SUBMISSION TO THE FINANCE AND EXPENDITURE COMMITTEE

ON THE

1997 BUDGET POLICY STATEMENT

NEW ZEALAND BUSINESS ROUNDTABLE
MARCH 1997

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SUMMARY

- The fiscal strategy outlined in the 1997 Budget Policy Statement (BPS) is, in our view, inconsistent with the government's objectives for economic growth and international competitiveness.

- We submit that if New Zealand is to achieve its potential, an economic strategy involving substantial reductions in government spending and taxation, flatter tax rates, an active privatisation programme and further deregulation is required.

- Instead the BPS foreshadows greatly increased spending, higher taxes (due to the deferral of the tax cuts), continued government ownership of many trading enterprises, no action on statutory monopolies, and the possibility of extensive regulation of retirement savings.

- The programme set out in the BPS will reduce New Zealand's growth prospects relative to its potential. Lower growth can only exacerbate the problems associated with an ageing population.

- The most fundamental problem is the failure to control government expenditure. In contrast to the government's target of reducing operating expenditures to below 30 percent of GDP, the last three years have seen progressive and substantial upward revisions in the projected ratios. The target looks further away each year. New Zealand businesses are having to compete with firms in countries where the ratio is less than 20 percent of GDP and which have correspondingly lower tax burdens.

- A major factor in New Zealand's strong rate of economic growth from 1991 to 1995 was the reductions in the scope and size of government through deregulation, privatisation and expenditure control.

- In our view, it is no coincidence that the recent economic slowdown has occurred at the same time as the rise in government expenditure. This is a significant source of the cost increases which are putting pressure on monetary policy and thereby the real exchange rate.

- Other factors within the government's control which are contributing to the rather mediocre economic outlook include the growth in meddlesome regulation of the private sector, the reluctance to expose state activities to greater competition and the standstill on privatisation of government-owned businesses.

- The debilitating trend towards increased state spending and greater regulation is epitomised by the government's plans to hold a referendum on whether to introduce a compulsory superannuation scheme while reducing its own savings.

- The suggestion in the BPS that tax cuts should be conditional on a compulsory savings scheme has no logical basis. The longer the government delays reductions in spending and taxes the greater the future difficulties it will face. Demographic factors are projected to increase spending on health and superannuation by 10 percent of GDP in a 40-year period from the year 2000.

- In contrast, vigorous action to reduce general government spending to 20 percent of GDP or below by, say, 2005 through a combination of specific cuts in programmes and measures to increase economic growth would allow large reductions in taxes and greater reliance on personal savings and private insurance as the population ages.

- The move to the 1 - 3 percent target range for inflation appears to have increased inflationary expectations amongst bond investors by 0.5 percent per annum, and New Zealand businesses and households are now facing higher costs of borrowing as a consequence. Unless the new range can be justified by a principled public policy argument, the previous 0 - 2 percent range should be reinstated.

- We also suggest that pensions and other benefits should not be indexed for movements in the consumers price index which simply reflect measurement errors; fiscal risks should be reeduced by divestment of assets; and a more meaningful long-term target for Crown net worth should be established.

1 INTRODUCTION

1.1 This submission on the 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 third BPS issued under the Fiscal Responsibility Act (the Act). In submissions on the two previous BPSs, the NZBR reaffirmed its support for the framework for fiscal management provided by the Act. We also supported the previous government's intentions to use increased revenue from economic growth first and foremost to generate operating surpluses, reduce debt and build net worth.

1.3 In our submission on the 1995 BPS we commented critically on the government's reliance on revenue growth for meeting its fiscal targets and expressed the view that more modest revenue growth and real expenditure reductions would better achieve its goals of promoting economic growth and social cohesion. We reiterated that view with greater urgency in our submission on the 1996 BPS, concluding that:

> ... the current trend in government non-finance expenditure is inimical to the government's high economic growth and social cohesion objectives. More vigorous action to reduce expenditure, sell assets, deregulate important areas of activity and move to a flatter income tax structure would increase New Zealand's competitiveness, reduce dependency on the state and foster self-reliance.

