NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE BUDGET POLICY STATEMENT 2002

JANUARY 2002

2002 BUDGET POLICY STATEMENT

Executive Summary

- From the viewpoint of New Zealanders' living standards, the most important commitment the government has made is to restore New Zealand to the top half of the OECD income rankings. It has also stated a goal of achieving a 3 percent unemployment rate. The government has set store on delivering on its commitments.

- Economic strategies take time to produce results. The path of the economy in this parliamentary term will have been largely determined by previous policy settings and external and cyclical events. Projections for the next three years will be reflecting assessments of the effects of the government's policies.

- In the 2001 budget the government acknowledged that New Zealand's growth outlook is unsatisfactory. To achieve within 10 years the goal of reaching the top half of the OECD income rankings, a sustained annual per capita growth rate of between 4.6 and 7.4 percent is required.

- The Budget Policy Statement (BPS) projections indicate that the government's policies are not moving New Zealand closer to this goal. In section 2 of this submission we note that the projections for economic growth envisage an underlying growth rate of gross domestic product (GDP) per capita of only 1.5 percent per annum. While we believe that this could be optimistic, we concur with Treasury's implicit view that the government's policies are incapable of achieving its stated goal. The Treasury's projections for unemployment also indicate that the government is not on track to achieving its goal of 3 percent unemployment.

- The government's failure to address the gap between its stated objectives for economic growth and unemployment and the reality of these forecasts creates problems of credibility. In section 3 we find that the BPS lacks a coherent strategy for closing this gap.

- In section 4 we make the point that conformity with the principles of the Fiscal Responsibility Act 1994 in funding government spending is a necessary but not sufficient condition for good fiscal stewardship. No fiscal policy is sound if the spending itself is wasteful or poorly targeted. We are critical of the government's novel premise that a sound fiscal policy involves increasing spending more or less in line with revenue growth simply on the grounds that there is money available to spend. It is impossible for the government to establish that spending provisions are justifiable when it does not know what they will be used for. The government appears to be only paying lip service to its declared aim of getting better value for money in government spending.

- We also argue that the government should conform with the requirement in section 6(2)(a) of the Fiscal Responsibility Act 1994 to specify its long-term objectives for total operating expenses, rather than for an aggregate that lacks any economic or accounting rationale.

- In section 5 we commend the government for resisting pressures to increase government spending even further for counter-cyclical reasons, but criticise its rationale for this decision.

- In section 6 we oppose the government's intention not to publish an objective for net debt in future BPSs.

- In section 7 we reiterate our opposition to the New Zealand Superannuation Fund and associated expenditure-increasing measures.

- In section 8 we stress the importance for any sound growth strategy of lower tax rates and urge the government to give favourable consideration to key recommendations of the McLeod tax review.

- In section 9 we revisit the importance for economic growth of lowering regulatory burdens.

- Section 10 contains a number of recommendations that would constitute a more credible strategy for economic growth if incorporated in this year's budget. While these would involve changes to government policy that might be difficult to contemplate, the absence of a credible strategy and the likelihood of continuing mediocre economic performance is no less unpalatable a prospect for the community.

1 Introduction

1.1 This submission on the Budget Policy Statement 2002 (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.

4.1 The 2002 budget will complete the government's fiscal programme for its current term of office. By foreshadowing its major features, the BPS provides an opportunity to assess the likely contribution of this programme to the government's major economic objectives.

4.2 We have made submissions on Budget Policy Statements since their inception. This is because we believe that fiscal policy and the disciplines introduced by the Fiscal Responsibility Act 1994 are important for sound economic management and good communication between the government and the wider community, particularly the business and investment community. We believe that the select committee process should be used to facilitate constructive dialogue on the government's fiscal plans.

4.3 The following sections of this submission focus on the strategy for economic growth that is implicit in the BPS. They end with some recommendations.

2 Inadequate prospects for economic growth

4.1 In the 2001 Budget the minister of finance stated that:

> We need to set ourselves a goal of being back in the top half of the developed world in terms of per capita GDP – a position we have not occupied since 1970. Even if we set the target for achieving that goal well into the future it still means lifting our present sustainable capacity from about 3% a year to 4% a year or more.

