for an overall economic programme which will improve New Zealand's poor long-run growth performance is pivotal.**

8 The government has recently announced that people over 55 years of age who are unemployed will qualify for a new benefit. The benefit will be similar to an adult unemployment benefit except that the stand-down period where the applicant has been made redundant will be relaxed.

9 For a brief discussion of the income and wealth of people aged over 60 years, see New Zealand Planning Council (1990).

Fiscal policy and the aggregate tax burden impact significantly on the growth performance of the economy. The current level of outlays on national superannuation represents a major component of government expenditure and the tax burden. It has made it difficult for governments to achieve balanced budgets and has contributed to the alarming accumulation of debt.

Claims have been made that national superannuation has been met out of taxes paid during the retiree's working life. Past taxes have, however, been used to pay for only part of the services enjoyed by present generations with the balance being funded by borrowing, which represents a tax on future generations. **Sadly, the claim that they have funded the liabilities of the national superannuation scheme is demonstrably false, and will be put beyond any doubt when the government's balance sheet is released.**

There is also a pressing need to send a strong and immediate signal to the community that more reliance must be placed on private retirement income provision. The NZBR study concluded that individuals can and will save for retirement provided a sound environment for savings is created and the public scheme is not so comprehensive as to substitute for such savings. Tax concessions or compulsory savings schemes (which are similar to taxes in many respects) were not seen as necessary to motivate private savings; indeed by increasing effective tax burdens and hence economic distortions they were seen as impairing the potential of the economy to grow and generate a larger flow of savings.

In respect of increasing the level of national savings, the elimination of financial deficits and a shift to surpluses are widely acknowledged to be the best option open to the government. We consider that the creation of an environment in which individuals would need to make their own savings plans if they wished to enjoy a retirement income above a modest level, with the government underwriting those who were unable to provide for themselves, is the preferable approach to an overall retirement income policy.

On the basis of this analysis, the key features of a redesigned public superannuation scheme are seen as being:

- a higher eligibility age;
- a lower benefit rate relative to average earnings; and
- tighter targeting of benefits;

in conjunction with transitional arrangements which reduced the fiscal burden as rapidly as possible while protecting to the maximum possible extent those in retirement who were not in a position to adjust to policy changes.

An increase in the age of eligibility for national superannuation to 65 was advocated by the Royal Commission on Social Policy and proposed by both major political parties. It appears to have been widely accepted by the public as being desirable and necessary. There is, however, a case for raising the qualifying age for government income support further to 68 or 70 with those people who are unable to work for reasons of poor health qualifying for an invalids benefit. Life expectancy and health status have increased substantially since the early pension schemes set the age for retirement at 65. Naturally many people would elect to retire earlier on the basis of their own savings.

The major weakness in the present arrangements remains the level of the benefit in relation to wage rates. The present benefit is approximately equivalent to providing a married couple with a lump sum of $150,000 on retirement, which is equivalent to 5.2 times the average annual wage for males and females combined. Some United States research suggests that wealth equal to 5 times pre-retirement salary is broadly consistent with the maintenance of pre-retirement consumption levels in retirement (Modigliani (1986)). National superannuation alone exceeds this level. Many retirees also own substantial assets such as a freehold house. The benefit level is well in excess of a safety net standard which the government has adopted as appropriate for other social assistance.

The steps taken to reduce the real value of benefits will be slow to impact, given the desirable objective of achieving price stability by 1993. There will be little erosion due to inflation, and there is little basis for real wage growth in general while unemployment remains high. One option would be to continue the freeze in benefit levels beyond 1992. A more important option, however, would be to lower the level of benefits, at least for new recipients. The objective should be to set the benefit level at the rate applicable to the invalids benefit as suggested by the Royal Commission on Social Policy and the Treasury. **There are no equity grounds for providing a middle-aged person with a serious long-term incapacity less income than an elderly person in the same or better physical condition. As people who are close to retirement have little opportunity to adjust to such changes, a reduction should be phased in over a period of 5-10 years.**

The superannuation surcharge is a loose form of income test for national superannuation compared with that applicable to other income tested benefits. As national superannuation provides more than a minimum acceptable level of income, there are no compelling grounds for not abating the benefit on the first dollar of additional income. **Secondly, as some elderly people own assets which produce limited recorded income, there is a strong argument for applying an assets test in addition to an income test.** A property test applied to the schemes which preceded national superannuation up until 1960. Moreover, the extension of the stand-down period for unemployment and other benefits (see below) amounts to an indirect assets test.

Unemployment and Training Benefits

At 30 June 1991, there were about 153,260 people on unemployment benefits[10] and around 7,480 on training benefits. In the 1991 budget, the government provided $1.4 billion for unemployment benefits in 1991/92.

Significant moves have been made recently to increase the incentive for unemployed people to seek paid employment or to undertake training, and to contain the costs of unemployment support. In addition, steps have been taken to improve the flexibility of the labour market, most notably through the implementation of the Employment Contracts Act.

The minimum qualifying age for the unemployment benefit was increased from 16 to 18 years and a two week stand-down period was introduced for all benefits (other than national superannuation) by the Labour government. A training allowance for certain unemployed persons aged between 16 and 18 years was introduced.

10 Includes unemployment and emergency unemployment benefit, and job search allowance and independent youth benefit.

In December 1990, the present government announced that the stand-down period would be extended to 26 weeks where an unemployed person had received redundancy or severance payments, had voluntarily left his or her previous job, had refused suitable work or had been dismissed from his or her previous work because of misconduct. In addition, people previously on 'high' incomes were made subject to a stand-down period of up to 10 weeks. For other people, the stand-down period remains at 2 weeks. The level of unemployment benefits has also been reduced. Furthermore, the age at which the adult rate of benefit is paid has been increased to 25 years.

The NZBR study of the New Zealand and Australian social security and welfare systems (New Zealand Business Roundtable (1990)), which was undertaken shortly before the changes were announced, found that New Zealand's assistance to the young unemployed was more generous than comparable schemes in Australia. The changes which have subsequently been implemented in New Zealand have reduced but not eliminated this difference.