1.4 Developments in the last year have heightened our concerns. In the first BPS, the then government set a long-term target of reducing operating expenses to below 30 percent of GDP. Despite this target being reaffirmed in each successive BPS, projected operating expenses have progressively increased as a percentage of GDP. For example, the 1995 BPS projected a ratio of 30.5 percent for 1997/98. This was increased to 32.2 percent in the 1996 BPS and then to 33.4 percent in the 1997/98 BPS. The long-term target no longer looks within reach even by 1999/00 when the ratio is already projected to be 32.1 percent of GDP.[1]

1.5 Section 2 of this submission elaborates on the view that a tighter expenditure strategy is needed to achieve the government's macroeconomic objectives. The question of what might be a desirable target for government expenditure is considered in section 3. Section 4 comments on some other aspects of the BPS.

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1 The ratios in the 1997 BPS are inflated to the extent that some of the measures in the Coalition Agreement result in revenue reductions rather than expenditure increases.

2 THE CASE FOR LOWER EXPENDITURE

2.1 The previous government's success in turning a large operating deficit in 1990/91 into a substantial surplus four years later reflected two factors. First, it was able, through economic growth, to raise $5.2 billion more in Crown revenue in 1994/95 than in 1990/91. Tax revenues are running at around 35 percent of gross domestic product (GDP) and have risen 35 percent in dollar terms in the last four years according to the December 1996 Economic and Fiscal Update. Secondly, the government was able to hold the increase in non-finance expenses to $1.1 billion while financing costs fell by $1.5 billion.

2.2 In sharp contrast, in the five years to 1999/00 *real* non-finance annual operating expenses are projected to rise by 15.7 percent, or $4.2 billion, from $26.6 billion to $30.8 billion (see the following table). Operating revenues are projected to rise by a further $1.4 billion in real terms during the same period.

The Lift in Real[1] Non-Finance Expenses (GDP Deflator)

	1994-95	*1998/99*		*1999/00*	
	Actual	*'96 Budget*	*'97 BPS*	*'97 BPS*	*% Increase 1994/95*
Total Real Operating Expenses ($bn)[2]	30,400	30,670	32,339	32,565	7.1%
Finance Costs ($bn)	3,757	2,217	1,970	1,729	-46.0%
Real Expenses less Finance Costs ($bn)	26,643	28,453	30,369	30,835	15.7%
Non-Finance Expenses (% of GDP)	30.7%	28.9%	31.0%	30.4%	

Notes:

(1) Base 1994/95 prices.

(2) Derived from the GDP deflator implicit in the Economic and Fiscal Update, 2 December 1996, the 1997 BPS and the 23 May 1996 Budget Economic and Fiscal Update.

2.3 There are several concerns here:

- the government's additional spending commitments are not conditional on the achievement of the revenue projections;

- the $4.2 billion real increase in non-finance spending undermines the effort put into curtailing the growth in government expenditure in the first half of the 1990s and represents a significant increase in average tax rates, compared with what might otherwise have been achievable;

- the quality of the additional spending appears to be low - where it is on transfer payments it will tend to benefit higher income earners and where it is on goods and services it tends to be in areas in which arguably a smaller rather than a larger government role would improve outcomes. Examples of decisions with a clearly regressive effect, in that they disproportionately benefit higher income individuals or families, are the proposals on universal student allowances, the superannuation surcharge, and free doctor visits for children under five;

- the announced expenditure increases maintain the disincentive effects of the existing tax system compared with the alternative of reducing tax rates; and

- weaker fiscal discipline is likely to undermine business and consumer confidence.

2.4 The major concern is that higher spending will fuel inflation in the sheltered sectors and reduce growth in the exposed sectors of the economy. Statistics compiled by the Reserve Bank make it abundantly clear that inflation emanating from property prices and the sheltered sectors of the economy is forcing the Reserve Bank to keep interest rates (and therefore the real exchange rate) higher than would otherwise be necessary. High interest rates and a high real exchange rate are undoubtedly squeezing the profitability of internationally competing industries and contributing to slower economic activity and reduced business confidence. Monetary policy impacts particularly on investment and the traded goods sector of the economy whereas the impact of fiscal policy tends to fall on consumption and the non-traded goods sector. Monetary and fiscal policies need to be better harmonised.

2.5 We believe that the greater fiscal discipline established in the 1991 budget was crucial to New Zealand's economic recovery and growth. Far from deepening the recession as predicted by many Keynesian-oriented economists at the time, it reduced the pressure on monetary policy and provided room for the private sector to expand. Fiscal policy, including asset sales, aided social policy by contributing to economic growth, job creation and self-reliance.