4.2 A Treasury paper has estimated that per capita real gross domestic product (GDP) would need to grow at 4.6 – 7.4 percent per annum for 10 years in order to get New Zealand back into this position.[1]

4.3 Such aspirations are not remotely credible under current policies. The per capita growth rate was only 1.8 percent per annum between 1991 and 2001. The forecasts for economic growth contained in the December Economic and Fiscal Update 2001 (DEFU) project trend per capita growth of only 1.5 percent per annum.[2] This is unchanged from the trend assumed in Annex 3 of the 24 May 2001 Fiscal Strategy Report.[3] In conjunction with demographic projections by Statistics New Zealand, this translates into real GDP growth of around 2.75 percent by the end of the current forecasting period (2006) falling to 2.2 percent up to 2011 and to 1.6 percent thereafter.[4]

4.4 Moreover, there is no indication in Treasury's forecasts of any recent lift in New Zealand's growth prospects. Prior to the last election, the Treasury forecast (in the 1999 Pre-Election Update) that growth four years ahead (2003) would fall to 2.9 percent.[5]

4.5 In our view the Treasury's assessments are more likely to err in being too optimistic. It is more than plausible that the policies followed by successive governments since 1993 have been reducing the achievable long-term growth rate. We recently suggested that New Zealand's trend growth may now be down to around 2.5 percent per annum.[6] Even if Treasury's assumed per capita trend growth of 1.5 percent per annum could be achieved, the average

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1 Peter Mawson and Grant Scobie, 'Climbing the OECD Ladder: What does New Zealand have to do?', New Zealand Treasury, 4 April 2001.

2 DEFU pp 42-43.

3 Fiscal Strategy Report, Budget 2001, p 33.

4 DEFU pp 42; Fiscal Strategy Report, p 33.

5 This was not an aberration, as the Treasury has been forecasting in Budget Policy Statements for many years now that economic growth would slow to below 3 percent per annum by the end of each four-yearly forecasting period. The Treasury's current forecast for 2003 is 1.9 percent, but this reduction clearly reflects the Treasury's assessment of the effects of the current international slowdown rather than its assessment of New Zealand's longer-term growth prospects.

6 Speech by Roger Kerr, 'Getting up the OECD Rankings', New Zealand Business Roundtable, 26 November 2001.

living standards of New Zealanders would not reach the top half of those in the OECD in the foreseeable future.[7]

The strategy in the BPS for economic growth

4.6 The 2001 budget did not contain a recognisable growth strategy.[8] The BPS does not outline one for the coming budget.

4.7 The BPS asserts that the government's "priorities for this year have a strong development component. This involves further developing the asset base, improving New Zealanders' living standards, developing our human capital and providing certainty to improve planning".[9] It then proposes large increases in operational spending on state health and education and further increases in industry development spending. It also proposes to bring forward capital spending to reflect "key capital pressures" in the social sector (hospitals and schools), prisons, transport, re-equipping the Defence Force and recapitalising Air New Zealand.[10]

4.8 Increases in government spending of this nature do not constitute a growth strategy. At current levels of spending, the deadweight costs of each additional dollar spent out of taxes effectively reduce national income by something in the region of 50 cents on average, even if it produces a dollar of value.[11] In fact there are good reasons for believing that the institutional arrangements in health, education and social welfare are so bad that each

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7 According to the latest international comparisons from Statistics New Zealand, New Zealand's GDP per capita would have had to be 55 percent higher in 2000 (ie at US$20,000 instead of US$13,000) in order to match the Australian level.

8 See speech by Roger Kerr, 'Agenda 2002: An Election with Vision', New Zealand Business Roundtable, 28 January 2002, p3.

9 BPS, p 5.

10 This section of the BPS also stresses the importance of keeping growth in spending below nominal GDP growth and actively reviewing value for money in government spending. We discuss these issues in the next section.

