

**New Zealand Society of Accountants  
Seminar on Balancing the Budget**

**Rescuing the Insolvent Society**

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## **RESCUING THE INSOLVENT SOCIETY**

A balanced budget is a bit like a market economy in New Zealand: something rarely sighted over the last 30 years.

It was not always thus. In that period of our history when the New Zealand economy used to work - when we were around the top of the league in living standards per head - New Zealand governments were generally good housekeepers.

There were some exceptions. Julius Vogel was an early architect of a 'Think Big' experiment, which led to the accumulation of a massive debt and the subsequent 'long depression' of the 1880s and early 1890s.

By 1890/91, however, government spending had been cut by almost four fifths, from around 1.5 million pounds a year to around 330,000 pounds. At the turn of the century, the government share of the economy in New Zealand and in many other countries was not much more than 10 percent. Taxes were correspondingly low. New Zealand's first income tax, effectively a flat rate of two and a half cents in the dollar in present day terms, was introduced in 1891 and did not apply to most workers.

Even with the growth of the welfare state, New Zealand governments remained relatively prudent housekeepers through to the early 1970s. Throughout the 1960s, for example, government spending fluctuated between 26 and 29 percent of GDP and in 1971/72 stood at 27.7 percent. Deficits in the period seldom exceeded 3 percent of GDP, and the deficit for 1971/72 was 1.1 percent.

The era of sustained spendthrift habits by governments has been the last 20 years. The relative size of the public sector grew by more than half in that period, to over 40 percent of the economy. Deficits blew out to 8.6 percent of GDP in 1975/76 under the Rowling government, and to 8.6 percent in 1978/79 and 9.1 percent in 1983/84 under the Muldoon government - election years in all three cases. Public debt per capita doubled since the mid-1970s to a peak of around \$14,000 for every New Zealander.

The last 20 years have seen a severe deterioration in New Zealand's relative economic performance, but the rot had set in much earlier. The Monetary and Economic Council, chaired by Sir Frank Holmes, noted in 1962 that in the period 1949-61:

"...the New Zealand economy has earned the unfortunate distinction of having one of the slowest annual rates of growth of productivity among all the advanced countries of the world."

Although it criticised the prevailing fortress New Zealand policies of the time, the burden of the Council's recommendations was Keynesian and interventionist. It advocated 'fine tuning' of the economy: "[I]t is the duty of Government to give a stimulus to the economy by increasing its expenditures or by reducing taxation" in the event of a deficiency in demand. It pushed for national economic planning, incomes policies, farm support schemes, tax incentives for exporters and the establishment of an Industrial Finance Corporation (the origins of the DFC). (To be fair, the Council also made a few sensible recommendations for deregulation and tax

reform.) The subsequent adoption of most of this programme immeasurably compounded New Zealand's economic problems.

As a matter of interest, it is highly questionable whether Keynes would have approved the fiscal pump priming policies of the spendthrift era. In 1937, when British unemployment was 12 percent, he called for a cut in government spending on the grounds that such spending was crowding out the private sector. It is untrue that cutting government spending has significant contractionary effects even in the short run in a flexible economy. In the postwar aftermath the United States underwent a colossal economic transformation: real government spending fell by 77 percent in 1946 - from 37 percent of GDP to 10 percent. Yet unemployment rose from an abnormally low 1.9 percent of the labour force in 1945 to only 3.9 percent in 1946, despite the demobilisation of millions of servicemen and women`.

For a small, open and debt-ridden economy such as New Zealand, expansionary fiscal policies are an act of economic suicide. A recent survey of opinion amongst New Zealand economists revealed that there was generally strong support for the setting aside of former policies since 1984, but that university economists were much more reserved. This year a group from Auckland University castigated the government for cutting spending and Bryan Philpott has recently advocated a programme of old-style public works such as roading. We appear to be seeing a confirmation of Adam Smith's opinion of publicly endowed universities as:

"...sanctuaries in which exploded systems and obsolete prejudices found shelter and protection, after they have been hunted out of every other corner of the world."

Outside the ivory walls there is surely little doubt that policies of borrow and spend have brought New Zealand to the economic brink. I suspect that the clearest evidence yet for that judgment will be revealed when the government publishes its first balance sheet, as it is required to do under the Public Finance Act. I am prepared to wager that the current gross public debt of around \$44 billion will be nowhere near matched by public sector assets. The government will be seen to be in a negative equity position. If it were a company, it would be technically insolvent. The statutory managers would be on the doorstep.

If I am right, what this means is that, as most of us have long suspected, New Zealand governments have been borrowing to pay for the groceries. It will be the clearest possible indication that Mr George Drain's contention that National Superannuation has been paid for by past taxation is utter nonsense. Every dollar of it is a charge on the next generation. Moreover, public sector net worth will continue to deteriorate until the budget is in balance.

At the present time we are still far from a balanced budget. Ministers have been pointing out that despite this year's efforts, the government will still be borrowing around \$3 billion or \$1,000 for every New Zealander in its present term. Unfortunately the situation is likely to be far worse than that. Analysts are now predicting that without further policy changes the financial deficit will remain at around 2.5 percent of GDP over the next 3 years, so that around \$6 billion - another \$2,000 for every New Zealander -will need to be borrowed.

Against that background I find claims that the government does not need to cut its spending incredible and downright irresponsible. Living within our means may be

hard, but failure to do so has been far worse for our economy and society, and has passed the hardship on to our children.

As many of us have argued in recent years, the rising spending and tax burden under the previous government was suppressing the prospects of private sector recovery, pushing up interest rates and putting New Zealand's credit rating at further risk. The government's commendable actions to date to curb its spending have vindicated the argument that pressure on monetary policy would ease and the export and import-competing industries would be better placed to lead a recovery.

