NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE
2003 BUDGET POLICY STATEMENT

JANUARY 2003

2003 BUDGET POLICY STATEMENT

1 Introduction

1.1 This submission on the Budget Policy Statement 2003 (BPS) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 In this submission, section 2 reviews the outlook for economic growth in the light of the government's growth targets. Section 3 comments on the government's fiscal strategy in relation to its growth objective. Section 4 reviews New Zealand's experience to date with the Fiscal Responsibility Act 1994. Section 5 provides our conclusions and recommendations.

2 Economic growth

2.1 The government's stated top priority is to increase the rate of economic growth. The Speech from the Throne at the opening of the current parliament indicated that the government:

> ... sees its most important task as building the conditions for increasing New Zealand's long term sustainable rate of economic growth.[1]

The government has amplified this statement by saying its goal is to see New Zealand attain a level of income per capita in the top half of the member countries of the Organisation for Economic Cooperation and Development (OECD). The minister of finance stated last year that within the next couple of years (ie by mid-2004) it will be clear whether New Zealand is on the right track.[2]

2.2 The economic reforms of the 1980s and early 1990s have given the government a solid platform on which to build. Over the 10 years to 2002, economic growth averaged 3.3 percent a year in real terms, a major improvement on New Zealand's previous record. The economy is now more resilient and it has continued to grow despite the recent international downturn.

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1 Dame Silvia Cartwright, Speech from the Throne, 27 August 2002.

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

2.3 However, contrary to the government's ambitions, there appears to be a general consensus that the trend rate of growth in gross domestic product (GDP) is now around 3 percent per annum, and falling.[3] In the 2001 Budget the minister of finance interpreted the government's goal as requiring a lift in sustainable economic growth from about 3 percent a year to 4 percent or above. This would be a major improvement, but it would fall well short of achieving the government's goal for living standards. For a start, the relevant indicator is not GDP growth but growth in real GDP per head. Only the latter is a measure of changes in average income levels if the size of the population is changing. The importance of this distinction is brought out by the fact that the economy appears to have grown by around 4 percent in 2002 but because population growth was around 1.5 percent, the increase in GDP per head was only around 2.5 percent. Moreover, even a growth rate in GDP per capita of 4 percent would not achieve the government's goal within a decade.[4]

2.4 It is therefore clear that the goal of returning New Zealand to the top half of the OECD requires a radical lift in trend growth in employment and/or labour productivity. In contrast, the mainstream forecasting agencies expect the trend growth in employment to decline progressively (as indicated, for example, by Statistics New Zealand's 'medium' projections for slower population growth and labour force growth). The BPS&DEFU itself projects that the trend growth of the working age population will fall "from 1.9 percent in 2002/03 to around 1.2 percent by 2006/07".[5]

2.5 The same agencies seem to agree that the trend rate of labour productivity growth has risen in the last decade, perhaps to around 1.5 percent per annum.[6]

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3 The Organisation for Economic Cooperation and Development (OECD), *Economic Survey of New Zealand*, 2002 (OECD I) put the growth in potential GDP at 3.0 percent per annum in 2001-2003 (see table 16, p 105). The Budget Policy Statement 2003 and December Economic and Fiscal Update 2002 (BPS&DEFU) sees the current rate of growth as being cyclically high and "unwinding gradually over the next 18 months, back to growth rates of 2¾-3%" (see p 3). The Reserve Bank of New Zealand (RBNZ) *Monetary Policy Statement* of August 2002 projected that GDP growth would be below 2.5 percent per annum by 2005 (see Table C, p 28). The New Zealand Institute of Economic Research (NZIER), *Quarterly Predictions*, December 2002 projected that trend GDP growth of 2.5 percent per annum in the five years to March 2002 would fall to 1.6 percent in the five years to March 2022.

4 A Treasury Working Paper in 2001 indicated that *per capita* growth of 4.6 to 7.4 per cent would need to be sustained for a decade to achieve that goal.

