NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE 1998 BUDGET POLICY STATEMENT

FEBRUARY 1998

CONTENTS

	Executive Summary	i
1	Introduction	1
2	The government's economic strategy	1
3	Government expenditure	3
4	Other issues	7
5	Conclusions	7

Executive Summary

- In our view, the economic strategy unveiled in the 1998 Budget Policy Statement (BPS) is risky to the point of imprudence. It is putting the fiscal position, the country's credit rating and the economy at risk.

- The BPS is based on economic growth rate forecasts which are inadequate compared with the country's growth potential and the coalition partners' growth objectives (3.5–5 percent annual growth to 2010 in the case of National and 6 percent by 1999 in the case of New Zealand First). Yet they look optimistic under present policy settings and compared with private sector forecasts. They are also dated as a result of the Asian 'crisis'.

- It is extraordinary that the BPS completely fails to comment on the woeful gap between its growth forecasts and the government's growth targets and that it proposes that all the burden of any downturn in activity following the Asian crisis should fall on private spending.

- The massive increases in government spending since 1995 have raised costs and prices in the non-traded goods sector of the economy and put export and import competing industries under great stress. They have been an important reason for the slowdown in growth and the increase in the current account deficit to a worrying level. Despite the fall in the nominal exchange rate in the past 12 months, New Zealand's international competitiveness remains inadequate.

- The New Zealand Business Roundtable (NZBR) supports many of the growth-enhancing measures listed in the BPS, but most remain merely statements of possible intent and they do not go nearly far enough to constitute a credible growth strategy. In particular, they do not include the reversal of the Employment Court's re-regulation of the labour market.

- In our view, much reduced government spending and taxes, flatter tax rates, a much more active privatisation programme and further deregulation is required if New Zealand is to achieve its potential. Our analysis in this regard coincides with that of the OECD and IMF.

- The government's long-term objective of reducing expenses to below 30 percent of GDP is far too modest. A more comprehensive measure of central government spending in New Zealand in 1995/96 suggests it was running at around 38 percent of GDP, appreciably higher than the figure of 34 percent for Crown operating expenses that year. Local government adds a further 3 percentage points. The goal of reducing Crown operating expenses to 30 percent of GDP would still leave general government with a very large share of the New Zealand economy. Recent research indicates that the deadweight losses associated with the taxes required to fund government spending at this level are very significant.

- Ongoing research into the costs of government spending and its relationship to economic growth strengthens our view that the government would better meet its growth objectives if government spending were reduced to below 20 percent of GDP. Genuine public goods and necessary social assistance could be financed by a level of outlays well within this ratio.

- In our view the BPS is far too preoccupied with increasing the level of spending. It should be paying much more attention to reducing spending and promoting growth in jobs and incomes by improving incentives and delivery structures.

- The coalition government's $5 billion spending programme contains far too much low quality spending. It should be abandoned.

- Any savings from eliminating low quality spending should be used to reduce taxes since spending which cannot be justified if it requires raising taxes is no more justifiable if it is funded from expenditure savings.

- In preparing the 1998 budget the government should comprehensively revisit its fiscal plans and implement other major policy adjustments to reduce the vulnerability of the economy and improve its current lacklustre performance.

1 Introduction

1.1 This submission on the 4 February 1998 Budget Policy Statement (BPS) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 This is the fourth BPS issued under the Fiscal Responsibility Act (the Act). In our submissions on the first two statements, we expressed support for the Act and for the government's intentions at the time to use increased revenue from economic growth first and foremost to generate operating surpluses, reduce debt and build net worth.

1.3 Since 1995 we have viewed the growth in government expenditures with increasing concern and expressed the view that real expenditure reductions would better serve the government's economic growth and social cohesion objectives.

1.4 This submission reiterates these concerns. Section 1 assesses the BPS in the light of the coalition partners' objectives for economic growth. Section 2 reviews trends in government spending, comments on the overall size of government, and emphasises the relationship between the size of government and economic growth. Section 4 comments on a some other issues, and Section 5 states our conclusions.

2 The government's economic strategy

2.1 The BPS is based on the economic projections contained in the 1997 December Economic and Fiscal Update (DEFU). Growth in real GDP is projected to peak at 4.2 percent in 1998/99 under the influence of the tax cuts and the presumed expansionary benefits of greater government spending. The average compounded rate of growth implicit in these forecasts is 3.3 percent per annum for the three years to 2000/01. This average is below the bottom end of National's 3.5–5 percent target range to the year 2010.

