

BUDGET 2011 DOESN'T SOLVE SERIOUS PROBLEMS

Some have described the 2011 budget as cautious and safe. Cautious, yes. Safe – maybe politically, but not in terms of removing economic risks. And no one to my knowledge described it as strategic – constituting a coherent, medium-term plan for restoring balanced growth.

Arguably the two main economic problems facing the country are the structural imbalances and the slump in productivity growth, both of which the government inherited from its predecessor. Both originate with the enormous increase in government spending and regulation, and the anti-growth policies more generally, of the last decade.

The imbalances take the form of stagnation of output in the tradeables sector of the economy (export and import-competing industries) while the non-tradeable sector (which includes government) continued to expand and absorb resources.

The budget noted that real export growth since 2004 averaged an anaemic 1.4% a year, compared with 5.4% in the previous 15 years. The current account deficit averaged 8% of GDP from 2005 to 2009, and external liabilities mushroomed.

As for productivity, the story is well known. We saw greatly improved labour productivity growth (to around 2.5 – 3% a year) after the economic reforms of the 1980s and early 1990s, followed by a dramatic slump (to just 0.9% per year over the 2006-10 period).

Fast rates of productivity growth must be achieved if New Zealand is to catch up to Australian income levels.

So how does the 2011 budget measure up in terms of dealing with these two fundamental problems?

If economic rebalancing were occurring, we would expect to see, among other things, a reduction in the government spending share of GDP to

release resources to the tradeables sector; strong export growth; and an economic recovery that did not put pressure on the current account.

Unfortunately, there is little evidence of such trends in the budget forecasts. Core Crown expenses are at all-time highs relative to GDP this year and next, and even by 2015 remain higher than in most of the Cullen years. Export volume growth is forecast to average a meagre 2.5% a year for the 5 years to 2015 (despite high terms of trade and a favourable exchange rate with Australia). The current account deficit is forecast to increase to over 6% a year as the economy recovers.

This is not a healthy outlook in the face of gathering risks in the global economy, including renewed financial turbulence which could make it difficult or expensive for New Zealand to roll over debt or undertake new borrowing. The government may have done enough to maintain the country's credit rating in the short term but the negative outlook remains and conditions could easily worsen.

In respect of productivity, no return to the rates of growth of the 1990s is in prospect. Labour productivity is forecast to grow by under 1% a year in the five years to 2015 and assumed to average 1.5% a year thereafter. This outlook is not surprising: the government has implemented few productivity-enhancing reforms.

The bottom line is that not a lot is happening to deal with New Zealand's two most serious economic weaknesses.

Some aspects of the budget were more encouraging. The return to a budget surplus by 2014/15, if achieved, would be a significant milestone, especially against the background of the Christchurch earthquakes. Ongoing tight control of core government spending would be required for this outcome, and the government's ability to sustain such control remains an open question.

It is also to the government's credit that the budget confirmed its intention to proceed with partial privatisation of four SOEs and to sell down its shareholding in Air New Zealand. This is probably not a politically popular

decision, although opposition to privatisation may not be deep-seated. The government should make the case for its plans by debunking the many myths that have been propagated about privatisation over the past 15 years.

The reductions in spending on KiwiSaver, Working for Families, and student loans policy were all moves in the right direction. These programmes were vote-buying measures unsupported by sound policy analysis. They are good illustrations of how the costs of poor policies can burgeon over time and gather entrenched interests around them, making them difficult to modify.

Even the limited changes made are not without their drawbacks. The savings of just 4% of the cost of Working for Families come at the expense of higher effective marginal tax rates for some taxpayers. Also from 1 April 2013 KiwiSavers will be required to contribute a minimum of 3% of gross wages (up 1 percentage point) unless they opt out. Employers will also have to contribute another 1 percentage point if the employee contributes. This will reduce the competitiveness of industries in the exposed sector.

Beyond Working for Families, however, no changes were made to the major income transfer programmes. Along with health and education, these are the big spending areas. New Zealand Superannuation remains the elephant in the room, with the prime minister's commitment not to increase the eligibility age. The costs of NZS are set to rise from \$8.8 billion in the current year to \$11.7 billion by 2015. There is widespread understanding that New Zealand cannot turn a blind eye to the problem – the demographic time bomb is ticking. A possible 'out' for the government would be to put the issue to voters in a referendum.

Social welfare is the other big transfer programme. Strangely, no announcements were made in the budget on the recommendations of the Welfare Working Group that reported in February. Earlier this year the government was saying that the WWG report and that of the Savings Working Group would be a major focus of the budget. Why has this not happened – election year politics, sluggish decision-making processes, or resistance to change on the part of the welfare bureaucracy? The budget

forecasts an ongoing rise in the costs of all the main benefits (Domestic Purposes, Invalids and Sickness) apart from the Unemployment Benefit.

Other opportunities to advance a stronger agenda were missed. No indication was given of a timetable for the government's stated goal of getting all income tax rates down to 30% or below. A stronger commitment could have been made to support the Regulatory Standards Bill and the Spending Cap (People's Veto) Bill promoted by the ACT Party. The former seeks to improve the quality of regulatory policies and the latter to cap real per capita government spending, unless voters authorise higher increases in a referendum. The proposed cap would not impose unrealistic disciplines – the government's forecast spending track would fit comfortably within it.

Perhaps most ominously, no mention was made in the budget of the government's top priority goal of closing the income gap with Australia by 2025. The government has also disbanded the 2025 Taskforce. The 2025 goal is not just an outcome of the Confidence and Supply Agreement between National and ACT; it is a vision articulated independently and earlier by prime minister John Key. Has the government thrown in the towel, just as Helen Clark's government gave up on its goal of lifting New Zealand incomes to the top half of the OECD income ladder? If so, the consequences will be serious. Australian per capita incomes are now 38% above those in New Zealand and the budget forecasts suggest the gap will continue to widen in the next parliamentary term. The consequence can only be continued migration of businesses and people across the Tasman.

What would a coherent plan to address New Zealand's economic imbalances and growth prospects look like? A credible answer was given in the two reports of the 2025 Taskforce. Essentially the Taskforce recommended less government intervention under the headings of government spending, regulation and ownership of businesses, thus creating a freer environment for entrepreneurial endeavour. Such a programme is orthodox rather than radical. It is consistent with the advocacy of the Business Roundtable and other major business organisations (Business New Zealand, Federated Farmers and the New

Zealand Chambers of Commerce). In its reports on New Zealand the OECD has made similar recommendations. No alternative programme for achieving its ambitious goal has been put forward by the government.

In summary, New Zealand is a nation at risk. The government is struggling to undo the economic damage inflicted by its predecessor. Its strategy of slow adjustment to the global financial crisis and now the Christchurch earthquake is fraught with danger. The MMP system is inimical to decisive remedial action. Another economic shock could provoke a major crisis.

As always, the solutions to these dilemmas are ultimately in voters' hands. A country's choice of institutions and policies largely determines whether it prospers or not. There is widespread disquiet in the business community and among international observers about New Zealand's economic risks and ongoing under-performance. The chance for voters at large to indicate whether they are satisfied with the current state of affairs or whether they want change for the better will be at the November general election and the referendum on MMP.

Roger Kerr is the executive director of the New Zealand Business Roundtable. Check out his blog on www.nzbr.org.nz