5 BPS&DEFU, *op cit*, p 40.

6 The NZIER uses 1.5 percent per annum. The RBNZ, *op cit*, Table C, p 28 projected trend growth of 1.25 percent per annum by 2005. The OECD, *op cit*, puts current trend labour productivity in the 1.25-2.0 percent range in Figure 28 on p 104 and at 1.8 percent in table 16 on p 105.

This is the figure in the BPS&DEFU.[7] It represents no gain on Treasury's estimate in its 1999 post-election briefing.[8]

2.6 Such a trend growth rate could well see a widening gap in living standards between New Zealand and better-performing OECD countries, in particular Australia. Even the cyclically high per capita GDP growth of above 2 percent per annum during 1998-2002 was no better than middling in an OECD context, as can be seen from the chart attached as an annex to this submission.

2.7 The far-reaching 1984-1993 reforms greatly improved New Zealand's overall economic performance and delivered a range of benefits, including a lift in labour productivity growth of around 1 percentage points per annum above Treasury's estimate of 0.5 percent per annum in 1981-1984.[9] The minister of finance acknowledged in the 2001 Budget that raising New Zealand's sustainable economic growth rate from 3 percent a year to 4 percent or more would require something like a doubling of our productivity growth rate.[10] To meet the government's target for per capita income growth an even larger increase is required. The size of this challenge is difficult to exaggerate. Clearly, further major changes in policies and business performance are required. Policy incrementalism, which is the government's description of its strategic approach, simply won't do the job.

2.8 In contrast to its declared goals, the government's current policy directions seem more likely to reduce the trend rate of growth. The BPS rightly states that macroeconomic stability and an open, competitive economy are important for growth. But past achievements in these areas are already built into existing projections. More recent initiatives – such as the increase in the top personal tax rate to 39 percent, the tariff freeze, changes to employment law, increasing regulation, new government spending commitments, ratification of the Kyoto Protocol and the bias against the private sector in state-owned enterprise policy, health and education – go in the wrong direction. Obstacles to growth such as the anti-development aspects of the Resource Management Act 1991 are not being meaningfully addressed. The generalised visions and

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7 BPS&DEFU, *op cit*, p 40.

8 The Treasury, *Towards Higher Living Standards for New Zealanders: Briefing to the Incoming Government*, 1999, p 5.

9 BPS&DEFU, *op cit*, p 39.

exhortations in *Growing an Innovative New Zealand* are swamped by these realities.

2.9 These views are widely shared in the business sector. A survey late last year by the *New Zealand Herald* of 120 business leaders revealed that only 5 percent of respondents thought the government had a coherent strategy for economic growth. To the contrary, such has been the policy drift in the last decade that competitiveness with Australia is now a serious concern.[11] In particular, differences in approaches to Kyoto, in the prospects of a free trade agreement with the United States, and in tax burdens and welfare dependency suggest the gap in living standards between the two countries is likely to widen.

2.10 In recent economic surveys of New Zealand, the OECD, representing the collective assessment of its member countries (not just its Paris secretariat) and the International Monetary Fund have urged the government to adopt more market-oriented policies. Their recommendations for improving New Zealand's growth prospects include curbing government expenditure growth, resuming privatisation, phasing out tariffs, aligning the top personal tax rate with the corporate rate, and introducing more restrictive welfare policies.

2.11 Australian economist and NZBR consultant Wolfgang Kasper has explained why policies for prosperity must be centred on the 'lodestar' of economic freedom.[12] Prosperity is facilitated when consumers enjoy competition and choice and when governments ensure the security in property and in contract that is necessary to encourage personal effort, investment and innovation. A strategy of higher spending, taxation and regulation is incompatible with this requirement.

2.12 In summary, mainstream views point to no further improvement in trend per capita growth and the likelihood of a declining trend for GDP growth. Realistically, New Zealand can expect to fall further behind on current policies. The implication is that without major changes the goal of getting into the top half of the OECD is unattainable.

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10 Budget 2001, p 6.

