

Economic Fallacies And Their Consequences

A few weeks ago I decided to look out for examples of economic fallacies that routinely appear in our media. It didn't take long to make a list.

Local government is always a happy hunting ground.

Mike Reid, governance manager of Local Government New Zealand, recently wrote that there wouldn't be much interest in private financing of infrastructure like water services "as councils are able to borrow more cheaply than the private sector".

However, councils can borrow more cheaply simply because they can levy rates to repay borrowings. The true social cost of a project is a function of the risk associated with it. This is unaffected by the source of funding. The risk element is borne by ratepayers and comes at a cost. Councils should look at the riskiness of projects and require a return commensurate with the risks to both lenders and ratepayers.

You can often spot a fallacy by thinking of the implications. If this proposition were true it would make sense for councils to take over most of the private sector. It would make even more sense for central government to take over local government and most of the private sector because it can borrow more cheaply than either.

If an employee of the peak local government organisation can make this elementary mistake, it may be a widespread misconception in the sector.

Staying with councils, a residential ratepayer objected to Wellington City Council lowering the business rate differential on the grounds that "businesses could claim tax breaks which were not available to the residential sector."

This claim is mistaken. It overlooks the point that firms are taxed on their income whereas the residential sector is not. Assessability and tax deductibility generally go hand in hand. Nobody seriously claims that it's an

advantage for businesses to be subject to income tax in order to be able to deduct expenses.

Next, I noticed in relation to government-owned enterprises a claim that the government would be worse off financially by selling assets. This overlooks the fact that the price received would tend to reflect efficiencies that bidders expect to make. As the 2025 Taskforce observed, “privatisation of government assets, into a competitive market, will generally improve the government’s financial position, and the performance of the economy as a whole.”

For the same reason councils don’t keep down rates by owning businesses.

Much myth-making surrounds privatisation. Another recent claim is that acquisition of government businesses by overseas interests would increase the current account deficit through the outflow of dividends.

But with a floating exchange rate, a foreigner buying a dollar of New Zealand assets exchanges it for a dollar claim on foreign assets. The net claims from the rest of the world are unchanged. And while dividends going offshore may be higher than otherwise, interest payments to foreigners would fall if the proceeds were used to repay overseas debt.

The labour market is a fertile source of fallacies.

One newspaper correspondent wrote that the recent fall in the unemployment rate reflects record numbers going to Australia. “More people leaving the country means extra jobs for those staying.”

This assumes there is a fixed ‘lump of labour’, which is wrong. Small and large countries alike can achieve full employment. The inverse proposition that immigrants (or more women entering the workforce) are job-stealers is wrong for the same reason. People are consumers as well as producers, and meeting their demands creates more jobs.

In the recent Australian budget the government announced an increase in compulsory superannuation contributions (payable by employers) which led local unions to suggest employers here should do the same.

This is an example of the free lunch fallacy. It presumes that employees can benefit at the expense of a firm's shareholders or customers. As Australian Treasury secretary Ken Henry explained, workers will pay for the increase in superannuation contributions through lower pay rises. Such levies can't come out of profits beyond the short term because firms must earn a normal return on capital.

Similarly, increases in ACC employer levies tend to be passed backward to workers (or forward to consumers through higher prices). More than anyone, workers should be concerned about lower wages due to the higher costs of an inefficient state monopoly scheme.

Talking of compulsory savings, the Australian budget decision led to proposals for similar action to "boost New Zealand's poor savings rate."

The evidence that our savings rate is low is weak but, more importantly, empirical evidence suggests that compulsory schemes do little to increase total savings. Mainly they distort people's savings decisions in favour of financial assets and away from savings in homes, businesses, farms and other assets.

Economic fallacies matter because public policy based on them makes the community worse off. This article may be the start of an occasional series on them.

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