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Faith in Government Spending is Misplaced

Listening to some commentators, one would think the recession has given governments the ability to produce wealth and jobs out of thin air. The government is being urged to increase its spending to 'stimulate' economic activity.

What seems to be overlooked is that the massive increases in core Crown spending in recent years – some \$25 billion since 2000 – saw New Zealand 'lead the world' into recession. The Treasury has stated that "The overall fiscal stimulus is at the upper end of international reaction to the current situation."

More spending now would be like throwing petrol on a fire.

To its credit, the government is largely resisting the pressure to add to the waste in government spending programmes.

Hundreds of economists in the United States are saying that the Obama administration's so-called 'stimulus' package is reckless.

It looks likely to drive the US budget deficit to around 12% of GDP, create enormous public debt, and necessitate big tax increases or spending cuts down the track.

The stagflation of the 1970s taught economists that recessions could not be solved simply by fiscal expansion and loose monetary policy. Japan relearned the lesson in the 1990s – its so-called 'lost decade'.

It is now widely considered that government policy mistakes caused the banking collapses of the 1930s, protectionism aggravated the decline and New Deal spending was largely ineffective.

But many governments, under populist pressures to 'do something', seem to have forgotten those lessons.

For a small, open economy like New Zealand; further increases in government spending would worsen the balance of payments rather than do much to increase output, even in the short term. Longer term they would raise future tax and debt burdens and risk a resurgence of stagflation.

High levels of government spending, already projected to be 45% of GDP on the OECD's measure (which includes local government), contributed to the balance of payments problem by driving up domestic costs, making exporting and competing with imports less profitable, and dragging resources (of capital and labour) away from those activities.

The imperative now is to switch resources into the internationally trading sector so as to increase exports and reduce imports. By marking down our exchange rate, the rest of the world is telling us that is what we have to do.

The fall in the currency will make exporting and import-competing activities more profitable and encourage their expansion, provided wages and other costs don't rise to offset the improvements in profitability.

The government is a large part of the domestic sector of the economy. If all government jobs are protected, the burden of adjustment will be largely borne by the private sector and the necessary shift of resources will be impeded.

It is impossible to argue that cutting low-value expenditure would harm the economy. Doing so would release resources for better use in the private sector.

We have seen the benefits of fiscal discipline in the past – there was strong GDP and employment growth following the 1991 budget cuts and the freeing up of the labour market.

Conversely, the big spending increases of the Kirk-Rowling and Muldoon governments in the 1970s were associated with stagflation.

The government's top goal is to catch up to Australian income levels by 2025.

This is feasible but challenging. No country has sustained the growth rate that would be needed with government spending of over 40% of GDP.

Australia's overall government spending ratio is projected by the OECD to be 35% in the coming year, compared with New Zealand's 45% ratio.

The government needs to reduce the government spending share of the economy over time to below Australia's level – and more like the ratios in Hong Kong and Singapore which are below 20% – to match Australia's performance.

The governments of those countries are able to ensure the provision of high quality public goods and maintain strong social spending programmes with government spending at far lower levels than New Zealand.

The benefits include lower taxes and levels of wages and other incomes that are now much higher than ours.

We must hope that the government's current spending review identifies the many government programmes and agencies that are of dubious value to taxpayers and eliminates or scales them back.

The planned task forces chaired by people from the private sector, such as the one on health already set up, will be able to look more deeply at achieving value for money.

Beyond those exercises, the Business Roundtable strongly supports the proposed Taxpayer Rights Bill which would cap increases in spending at the rate of inflation plus population growth, unless taxpayers give their consent to higher increases in a referendum.

Improvements of this kind in fiscal policy are a key element of any serious plan to catch up to Australia – although many other improvements in institutions and other policies are needed as well.

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