11 *New Zealand Herald*, 'What our chief executives think', 29 November 2002.

12 Wolfgang Kasper, *Losing Sight of the Lodestar of Economic Freedom: A Report Card on New Zealand's Economic Reforms*, New Zealand Business Roundtable, December 2002.

3 Fiscal outlook

Government expenditure targets

3.1 The BPS states that new operating spending of $1.0 billion is planned for the 2003 Budget, with ongoing spending of $1.1 billion per annum from 2004/05 and beyond. When governments increase (ongoing) spending by the order of $1 billion a year they spend much of the 'growth dividend'.[13] For example, trend labour productivity of 1.5 percent roughly translates to an annual increase in real GDP of around $1.8 billion.[14] On plausible estimates each dollar of additional spending from taxes costs the community 50 cents.[15] On this basis, new spending of $1 billion from taxes represents a welfare loss of around $0.5 billion. Even if new spending were reduced to, say, 33 percent of the trend productivity gain, the burden would be substantial – perhaps equivalent to reducing the growth rate of labour productivity to 1.25 percent.[16]

3.2 Extensive scrutiny of data in the past year has established that it is implausible that New Zealand could achieve per capita economic growth of 4 percent per annum or more for a decade with total government outlays (central plus local government) at around 40 percent of GDP on the OECD's measure.[17] The most recent (and materially revised) data from the OECD project New Zealand's ratio for 2003 to be 37.2 percent, up from a 15-year low of 36.5 percent in 2001.[18] Unfortunately, no additional examples of countries that have achieved this feat emerge even at this lower level.[19]

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13 See the BPS&DEFU, *op cit*, p 9 for new operating spending intentions.

14 Real base expenditure can generally be expected to increase with population growth *if* demand is being controlled. In broad terms, new spending must be funded from productivity growth if government spending is not to rise relative to GDP.

15 This estimate of what economists refer to as a deadweight loss comes from Winton Bates, *How Much Government: The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, 2001.

16 The deadweight cost would be 1.5 x .33 x 0.5 = 0.25, reducing 1.5 per cent labour productivity growth effectively to 1.25 per cent. New spending needs to generate more than $1.50 of benefit to the community for each dollar spent in order to offset a deadweight cost of this magnitude. Note that the calculation does not include the burden of discretionary new capital spending in the $100-$600m range annually (see Budget 2002 Economic and Fiscal Update, pp 92-93 and BPS&DEFU, *op cit*, p 108).

17 Roger Kerr, 'Memo to Dr Cullen: Big Government Harms Growth', New Zealand Business Roundtable, 25 September 2002.

18 OECD *Economic Outlook*, December 2002 (OECD II), Annex Table 26.

19 For a discussion of performance at the 40 percent level, see Kerr, *op cit.*

3.3 An increasing body of academic research indicates that high levels of government spending impair economic growth. Australian economist Winton Bates reviewed this literature for the NZBR in 2001.[20] In the case of New Zealand, he estimated that reducing government spending by 10 percentage points (for example from 40 to 30 percent of GDP) could add 0.5 percent per annum to the rate of economic growth over a decade. A widely quoted OECD study found that increasing the ratio of tax revenue to GDP by 1 percentage point reduces per capita income by a comparable 0.6-0.7 percent.[21] The Treasury acknowledged that smaller government could lift economic growth in its 1999 post-election briefing.[22]

3.4 Up to a certain level, government spending can improve economic performance and social cohesion by ensuring the provision of public goods and access to social services, including a welfare safety net. But spending is only justified where it provides value for money. The OECD has amply documented deficiencies in the quality of government spending in New Zealand. Base spending, 95 percent of the total, is not properly reviewed.[23] It seems to be easier for governments to increase spending than to stop unjustified spending. By 2002, policy decisions since 1993 had added 4 percent of GDP to base spending. By 2006 this is set to rise to 6 percent.[24] New Zealand is squandering an opportunity to reduce taxpayer burdens.[25] The OECD comments that New Zealand has slipped from first place to thirteenth since 1999 on one indicator of government efficiency.[26] Resources need to be shifted from the public sector to the private sector and transfer payments reduced if wealth is to be created.