Unemployment remains a serious economic and social problem. **There is no reason why the New Zealand economy cannot return to a state of full employment – in which nobody is voluntarily unemployed apart from periods of job search.** The view that we must tolerate a permanent level of unemployment is defeatist. However, the New Zealand economy will need to perform well if we are to achieve full employment (along with other desirable economic goals) by 2000. To achieve significant reductions there remains a need to achieve competitive wage levels (which balance labour supply and demand), to increase the incentive to search for employment, to undertake appropriate training and to be productive in work. The gap between the return from employment and benefits payable to the unemployed needs to be expanded. The levels and duration of unemployment can be expected to be influenced by the generosity and structure of unemployment support. **A time limit should be set on the period for which the unemployment benefit is paid to a recipient, as proposed by the Liberal party opposition in Australia and applied in many other OECD countries, as indicated in the table below. Those who have not found paid employment within the prescribed period should be placed on training programmes or on a lower rate of benefit.** A logical complementary move would be to eliminate the obstacle which the current statutory minimum wage presents to unskilled people gaining initial employment, **by reducing it at least to the level of the unemployment benefit**.

Table 7

THE MAXIMUM DURATION FOR UNEMPLOYMENT BENEFIT FOR A PRIME-AGE UNEMPLOYED WORKER

	Benefit Type	Maximum Benefit Duration
European Community		
Belgium	UI	Indefinite
Denmark	UI	30 months
	GI	Indefinite
France	UI	30 months
	UA	Indefinite
Germany	UI	12 months
	UA	Indefinite
Greece	UI	5 months
Ireland	UI	15 months
	UA	Indefinite
Italy	UI	6 months
Netherlands	UI	36 months
Portugal	UI	pay record dependent
	UA	15 months
Spain	UI	24 months
United Kingdom	UI	52 weeks
	GI	Indefinite
Other OECD Europe		
Austria	UI	30 weeks
	UA	Indefinite
Finland	UI	24 months
	UA	Indefinite
Norway	UI	80 weeks
Sweden	UI	60 weeks
Switzerland	UI	50 weeks
OECD Non-Europe		
Australia	GI	Indefinite
Canada	UI	50 weeks
	SW	Indefinite
Japan	UI	30 weeks
New Zealand	GI	Indefinite
United States	UI	26 weeks

UI = unemployment insurance
UA = unemployment assistance
GI = guaranteed minimum income
SW = social welfare.

Source: OECD Employment Outlook, July 1991.

Domestic Purposes Benefit

The DPB has been the most controversial benefit in the New Zealand social security system. It is paid to people who are not in paid employment, or who are employed on a part-time basis, because they are caring for a dependent child or

some other dependent family member, or have done so in the past. Three groups qualify for the benefit. These are sole parents, people caring at home for the sick or frail, and women alone.

Sole parents are by far the largest group. To qualify for the DPB, a sole parent must be aged 18 years or older and living full time in New Zealand. The age of eligibility was increased from 16 to 18 years from 1 August 1991.

People who have encountered a breakdown in a marriage or in a de facto relationship accounted for 69.8 percent of total domestic purpose beneficiaries at 30 June 1991. Unmarried mothers accounted for a further 25.3 percent of beneficiaries. The balance is made up by other groups.

The number of beneficiaries in receipt of the DPB has continued to grow rapidly. When it was introduced in 1973, fewer than 4,000 were in receipt of the benefit. Between 1986 and 1991, the number grew from around 60,000 (all groups) to 97,000 (at 30 June), an average increase of about 9 percent a year. It is now over 100,000. The 1991/92 budget provided for expenditure of $1.1 billion on the scheme. In addition, DPB beneficiaries commonly qualify for supplementary social welfare assistance (e.g. special needs grants, special benefit and child care subsidy) as well as housing subsidies.[11]

A major concern with the DPB is that it weakens the incentives for people to consider the implications of family responsibilities in advance. Because the state provides assistance to care givers (and their children) who are not supported by the non-custodial parent, the latter have a diminished incentive to support their former partners and their children. The Department of Social Welfare endeavours to recover at least part of the cost of the DPB from the non-custodial parent under the liable parent scheme, and maintenance orders and registered agreements provide for similar recoveries. These sources typically yield only around 45 percent of the amount due. Moreover, in 1990/91 the total amount due under these schemes accounted for around 15 percent of the cost of the DPB. Steps are being taken to increase the recovery of payments from non-custodial parents. The Inland Revenue Department, which is to become responsible for collections, hopes to raise the level of recoveries to 70 percent.

The NZBR study of Australian and New Zealand social welfare arrangements showed that in 1989 New Zealand payments to a sole parent with one or two children were substantially higher relative to average wages than in Australia (New Zealand Business Roundtable (1990)). **In addition, sole parent benefits were payable to around 2 percent of the total Australian population compared with 3 percent of the total New Zealand population, a 50 percent higher rate of coverage.**

Options for containing the cost of the DPB in the short term include reducing the level of the benefit, tightening eligibility criteria and recovering a higher percentage of the cost of the DPB from non-custodial parents. In the longer term, arrangements which place the prime obligation for supporting care givers and children on the non-custodial parent, rather than on other members of the community as taxpayers, would be more equitable and would encourage greater personal and family responsibility.

11 In 1987/88 75 percent of new rental clients of the Housing Corporation were social welfare beneficiaries. Sole parents accounted for 51 percent of such clients. See New Zealand Business Roundtable (1991a).

In December 1990 the government reduced the level of the DPB. For example, the weekly benefit payable to a sole parent with one child was reduced from $255.14 to $227.93 (net of tax and with family assistance)[12]. The level of the benefit could be frozen at its current level to reduce its value relative to wages. Consideration could be given to introducing a lower benefit structure for new recipients after a suitable announcement period.

At present a beneficiary on the DPB can earn $3,120 a year before tax without facing a reduction in the benefit. Beyond this level and between $3,120 and $4,160 a year the benefit is reduced by 30 cents in the dollar. If more than $4,160 a year is earned, the benefit is reduced by 70 cents in the dollar. These abatement rates, coupled with tax on the additional income, provide a strong disincentive for beneficiaries to undertake paid work (other than that which escapes abatement) beyond $3,120 a year. It might be desirable to abolish the threshold at which the abatement applies, to abate the first dollar of additional income and to set a uniform rate of abatement at a level below the current 70 percent rate. Similar changes should be made to the abatement arrangements for other benefits[13]. Improvements along these lines should be possible while providing some savings.