2.6 In contrast, the rate of economic growth has slowed as non-finance government expenditures have increased and the pace of economic reform and privatisation has slowed.

2.7 Higher spending necessarily means higher taxes now or in the future. Government operating expenses are projected to remain appreciably above 30 percent of GDP. This is well above the levels in many of our better-performing trading partners and much higher than it was in the decades up to the 1970s when New Zealand achieved a more satisfactory economic performance.

2.8 Further, the burden of the additional spending seems likely to fall disproportionately on sections of the population and industries on which the government is relying for increased economic growth. For example, the burden of funding higher transfer expenditures to the aged is likely to fall largely on the working-age population. The workers in question will be distributed between the exposed and sheltered sectors. However, the exposed sectors are particularly at risk when government expenditures are increased on sheltered sector activities (such as education and health) since they are likely to gain resources at the expense of internationally competing industries.

2.9 The competitiveness of the traded goods sector can also be harmed by regulations which impose excessive costs. Cost increases from the ACC scheme and from the large increase in minimum wages fall into this category. Other sectors in which dominant suppliers enjoy state protection from competitive forces include NZ Post and the single desk producer boards.

2.10 A further concern is that the BPS is based on economic growth projections which fall well short of New Zealand First's target of 6 percent annual growth by 1999/00 and the projected growth rates of many of our trading partners. For the next three years projected growth is also below the bottom end of National's 3.5 - 5 percent target range to the year 2010.

2.11 This concern is compounded by the possibility that these forecasts might be too optimistic. For example, the average of the forecasts surveyed by the NZIER in December 1996 revealed a profile for GDP of 1.8 percent, 3.0 percent and 3.1 percent for 1996/97, 1997/98 and 1998/99 respectively. In contrast, the projections in the BPS are based on GDP forecasts of 2.6 percent, 3.6 percent and 3.1 percent respectively. Lower than forecast economic growth is likely to result in reduced revenues, smaller reductions in debt, higher interest expenses and higher expenses on social welfare benefits.

2.12 For these reasons we do not see how the government can avoid the conclusion that current policies will not produce satisfactory outcomes, either relative to the economy's potential or relative to the growth aspirations of both parties to the coalition. In our view the problem is not that the goals are undesirable or unachievable; rather it is that current policy settings make them unrealistic.

2.13 The same point can be made in respect of the projections for the rate of unemployment which underlies the BPS. According to these projections, the rate of unemployment will remain at or close to 6 percent

through to 1999/00. In our view such an outcome would be extraordinarily wasteful and entirely unnecessary. The better-performing Asian countries have demonstrated that very low rates of unemployment are achievable with flexible labour markets and strong growth. New Zealand's own experience from 1991 to 1995 demonstrated that rapid economic growth and the more flexible labour market created by the Employment Contracts Act can dramatically reduce unemployment. We concur with the widespread view that weaknesses in the Act have allowed successive Employment Court decisions to reduce the efficiency of the labour market and the rate of job creation. These weaknesses can be readily rectified by a government with a will to do so. We also believe that many other statutes, such as those relating to holidays, minimum wages and workers' compensation, are unduly inhibiting employment.

2.14 The unsatisfactory outcomes from much existing expenditure are a further source of concern. Community welfare is reduced if government spending is wasteful, for example if the government uses taxpayers' money to buy health and education services on behalf of those same taxpayers but only produces 90 cents of value for each dollar taken. There are many reasons why governments tend to spend taxpayers' money less wisely than taxpayers themselves.

2.15 Even when government spending is well directed, the opportunity costs of a dollar of such spending are higher than for private spending. The most commonly recognised costs comprise the costs of tax collection, administration, enforcement and compliance. While compliance costs cannot be accurately measured, one study found that the costs of complying with business taxes were about 2.5 percent of GDP.[2] The same study found that the cost per dollar of complying with business taxes was over two and a half times the cost per dollar of complying with GST.

2.16 A further economic cost arising from taxation takes the form of people altering their behaviour in unintended and undesired ways in response to the disincentives created by taxes. For example, they might work fewer hours, opt for a lower-paying job, fail to seek promotion, work and invest for capital gains rather than income, and/or organise their affairs so that income accrues to a family member on a lower tax rate. Economists refer to such costs as the 'deadweight' costs of taxation.

