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SIZING UP THE 2004 BUDGET

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In just under a fortnight, finance minister Michael Cullen will be bringing down the 2004 budget. This will be his fifth budget – Dr Cullen has had a longer opportunity than Roger Douglas and Ruth Richardson to make a difference to New Zealand's economic affairs. How should we think about the budget he will deliver on 27 May?

Not so long ago, Fred Dagg was one of our better known budget commentators. He used to talk about 'good' budgets and 'bad' budgets. A good budget was one that showered money liberally around, and a bad budget was one that raised taxes, particularly on cigarettes, booze and petrol.

Budgets also used to be political auctions. Labour campaigned in 1957 on the promise of a tax cut: its billboards read "Do You Want £100 or Not?" Rob Muldoon (as he then was) bought the 1975 election with his promise of National Superannuation at 80 percent of the average wage. He once tried to pre-empt Labour from making election spending promises, declaring, "I've spent the lot."

I would like to think that New Zealanders are more economically literate than when Rob Muldoon said they wouldn't recognise a budget deficit if they fell over one. Most people nowadays recognise that governments have no money of their own. Generally speaking, all they can do is take money from some people and give it to others. Thus if journalists report on 27 May that some groups are winners to the tune of, say, \$1 billion, they should point out that others are losers to the tune of \$1 billion also. The losers will be paying \$1 billion more in taxes than could otherwise be the case. Sometimes, of course, the winners and the losers are the same people – governments have the habit of thinking they can spend taxpayers' money better than taxpayers themselves.

Budgets are primarily statements of governments' spending plans and their plans for financing that spending. But governments don't spend and tax just for the sake of doing so: they have underlying goals in mind. At the opening of the current parliament, the government said that it "sees its most

important task as building the conditions for increasing New Zealand's long term sustainable rate of economic growth." It surely follows that the main thing the government would expect commentators to focus on in the budget is whether it is achieving its top priority goal.

I am confident that the government did not decide on its top priority goal – a faster rate of economic growth to lift New Zealand back into the top ranks of the high income countries – lightly. A recent survey found that what New Zealanders rated most highly was a good quality of life.

What do we mean by a good quality of life? Well, for a start, I suggest we mean decent incomes. Most people who are struggling on low wages or a benefit would prefer to be better off. A Sunday paper has recently been running stories about middle income families having trouble making ends meet. Only a productive, growing economy can ease these problems.

Most people also want a decent work/life balance, which I think is a new age term for leisure. The average working week has come down from around 60 hours to 40 hours over the last hundred years, and on average people enjoy many more years of retirement. More leisure is a product of today's more productive economy. It's not a free lunch to give people an extra week's holiday by passing a law; unless productivity improves they will pay for it themselves in the form of lower wages than otherwise (and many would prefer a different trade-off). So the leisure element of the quality of life is also dependent on a productive, growing economy.

By quality of life, many people are also thinking of a decent environment. Here again there is a link with the economy. Poor countries typically have poor environments. As incomes rise beyond a certain point, environmental quality tends to improve, both because people put more weight on it and because the resources are available to achieve improvements. When I was growing up on a farm in Appleby, the roads were bad and the countryside to Motueka was mostly scrub and scruffy farms. Now the landscape is looking like Tuscany and the Mapua chemicals dump is at last being cleaned up. To be sure, there are economic and environmental trade-offs, but only richer countries can readily afford them.

Growth is thus not an end in itself, and we don't want growth unconditionally: who would want to achieve it by legislating for a 60-hour working week, for example? Rather, a more productive, growing economy allows wider choices about a better quality of life, which individually and collectively people will make in different ways. So it is no surprise that the government and most other political parties want to promote growth.

The Labour-led government that came into office in 1999 inherited a much stronger, more productive and resilient economy. Back in the 1970s the Planning Council was lamenting the economy's lacklustre performance and wanted to see the country's growth rate lifted to 3 percent a year in real terms. There was no prospect of that happening with the economic framework of that time.

However, with the two waves of reforms in the 1980s and early 1990s, a much better economic framework was put in place. Largely as a result, the economy grew by 4 percent a year in the five years to 1996 and has averaged 3.5 percent annual growth in the last decade – well above the Planning Council's target. In addition, trends in productivity, employment, unemployment, inflation and public debt have all been in the right directions. So the Labour-led government inherited an excellent platform on which to build further: no economically literate observer takes claims of 'failed policies' seriously.