The major justification for the sole parent's benefit is that care givers are unable to work to support themselves and their children fully. The DPB is available to the custodial parent who cares for a school child aged under 18 years. The comparable age in Australia is 16 years. The force of the argument for the DPB diminishes as the age of the youngest child increases. There has been a rising trend among non-beneficiary families for the primary care-giver to return to the work force while children are still at school. The previous government intended to require beneficiaries with children over the age of thirteen to be available for part-time work. The Treasury (1990) noted, however, that that proposal did not go far enough. One option would be to restrict the DPB to sole parents with dependent children of primary school or pre-school age, except where the child is handicapped and requires special care. Another option would be to raise the age of eligibility for the DPB to 21 years since parents are commonly regarded as having responsibilities for family support up to this age. A hardship grant at a lower level may need to be available to those people under the age of 21 whose parents would not support them.

Some DPB beneficiaries may own significant assets or become entitled to such assets as part of a matrimonial property settlement. There are grounds to either disallow the benefit in those cases where the applicant owns assets or to claw it back where a beneficiary becomes entitled to assets. All applicants for the DPB are required to disclose their cash assets and a simple assets test based on this information could be implemented as a first step.

We are not convinced, however, that enough is being done to sheet home responsibility to the non-custodial parent for the care of dependent children and their care givers. The DPB makes it too easy for the non-custodial parent to opt out and the government has inadequate incentives to recover costs from non-custodial parents. The emphasis, however, needs to be placed on finding a long-term solution. **This would require a broad review of the options available, including changes to matrimonial property laws, with a view to shifting the prime responsibility for providing for the custodial parent and children from the taxpayer in general to the non-custodial parent.**

12 The benefit level is to be increased by 1 percent from 1 April 1992.

13 Other income tested benefits are abated on a comparable basis.

Other benefits

Social security benefits (other than national superannuation, unemployment and DPB) are less significant in terms of their costs. They include invalids, sickness and widows benefits. At 30 June 1991, there were 64,800 recipients of such benefits.

The number of people receiving the sickness benefit more than doubled between 31 March 1986 and 30 June 1991 at a time when health expenditures were growing strongly. This partly reflects the substitution between unemployment and sickness benefits. Increased pressure will be placed on the sickness benefit now that unemployment benefits for under 25 year olds have been curtailed.

The sickness benefit is intended to support people who are temporarily unable to work because of illness. The invalids benefit, on the other hand, is paid to people who are unable to work full-time because of total blindness or a severe and permanent illness, injury or disability.

The life cycle model, which is a widely accepted model of consumption and saving behaviour, suggests that temporary losses of income are unlikely to lead to substantial cuts in consumption and hence welfare because people tend to set their expenditure patterns according to expected lifetime income. Thus, in the absence of excessive uncertainty and constraints imposed by incomplete finance markets (such as the inability to borrow on the security of one's human capital), people who suffer a temporary loss of income through illness, unemployment or other causes could generally be expected to draw on their savings to maintain consumption. In these circumstances, the grounds for government assistance is weak.

Furthermore, a loss of income from illness, injury or disability is an insurable contingency for the vast majority of the population. The main exceptions would relate to people who suffer with health defects from birth, and those who suffer from a limited range of conditions which, because of uncertainty as to the cost involved or for other reasons, private markets may not be prepared to insure.

Greater reliance on private insurance markets to provide for temporary or permanent loss of income in the case of illness is desirable. This would enhance incentives for healthier life styles and lead to better control of moral hazard and a more efficient monitoring of claims. A move in this direction would need to be associated with steps to limit the extent of public provision of income support to people who become ill or who are disabled as a consequence of an uninsurable event.

Appropriate rules in respect of people who could be expected to take out private insurance could include the following:

- a reduction in the level of benefits and in access to supplementary state assistance;
- the introduction (as a first step) of a simple assets tests based on cash and other readily realisable assets.

Housing

Successive governments have played an extensive role in New Zealand's housing market. In 1989/90 we estimated that the subsidy to housing services, including the non-taxing of imputed rents on owner-occupied houses, amounted to at least $1 billion. Only a part of this subsidy is reflected directly in the government's expenditure.

In the 1991 budget the government announced the following policy initiatives:

- direct housing assistance is to be taken over by the Department of Social Welfare and integrated into a new accommodation supplement which will be available to renters and home owners. Renters of private sector accommodation will qualify for the supplement. The supplement will replace existing rental and lending programmes;
- the Housing Corporation's 69,500 rental units are to be transferred to a separate entity which is to be established on state-owned enterprise principles;
- the Housing Corporation's mortgage lending business is to be reviewed. Its prime rate mortgages are to be offered for sale;
- the homestart scheme is to be abolished;
- Housing Corporation rents are to be raised to market levels over a five year period.

The details of the new accommodation supplement have not yet been announced. A small parcel of prime rate mortgages has been sold.

These policy moves are clearly in the right direction. We remain sceptical, however, that housing subsidies are justified in the medium term. Cash transfers enable recipients to maximise their welfare at a lower cost to the community than equivalent tied assistance. The argument for this view is set out in the NZBR study on housing (New Zealand Business Roundtable (1991a)).

In our report we advocated the following policy changes in respect of specific housing programmes:

- a reduction in total assistance to housing;
- privatisation of the Housing Corporation's rental business;
- the sale of the Housing Corporation's entire mortgage portfolio or of its lending business;
- the separation of the Housing Corporation's regulatory and operational functions;
- a range of steps aimed at improving the functioning of housing and finance markets.

Implementation of the detailed proposals set out in the report would be justified on both efficiency and equity grounds and would contribute to a reduction in the cost of housing subsidies. We also recommended a range of measures relating to planning and building controls, tariffs and the regulation of renting which would reduce the costs of housing.

Accident Compensation

Although the accident compensation scheme only partly falls within the government's budget, it is considered here in its totality for two reasons. First, the tied taxes used to finance the bulk of the scheme directly add to labour costs. Secondly, the benefits under the scheme have implications for the treatment of people who suffer from sickness and illness as opposed to those who are injured as a result of an accident.

The cost of accident compensation for non-earners ($138 million has been provided for 1991/92) is funded from general taxation and that for injuries sustained in motor accidents is funded by a levy on the owners of registered motor vehicles. The total cost of the scheme increased at an average rate of 25 percent between 1985 and 1990 (Birch (1991)).

In the 1991 budget the government announced the following reforms to accident compensation:

- employers are to be liable for the cost of work place accidents only (except where a motor vehicle is involved);
- employers will be required to meet public health costs involved in treating injuries sustained in the course of employment. Owners of registered motor vehicles will be required to meet the similar costs in respect of motor accidents. These costs were previously funded out of general taxation;
- earners are to be required to pay a premium to meet the cost of non-work accidental injury. The levy will initially be a flat-rate one of 70 cents for every $100 of earnings;
- a new tax on premium grade petrol is to be introduced to fund part of the costs of motor accidents;
- qualifying employers will be given an option of making their own provision for funding a longer stand-down period for earnings related compensation in return for a lower premium;
- experience rating of employers will be introduced in the future.