2.17 While such costs obviously defy precise measurement, research suggests that they can be very high. Marginal tax rates (income tax at 33 percent plus GST of 12.5 percent) are much higher for many taxpayers than is the ratio of government expenditure to GDP. A study commissioned by the NZBR found that each additional dollar raised in taxation costs the community a further 14 - 18 cents (i.e. national income is lowered by that amount).[3] Higher estimates, of 25 - 146 cents for each additional

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2 Sandford, C and Hasseldine, J, 'The Compliance Costs of Business Taxes in New Zealand', Institute of Policy Studies, Wellington, 1992.

3 Diewert, W E, and Lawrence, D A, 'The Marginal Costs of Taxation in New Zealand', report prepared for the New Zealand Business Roundtable by Swan Consultants, March 1994.

dollar of taxation in 1988, have been derived by two economists at the University of Canterbury.[4] With tax revenues running at around 34 percent of GDP throughout the forecast period, such estimates strongly suggest that government spending and taxation is imposing a heavy and ongoing cost on the community.

2.18 In addition, costs arise as individuals organise their affairs so as to make themselves eligible to receive benefits, for example under transfer programmes. Political lobbying to enhance the range of benefits and to extend its scope represent the expenditure of real resources on what is a non-productive activity from the viewpoint of society as a whole. While such costs are difficult to measure, they may be significant.

2.19 Universal transfer programmes are costly and impose large tax burdens. Taking money from people simply in order to give it back to the same group wastes resources. On the other hand, transfer programmes which take from some in order to give to others necessitate targeting. Targeted transfer programmes induce members of the target groups to change their behaviour so as to avoid taxes and gain benefits. Such costs impose a burden of proof that transfer programmes generate commensurate benefits for society.

2.20 In addition to reducing deadweight losses, tax reform involving lower, flatter income tax rates would also reduce the difficulties currently caused by the tax structure in the areas of income testing, income splitting, international taxes, capital gains taxes, trusts, superannuation funds and forestry. We welcome the Treasurer's recent statement foreshadowing possible reductions in business taxes. In our view a lowering of all high marginal rates of tax would have major economic benefits.

2.21 This section has outlined the immediate case for reducing rather than increasing spending. The next section considers the issue of a longer-term target for government spending.

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4 McKeown, Paul and Woodfield, Alan, 'The Welfare Cost of Taxation in New Zealand Following Major Tax Reforms', *New Zealand Economic Papers*, Volume 29(1), June 1995, pp. 41-62.

3 A LONGER-TERM TARGET FOR OPERATING EXPENSES

3.1 The growth in the size of government in New Zealand since late last century mirrors developments in the United States and most European countries. As summarised in an article in *The Economist* of 6 April 1996, government spending in the industrialised countries was around 8 percent of gross domestic product (GDP) in 1870, rose with World War I and rose again with the Great Depression to reach almost 21 percent of GDP by the late 1930s. Even so, the biggest rise in government spending took place with the expansion of the welfare state which followed World War II. This expansion saw the ratio rise to 43 percent of GDP by 1980. The growth in the size of government in the New Zealand economy followed a broadly similar pattern.

3.2 The research by two IMF economists[5] which forms the basis of the article found evidence that countries which had the lowest increase in public spending since 1960 appeared to be more efficient, more innovative, enjoy a lower level of unemployment and have much smaller 'black' economies. Nor did the wealthy industrialised countries appear to have significantly superior figures for school enrolment, life expectancy or infant mortality than newly industrialised countries where spending averages only 18 percent of GDP. The authors concluded that rising public spending since 1960 has delivered few social benefits and, in some cases, has harmed economic performance.

3.3 Reflecting on what might be done in response to the evidence that increased government spending in the industrial countries since 1960 had not improved outcomes, the IMF authors observed that:

> Cutting back the welfare state in a careful and well-planned way that preserves basic social and economic objectives could yield significant budgetary savings while still providing essential social safety nets and basic social insurance. ... A major rethinking of public expenditure policies is therefore necessary.

They suggested that governments should be thinking about reducing state sector spending to the proportion of gross domestic product prevailing 30 years ago.

3.4 In the late 1960s central government non-finance current spending in New Zealand was around 21 percent of gross domestic product. Today non-finance Crown account *current* spending is around 28 percent of GDP on an SNA basis and around 31 percent on a GAAP operating expense basis. The 28 percent ratio is split equally between central government spending on final consumption and Crown spending on transfer programmes.