2.2 The underlying situation is almost certainly worse than the BPS suggests. First, the relatively high rate of growth projected for 1998/99 depends on the assumption that higher government expenditure will increase GDP. In our view many economists have given too much credibility to this presumption. New Zealand's strong economic expansion from 1991 was triggered at a time of government expenditure cuts. This outcome was a source of humiliation to a number of economists at the University of Auckland who went public asserting that the

government expenditure cuts "can only depress the economy further". Action by the government to take money from the private sector and spend it itself cannot boost the economy even temporarily unless national saving is reduced – which would be contrary to the government's aims. Trends in business and consumer confidence since the coalition government first announced its plans to spend an additional $5 billion have not been encouraging. One major rating agency has served notice that New Zealand's credit rating is again at risk. As we explain in Section 4, the degree to which the AMP demutualisation will affect consumer spending is also in doubt. We note that the BPS does not list the currency depreciation which occurred late last year as a growth-enhancing event (see p 23) and we concur with this assessment. A currency depreciation can simply reflect reduced confidence in a government's economic strategy given some new development.

2.3 Secondly, the GDP growth forecasts on which the BPS is based are somewhat dated and are significantly higher than private sector forecasts. For example, the latest Survey of Expectations by the Reserve Bank of New Zealand reveals that on 11 February 1998 respondents expected (on average) an increase in GDP of 2.2 percent to December 1998 and 2.6 percent to December 1999.

2.4 Thirdly, the Treasury's projections suggest that it also believes that New Zealand's underlying annual rate of GDP growth under current policies is under 3 percent. The forecast rate of growth for 2000/01 is 2.7 percent. This is consistent with recent experience – according to the same database and projections the average annual compounded growth rate during the three years between 1995/96 and 1997/98 will also be 2.7 percent. It is also about the forecast average for OECD countries during 1998 and 1999.

2.5 The government's inertia in the face of New Zealand's mediocre economic growth prospects is incomprehensible. The BPS makes it clear that the government has determined that any reductions in spending will take place in the private sector rather than in the public sector as a result of the Asian crisis; the government will still increase its spending. Given the low quality of the planned additional spending, this is lamentable economic management. The BPS does not even acknowledge that New Zealand's economic growth prospects are meagre compared with what the coalition partners pledged to aim for at the last election. We believe the government must face up to the fact that it is not meeting its commitments to the electorate and adjust its policies accordingly.

2.6 In its section on economic strategy, the BPS points to a range of measures which the government is pursuing as part of a "comprehensive strategy for growth". The NZBR supports

many of these measures but they are largely statements of possible intent and do not constitute an adequate package. Much more needs to be done to reduce wasteful spending, exit state businesses and deregulate. It is noteworthy, for example, that the task of reversing the re-regulation of the labour market by the courts is not even mentioned, despite the trend increase in New Zealand's rate of unemployment. The much lower rates of unemployment in the United States, the United Kingdom and several Asian countries are due in part to their freer labour markets.

2.7 In our view, the economic strategy unveiled in the BPS is risky to the point of imprudence. It is putting the fiscal position, the country's credit rating and the economy at risk.

3 Government Expenditure

3.1 The BPS:

- retains the government's long-term objective of reducing expenses below 30 percent of GDP and forecasts a ratio of 33.1 percent in 2000/01, down from 34.1 percent in 1998/99;
- asserts the short-term intention of maintaining control over expenses and a steady decline in the ratio of expenses to GDP;
- states that the government "will continue its programme of *high quality spending in high priority areas* such as health and education" (emphasis is in the original); and
- states that ministers have "devoted considerable energy to identifying areas of low quality spending *so that this money can be reallocated to high priority areas*" (emphasis added).

3.2 We submit that:

- the long-term target ratio is much too high given the coalition partners' economic growth objectives;
- the target ratio is, in any case, not likely to be achieved in the foreseeable future given the expenditure creep which has occurred since 1995 and which is continuing to occur (a

further very large amount of additional spending – $966 million – is budgeted for 2000/01);

- much of the additional spending in health and education is neither high quality nor of high priority;
- not enough is being done to prune low quality spending; and
- any savings from eliminating low quality spending should be used to reduce taxes since spending which cannot be justified if it requires raising taxes is no more justifiable if it is funded from expenditure savings.