Since 1999, most of the trends have continued: inflation has stayed low, unemployment has fallen further and the economy has continued to grow at around 3.5 percent a year, helped by favourable external and internal factors. However, contrary to the government's aim, there has been no *improvement* in the rate of progress. As the OECD put it in its recent report on New Zealand:

The slide in relative living standards *vis-à-vis* the OECD average seems to have been arrested, but a further acceleration – necessary if New Zealand is to move back into the top half of the OECD ranking, as the government is intent on doing – is still not in sight.¹

Indeed, the situation is worse than this. In the Budget Policy Statement

¹ OECD Economic Surveys, New Zealand, December 2003, OECD, Paris.

released last December, economic growth is projected to fall away to around 3 percent a year on average in the six years 2003-2008, and no increase in labour productivity growth is foreshadowed. A recent survey of international competitiveness showed that New Zealand has slipped two further places to 18th, down from 8th position in 1995 and back to where it was in 1991. Two years ago, Dr Cullen said that by the middle of 2004 it would be apparent whether the government's growth strategy was on track. This month's budget will almost certainly confirm that no acceleration of growth is in sight. In the terms of the NCEA, I think Dr Cullen's scorecard will be 'not achieved'. If I am right, this should be the most important headline of budget commentary.

With five budgets to his name, enough time will have passed to assess Dr Cullen's record. Some of it deserves credit: he has kept key elements of the new economic framework such as the Reserve Bank Act, the Fiscal Responsibility Act and the open economy more or less intact, and has seen off damaging policy proposals by the Alliance and the Greens. But the government has continued to implement a series of anti-growth measures which shows no sign of ending. These range from higher government spending, tax increases, ACC and employment law changes to business regulation and the Kyoto Protocol. Chronic problems like infrastructure and the Resource Management Act have not been effectively tackled.

A recent survey of business opinion showed that 95 percent of business leaders do not think the government has a credible growth strategy. Dr Cullen's response was rather grumpy, suggesting that they were "curiously ill-informed" and that current conditions were still positive. But business people today are not short-termist; they understand the medium-term implications of deteriorating competitiveness. Economies grow when governments get out of the way. Our government's role in the economy is becoming ever more intrusive. Just as it took time for the benefits of better policies to show up, so it takes time for bad policies to take their toll. The budget projections are likely to confirm that they are doing just that.

The budget is not the place for many growth policies to be addressed; we must hope that will happen subsequently in the light of the 'not achieved'

score. However, it is the place where the government brings together its plans for spending and taxation, both of which have a big impact on growth. How should we assess the spending and revenue sides of the coming budget?

The first point to make is that big government harms growth. The Hong Kong government understands this: the slogan of its budget this year was “big market, small government”, and it is planning to reduce government spending from 22.5 percent of gross domestic product (GDP) to 16.9 percent over the next 5 years. The Business Roundtable has been saying for some time that it is not credible to suggest that New Zealand can achieve sustained per capita economic growth of 4 percent or more a year – the kind of rate the government is targeting – with government spending (central plus local) at its current level of around 40 percent of GDP. It is simply not going to happen.

However, there is no sign that the government intends to reduce this high and excessive spending ratio. To the contrary, it intends in the budget to use buoyant tax revenues to go in for what Westpac bank economists have called a “spending extravaganza”. They point out that the fiscal forecasts show a cumulative \$13.3 billion increase in spending over the next three years, almost double the allocation for the same period in the 2003 budget. In other words, the government is now planning to spend over \$6 billion more in the next three years than it was planning just 12 months ago. If the extra spending wasn’t considered to be value for money then, how come it suddenly is now? Are we back into old-style electoral auctions?

What’s more, the \$13.3 billion of spending over the next three years comes to around \$3000 for every New Zealander, or nearly \$10,000 for every household. The government clearly thinks it can spend a large proportion of the growth dividend better than households could spend it themselves. No wonder middle New Zealand feels it is not getting richer fast.

In addition, it is clear that only a small part of this spending will be positive for growth. The government will no doubt continue to dole out parcels of money to business, and represent this as evidence that it is business-friendly. But organisations like the Business Roundtable have been saying

they don't want corporate welfare, just a good business environment, and the OECD has said that such spending is only warranted to correct demonstrable market failures.

The lion's share of the spending will be targeted at redistribution, not growth, in forms such as family and housing assistance. No reasonable person can be against state safety net assistance to those in genuine need, but here the crucial questions will be the size of the outlays and whether they are in line with the government's professed aim of moving people from welfare to work. To date its policies have tended to entrench welfare: for example, the number of people on sickness and invalids benefits has mushroomed by 30,000 since Labour took office. Is the country really becoming sicker? There is every sign that the Future Directions package is not well designed and may even encourage greater welfare dependency. There are limits to the effectiveness of changes in tax and benefit rates and case management to get people into work. The United States has shown that greater emphasis must be placed on tightening up eligibility rules, such as the introduction of time limits. It has succeeded in reducing its welfare rolls by more than half since the mid-1990s. Yet the government has shown no interest in learning from US experience – presided over by a Democratic president.

What about the tax and revenue side of the budget? Here again the direction of policy is clear if the government were serious about growth. High personal tax rates and high taxes on capital income are among the most damaging to the economy.