In our submission on these proposals we noted that the directions taken by New Zealand over the last 20 years in dealing with personal injury by accident have not been followed elsewhere (New Zealand Business Roundtable (1991b)). Few jurisdictions have based policy on the essential features of the New Zealand model, a monopoly state insurer and a no-fault liability regime. We argued that there are grounds for believing that the concept of the accident compensation scheme is fundamentally unsound.

Given the present framework, we acknowledged that the budget proposals move in the right direction but we also pointed out that they are very limited in their scope and that they fall well short of the changes recommended by the working party set up to advise the government on the scheme. **Because they do not alter its basic features they will not eliminate its propensity to ongoing cost escalation.**

In our view, thoroughgoing structural reform of the accident compensation scheme is required. A critical factor is the recognition that accident compensation is a matter of insurance, not welfare. Proper cost control and enhanced responsibility for preventing accidents and minimising the costs of

those that do occur will depend on the refinement of the insurance mechanisms contained in the present scheme. Essentially this requires the creation of a competitive insurance market. **The Accident Compensation Corporation should be corporatised and ultimately privatised and barriers to competition in the provision of accident insurance should be removed.** This would require, among other things, that the present scheme be fully funded.

We also noted in our submission that there is a case for a fuller examination of the contribution which a modified tort system could make to accident prevention. The government's document on the accident compensation scheme (Birch (1991)) misconstrued the role of the tort system, viewing it as a means of compensation rather than as a device to encourage safety. The provision of compensation is a function of insurance markets.

The reform of accident compensation as outlined in our studies would complement the current reform of the health sector.

Health

The provision of health services constitutes a major industry, comparable in size to the agriculture sector. Total public and private expenditure on health services in 1990/91 amounted to $5.3 billion or 7.2 percent of GDP. Between 1979/80 and 1990/91 real health expenditure per head grew by 1 percent a year (Muthumala and McKendry (1991)). Almost 82 percent of total spending on health services in 1990/91 ($4.3 billion) was funded publicly, a slight decline from the 88 percent recorded in 1988.

In 1990/91, public expenditure on institutional care cost $2.9 billion, community care (general practitioner services, specialists and medicaments) cost $1.1 billion while public health services and teaching and research cost $0.3 billion, giving a total of $4.3 billion. In the 1991 budget net health expenditure was forecast to amount to $3.9 billion in 1991/92.

The NZBR commissioned Professor Patricia Danzon of the University of Pennsylvania and CS First Boston New Zealand Limited to examine the delivery and financing of health care in New Zealand. Their report (Danzon and Begg (1991)) examined a range of options for health care and forms the background to the following commentary on the government's reform programme.

In the 1991 budget, the government announced major policy changes affecting health which are designed to achieve the following objectives:

- to improve access for all New Zealanders to a health care system that is effective, fair and affordable;
- to encourage efficiency, flexibility and innovation in the delivery of health care to the community;
- to reduce waiting times for hospital operations;
- to widen the choice of hospitals and health care services for consumers;
- to enhance the working environment for health professionals;
- to recognise the importance of the public health effort in preventing illness and injury and in promoting health;
- to increase the sensitivity of the health care system to the changing needs of people in our society.

The policy initiatives which were announced included the following:

- the separation of the purchasing and provision roles currently performed by area health boards;
- the establishment of four regional health authorities (RHAs) to manage the purchasing of, and contracting for, health services;
- RHAs to assume responsibility for funding both primary care and hospital-based care;
- RHAs to purchase services from the public, private or voluntary sectors;
- most big public hospitals are to be established on more business-like lines as Crown Health Enterprises (CHEs);
- people are to be given a choice of obtaining their health care through RHAs or through other health care plans;
- the government is to define core health services, for which assistance will be provided;
- part charges for health services are to be rationalised and extended.

The reforms correctly recognise that the funding and provision of health services need to be separated to enable consumers to better express their preferences for services, to make producers responsive to such preferences and to encourage greater efficiency in the production of health services. It has also been recognised that the subsidisation of health services does not require that the services be produced by the government. Furthermore, the Rand health experiments have shown that part user charges can have a significant impact on the quantity of health services demanded by consumers without adversely effecting health outcomes and can thereby improve resource allocation (Pauly (1986)).

The largely free provision of hospital services, coupled with the dominant role of the public sector in providing institutional care, suggests that the scope for efficiency improvements in the health sector is enormous. The Gibbs Task Force and the Arthur Andersen report on the health system both reached this conclusion. Experience with SOE reforms has shown that efficiency improvements of 30-50 percent are typically attainable, and it is highly likely that the potential for such gains in the health sector is of a similar magnitude.

While the above proposals represent a desirable first step, they suffer from the following deficiencies:

- CHEs will have insufficient incentives to operate efficiently. They suffer from the well-known limitations of state-owned enterprises. In addition, they will supply a market in which competition on the demand side is severely distorted;
- consumers will have inadequate incentives to economise on hospital services, to search for the most effective service, to monitor health providers, to undertake an optimal investment in healthy life styles and to minimise losses from ill health. They also need to be able to express their preferences more directly;
- RHAs will have weak incentives to reflect the wishes of consumers and insufficient information to do so. As a consequence, health care is likely to be less innovative, less flexible and less responsive to consumers' preferences than is desirable;

- the health care decisions of consumers will be influenced to a limited extent only by direct charges. As a result there will be excess demand for health services, and non-price methods of rationing, such as waiting and queuing, will continue to be required.

Steps which could overcome these deficiencies include the following:

- **CHEs should be privatised.** There is ample experience in running hospitals in the private sector in New Zealand and around the world. This would improve their incentives to produce efficiently and would facilitate competition in the supply of hospital services;
- a significant range of health services should be funded privately. As the liberal United States economist, Lester Thurow (1974) noted:

  > ". . . once society gets beyond basic public health measures and communicable diseases, medical care does not generate externalities".

  The benefits of most health care are private ones. There is a case for a low level of compulsory insurance to cover large unpredictable health expenditures. Regular and readily predictable health costs should be funded by voluntary insurance or from income or savings. This would give the consumer a much greater interest in the quality and cost of services provided. It would also utilise the well-developed features of insurance markets to monitor health suppliers and consumers of health insurance. A range of insurance and supply arrangements could be expected to develop. **Private health plans would be allowed to subsume many of the functions of RHAs;**
- **income tax should be scaled back as consumers accept responsibility for their health costs directly and via compulsory insurance premiums.** The improved efficiency from the above arrangements and the proceeds from the privatisation of CHEs would enable the fiscal position to be improved at the same time.