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20 Winton Bates, *op cit*. More recent literature includes A Bassanini and S Scarpetta, 'The driving forces of economic growth: Panel data evidence for the OECD countries', *OECD Economic Studies* No 33, 2001/11; Edward C Prescott, 'Prosperity and Depression', *American Economic Review*, Papers and Proceedings, May 2002, pp 1-15; Alberto Alesina, Silvia Ardagna, Roberto Perotti and Fanbio Schiantarelli, 'Fiscal Policy Profits and Investment', *American Economic Review*, June 2002, pp 571-589; and Atal A Dar and Sal Amir Khalkhali, 'Government Size, Factor Accumulation, and Economic Growth: Evidence from OECD countries', *Journal of Policy Modeling*, Volume 24, Issues 7-8, November 2002, pp 679-692.

21 Andrea Bassanini and Stefano Scarpetta, *op cit*.

22 The Treasury, *op cit*, p 22.

23 OECD I, *op cit*, p 71.

24 OECD I, *op cit*, p 67.

25 The Treasury, *op cit*, p 22.

26 OECD I, *op cit*, p 61.

3.5 Seen in this light, the government's decision early in its first term of office to raise the target ratio for Crown operating expenses from 30 percent of GDP to 35 percent was the opposite of what is required for a credible growth strategy. The contrast with Ireland (or even Australia) is stark. Ireland cut general government outlays sharply, with spending falling by 9 percent of GDP between 1987 and 1989, and then used high economic growth to achieve a further 9 percentage point reduction by 2000 (to 29.2 percent of GDP).

3.6 The key to progressively reducing the share of government spending and taxes in the economy is, in the first instance, to keep the rate of increase in government spending lower than the growth rate of the economy. In addition, there are many avenues for achieving reductions in current spending including:

- general growth-oriented policies and labour market reforms to reduce spending on the unemployed;
- welfare reforms along US lines (eg time limited benefits, work tests and more vigorous efforts to place beneficiaries in employment);
- reductions in middle class welfare (spending on superannuation, education and health that benefits better-off groups);
- privatisation, and the scrapping of the New Zealand Superannuation Fund, which would generate lower debt servicing costs;[27] and
- reductions in general government spending that is directed towards

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27 A study by Phil Barry, *The Changing Balance Between the Public and Private Sectors*, New Zealand Business Roundtable, 2002, also found that privatisation of state-owned enterprises could raise national income by around $1 billion on an ongoing basis.

– private rather than public goods, including business subsidies, or is not justified on equity grounds.

3.7 A significant amount of government spending is on non-traded goods and services. Inflationary pressures are currently concentrated in the non-traded goods sector of the economy and reductions in spending would help support monetary policy and lower the real exchange rate. This would benefit export industries which are coming under pressure with the rising value of the dollar, with the result that the balance of payments deficit may widen to uncomfortable levels again.

3.8 The government is continuing to apply all or most of the increases in tax revenue generated by economic growth to spending increases. Instead we believe it should emulate the successful approach of Dutch (left-of-centre) governments in the 1990s, namely to announce that all dividends in the form of higher revenue growth will be distributed in the form of regular income tax cuts. Many of the dividends of Ireland's economic reforms were also applied to tax reductions.

Tax rate structures

3.9 To increase economic growth, taxes should be designed to raise the revenue needed to fund any given level of government spending at least cost. For tax policy, the government's economic growth objective implies priority should be given to increasing the economic efficiency of the tax system. As the McLeod Tax Review recommended, this means, in particular, reducing the highest effective marginal tax rates. High personal tax rates, high effective rates resulting from the tax/benefit interface, and taxes on capital income are among the most damaging to the economy.