However, it is equally clear that the task has only just begun, and that the risks of fiscal slippage pose the single greatest threat to the government's programme. We can expect another round of soul-searching in the coming months over whether to resist pressures from superannuitants, teachers, health sector groups and even those who still believe in a welfare state for business, or whether to revert to the soft options of taxing and borrowing.

Either would be a disaster. The increases in GST and the company tax rate in 1989 stopped a fragile recovery in its tracks, and tax increases in the next budget would put paid to the growing chances of emerging from the present recession in 1992/93.

Even worse, maintaining a high tax burden over the long run would continue to undermine our economic performance. Studies show that there is a very large sacrifice of national income involved at the margin with high rates of taxation. By taking \$1 of income from Peter to give to Paul, we probably forgo somewhere between 20 cents and \$1 of national income. These figures relate to the disincentives to work and save, and do not take into account the costs of the vast industry devoted to tax administration and compliance. It is no accident that the fast-growing Asian economies have relatively small government sectors and low tax burdens while high tax economies like Sweden are in deep trouble.

The conclusion is that we simply must kick the spending and taxing habit before the pressures of international competition and the rating agencies force us to do so. Technological changes are increasing the mobility of labour and capital around the world. Productive resources are deserting high tax locations for warmer fiscal climates. While Swedish companies directed only 10 percent of their total new investment abroad in 1980, by last year the figure had climbed to 75 percent. In the United States between 1970 and 1990 the 10 states with the lowest tax burden had an average employment growth of 18 percent while the 10 states with the worst job growth records all had tax burdens above the national average.

Government spending is no longer growing relative to the size of the economy in most developed countries, and in some it is now falling. Governments around the world are lowering marginal tax rates, privatising and deregulating. A new international market for governments is emerging. In this market, governments hostile to private enterprise are losing resources in competition with other governments.

There is increasing recognition in the business sector in New Zealand that New Zealand will have to meet this international competition or fall further and further behind. Last year the Wellington Chamber of Commerce called for government spending to be wound back during the 1990s to 25-30 percent of GDP, the same level as in the 1960s. With rigorous efforts to eliminate wasteful and ineffective public

spending, coupled with growth in the economy, there is no reason why this target could not be achieved. Indeed the government's efforts to date have put it on track to reach it.

New Zealand still has a long way to go to throw off the legacy of interventionist and welfarist policies that have sapped the economy's wealth-creating potential. Perhaps more than any country outside the Eastern bloc, we gave up on rewards for work and effort and subscribed to the doctrine of "from each according to his ability; to each according to his needs." The user of services was separated from the payer, with disastrous consequences. We have also found to our cost that with political rather than market decision making the rule actually is: "to each according to his power and duplicity; from each according to his vulnerability".

With government in retreat around the world, I contend there needs to be a much more fundamental debate in New Zealand about the role of the government and the role of private and voluntary initiative. This is a much more fundamental enterprise than merely balancing the budget, though it would contribute substantially to that goal.

The evidence is clear that there are far more successful ways of achieving social goals than ones that we have chosen. As the National Business Review wrote recently, "It has taken ... less than 20 years for the seductive attraction of accident compensation to evaporate ... why not end it now, instead of tinkering with it?" We spend nearly twice as much as Australia on social security and welfare, but few would contend we have been more successful in alleviating poverty. We could take a leaf out of Sweden's book, where the new government plans a "revolution by choice" in health care and education, which are monopolised by public services. The government seems to have taken fright over electricity privatisation at a time when more than 75 percent of the electricity industry in the OECD is already in private hands and literally dozens of countries around the world are privatising electricity systems. Led by Jim Anderton, are we still in thrall to Lenin's doctrine: "Communism equals socialism plus electricity"?

An outcome of a reduced role for the government would be lower taxes and higher after-tax income in the hands of citizens. I am constantly amazed to find people like lawyers and accountants unable to conceive of a world where, for example, they or their children could finance their own higher education. Yet prior to the rise of the welfare state the average New Zealand family had resources to spend on their own welfare. In 1926 only 1 in 20 salary and wage earners in New Zealand paid income tax. Today the average worker pays 37.5 percent of his or her income in income tax and GST. This is about \$8,000. For \$8,000 a year a worker could afford to take a lot of responsibility for a family and others he or she cares for. And that worker would be part of a much more dynamic economy, the most effective anti-poverty remedy ever implemented.

Outside the marketplace, another outcome of more limited government would be a renewed role for private welfare. As a recent *Herald* editorial noted:

"... private arrangements carry more meaning than social welfare ever can. Much nonsense is heard about the caring ethic of the welfare state; far from fostering human concern it provides an excuse to people disinclined to offer personal help."

Instead of the ecclesiastical hand-wringing and calls for government assistance that we are incessantly subjected to on Morning Report, we might find a resurgence of initiative and hard work in the church and other voluntary organisations, which would in the process help reverse their diminished standing in society.

By deregulating financial and labour markets, recent governments have restored to New Zealanders much more freedom in disposing of their savings and labour services. Paradoxically, the last government at the same time interfered even more with the lives of citizens by appropriating an increased share of the rewards for their savings and labour in the form of tax.

Taxation is the most intrusive form of intervention in any economy. With spending by governments at all levels in New Zealand reaching nearly 50 percent by the late 1980s, New Zealand has become a high tax economy. My hope for the 1990s is that we join the rest of the world in reducing the scope of the political sector and giving citizens more say over how they run their lives. Instead of workers on average having to work until late May each year to pay taxes to the government, we should aim to leave them with their own earnings after April or even March. In the process we should aim to do more than balance the budget: we should achieve financial surpluses, repay some of the debt from the spendthrift era, and stop robbing our children blind.