The government would continue to undertake significant functions such as public health and regulatory functions since these are roles which it is best equipped to undertake. Recent criticism of modest moves to increase health charges ignores the information which is conveyed by the pricing mechanism and the value of this in deciding what goods and services should be produced and consumed. A centralised agency cannot hope to make decisions which accurately reflect the interests and preferences of a diverse population. It is vital that the price mechanism be employed in the health sector so that better value is obtained for the consumer's dollar.

Education

In the 1991 budget, provision was made for $4.6 billion to be spent on education in 1991/92. Reviews in recent years have found major problems with the structures and performance of the education sector. Substantial additional resources have been devoted to education, yet there is little evidence that educational outcomes have increased commensurately. **There is a need to raise educational standards so that available human resources are consistent with the achievement of a high productivity, high income, high growth economy.** Positive changes have been set in train but the process is by no means complete.

In our study on tertiary education, we concluded that the key policy requirement was to subject the whole range of tertiary institutions to the

opportunities and constraints provided by a decentralised competitive market for their services, while funding services (to the extent desired) by a system of targeted entitlements financed at least in part by the government (New Zealand Business Roundtable (1988a)). We still believe that that policy is the best one, for reasons which are set out fully in our report. Policy has moved in that direction and where the changes from bureaucratic controls to autonomous and accountable management have been most pronounced, as in the case of the polytechnics, the efficiency and responsiveness of the institutions has improved dramatically.

The grounds for government provision of most post-compulsory educational services on a free or highly subsidised basis do not stand up to close scrutiny. Such educational services do not constitute a pure public good. As with most other goods and services, the benefits of many education services largely accrue to the consumer. Thurow (1974), for example, has stated:

> ". . . I find the arguments that education generates externalities unconvincing once one gets beyond elementary education (literacy, etc.)."

The requirement for children up to the age of 16 to attend school can be justified on the grounds that some parents may not always take care of the interests of their children in schooling, and young children are not equipped to do so. This does not, however, require the public provision of educational services nor their provision on a highly subsidised basis at all levels. Japanese education, which is recognised as being of high quality, is provided and financed privately to a significant extent from the senior secondary school level on (with strong competition among schools and higher learning institutions), and the superior performance of higher education in the United States owes much to outstanding private institutions (whereas the much-criticised school system is largely public).

The argument that public provision of education, free education or both is required to achieve income distributional objectives is also weak. There is substantial evidence that middle and upper income groups benefit most from post-compulsory education which is financed in part by taxes on lower income groups, and highly subsidised tertiary education in particular has perverse equity outcomes.

These arguments suggest that over the medium term there should be a move towards requiring a greater share of the costs of post-compulsory education to be met by the beneficiaries of that education (or their parents), and, secondly, that the provision of education services should be opened up to greater competition between the public and private sectors. These moves, like those proposed in respect of health services, would offer the following benefits:

- schools and institutions would be more responsive to consumers' preferences. They would better cater for diversity of learning requirements and tailor their offerings to the demands of their communities;
- students would have greater incentives to select courses wisely, to consider whether the benefits of study were worthwhile and to demand performance from educators;
- institutions which successfully attracted students would be allowed to expand, while those which were unattractive would be allowed to decline – unless they responded with an improved performance;

- there would be incentives to improve efficiency and to shift resources from higher to lower cost suppliers of services.

The move to full self-management of schools, including bulk funding of teacher salaries, is consistent with these medium-term objectives. It would place schools in the same position as tertiary and pre-school institutions. They would be able to optimise their budgets between teacher requirements (with varying levels of skill and experience) and non-salary expenditure rather than being forced to comply with an administrative allocation which cannot hope to reflect the particular circumstances of each school. **Full budgetary self-management and devolution of the employment role would enable schools to reward performance and to adjust remuneration to reflect supply and demand in the relevant locality[14].** The education union-led opposition to bulk funding is indicative of the extent to which the interests of parents and students have been subordinate to those employed within the system. The abolition of zoning and compulsory teacher registration is also consistent with the desired direction of policy.

Loan facilities, where necessary underwritten in part by the government, are the best means of financing the investment in human capital which tertiary education represents and of guaranteeing access. The newly-established student loan scheme contains a substantial subsidy to tertiary students. In addition, student fees reflect only a small part of the full costs of tertiary education. Many institutions have set uniform fees which do not reflect the variation in actual costs of the particular courses involved. Such a fee structure is unfair to many students, sends poor signals for the purposes of resource allocation and would not survive long in a competitive market. Nevertheless, fees are already causing students to be more demanding about teaching standards and encouraging a rethinking of course structures.

There is evidence of a continuing lack of responsiveness to market demands and inferior academic performance in the universities and colleges of education in particular. **A more far-reaching review of governance arrangements is warranted to introduce both greater managerial freedom and greater accountability, together with changes to employment arrangements embodying rewards and sanctions for academic performance.** Productivity improvements would provide scope to economise on tertiary budgets. Once the student loans scheme is bedded in, the subsidy elements involved in it should be reduced and the contribution from fees should be allowed to rise.

Defence

In the 1991 budget, $1.3 billion was provided for net expenditure on defence in 1991/92. Recent reductions in defence expenditure have concentrated on manpower reductions, the rationalisation of services within existing structures and the disposal of land. At the same time, the decision to acquire new frigates for the Navy has committed a significant part of the existing budget. Informed observers now believe that major reductions in defence spending would involve strategic decisions such as the abandonment of an air defence capability or a blue water navy.

New Zealand's defence arrangements should be reviewed in the context of a rigorous military assessment of the threats and risks to its security and of its political, economic and defence relations with other countries. The key objective should be to put in place arrangements which would safeguard New

14 The case for moves away from national awards, site-based and individual contracts, performance pay and simplification of employment codes is made in Education Forum (1992).

Zealand's security at least cost. This could involve collective or bilateral agreements, or both, with countries having shared security interests. **These might also be underpinned by promoting wider political and economic agreements with North American, Asian and Pacific basin countries, including regional free trade agreements.** To our knowledge no fundamental review of New Zealand's defence requirements along these lines has been undertaken in recent years. We believe that such an assessment should form the basis for future strategic decisions on defence spending.