5 Tanzi, Vito and Schuknecht, Ludger, 'The Growth of Government and Reform of the State in Industrial Countries', International Monetary Fund, Fiscal Affairs Department, 1995 IMF Working Paper, WP/95/130.

3.5 Thirty years ago Crown spending on social security benefits and pensions was only 6 percent of GDP. There is no obvious intrinsic reason for the sharp rise in such spending. For example, the chart on p. 19 of the BPS indicates that the ratio of those aged 65 and above to those aged 15 to 64 has only increased marginally during this period. The rise in per capita incomes since the 1960s ought to have reduced, rather than increased, the need for other welfare spending.

3.6 New Zealand governments are now spending over 12 percent, or more than twice the 1960s percentage, of a much higher level of GDP[6] on social welfare for greatly inferior outcomes in terms of crime, schooling, family break-up, inadequate parenting and allegations of poverty and/or state dependency. A plausible case has been made by scholars such as Charles Murray and Thomas Sowell that the welfare programmes which many industrialised countries have pursued in recent decades have themselves contributed to such outcomes and that more spending will exacerbate many of the problems. In our view this case has not been adequately rebutted by the advocates of current policies in New Zealand.

3.7 In a report *Moving into the Fast Lane* released in March 1996, the NZBR in association with the Auckland and Wellington chambers of commerce advocated an interim medium-term goal of reducing total (central and local) government spending to below 20 percent of GDP by 2005. We are still firmly of the view that reductions in tax burdens of this order are necessary if New Zealand is to reach its full growth potential. This judgment is based on the evidence of the unsatisfactory outcomes of heavy government involvement in such areas as health, accident compensation, education and social welfare, on contemporary cross-country comparisons, and on the historical record. The case for such a target is strengthened by the ageing of the population which is emphasised in the BPS.

3.8 Some empirical research posits a relationship between economic growth and government spending as a percentage of GDP and estimates that the growth-maximising spending ratio is about 20 percent.[7] This reinforces other evidence that an overly large public sector inhibits innovation and growth, although we suspect such an estimate is too high. First, we do not see why government spending as a ratio of GDP should be independent of a country's population, demographic structure, and other characteristics. Some spending should surely fall in relation to GDP as the country grows. Second, in our view government expenditure should ultimately be determined by expenditure-by-expenditure analyses of the value for money associated with government programmes, taking the costs of raising taxes into account. Top-down approaches fail to do this. It is hard to see that government spending on genuine public goods and a well-

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6 Data in Table 1 of the Annex to the OECD's Economic Outlook, December 1996, indicate that real GDP in New Zealand increased by 67 percent between 1969 and 1996.

7 For example, Scully, Gerald, 'What is the Optimal Size of Government in the United States?', National Centre for Policy Analysis, Report No. 188, November 1994, Texas, pp. 1-15; and 'Taxation and Economic Growth in New Zealand', Pacific Economic Review, 1:2 (1996), pp. 1-9.

designed social safety net would amount to 20 percent of GDP in a well-functioning, high income economy.

3.9 Spending on health, education and social security and welfare currently account for 80 percent of non-finance Crown operating expenses. The private sector is well placed to provide health, education and disability insurance services. In our view consumers would derive major benefits in these areas from privatisation of the supply of such services and greater competition. The size of the state sector would be further reduced if people who are not regarded as being in need were allowed to spend their own money on these services directly rather than have the government raise tax revenue and spend it for them. There is ample scope here for substantial reductions in government spending relative to GDP. In the case of welfare, the challenge for the future is to find a system which provides better incentives for responsible behaviour and the preservation of viable family structures and support systems. It seems likely that this will require a shift towards greater personal, family and community responsibility, with the state undertaking a role of last rather than first resort.

4 OTHER ISSUES

Economic and Social Priorities in the BPS

4.1 The government's economic and social priorities are set out on pp. 5 - 6 of the BPS. The priority aims of achieving a strong economy through low inflation, lower taxes, reduced public debt and prudent and conservative fiscal management are strongly supported by the NZBR and, we believe, the business community in general. Many other objectives concerning the family unit and care for others also clearly command support.