11 For details on this estimate see Winton Bates *How Much Government?*: *The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, Wellington, 2001 (copy attached). Note in this context that a recent study for the Joint Economic Committee of the United States Congress assessed the cost in that country to be at least 40 cents in the dollar. Government spending accounts for a much lower percentage of national income in the United States.

dollar spent will return much less than a dollar in value. It is difficult to describe the evident determination of any government to pour good money into systems that are guaranteed to waste it as anything other than irresponsible. The problems in health and education in New Zealand mirror those in centrally-directed and planned systems elsewhere. There is a vast amount of evidence that such systems do not work.

4.9 Economists have long recognised that competition, private ownership and decentralised decision-making are the key to forcing providers to serve the interests of consumers. *The Economist* recently highlighted the folly of spending more money on health services in the United Kingdom without reforming them. It called the proposals for increased spending a "terrible mistake, both for voters and for the government".[12] Second, according to highly respected Harvard University economist Martin Feldstein, many researchers have concluded that competition and decentralisation are essential for reducing schooling failures.[13]

4.10 Far from representing a coherent strategy, the increases in spending in health and education look like a short-term political response to crises of a structural nature. It is even more obvious that the spending on Air New Zealand is a response to exigencies related to government regulation in Australia and New Zealand. This spending was entirely reactive.

4.11 As the minister of finance correctly observed in his 2001 budget, lifting a country's underlying growth rate is no easy matter. In our submission on the 2001 BPS we summarised the essential elements of a sound growth strategy. If New Zealand's economic performance is to improve markedly, far-reaching and fundamental changes are necessary. In our view, these include extensive privatisation, reduced spending and tax rates, less government regulation of business and of interactions between private individuals, and a much improved performance by the state in relation to core government activities.

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12 'British Fiscal Policy: Cash is no Cure', *The Economist*, 1 December 2001, p 15, and 'National Health Service: Walking Wounded', *The Economist*, 24 November 2001, pp 57-58.

13 Martin Feldstein, 'Reducing Poverty, Not Inequality', *The Public Interest*, No 137, Fall 1999, pp 33-41.

4.12 The government's failure to implement a growth strategy that is consistent with its own growth targets is disappointing.[14] As we noted in last year's BPS submission, there can be no meaningful dialogue about what might constitute a more successful strategy if the government continues to take an ideologically rigid position on key issues. These include the roles for competition, the price mechanism, the private sector, privatisation, tax rates and the level of government spending.

4 The BPS's concept of sound fiscal management and good fiscal stewardship

4.1 The quality of fiscal policy matters for prosperity.[15] Crown operational spending is to be of the order of 33 percent of GDP (although imminent accounting changes are set to lift this by around 5 percent of GDP).[16] The Crown is a major owner and purchaser of assets.[17] (Successive governments have also played a major regulatory role, the effects of which have often been to impede freedom of contract and to remove private property rights without compensation.) When governments assume such a large economic role the quality of their policies strongly influences national economic performance.

4.2 On page 1 the BPS refers to the achievement of policy commitments, operating surpluses and the need for consistency with debt objectives. On page 2 it presents "good fiscal stewardship" as a matter of keeping spending increases below projected increases in GDP and running surpluses that help achieve independently derived debt targets. On page 8 the BPS returns to this theme.

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14 The Treasury's projections for unemployment demonstrate that the government also appears to be content to only pay lip service to its professed target of reducing the unemployment rate to 3 percent. See DEFU p 30.

15 See, for example, Bates, *op cit*.

16 See DEFU p 46 for the lower figure. The five percentage points estimate is based on the table provided on p 71. This table provides indicative figures summarising the full effects on measured Crown spending of the pending change in the 2002 budget to GAAP rules requiring the adoption of line-by-line consolidation. The increase occurs despite an associated reduction in core Crown expenditure of around $1 billion from the pending exclusion of GST (see p 15).

17 On p 23 the DEFU explains the extent of the government's borrowing programme by observing that investment outlays of $23.6 billion (during the next five years) exceed cash surpluses by $10.6 billion. Such outlays represent 3.8 percent of forecast GDP during the period.