Other Outputs

The above expenditure areas, together with debt servicing which is largely contractually committed, account for more than 70 percent of the net cost of outputs. The balance of expenditure is allocated among a large number of smaller votes. We have not reviewed these in detail but we believe there is still massive scope for reducing expenditure which is not cost effective in many of them. We note, for example, that:

- there has been a very high rate of growth of spending in some departments in recent years (e.g. Environment);
- additional resources have been committed to some functions where there is scope to raise productivity and to deploy existing resources more effectively (e.g. police);
- the rationalisation of some departmental functions has not yet yielded commensurate economies (e.g. the Energy division of Commerce);
- New Zealand devotes disproportionate resources to some activities compared with many other countries (e.g. diplomatic personnel)[15];
- the extent of New Zealand's involvement in many international organisations and conferences of limited value appears excessive for a middle income country;
- there is a worldwide recognition that many foreign aid programmes have been failures and it is not clear that New Zealand's efforts have yielded greater success;
- there is scope for many more activities to be run on SOE lines (e.g. Trade Development Board) or contracted out (e.g. prison services). The management of a number of prisons in Australia has been contracted to private firms to avoid costly work practices;
- a number of grants are not appropriate functions for central government (e.g. urban transport subsidies);
- so-called job creation schemes are of dubious benefit;
- the financing of a number of activities could be shifted further in a user pays direction, resulting in better monitoring by users (e.g. fire services);
- the rationalisation of science policy should be advanced by providing Crown Research Institutes with an appropriate capital structure as a step towards their privatisation;
- despite much criticism of their proliferation, few quangos have been eliminated in recent years and new and larger ones have been created. Substantial private sector resources often have to be devoted to their activities.

15 On a population basis, for example, New Zealand has 5 times as many diplomats as Japan. This rises to nearly 10 times on a GDP basis. Moreover, 60 percent of Japan's diplomats work abroad whereas only one third of MERT's personnel are located overseas. Source: *The Economist*, December 7 1991 and MERT Annual Report for 1991.

We believe that the potential to reduce low quality expenditure is far from exhausted. As part of forthcoming expenditure rounds, we recommend that the government establish a small private sector advisory group to help identify budgetary savings.

4.2 Inputs

Labour Costs and Productivity

Labour costs are a major element of the total cost of providing government services. Health, education and police services, as well as government administrative services, are labour intensive. At the present time there do not appear to be general recruitment and retention problems in the public sector. **To the contrary, there is evidence of a substantial imbalance between applications and positions available in a number of departments, suggesting that many government sector pay rates are excessive given the available supply of labour.** The Justice Department, for example, recently reported that a large number of applications had been received for jobs in the prison service. There has been public concern that many recently trained nurses cannot find employment in New Zealand. Several hundred teacher college graduates are reported to be having difficulty finding work. The police force and administrative departments do not appear to face difficulties in filling vacancies, including training positions. These developments are not surprising given the high level of unemployment. Where there is an excess supply of labour there is a tendency to raise quality standards to ration jobs rather than to lower wage rates, thereby promoting more employment, enhancing services and contributing to an improvement in the fiscal position.

The public sector still clings to a number of national awards. **The need for employment arrangements to reflect local supply and demand conditions, to embody performance-related features and to meet the needs of specific employers and employees suggests that these should be abandoned.** Site agreements and individual contracts are particularly appropriate in sectors such as health and education where there is considerable geographical diversity and varying levels of individual performance. The public sector should aim to reflect these features in employment contracts in the same way that the private sector is doing.

In the private sector, extensive effort has also been applied to improving productivity and implementing more flexible employment conditions such as reductions in penal rates. We are not aware of many comparable changes in the public sector.

The key criterion which should determine the movement in labour costs is supply and demand for the particular class of labour at the locality where it is required. This is reflected in recruitment and retention performance provided that there are no artificial barriers to entry, such as quotas on training. If the government sector pays more than the competitive wage rate it will bid labour away from the private sector, lower aggregate employment and result in higher taxes on the private sector.

The indications that there is generally an excess supply of labour and the scope for productivity increases suggest that the government could reduce the wage bill without lowering performance levels. **Both of these objectives would be promoted by reducing funding for operating cost allocations in 1992/93. These should concentrate on activities where the scope for productivity gains is largest, but average adjustments in our view should amount to**

around 5 percent. The recently announced decision not to adjust such costs for inflation is far too accommodating. A negative annual adjustment should continue until productivity levels in the public sector are comparable to those of the private sector.

It is not surprising that labour costs in the public sector should grow more rapidly than those in the private sector. Public sector managers face weaker incentives to control costs. In addition, they tend to operate in non-competitive markets. A reduction in the grant to the IHC has forced it to cut staff numbers and salaries. At a time when budgetary stress in the central government sector is no less severe, and when there is excess demand for available positions in government social services and elsewhere, comparable adjustments are fully justified.

Debt Servicing

The cost of debt depends critically on the government pursuing the goal of price stability and on a consistent and predictable fiscal strategy aimed at eliminating the deficit and subsequently achieving surpluses. This would enable debt levels to be reduced to levels that are consistent with those of other OECD countries.

Considerable progress has been made in reducing nominal interest rates but less progress has been made in reducing real interest rates. Consistent application of orthodox economic policies and lower debt levels will be necessary to bed-in permanently lower real interest rates.

As noted earlier, we believe that the government's debt portfolio is over-weighted in foreign currency, thereby exposing taxpayers to excessive currency risks. The depreciation in the currency over the past year, for example, can be expected to have added in excess of $2 billion to the New Zealand dollar value of gross public debt. The argument that repatriation of the debt would push up domestic interest rates significantly does not stand up to close scrutiny. As the New Zealand economy is open to international capital flows, domestic interest rates are essentially determined in an international market. **A planned programme of restructuring the portfolio over the next 3 to 5 years should be implemented.**

The case for the present Reserve Bank policy of holding large foreign reserves, which effectively result in offshore borrowing, is dubious. It appears to be a hangover from the previous exchange rate regime. **Since the Bank is no longer involved in active foreign exchange market intervention there is a case for reviewing the justification for official reserves and to put in place a policy which is consistent with wider economic policy.** Provision for contingencies such as a natural disaster or an outbreak of foot and mouth disease would be better handled by a range of measures, including committed lines of credit from foreign banks and reciprocal agreements with other countries, rather than the holding of large foreign reserves. Eliminating foreign reserves management would decrease government indebtedness and debt servicing costs.[16]

Another debt issue is the question of whether the Reserve Bank needs such a large balance sheet in order to carry out its monetary policy role. We believe that this issues deserves investigation.