3.3 We elaborate on these points below.

The long-term target for government expenditure

3.4 According to the BPS, Crown operating expenses will be 34.1 percent of GDP in 1998/99. However, this statistic materially understates the burden of government spending. This is because it excludes capital expenses, some central government spending which is additional to Crown account spending, and local government spending. How much larger is the true share of government is a source of some controversy. According to the OECD's December 1997 *Economic Outlook,* general government outlays in New Zealand are running slightly above 47 percent of GDP. This would be well above the OECD average of around 39 percent. The New Zealand figure was given some prominence by *The Economist* last year. We understand from informal discussions with Statistics New Zealand that the OECD figure double counts by adding spending by non-core Crown entities to the funding such entities receive in the form of spending by core Crown entities. In the absence of further clarification, it is not evident what statistics for New Zealand would be comparable to those used by the OECD for other countries. However, the comparable figure for New Zealand central government spending would appear to be around 38 percent of GDP in 1995/96, appreciably higher than the figure of 34 percent for Crown operating expenses that year. Local government spending adds a further 3 percent of GDP. Given the deadweight cost of government taxes, levies and rates, this is a substantial burden on the economy. The low quality of much spending adds to the burden. The goal of reducing Crown operating expenses to 30 percent of GDP would still leave general government with a very large share of the New Zealand economy.

3.5 In last year's submission we summarised International Monetary Fund research which found that increased government spending in many countries since 1960 has delivered few social

benefits and harmed economic performance in some cases. The authors concluded that state spending should be reduced to the proportion of gross domestic product which prevailed 30 years ago. Excluding interest payments, this would mean current spending of about 21 percent of GDP in New Zealand's case.

3.6 Similar research is receiving increasing prominence in New Zealand. The National Bank indirectly drew attention to the issue in an article in its April 1997 *Business Outlook* which included a chart which showed that the larger a country's ratio of government spending to GDP, the lower its likely rate of economic growth, other things being equal. For the purposes of determining a sound fiscal policy, we would prefer to rely on such evidence, findings such as those of the IMF researchers, and studies of the deadweight losses from taxation rather than studies purporting to estimate a relationship between tax and growth since these lack a sound theoretical rationale. The size of government should be determined not on the basis of some 'growth-maximising tax rate' but on an assessment of its proper role of producing genuine public (not private) goods and necessary social assistance. Policies framed on this basis would maximise economic growth subject to the constraints of promoting equity goals. The necessary expenditures would account for a much smaller share of the economy than 20 percent of GDP.

3.7 Governments often spend money taken from those who are comfortably off on services (such as health, education and superannuation) which the same individuals could better purchase for themselves if they were allowed to do so. There are no obvious general benefits from this churning of taxpayers' money, and research undertaken in recent years indicates that the deadweight costs of taxation could be enormous. Much other spending (eg on employment schemes) may benefit people at whom it is targeted, but is highly questionable from a national interest perspective. It may be defended by spending departments on the grounds that the research into its efficacy is inconclusive. The deadweight costs of taxation and the incentive structures which such schemes embody make them a costly gamble with taxpayers' money. Deregulation of the labour market would be a much more efficient means of promoting employment and on-the-job training. Finally, the objectives of many government departments are either inoperable (as in the case of the Department of Conservation's objective of preserving intrinsic values) or fail to require them to balance benefits against costs (as in the objectives of improving the nation's health, raising educational levels, or promoting safety).

Government expenditure creep

3.8 The rate of government expenditure creep since the 1995/96 fiscal year is so high as to raise doubts about the government's commitment to its goal of reducing government expenditure

to 30 percent of GDP. The attached chart summarises the upwards ratchet in government expenditure net of financing costs since the BPS system was introduced. We focus on non-finance spending since this is the spending which government expenditure control actually affects. (Trends in finance costs largely reflect operating balance trends which result from decisions about the balance between expenditure and revenue rather than decisions about the level of expenditure.)

3.9 The picture that emerges is that actual (non-financial) government spending in 1996/97 was $2.2 billion (8 percent) higher than it was estimated that it would be in the 1994 budget. Actual government spending in 1997/98 was forecast in the 1997 DEFU to be $3.6 billion (13 percent) higher than it was estimated it would be in the 1995 budget. Forecast expenditure for 1998/99 is now 10 percent higher than it was estimated it would be in the 1996 budget. Forecast expenditure for 1999/2000 is $0.4 billion (1 percent) higher than the forecast in the 1997 budget. A gap between actual spending and forecast spending of $2–3 billion is a gap of about 2–3 percent of GDP.

