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### **Budget 2008: An Admission of Failure**

What should we hold a government accountable for?

The answer would seem obvious: whether it is achieving the goal which it has stated to be its “top priority”.

The current government has been unequivocal about its top priority goal: to get New Zealand back into the top half of the OECD income range. Prime minister Helen Clark reaffirmed that goal in parliament earlier this year. Finance minister Michael Cullen has said that the government needs to achieve 4% plus annual growth in real GDP on a sustained basis to achieve it.

The goal is important and achievable. Economic growth – or more precisely growth in real per capita incomes – means the difference between hardship and a comfortable standard of living for many. Over the past 20 years Ireland and Australia have lifted themselves from below-average OECD income levels to well into the top half of the range.

Measured against this “top priority” goal, the budget is an admission of failure. Indeed, the goal is not even mentioned. It is not difficult to understand why. The economy’s average growth rate is falling, not rising. Over the so-called forecast period (the next four years) annual growth in real GDP is expected to average only 2.5%. At that anaemic rate New Zealand will be lucky not to fall further down the OECD income ladder, and the income gap with Australia will almost certainly widen.

This depressing outlook should be no surprise. For years the Business Roundtable has been saying that the government does not have a credible strategy to achieve its goal. The clearest evidence of failure has been the slump in productivity growth relative to the 1990s. Labour productivity growth in the measured sector of the economy (essentially the business

sector) has fallen from an average of 2.6% a year in 1992-2000 (after the reforms of the 1980s and early '90s began to pay dividends) to just 1.1% a year in 2000-2007, a lower rate than in the last economic cycle in the Muldoon years (1.4% in 1982-85).

As the budget rightly noted, "New Zealand needs to significantly lift productivity in order to build a high value, high wage economy to better compete globally." Plainly this is not happening.

It is a prime role of the fourth estate – the media – to hold governments accountable for their commitments. Few journalists even mentioned the government's growth objective in their commentaries. No doubt many had cynically discounted it years ago. But is this good enough? This is an issue that goes to the heart of people's living standards. If the voting public does not have an informed understanding of the credibility gap between the government's policies and its goals, it can commit fraud on the electorate.

Several other important issues were underplayed in budget commentary.

The first and related one is that the budget was all about redistribution, not economic efficiency and growth – about redividing the economic cake not making it larger. Indeed Michael Cullen openly admitted that he has taken redistribution as far as it could go. He made no claim that the budget was directed at achieving faster growth.

The lukewarm reception the budget received, after many taxpayers realised they would only benefit to the extent of a block of cheese a week from taxation and spending measures that completely wipe out future operating surpluses, will bring home to many people the limits of income redistribution. (For a good treatment of this issue, see Mark Harrison, *The Outcomes of Income Transfers*, [www.nzbr.org.nz](http://www.nzbr.org.nz).)

Only a rising economic tide can lift all boats. There has been too much talk of reducing wage gaps with Australia by cutting taxes (and thus improving after-tax incomes). As Peter Conway of the Council of Trade Unions said after the budget, "The wage gap with Australia cannot be closed by tax cuts. It requires ongoing wage rises for New Zealand workers." In turn,

wage rises must be underpinned by productivity growth – they cannot be conjured out of thin air.

To restate this point: overall material living standards depend on gross incomes, not incomes after tax. Gross incomes are determined by what we produce. Tax merely divides the cake between what governments spend (which matters for living standards if the spending delivers value for money) and income available to be spend privately. The focus must be on the incentives needed to encourage productive activity, and excessive redistribution blunts incentives to work, save and invest.

Another aspect of redistribution is poorly understood. As the 2001 McLeod Tax Review pointed out, most redistribution occurs through government expenditure – on services such as health, education, welfare benefits and housing – not through the taxation system. This point will be brought home to those who notice that the difference in the weekly gains to people in different income categories from the personal tax cuts in the budget is not great. The current progressive income tax system (the PITS) owes its origins to Karl Marx, writing in his *Communist Manifesto* of 1848. The McLeod Review pointed out that in practice a flatter or more proportional tax system redistributes just about as much income as the PITS. Progressive taxation ultimately rests on envy, not compassion for the poor. (See Cathy Buchanan and Peter Hartley, *Equity as a Social Goal*, [www.nzbr.org.nz](http://www.nzbr.org.nz).) By cutting the bottom tax rate to 12.5%, Dr Cullen has widened the tax scale and made it more progressive, rather than moved towards a lower and flatter tax structure as recommended by the McLeod Review.

PricewaterhouseCoopers chairman John Shewan has made the point that “sharply progressive rates that result in a family with two children on \$80,000 paying 14 times as much tax as the same family on \$45,000 result understandably in perceptions of unfairness.” The top 15% of taxpayers (people on over \$60,000) currently pay 55% of personal income tax; the bottom 47% pay less than 10%. This is a dangerous state of affairs in a world of highly mobile taxpayers, and it sets up worrying political dynamics

with a large group of people having incentives to lobby for more government spending at others' expense.

John Shewan added that it is too much to expect the tax system to do things like resolve poverty, reduce income inequalities, compensate for surging food and petrol prices, incentivise savings, and keep All Blacks in New Zealand. Essentially the tax system should be used to raise necessary government revenue at least economic cost. This puts the emphasis on cutting high effective marginal tax rates and moving to a flatter scale. Earlier this year the Business Roundtable, the New Zealand Chambers of Commerce, Federated Farmers and the New Zealand Institute of Chartered Accountants called for all high income tax rates to be reduced and aligned with the company tax rate at 30% as a step in this direction. Such a move, which has been advocated by revenue minister Peter Dunne, would also greatly simplify the tax system. Once again, the government showed no interest in listening to business. We are left with a situation where companies are facing a 30% rate but many other businesses, such as sole traders, farmers and partnerships, are still facing a 39% business tax rate – the personal rate is what matters to them. This is patently inefficient and unfair.