4.2 By contrast, questionable priority is given to "increasing the national savings rate by the most effective means possible". First and foremost, there is no reason to believe that the government possesses the information necessary to determine the 'right' level of national savings. A higher savings rate is not necessarily favourable for economic growth, let alone for general community well-being. New Zealand's national savings rate has long been around the OECD average. It has been well above that of some more successful economies, notably the United States, and well below that of some successful Asian countries. How can the government know in which direction it should move?

4.3 Second, the national savings rate is outside the government's direct control.[8] All it can do is alter its own savings behaviour and people's incentives to save for themselves. The most direct way the government might hope to increase the national savings rate is to increase its own savings. Paradoxically, the decisions foreshadowed in the BPS go in the opposite direction by reducing projected operating surpluses. A further way in which the government might improve incentives to save is to reduce the extent to which welfare and superannuation policies reward those who choose not to save. Much could be done here, but the decision to abolish the superannuation surcharge impinges on so few people at the margin that any positive effects on savings may well be offset by the negative effects of the higher implied tax rates for the population as a whole. The government's proposal to introduce a compulsory retirement savings scheme subject to the outcome of a referendum is unlikely to alter the national savings rate for well understood reasons - such schemes basically alter the form in which people make their savings but do little or nothing to raise total savings.

4.4 A further objective in the BPS is to provide health and social services with a "particular focus" on those who have problems through "misfortune or bad luck". We entirely concur with the implied view that a

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8 We made a similar comment about growth targets for GDP in our submission on the 1996 BPS.

fundamental problem with many social policies is that they reward far too much self-destructive and dysfunctional behaviour. The stated objective implies a major restructuring of the welfare state. Currently eligibility for support does not depend on recipients being able to establish that their misfortune is not due to their failure to get a better education, adopt a disciplined lifestyle and work habits, or purchase appropriate insurance policies. The adoption of such a focus would clearly lead to reduced expenditures on welfare, but such reductions are not apparent in the published expenditure projections. Either this objective is simply rhetoric or it has substance. The government's intentions in this area need to be clarified. Similarly the government's objective in the same section of respecting the spirit and letter of the Treaty of Waitangi needs to be clarified. How does the government propose to hold itself accountable for meeting this objective?

4.5 Finally, this section states that the government's overall aim is to help people to help themselves and to support them when they cannot. It is not clear what role the government envisages here for support by family, friends, colleagues, societies, private welfare agencies and insurers. The criteria for distinguishing the government's role from these other forms of support need to be clarified.

Additional Spending on Education and Health

4.6 The emphasis in the discussion on education and health in the BPS is on greater government provision of services and increases in expenditure. Government provision is often notable for its protection from competition, conflicting and/or poorly-specified objectives, failure to offer diversity and choice, and vulnerability to capture by professionals whose concern to improve their own pay and working conditions can conflict with the interests of consumers. All these problems are evident in current arrangements. In many cases there is little evidence that higher spending has improved outcomes. We would urge the government to have full regard to such issues and to consider the case for wider reforms to education and health provision.

The Ageing Population

4.7 According to the BPS, the ageing population could see spending on health and New Zealand Superannuation increasing by over 10 percent of GDP during the next 40 years as the ratio of those aged 65 years and over to those aged 15 to 64 doubles. Since the best way of alleviating the burden of an ageing population is through economic growth, such statistics heighten concerns about the adverse effect of the government's proposed economic strategy on the economy's growth performance. Lower and better targeted expenditures and an active programme of asset sales would increase the growth rate of the economy and allow tax rates to be lowered to more competitive levels. At the same time incentives to work, save and invest in skills would be enhanced for the working-age population. Immigration also has a role to play in modifying the demographic outlook.

4.8 Given such policies, there is no need to expect the ageing population to be associated with a substantial increase in public expenditures. Greater self-reliance through private savings and the purchase of health insurance and, where desired, later retirement would obviate the need for greater public provision. The provision of real goods and services to people in retirement, however, can only come from the productive activity of those engaged in the work force, and hence is ultimately dependent on economic growth.

4.9 It is disappointing that the BPS does not (on p. 20) have a clear focus on economic growth and such options for greater self-reliance. Instead of recognising the degree to which current government policies penalise thrift, work and self-provision and foster reliance on the state, it proposes to expand the state's role by adding all the regulatory costs and barriers associated with a compulsory retirement savings scheme to the other impediments to economic growth. The document expresses the hope that such a scheme could help increase the savings of those who currently make little provision for the future. However, it does not comment on the costs which the regulatory structure would impose on all other members of society whose flexibility to mobilise funds for education, business and family purposes would be reduced.