It asserts that the government is working from "sound fiscal management foundations". It goes on to state that:

> The underlying premise remains unchanged – the combined increase in capital and operating spending has to be in line with nominal GDP growth such that debt as a percentage of GDP is stable and trends towards our objective over the longer-term.

4.3 Contrary to the opening remark in this statement, to the best of our knowledge this is the first time such a premise has been proposed in a BPS. Nor are we aware of any basis in the Fiscal Responsibility Act 1994 for proposing that debt should be stable as a percentage of GDP. The principles enumerated in the Fiscal Responsibility Act refer only to the desirability of predictability about the level and stability of *tax rates* for future years.

4.4 We do not know of any basis in public finance theory for suggesting that public debt should be stable as a percentage of GDP. To the contrary, if government spending plans are soundly based and tax rates are to be reasonably stable through time, it follows that operating balances and debt will fluctuate in response to unevenness in spending plans and revenues. To propose that debt ratios be stable is to propose that spending plans be adjusted regardless of value-for-money considerations. This makes no economic sense.

4.5 Instead, the government should put value for money first in determining expenditure plans, taking the deadweight costs of taxes and the importance of a high level of economic freedom into account. Spending plans determine the average revenue requirement through time and therefore, in conjunction with projected income growth, average tax rates. Stability in tax rates consistent with this average funding requirement implies instability in the operating balance and in debt. Capital spending is intrinsically lumpy and unevenness in this spending will also contribute to changes in debt as a percentage of GDP. The requirement in the Fiscal Responsibility Act for debt to be at prudent levels in no way implies that it should be stable through time. The debt tail should not be permitted to wag the spending dog.

4.6 More importantly, the premise that government spending should be increased in line with GDP is devoid of value-for-money considerations. For many years successive governments have provided for major spending increases without knowing how they propose to spend the money. When they don't know what it is to be spent on they do not know that it represents better value for money than lower taxation.

4.7 In contrast, a responsible fiscal policy would assess the relative merits of spending increases or tax cuts on a principled basis. It would acknowledge the deadweight cost of taxes and the undesired perverse incentive effects of much government spending. It would develop a principled public good and equity basis for determining government spending priorities. Ensuring the provision of public goods (not goods and services that can be supplied privately) and of a sound safety net (including underwriting access to health services and education) should be the government's key roles.

4.8 The government cannot credibly claim that all existing spending reflects value for money. In our view there is every reason to agree with the statement in the BPS 2001 to the effect that much current spending is wasteful.[18] We are assailed almost daily by newspaper reports of incompetence, waste and fraud in government spending. Governments typically lament the gap between the outputs of spending programmes and the outcomes that they seek. Departmental post-election briefing documents routinely gloss over the absence of any adequate proof that spending is effective by stating that "more research needs to be done" in evaluating its impact.

4.9 We have seen no evidence of material savings following the statement in the BPS 2001 that the government's "initiatives in 2001 will also focus on improving the effectiveness of existing policy interventions". In response to a question at the 2001 budget lock-up, the minister of finance acknowledged that little had been achieved to that point but suggested there were savings to be made in some areas, notably health. It is difficult to be optimistic about the statement in the latest BPS that "we are actively reviewing the value for money the Government receives from its expenditures and investments, and are continually looking at ways of reprioritising expenditure to best match the

18 See BPS 2001, p 7, last paragraph.

Government's social and economic objectives".[19] There is no tangible evidence of progress. A concern here is that the government's objectives in an election year may reflect party political concerns rather than the national interest.

4.10 In short, the BPS does not appear to recognise that a responsible fiscal strategy requires value for money in spending as well as prudent funding of that spending through taxes and debt. Compliance with the principles of the Fiscal Responsibility Act 1994 only addresses the latter aspect. If much spending is wasteful, it is obviously better if expenses grow at less than the rate of growth in GDP rather than at the same, or a higher rate.