3.10 It follows that from a growth perspective, the move to increase the top personal tax rate to 39 percent was a mistake. Deadweight costs were increased, and the tax code and tax administration were made more complex. In addition, many firms faced higher labour costs as they were forced to increase wages and salaries to attract and retain internationally mobile workers, and New Zealand suffered a 'brain drain' which may resume when international conditions improve. As the McLeod Review and the OECD have recommended, New Zealand should adopt a lower, flatter tax structure, and

the top personal rate should be aligned with the company rate. There is much less merit in reducing the company rate alone. Subsidies to capital in the form of allowances for depreciation at above economic rates are also undesirable. In the context of the international tax regime, the tax burden on inbound investment should be reduced and a cap should be placed on the total tax liability of any individual. These and other recommendations of the McLeod Review should be revisited by the government.

3.11 Instead of foreshadowing a growth-oriented approach to future tax policy, the government has foreshadowed tax cuts and/or increased family assistance to low or middle income earners. Taxes were cut for these groups twice in the 1990s. They were motivated by income redistribution, not wealth creation (economic growth), goals. The minister of finance is correct to argue that the form of these cuts did little to improve growth. A renewed emphasis on income redistribution would further call into question the government's stated priority of achieving faster economic growth. This is the only sustainable basis for raising incomes and alleviating hardship generally.

4 Review of experience under the Fiscal Responsibility Act 1994

4.1 This year marks the tenth anniversary of the introduction of the Fiscal Responsibility Bill into the House of Representatives in 1993. It would be timely to review the operation of the FRA in the light of experience in New Zealand and internationally since that time.

4.2 In our view, the legislation has served New Zealand well in some important respects. The focus on fiscal prudence has paid dividends, as evidenced by the sustained operating balance surpluses, improvements in Crown net worth and, most recently, the Triple-A credit rating for Crown foreign currency debt. These are major achievements given the erratic course of fiscal policy in the 1970s and early 1980s.

4.3 The new system is also much more transparent. An incoming government faces less risk of unpleasant fiscal surprises. The system of improving accountability by requiring the minister of finance and the secretary to the Treasury to sign a statement of responsibility appears to have worked well. The requirement under the Public Finance Act 1989 for public sector

accounting standards to be set independently is another positive feature of New Zealand's 'fiscal constitution'.

4.4 On the other hand, a material disappointment is the failure of the BPS process to engage the government in effective debate with the public and parliament about budget policy. For example, business organisations have been saying at least since 1996 that successive governments have not had credible strategies for achieving their growth targets. No effective engagement on that point has occurred and, as predicted, the growth aspirations have not been achieved. In addition, governments have not met their long-term expenditure targets established under the FRA and not taken remedial action, or have increased the targets to accommodate more spending. There has been a drop-off in the numbers of submissions on successive BPSs, and the select committee process has become largely perfunctory.

4.5 In the decade since the FRA was framed, other countries have moved in similar directions and New Zealand can learn from their experience. Australia and Britain have adopted comparable fiscal frameworks. Some US states have gone further. For example, 26 states in the United States have adopted some form of tax and expenditure limitations. Some were imposed by citizens' initiatives while others were self-imposed by state legislatures. Constraints that limit government spending to the inflation rate and population growth and mandate immediate rebates of government surpluses appear to have been most effective.[28]

4.6 Currently, Colorado and California provide contrasting lessons. Both experienced buoyant revenues during the 1990s technology boom. However, in the subsequent crash California experienced a fiscal crisis while Colorado ran a balanced budget with tax rebates. California used the boom to entrench bigger government, whereas Colorado did not.[29] It is noteworthy here that New Zealand has been using strong growth to build base spending (as noted above) and does not appear to have been running cyclically high surpluses.[30]

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28 Michael New, 'Limiting Government through Direct Democracy: The Case of Tax and Expenditure Limitations', *Policy Analysis*, Cato Institute, 13 December 2001.

29 'States of Prosperity (or not)', *Wall Street Journal*, 16 July 2002.