Another point that has been missed by most commentators is that in reality the government is not giving tax cuts at all. There are two ways of illustrating this point.

The best measure of the overall tax burden is ongoing government spending. Broadly speaking, whatever the government spends must be raised from taxation sooner or later. The ratio of government spending to GDP can be thought of as the 'economy-wide' tax rate. On top of the massive increases in government spending in recent years, the government spending (core Crown expenses) share of the economy is forecast to rise further rather than fall (from 31.8% of GDP to 33.3%, or a rise of 1.5 percentage points) between 2008 and 2010. Taxation overall, in other words, is going up, not down.

The other way of illustrating the point that the package is essentially a Clayton's tax cut is to consider fiscal drag. This is the increase in

government revenue that occurs without any increase in tax rates as taxpayers move into higher tax brackets because of wage increases. In response to a question in parliament, Dr Cullen provided Inland Revenue Department estimates that fiscal drag between 2000 and 2007 amounted to around \$1.7 billion. Some analysts consider the figure to be substantially understated, and it should be investigated further. The tax package will return to many taxpayers only part of these hidden tax increases; they will not benefit from real tax reductions. They would have been better off if the tax scales applying in 1999 had been indexed for inflation. It is surprising that this issue has not featured prominently in budget commentary. The fact that Treasury officials at the budget lock-up were instructed to refer all inquiries about fiscal drag to the office of the minister of finance may point to a smoking gun.

New Zealand's core fiscal problem is government spending. As the Business Roundtable has long pointed out, no comparable OECD economy has achieved sustainable economic growth at an annual rate of 4% or more with total government spending (central plus local) at over 40% of GDP. The implied tax burden is simply too high. Even the Treasury has recently acknowledged in recent research that the "empirical literature – at micro and macro levels – [is] increasingly supportive of negative impacts of taxes on GDP, or productivity, or investment."

Moreover, instances of wasteful government spending are legion. At a trivial level, it is obvious that when the budget ludicrously allocates \$9 million to boost prize money for racing, any pretence of spending discipline has gone out the window (and the consequences of MMP are starkly revealed). Far more significantly, we have seen things like the Kyoto liability fiasco and billions of dollars being spent on health without commensurate output gains. Dr Cullen's redistributive efforts have also been incoherent: instead of redistributing from higher to lower income groups the transfers have been in the opposite direction in cases like the extension of Working for Families to people on high incomes, the interest-free student loan initiative, and KiwiSaver (where among the major beneficiaries are people on high incomes close to retirement). The tax subsidies associated with KiwiSaver are indefensible and the budget

indicates that its annual fiscal cost has already blown out to \$1.5 billion. It cannot possibly be politically sustainable.

Even Dr Cullen has been forced to recognise the costs of profligacy, and has cut back on future spending allocations. But such weak disciplines are not enough. There is a strong case for strengthening the Fiscal Responsibility Act (now part of the Public Finance Act) by introducing rules that would keep spending and taxation growth to the rate of population growth plus inflation, unless a government obtained the agreement of taxpayers to higher increases by way of a referendum. This would not require any cuts to government spending in real terms – even though wasteful spending should be cut – and as the ratio of government spending to GDP fell over time with growth in the economy, significant real tax reductions could be implemented. This would be the best answer to the mindless mantra that lower taxes mean cutting government services. The boost to growth of lower government spending and taxation would generate more resources for government spending over time, as Ireland's experience has shown.

What should we make of all this? We are seeing productivity growth plummeting, the income gaps with Australia widening, large current account deficits persisting according to budget forecasts, high rates of inflation putting pressure on household budgets, a 20% fall in the value of the New Zealand dollar forecast in the budget (which will exacerbate inflationary pressures), large-scale out-migration – and yet there is still no effective response in the budget to the mounting problems.

What should stand out to New Zealanders is just how little we have made of our tremendous good fortune over the last few years. In many ways the current decade feels like a re-run of the 1960s – the Holyoake years, which we look back on as a time of complacency and squandered opportunities. Favourable recent circumstances include the hugely positive impact of the converging market economies (China, India and others in Asia, Latin America, Russia and even Africa) in terms of the normal gains from trade to a trading economy; the deflationary impulse that has allowed access to cheap and easy money for a country which is a large external borrower, the

turnaround in the long trend decline in our terms of trade; and even the discovery of oil. Yet none of this has lifted New Zealand up the OECD rankings and we have run up large imbalances that will need correcting because a weak productivity performance has undermined supply-side growth. Even more amazing, these sorts of issues do not seem to be of much public concern.

The government deserves credit for a number of its moves over the years – such as the dismantling of producer boards, the prime minister’s stand on genetic modification, some further tariff reductions, cutting company tax and the recent free trade agreement with China.

But the list of wealth-creating as opposed to redistributionist moves over nine years is a very short one, and the budget confirms the government has thrown in the towel on pro-growth reforms. Increasingly its reactions look close to those of the disastrous Muldoon administrations, and New Zealanders seem likely to look back on this decade in a similar light.

We must hope that whatever government is in office after the election recognises the need to vigorously pursue much higher quality policies.

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