4.11 The minister of finance claims credit for reducing government spending as a percentage of GDP since taking office. The government's degree of fiscal discipline has been important for business and financial market confidence. However, projected spending for 2002/03 is now more than $1 billion higher than was projected by the Treasury under the previous government's policies. With evident expenditure pressures we see risks that the government will be unable to keep within the current (increased) limits it has set for itself, and of future tax increases. If the government is serious about reducing government spending as a percentage of GDP it is hard to see why it increased the long-term target in the BPS 2000 for operating expenses from below 30 to around 35 percent. In the light of its more recent statements it should reverse that decision.

4.12 The BPS forecasts that in 2004/05 operating expenses will be 32.4 percent of GDP and that capital transfers to the New Zealand Superannuation Fund will be around 1.6 percent.[20] The government proposes to hold operating expenses well below 35 percent of GDP while capital contributions to the Fund are positive and to raise them above 35 percent when they are negative so that the total is held at around 35 percent. However, there is no economic case for varying operating expenses in a manner that so obviously ignores value-for-money considerations. Nor is there any obvious accounting justification for combining operating expenses with the capital contribution. Moreover, section

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19 *Op cit*, p 7.

6(2)(a) of the Fiscal Responsibility Act 1994 requires the government to specify its long-term objectives for total operating expenses in each BPS, not some composite aggregate. In our view the government would communicate its intentions more clearly if it stuck to a target for operating expenses alone. On the basis of the 2004/05 projection, the target should be below 33 percent of GDP.

20 *Op cit*, p 13.

5 Counter-cyclical fiscal policy considerations

5.1 On page 3, the BPS commendably resists the argument that the government should increase its spending further for counter-cyclical reasons. Unfortunately, it does so on the grounds that "our assessment of the fiscal stance is that the Government is moderately supporting economic growth over 2001/02. This largely reflects higher capital spending in 2001/02, including equity injections into hospitals and increases in student loans".

5.2 This rationale assumes that increased government spending can support economic growth, even if it is on unprofitable projects. Economists have long since discarded such hubristic and profligate Keynesian notions.[21] At current levels of spending, there are sound grounds for believing that fiscal contractions can be expansionary. For example, a recent study of fiscal contractions in 18 OECD countries between 1960 and 1996 found that spending cuts in particular can have large expansionary effects.[22]

5.3 Once again we stress the importance of judging the soundness of each and every item of government expenditure on its own merits in evaluating the contribution of government spending as a whole to the welfare of the community.

Gross and net debt targets

5.4 On page 12 in Annex II, the BPS states that the government has dropped net debt as a fiscal objective, in good part because "two objectives can be confusing, because it is not clear which is binding". While the text supplements this reason with the comment that the trend in gross and net debt is similar, it is clear from their nature that this will not necessarily always be so. The difference between the two, "financial assets", includes such

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21 See for example, Martin Feldstein, 'The Retreat from Keynesian Economics', *The Public Interest*, No 64, Summer 1981; Robert Skidelsky, 'Bring Back Keynes', *Prospect*, May 1997; Robert Barro, 'Keynes is Still Dead', *Wall Street Journal*, October 30-32 1992; and 'Unbalanced Keynesians', *The Economist*, September 11-17, 1999, 20th Century Survey section, p 15.

22 Alberto Alesina, Roberto Perotti, Silvia Ardagna and Fabio Schiantarelli, *Fiscal Policy, Profits and Investment*, National Bureau of Economic Research Working Paper 2707, 1999. See also Tony Makin, 'When Contractionary Fiscal Policy is Expansionary', *Agenda*, Vol 5, No 4, 1998 pp 419-426, and International Monetary Fund, *World Economic Outlook*, May 1996.

potentially large and volatile items as the value of the New Zealand Superannuation Fund, advances to state-owned enterprises and student loans.

5.5 We question the rationale for this decision and therefore the decision itself. In our view a coherent budget strategy will involve internally consistent forecasts for the major aggregates such as expenses, revenues, operating deficits, assets and liabilities, including gross and net debt and the government's borrowing programme. When likely outcomes differ from plan, it is up to the government to determine its priorities in setting new targets or objectives. We know of no economic basis for presuming that any adjustments should seek to preserve an earlier gross debt target rather than an earlier net debt target, or either target. Nor does the Fiscal Responsibility Act 1994 appear to imply any such requirement.