30 For general government balances see Annex Tables 28 and 29, OECD II, *op cit*. The actual surpluses are close to the cyclically adjusted surpluses.

4.7 There are parallels to this discussion in the debate over the regulation of corporate governance. Some governments believe company boards should be more strictly accountable to those who entrust funds to them – the shareholders. There is a high level of concern about conflicts of interest and a widespread presumption against control of the board by company executives.[31] By analogy, parliament needs to be fully accountable to taxpayers, and it is unhealthy for the executive to control parliament. In reality, the issue of inadequate accountability is much more serious in the case of parliament because taxpayers do not have the option of not paying taxes and parliamentarians face an obvious conflict of interest in that they can seek the support of voters who are not taxpayers. In contrast, non-shareholders

31 The concerns are surely exaggerated because shareholders have 'direct democracy' annually at general meetings and can 'vote with their feet' at any time by selling their shares.

cannot vote on board representation.

4.8 The fundamental problem that productivity growth and fixed tax rates give politicians money to spend at will also has a parallel in the corporate sector. Here there is no dispute that shareholders have the right to use dividend and debt policies to strip 'free cash flows' out of the company before its executives can spend them unwisely. Taxpayers arguably need more protection than shareholders. An improved fiscal constitution could give greater weight to the longstanding principle that there should be no taxation without the consent of taxpayers, or their representatives.

4.9 We suggest that a review of the Fiscal Responsibility Act should focus in particular on the case for introducing some form of tax and expenditure limitations, with strict criteria for authorising and correcting any departures from them. A specific feature could be a prohibition of subsidies to businesses, along the lines of the constitution of the US state of Georgia.

4.10 We have also suggested that similar disciplines should be imposed on regulatory decisions.[32] Regulations can be as unconstitutional as taxes. Here the principle of compensation for regulatory takings, funded if possible by the beneficiaries of those takings, could improve the incentives of politicians and those lobbying for a regulation to better balance its benefits and costs. We were pleased that two parties contesting the 2002 general election favoured consideration of a Regulatory Responsibility Act and would like to see other parties prepared to examine this idea in an open-minded way.

5 Conclusions and recommendations

5.1 In last year's submission we suggested that the following measures would enhance New Zealand's growth prospects:

- restoring the goal of reducing Crown operating expenses to below 30 percent of GDP;
- moving towards more uniform rates of income tax at a lower level, with a maximum of 25 percent being a medium-term goal;

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

- aligning the top personal rate with the corporate tax rate;
- undertaking a thoroughgoing review of the value for money being obtained from major spending programmes, focusing on the gap between what is being achieved by government spending in major areas and desired outcomes;
- setting up expert task forces to undertake a fundamental review of the major regulations that the ministerial review of business compliance costs found were imposing the greatest costs on businesses;
- privatising government entities that supply private goods and services;
- not proceeding with the New Zealand Superannuation Fund; and
- not ratifying the Kyoto Protocol in advance of major trading partners and in the absence of sound analysis.

We suggested that without such measures the 2002 Budget would lack a credible growth strategy and in that event it would be disingenuous of the government to continue to maintain that it was serious about restoring New Zealand to the top half of the OECD income ladder.

5.2 None of those recommendations has been accepted yet the BPS continues to espouse goals for economic growth that we believe are unattainable with present policies. In our view this will simply strengthen the widespread view in the business community that the government has no coherent growth strategy. The gap in living standards with Australia looks set to widen.

5.3 With government in all its forms still spending close to 40 percent of GDP after years of good economic growth, the pressing need in a BPS context is for much greater control over the quantum and quality of spending. In addition to repeating our previous recommendations, we also recommend that the Finance and Expenditure Committee undertakes an inquiry into the effectiveness of the Fiscal Responsibility Act and invites submissions on what might be done to improve its effectiveness. We would also urge the Committee to ask the government to agree to a multi-party inquiry into the idea of a complementary Regulatory Responsibility Act.

Annex

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Source: *The Economist*, January 4-10 2003, p76.