16 For an elaboration of this argument, see Cowen (1991).

Other Inputs

The key to lowering the cost of other inputs to government services is a continuation of microeconomic reforms aimed at improving the efficiency of markets for goods and services such as energy supplies, transport services, building costs and non-wage costs such as ACC levies. The broad steps which are required include the following:

- removal of barriers to entry into, and exit from, industries;
- lower tariffs and other industry assistance;
- privatisation of government-owned businesses to enhance their incentives to produce efficiently;
- elimination of other industry-specific regulations which are not justified on valid economic grounds;
- application of a tax-neutral treatment to industries, business entities and forms of income and consumption.

4.3 Public Sector Management

Major departments within the core state sector are large enterprises by any criterion. The quality of their management, with few exceptions, however, is inferior to that of the best managed private sector enterprises. **A recent review of state sector management has pointed out that under the State Sector Act chief executive appointments have continued to be made largely from the same pool and that the Senior Executive Service concept has not been successful.** There has been widespread external criticism of the financial management performance of some departments and lack of professional leadership (e.g. Education). Objectives have been set for relatively less important but nonetheless quantifiable outputs while qualitative assessment of key performance indicators have tended to be ignored. Performance reviews of departments by the State Services Commission have lacked penetrating analysis and have been acknowledged to be of little value. There is, therefore, a need to rethink a number of performance and accountability issues and upgrade the quality of management within the public sector.

Top quality implementation and administration of policy is required if the transformation of New Zealand into a high growth, high wage economy is to be achieved. To further this objective, the mechanisms for specifying and monitoring contracts between ministers and their chief executives need to be improved. It needs to be recognised that ministers' priorities, experience and information bases are unlikely to equip them to carry out this function without supporting assistance.

Supplementary arrangements could include the establishment of boards to oversee the administrative functions of major departments such as DSW, IRD, Internal Affairs and Justice. In line with the SOE model, a statement of corporate intent could be formulated and agreed between the responsible minister and the board. This should be made public. The board could then be assigned the task of monitoring the chief executive and through him or her, the department, on the basis of the agreed statement of intent. Arrangements could also be made for regular reporting to both the minister and Parliament. The board could be responsible for the appointment and remuneration of chief executives, after consulting with the minister.

An alternative model in some cases would be to augment the resources available to ministers. This might also enable ministers to monitor more thoroughly their chief executives.

The attractiveness of public service management positions to talented private sector executives is severely attenuated by ministerial interference in management decisions, political arguments over petty details of administration and intrusions into personal privacy (e.g. over conditions of employment). No private organisation could operate successfully in such an environment. The constraints which the Official Information Act places on the advisory and decision-making process are not always conducive to efficient public administration and there is a case for reviewing its scope and the cost of its administration. We believe the use of the board model would also help reduce these problems, that experienced private sector people would be prepared to serve on boards, and that the range of quality candidates for public sector positions would be extended.

There is still a lack of contestability for policy advice and service delivery in many parts of the public sector. **There is clear evidence that major cost savings can be made by contracting-out, and where this option is not possible internal competition should be fostered.** The government has hardly scratched the surface of such possibilities. The benefits not only take the form of lower costs but, equally important, the possibility of accessing higher quality professional expertise. It is a reality that government agencies such as the Justice Department and the Securities and Commerce Commissions, for example, are unlikely as a general rule to attract professional talent of the calibre available in the private sector. Examples of services which are candidates for contracting-out include the payment of welfare benefits, the registry functions of the Reserve Bank, lost property services run by the Police and the audit function.

In addition, external reviews of the use of resources by departments have shown the potential for more searching performance appraisals than those undertaken by the government's control agencies. In our view the following departments seem to have resources well in excess of those needed: Commerce, Environment, Labour, Justice and External Relations and Trade. Transport is a department which has made significant economies which could be matched elsewhere.

4.4 Privatisation

Our studies on electricity, housing, health and state-owned enterprises generally have pointed to the benefits which can accrue from privatisation of state-owned entities. Experience with privatisation in New Zealand and around the world has put the benefits of such moves beyond dispute.

Treasury has estimated that shareholder wealth in the original 14 SOEs increased by $1.7 billion in their first three years. The success of the corporatisation programme is illustrated by a number of different businesses. CoalCorp, in its first full year of operation, turned a loss of $23 million into a small profit without increasing its prices. New Zealand Post transformed a loss of $38 million in 1986/87 into a profit of $53 million in 1989/90 without increasing the price for basic mail and at the same time improved service delivery by 5 to 10 percent despite an increase in the volume of mail delivered. Telecom reduced its staff from around 25,600 in 1987 to approximately 17,000 in 1990, lowering costs in many areas by using sub-contractors for services previously provided within the company. Service standards improved substantially; for example, the average time for telephone connections has been reduced from 6 weeks to 2 working days. In 1991 prices for toll calls fell dramatically in response to competition. The Electricity Corporation has reduced its unit operating costs in real terms by a total of 28 percent and

increased its productivity (measured in terms of GWh per employee) by 71 percent over the four years to March 1991. New Zealand's ports, which have been exposed to a similar corporatisation process, achieved a first year saving from port reform estimated by the Ministry of Transport at $58 million.

The government's privatisation programme has stalled over the last year. In addition, there is a widespread belief that political considerations are having a greater bearing on SOE operations. Experience with public enterprises around the world indicates that sooner or later political decision-making prevails and commercial failure ensues. **To capitalise on the progress achieved to date and to reduce the government's exposure to commercial risk, the privatisation programme should be revitalised.**

Prime candidates for privatisation include the Electricity Corporation, state forest assets including Timberlands, New Zealand Post, New Zealand Rail and other railway assets, Land Corporation, Coal Corporation, Government Computing Services, Television New Zealand, Radio New Zealand (at least the commercial stations), Works Corporation, Bank of New Zealand, Public Trust, Housing Corporation activities (or assets), Earthquake and War Damage Commission (though it may be better to phase out this activity), the Accident Compensation Corporation and Crown Health Enterprises. New Zealand is still lagging well behind many other countries in respect of privatisation. For example, some three quarters of the electricity industry is now in the private sector in OECD counties, and literally dozens of countries and states are currently engaged in electricity privatisation.

The government should actively encourage the privatisation of other businesses in public ownership such as ports, airports and electricity distribution companies.