Long-Term Objectives

4.10 In our view, as explained in sections 2 and 3, the government would have a much better chance of achieving its overall objectives if it aimed to reduce non-finance operating expenses to below 20 percent of GDP while demographic factors permit. This compares with a projected ratio of 30 percent for 1999/00 in the BPS.

4.11 The BPS also fails to present a meaningful long-term objective for Crown net worth. The stated objective is to achieve "[n]et worth at significantly positive levels". Currently net worth is at 6.3 percent of GDP (the projected 1996/97 ratio) but this will rise to 13.8 percent of GDP by 1999/00 on the government's projections. We acknowledge that arriving at a meaningful objective for Crown net worth requires considerable analysis. However, clarification of this objective is desirable in the interests of greater accountability on the part of the government for its fiscal management and to reduce uncertainty in private decision making.

4.12 Given government spending intentions, increases in net worth trade higher current tax rates for lower future tax rates. This is likely to represent an intergenerational transfer of income. Alternatively, if higher current net worth reduces government resistance to pressures for greater spending, such a policy represents a transfer from taxpayers to the beneficiaries of the increased spending, and an increase in the deadweight losses caused by taxes.

4.13 The government might be able to provide a more meaningful long-term objective for Crown net worth in the context of a more explicit assessment of the implications of an ageing population for the stability of future tax rates through time (since Crown net worth may be more volatile the more stable the rates of tax). Such projections should heighten awareness of the sensitivity of future tax rates to policies which opt, for example, for tax-based social insurance for health care costs rather than a private insurance approach. Alternatively, the government may be able to form a less far-reaching view about the optimal longer-term credit rating for sovereign debt or about a prudent debt to net worth ratio for the Crown's balance sheet.

Fiscal Risks

4.14 The section in the BPS on managing risk (pp. 21-22) fails to comment on the management of risks to which the Crown is exposed as a result of its regulatory interventions and its policy of retaining certain 'strategic' assets in public ownership. Examples here include its ongoing ownership and regulation of the ACC, the Earthquake Commission, the major generators of electricity and Trans Power.

The 1 - 3 Percent Target for Inflation

4.15 ANZ economists have recently reported tentative evidence that the recent widening of the target range for inflation has increased nominal bond yields by 0.5 percent per annum relative to the yield on inflation indexed bonds.[9] This accords with the intuition that shifting the mid-point of the target range for inflation from 1 to 1.5 percent per annum would be likely to lift inflation expectations by 0.5 percent per annum. As a result, New Zealand businesses and households are now likely to face higher costs of borrowing.

4.16 The original 0 - 2 percent target rate for inflation had a clear rationale: price stability was the objective and the mid-point of 1 percent per annum reflected an allowance for the lagged nature of the index and measurement problems in respect of unquantifiable quality improvements in products. In the absence of any technical argument that this mid-point was too low, the increase in this range appears to have no sound basis. If so, the decision surely should be reversed. If, to the contrary, there is a sound public policy rationale for increasing inflationary expectations and nominal interest rates by 0.5 percent per annum, it should be articulated in the interests of transparency, credibility and time consistency.

Policy on Indexation

4.17 The discussion on p. 19 of the BPS notes the expenditure implications of the indexation of superannuation payments in conjunction with the abolition of the surcharge. In a letter to the Treasurer dated 21 January

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9 ANZ Market Focus, Issue No 11/97, week ending 20 March 1997.

1997 (copy attached), we pointed out that the conbination of a price stability objective for monetary policy in the Reserve Bank Act 1989 and the determination of a target range for CPI inflation of 0 - 3 percent per annum in the Policy Targets Agreement implied that the government was taking the view that measured inflation of 1.5 percent per annum is consistent with price stability. Given this view, it is incorrect to index superannuation (or other) payments for changes in the cost of living except for any deviation in measured inflation from 1.5 percent per annum.

4.18 We see no evidence of any adjustment to government expenditure projections to reflect this point. The longer the government delays responding to this anomaly, the more difficult it will find it to do so at a later date. Over time significant unplanned changes in the real value of superannuation and other payments would occur. We recommend that the government review as a matter of urgency the basis on which it adjusts relevant payments (and taxes) in response to movements in the CPI.