5.6 We are not aware of the basis for the concern that the presence of both objectives is causing confusion. If it is occurring amongst financial market professionals it should presumably be possible to explain to them that these objectives are not set independently and so are not in conflict. They simply represent different components of a coherent overall plan.

5.7 Given the potential for significant differences between the two series, in our view the elimination of one of these objectives would represent a material reduction in the quality of information disclosure in future BPSs.

New Zealand Superannuation Fund

5.8 As we stated in our submission last year on the New Zealand Superannuation Bill, the government's pre-funding proposal is largely an accounting exercise with no direct economic impact on the retirement problem.[23] By creating the false impression that it alleviates future funding burdens it could discourage private savings. Other policies, such as the attempt to entrench the age of eligibility and the level of payment of New Zealand Superannuation, and the lift in the government expenditure to GDP target to 35 percent, will increase future funding difficulties. The Fund constrains the scope for tax reductions

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23 *Submission on the New Zealand Superannuation Bill*, New Zealand Business Roundtable, February 2001.

that would spur growth and enlarge the economic cake. The availability of an adequate level of real goods and services is ultimately the only safeguard for retirement living standards. We consider that the Fund should be wound up and the proceeds used to repay debt.

Taxation and the McLeod report

5.9 In our view no strategy for materially lifting economic growth prospects will be credible unless it envisages significant reductions in marginal tax rates in conjunction with spending reductions. The tax scale needs to be flattened as the McLeod report recommended. The top personal rate of tax should be reduced and aligned with the corporate tax rate. The medium-term goal should be to reduce all income tax rates to a maximum of 25 percent.[24] We concur with the views contained in the McLeod report about the basic soundness of the New Zealand tax system, the merits of a broad-based, low-rate structure, and the weak case for some novel forms of taxation that have been proposed. These include the idea of a dedicated health tax.

5.10 There have been suggestions of an increase in the excise tax on petrol. The McLeod committee, correctly in our view, recommended that in general excise taxes, including on motor spirits, should be abolished. Problems of road congestion have much to do with misplaced spending priorities, expensive delays to new projects caused by government regulation, the lack of progress on introducing congestion pricing, the failure of successive governments to increase the role of the private sector, and uneconomic commitments such as the Britomart project and ill-justified subsidies for selected forms of public transport. Meanwhile road users have been making a large contribution to general government revenue. Instead of taxing motorists more heavily these longstanding problems should be addressed.

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24 For our detailed reasons, see 'Submission on the Tax Review 2001 Issues Paper', New Zealand Business Roundtable, 2001.

Regulatory burdens

5.11 Enhanced rates of economic growth cannot be achieved if governments deter investment through an unfavourable regulatory environment. In recent years the increased regulation of business has been relentless, particularly in the labour market, safety, environmental, utilities and securities market areas. This trend is continuing and there have been few initiatives to reduce regulatory costs. The government's business compliance cost review has yielded meagre results. Ratification of the Kyoto Protocol in advance of major trading partners and in the absence of sound analysis would impose further costs on New Zealand businesses.

5.12 In our view, one problem here is that successive governments have failed to require departments proposing regulations to support them with professionally competent regulatory impact statements. Competent analysis is a necessary first step to improving regulatory policies. Consideration should also be given to the concept of a regulatory responsibility act.[25]

Recommendations

5.13 New Zealand's economic outlook is acknowledged by the government to be inadequate. To improve the economy's growth prospects we recommend that it give serious consideration in this year's budget to:

- restoring the goal of reducing 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;
- 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 recent ministerial review of business compliance costs determined 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.

5.14 Failing such measures, we suggest that the budget will not contain a credible growth strategy. In that event it would be disingenuous of the government to continue to maintain it is serious about restoring New Zealand to the top half of the OECD income ladder.

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25 See Bryce Wilkinson, *Constraining Government Regulation*, New Zealand Business Roundtable, Federated Farmers of New Zealand, Auckland Regional Chamber of Commerce and Industry and Wellington Regional Chamber of Commerce, December 2001.