The sale of state businesses could yield $10 to 15 billion over the next few years and make a significant contribution to the achievement of the debt target.

4.5 Revenue

Taxation

Some desirable improvements in tax policy, such as a reduction in the level of taxation on interest paid to non-residents, have recently been made. **Nevertheless, there has been a decline in the quality of tax policy decisions in recent years.** At least up until 1988, the previous government sought to reduce the efficiency cost of the tax system by lowering marginal tax rates and extending tax bases, thereby applying lower and more even effective rates of tax to different activities, forms of finance and entities. Its programme was widely supported. The broad directions of present tax policy are much less clear.

The government has re-introduced a number of distortions on the basis of incorrect claims that it is correcting anomalies. Examples include the following:

- the re-introduction of expenditure tax treatment for forestry;
- the qualifying company regime which will allow tightly-held companies to distribute income tax free which would otherwise be taxable if distributed by other companies;

- the new depreciation regime which should have been based on economic rates of depreciation but which has been designed on the basis of other countries' depreciation regimes. (A similar argument would suggest that farmers in New Zealand should be paid the same subsidies as farmers in the European Community);
- the proposal to treat exploration expenditure on an expenditure tax rather than an income tax basis. The decision to treat exploration farm-in and farm-out arrangements on an inconsistent basis is open to abuse;
- the proposal to re-institute expenditure tax treatment for certain farming activities.

In addition, we believe that the decision to increase the continuity of ownership requirement from 40 percent to 49 percent in order for a company to be able to carry forward tax losses was not economically justified. In our view, the desirable objective is to move toward a full cashing out of losses.

The tax path which the government is currently following runs the risk of progressively undermining the income and GST tax bases with a corresponding risk of higher tax rates in the future, higher deficits, or both. This would entail significant efficiency costs for the community.

The preferred course is for the government to apply valid economic principles in reforming the tax system with a view to raising required revenue at the least cost to the community. There is widespread academic and international organisation support for moving toward a comprehensive tax base and low uniform effective marginal tax rates and the phase-out of most excises. Many countries have adopted such policies in recent years.

User Charges

There are valid grounds for applying user charges to finance services provided by the government outside the category of pure public goods such as defence. They can help to achieve the following objectives:

- improve the efficiency with which resources are used;
- enable consumers to express their preferences more accurately. They therefore provide information which is relevant to producers;
- avoid the deadweight losses associated with taxes.

Excessive user charges, however, take on the feature of selective taxes, which can be among the most distorting of taxes. There is a significant risk of such excesses when the government is a monopoly supplier. We suspect that Justice and Transport are among departments that are guilty of imposing such charges.

5 Conclusion

The essential points which arise from this review are as follows:

- Fiscal policy has been the consistently weak feature of the economic reforms pursued since the mid-1980s. Insufficient progress has been made in lowering the level of net government expenditure relative to GDP, in improving the fiscal balance relative to GDP and in reducing the ratio of net public debt to GDP.
- Fiscal policy is at the heart of the coherent economic policy which needs to be implemented and adhered to over the medium term. It is now the main threat to the programme which the government is putting in place. While adjusting to living within our means is hard, failure to do so in the past has brought about the cumulative economic and social stresses which the country has been experiencing and continuing failure would compound them in the future.
- The progress made by the government since late 1990 with its financial position has taken the pressure off monetary policy and financial markets and made room for private sector expansion. The benefits of lower government spending and an improved fiscal outlook have contributed to the recovery in economic activity.
- To capitalise on this progress, the government should adopt explicit fiscal targets for government expenditure, the financial balance and public debt to be achieved by the year 2000. This would improve the credibility of its fiscal policy.
- The share of government expenditure in national income should be reduced to between 25 and 30 percent by 2000. To achieve this target, the ratio should be reduced by an average of between 1 and 2 percentage points a year.
- The financial balance as a percentage of GDP should be improved by around 2 percentage points a year on average.
- Net public debt relative to GDP should be reduced to the average ratio for OECD countries by 2000.
- The government should continue to improve its underlying financial balance throughout economic cycles. Concerns about the impact on the level of economic activity of changes in the financial balance should be reflected in the speed at which it is improved.
- Expenditure reductions rather than revenue increases are needed to improve the financial balance. There is ample scope to reduce low value expenditure and New Zealand is already a heavily taxed nation.
- The government's three year fiscal projections, released in December 1991, show an insufficient reduction in the level of expenditure and an insufficient improvement in the financial balance – both relative to GDP – and no improvement in the ratio of net public debt to GDP.
- Substantial policy changes are required to achieve the desirable targets.
- The focus of expenditure savings necessarily includes the large expenditure items – social services, including health and education, and significant inputs such as labour and other operating costs.

- Significant expenditure savings in welfare spending can be realised by lowering the ratio of some benefits to wages, tightening abatement and eligibility rules, and applying a means test to assets as well as income.
- Greater reliance should also be placed on private insurance markets to manage the risk of income losses and additional costs from retirement, sickness, accidents and natural disasters.
- Consumers should bear a higher proportion of the costs of at least post-compulsory education. In addition, steps should be taken to promote choice and competition on a competitively neutral basis among educational establishments.
- The ease or difficulty of recruitment and retention for particular jobs in the relevant locality should generally determine state sector remuneration policy. Excess demand for many positions is clear evidence that remuneration should decline in the interests of promoting employment in both the public and private sectors. There should be a move from national awards to local collective and individual contracts.
- The public sector has not yet achieved the productivity improvements which have been realised by leading private sector firms. Operating grants should be cut by around 5 percent on average in 1992/93 with further negative adjustments in subsequent years to force productivity improvements.
- Public sector management needs to be strengthened to improve efficiency. The establishment of advisory boards to assist in monitoring the performance of major administrative departments is suggested.
- The privatisation programme needs to be reactivated to realise efficiency gains and to reduce debt.
- A private sector advisory group should be constituted to assist the government with its annual review of expenditure programmes.

Such a programme would enable the fiscal targets to be met and enhance the benefits that are now becoming apparent from the structural reforms of recent years and the better balance of policies achieved by the government. With the economy clearly in a recovery phase and the likelihood of an improved international economic climate within a year or so, it is vital for New Zealand to consolidate its position before the next international downturn or other external shock. The failure to do so during the buoyant period of world growth in the second half of the 1980s left the economy exposed and worsened the recent recession. Achieving a more robust position in the period ahead would secure the foundation for the much faster rate of growth of incomes and jobs that New Zealand ought to be able to look forward to in the 1990s.

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