3.10 Non-finance operating expenses were 30.6 percent of GDP in 1995/96 and are now forecast to be 31.2 percent of GDP in 1999/00 and 30.9 percent in 2000/01. The reduction in this ratio for 2000/01 could easily be eliminated by a continuation of expenditure creep, but in any case the figure is already too high to give any confidence the government will achieve its long-term objective of reducing total expenditure below 30 percent of GDP. We believe the government should act to make its commitment more credible by establishing a firm target date for the achievement of its long-term objective. We suggest this should be the 2000/01 financial year.

Is extra spending on health or education high quality or high priority?

3.11 The BPS asserts that the coalition's additional spending on health and education is high quality and high priority. However, as already noted, it makes little sense to impose the deadweight costs of taxation on society for expenditures which largely churn the money of middle income earners. Abolishing the superannuation surcharge, increasing tertiary education allowances and making doctor visits free for young children will favour relatively well-off families, fail to target the poor, and waste medical services.

3.12 Moreover, as the National Bank observed in its April 1997 *Business Outlook*, there are obvious reasons why research can find little relationship between the level of per capita government spending on health and per student spending on education and health and

educational outcomes. It is the quality of the delivery mechanisms and incentives which are likely to be much more important for outcomes than the level of spending. Current structures disempower users of those services and encourage professional and bureaucratic capture.

3.13 In both these sectors there is a powerful case that outcomes could best be improved by reducing rather than expanding the role of government.

4 Other issues

4.1 The BPS (p23) and the 1997 DEFU (p44) make much of the expansionary effects on the economy of AMP's pending demutualisation. They express the view that it could add 0.4 percent to total consumption in 1998/99.

4.2 One reason why we suspect that the economic growth forecasts in the BPS are too high is that we are sceptical that allowing one individual to sell newly-created shares in an existing asset to another will, in itself, raise their combined consumer spending materially. If so, the same arguments would apply to privatisation initiatives, the creation of tradable ownership rights in the Auckland Regional Services Trust and producer board deregulation and corporatisation. In each case, like the AMP demutualisation, the effect would be to allow individuals to own and trade property rights to existing assets. These advantages, with their positive effects on the management and operation of the businesses in question, are far more important than any demand-side effects. The government's reluctance to move more vigorously on these matters appears to reflect an unwillingness to adopt important policies which would be in the broad national interest.

4.3 We support the planned tax reductions on 1 July 1998. Their deferral in 1997 was harmful to the economy and the interests of low income people. The main benefit of tax reductions is not the impact on consumer demand which the government has been stressing but the positive impact on the supply side of the economy and economic growth.

4.4 The 1996 and 1998 tax reductions widen the income tax scale and make it more complex and distorting. A priority for future tax reductions is to flatten the income tax scale by lowering the top personal and business tax rates. This would also lower the taxation of capital income which is associated with the highest deadweight losses. The scope for future tax reductions depends on the government adopting more prudent expenditure policies and advancing a more vigorous microeconomic reform agenda to promote economic growth.

5 Conclusion

5.1 Continuous increases in government spending were a major cause of New Zealand's poor economic performance in the 1970s and 1980s. The moves to regain fiscal discipline in the early 1990s improved incentives and produced a better balance with monetary policy, and helped promote the strong export-led recovery of 1993-95.

5.2 Since 1994/95, fiscal discipline has again become weak with the predictable consequences for economic growth, employment, national savings and the balance of payments. Weaker policies have not helped to overcome problems of unemployment, poverty and welfare dependency but rather made them worse overall. New Zealand is now vulnerable to external shocks from events in Asia or elsewhere, a downgrading of our credit rating and further falls in business and investor confidence.

5.3 We are at a loss to understand why the government has not heeded the repeated warnings from the business sector, the OECD and IMF and other economic commentators. In the government's preparations for the 1998 budget, we cannot over-emphasise the case for completely revisiting its expenditure plans and taking other urgent action to reduce the vulnerability of the economy and improve its current lacklustre performance. The public will have a right to hold the government to account for promising to aim for high rates of growth in output and incomes if it does not take credible action to achieve them.