From a growth perspective, the 2001 McLeod Tax Review found that the government's move to increase the top personal tax rate to 39 percent was a mistake. Deadweight costs (output losses caused by the disincentive effects of taxes) were increased, and the tax code and tax administration were made more complex. Both the McLeod Review and the OECD have recommended that New Zealand should adopt a lower, flatter tax structure, and that the top personal rate should be lowered and aligned with the company rate. There is much less merit in reducing the company rate alone; among other things, the owners of most small businesses and

farmers are primarily affected by the personal rate. In the context of the international tax regime, the McLeod Review argued that the tax burden on inbound investment should be reduced and a cap should be placed on the total tax liability of any individual.

The Treasury has recently released a paper on growth which makes similar points.² It advocates cutting the top personal tax rate to at least 33 percent to improve incentives to work, save and invest. The Treasury says that the greatest impact on economic growth would come from moving to a flat rate for both personal and corporate taxes. It calculates that the annual fiscal cost of moving to an 18 percent tax rate would be approximately \$4.7 billion. In the context of planned government spending increases of \$13.3 billion over the next three years, it is clear that an 18 percent rate would be easily affordable. It would put New Zealand in the same income tax zone as countries like Hong Kong and Singapore – even if not on a par with Russia which has a 13 percent flat rate – and be a huge boost to New Zealand's international attractiveness and economic growth prospects.

What are we to make of all this? Some commentators have described the government as a prudent fiscal manager. What they are mainly thinking is that it has continued to run operating surpluses, not deficits, which is indeed commendable given the case for reducing debt and preparing for future demographic changes. But that is not the beginning and end of fiscal prudence. It overlooks the fact that from the outset the government embarked on a high spending and high taxing path. It raised the long-term target for central government spending under the Fiscal Responsibility Act from 30 to 35 percent of GDP, thus signalling that it wanted to spend a further one-twentieth of national income. Recent OECD statistics reveal that New Zealand was one of only three OECD countries where the tax burden (measured by the ratio of total tax revenue to GDP) increased between 2001 and 2002 by more than one percentage point, continuing earlier trends.³ New Zealanders are paying about \$400 million more in income tax than they should be because pay rises to meet inflation are pushing them into higher tax brackets. Nearly twice as many New

² The Treasury, 'New Zealand Economic Growth: An Analysis of Performance and Policy', 22 April 2004.

³ OECD Revenue Statistics, October 2003, OECD, Paris, p 18.

Zealanders are now paying the top 39 cent tax rate than the government said it would catch when it set the rate. I am all for cuts to tax rates on low incomes, which we may see in the budget, but there is an overwhelming case for cuts to other rates as well, in the interests of fairness and growth.

The reality is that there are strict limits to redistribution as a means of making people better off. Those limits have been tightened with globalisation: governments with high taxes and regulations make their countries less attractive and lose mobile capital and skilled people. Only a growing economy driven by productivity improvements can raise incomes generally and provide more and better public services such as health and education. Ireland is spending far more on such services than when it began its economic reforms in the late 1980s, yet government spending in Ireland fell from over 54 percent of GDP in 1987 to 32 percent in 2000. People who say they are against smaller government and lower taxes because that would mean fewer government services have it exactly backwards. The trick is to keep the rate of growth of government spending lower than the growth of the economy, and to eliminate wasteful and badly targeted spending. With a smaller government share of the economy imposing less of a drag on it, both growth and government revenues available for spending on things like health and education are boosted. As President John F Kennedy – to the best of my knowledge, no flinty-faced, ‘new right’ acolyte – pointed out when he cut taxes in the United States in the 1960s:

It is a paradoxical truth that tax rates are too high today and tax revenues are too low – and the soundest way to raise revenues in the long run is to cut rates now.⁴

The lesson is simple: it’s better to have a smaller slice of a large and fast-growing pie than a big slice of a small and slow-growing one.

The government recognises at least some of these realities about growth, but it is only paying lip service to them. It is ironic that this year’s budget falls one day after Tax Freedom Day, the day that the average New Zealander stops working for the government – central and local – and starts working for themselves. Next year Tax Freedom Day will fall three days

⁴ Speech to the Economic Club of New York, 1963.

later on current projections. Big and growing government is no way to encourage faster growth.

The Business Roundtable has been arguing that the government is slowly killing the goose that has been laying the golden eggs. So too have other business organisations and observers like the OECD. The government has been in denial. The budget's medium to longer-term projections for growth may settle the argument. Nearly two years ago a Tremain cartoon had a rather puny Dr Cullen flexing his muscles behind a set of weights marked '4 percent growth', and two onlookers saying, "Don't you wish he'd stop all the flexing and just step up and get on with it?" If the budget confirms that Dr Cullen has failed to raise the bar, the time he set himself for doing so is – for all practical purposes – up. In that event we must hope that the government will reconsider its growth policies, as it has reconsidered its policies in some other areas, or that other political parties will offer voters more credible policies at the next election. The success of the earlier reforms greatly improved the country's outlook, but there is no excuse for not doing a lot better yet. A wide and growing income gap with Australia and other better-performing countries is not – I suspect – what most New Zealanders want to look forward to.

