

**New Zealand Society of Accountants
Waikato/Bay of Plenty Branch**

Rating New Zealand Incorporated

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RATING NEW ZEALAND INCORPORATED

My topic is the state of the nation's finances and, looking forward, their implications for the economy. The OECD recently came down with a positive report card on New Zealand, but highlighted the fiscal situation as a major threat to a sustained recovery. It will not have escaped you as accountants that the government's accounts are not a pretty sight.

The problem has been a long time in the making. When George Bernard Shaw visited New Zealand in 1934, he thought our milk cost too much. "I just want to ask," he said, "why not distribute milk freely... and then on from free milk to free bread ...". Bliss was it in that dawn.

For years, New Zealanders took Shaw's advice to heart. The idea that somebody had to pay the bills became a quaint notion only held by a few spoil sports. Even today we often hear people talk about 'free' health services or education. What that means of course is that other people bear the cost, quite often people who are less well off than the recipients. Policies that divorce costs and prices commonly divorce perception from reality.

In some quarters little seems to have been learned. A recent illustration was the \$2000 'bonding session' of the Auckland Regional Services Trust at an expensive Auckland restaurant, organised by Alliance member Bruce Jesson. "We didn't realise what it would cost," was the explanation. That just about sums up the Alliance Party's economic manifesto.

New Zealand governments have been prone to spending other people's money. Our budgetary problems became serious during the Kirk/Rowling government of 1972-75. They became immeasurably worse in the era of the Great Spendthrift. Serious attempts were made to deal with the problem in the mid-1980s but were then largely abandoned. The present government came into office with a commitment to balance the budget in 1993/94 but will come nowhere near to doing so, as it has admitted. We still seem to be in "Don't Worry, Be Happy" mode, and the debt is continuing to mount.

I don't want to put myself in the position of some other unfortunates and fail to show appreciation for what the present government has achieved in this area. There are some reasons for saying "Thank you." The action the government took in the December 1990 package and the 1991 budget to halt an alarming deterioration in the fiscal position was commendable. The decisions were not easy ones politically but they made a major contribution to relieving pressure on financial markets and the currency, improving New Zealand's international competitiveness and initiating the present economic recovery.

Moreover, the government, and the minister of finance in particular, deserve particular credit for their commitment to reverse the increasing share of government expenditure in the economy. They have achieved a measure of credibility for expenditure control, and markets have some confidence that there will not be an election year blow-out. But the real issue is not whether the situation might get worse. The issue is how to rectify what remains an alarming problem.

As the OECD report pointed out, since the 1991 budget real government spending has been allowed to grow again, and was estimated in the 1992 budget to increase by 2.6 percent over the next 3 years. It added that despite the restrictive measures taken, fiscal slippage continued and expected financial deficits are well above initial projections. And it noted that net public debt continues to grow and is forecast to reach an all-time high of over 53 percent of GDP in the next two financial years.

Since the OECD report was prepared, the government has published an economic and fiscal update in December 1992. There was no significant change from the projections in the 1992 budget. The financial deficit is projected to stay above 3 percent of GDP through to 1994/95. Debt servicing costs are set to rise to \$4.7 billion in the same year - more than we spend on health and only slightly less than education spending. The burden of debt servicing is expected to grow from 14.2 percent of government spending in 1991/92 to 14.7 percent in 1994/95.

Perhaps most disturbing of all, the Crown's net worth (the excess of assets over liabilities) is expected to deteriorate by \$9 billion from a negative \$15 billion in June 1992 to a negative \$24 billion in June 1995. The continuation of fiscal deficits is the prime reason for this trend. Our debt is still rising because we are borrowing to pay interest and our asset base is eroding. If New Zealand Incorporated were a business, we would now be in receivership.

The extra \$8 billion dollars that the government will have borrowed in the current parliamentary term amounts to around \$2,500 for every New Zealander. Gross public debt - the amount that has to be serviced - now stands at around \$45,000 for every household. This is the equivalent of a sizeable mortgage, and comes on top of other household commitments. It is not surprising that many are finding it hard to make ends meet.

These are mind-numbing statistics. Why do we need to worry about them? Incredible as it may seem, it is still necessary to make the case for reducing government spending, deficits and debt. A brief summary goes something like this:

- Much government expenditure remains wasteful and poorly targeted. Households would be better off if the government spent less of their money and left them with more after-tax income to spend as they liked.
- Governments are particularly poor managers of businesses. The large productivity gains achieved in businesses that have had to raise their standards to commercial levels through the introduction of private sector disciplines or privatisation establish this point beyond doubt. The same gains stand to be made in the new Crown Health Enterprises and organisations such as the Fire Service.
- Taxes raised to finance government programmes slow down economic growth because they reduce incentives to work, save and invest. Economies with high tax burdens are finding it more and more difficult to grow rapidly.

- Continued fiscal deficits risk an escalating debt and interest spiral. Interest rates are possibly now close to cyclical lows, with the risk of increases that would add to the costs of debt servicing.
- High borrowing requirements generate interest and exchange rate pressures, thereby discouraging investment and internationally competing industries respectively.
- High debt levels increase the vulnerability of the economy to external shocks and increase the risk premium built into interest rates. Our credit rating has already been downgraded three times in the last ten years, and only the government's decisions in 1991 prevented a further downgrade. Such downgrades affect the borrowing costs of the entire community.

Ultimately a 'spend now, pay later' policy poses moral issues. I fail to understand how in good conscience we can justify maintaining our own levels of consumption and putting the tab on Bankcard for our children to pick up. Yet that is effectively what we have been doing for the last 20 years.

It is now clear to most, other than the Alliance Party, that tax increases are no solution. Tax revenue has grown substantially since the mid-1980s but the problems of deficits and debt remain with us. Tax receipts are forecast to increase by a further 10-11 percent over the next 3 years. Business taxes, net of refunds, are expected to grow by 33 percent over that period. The belief that business is not paying its share of tax is a myth. In any case the idea of a separate company tax has become largely irrelevant with imputation as any tax not paid by companies themselves is extracted from their shareholders on dividend distribution.

Increases in tax rates or new taxes would be a blow to confidence and economic recovery, and would call into question the resolve of the government to reduce expenditure. Failure to control spending and deficits inevitably leads to tax initiatives of progressively lower quality. We have seen several such examples over the last couple of years, most recently in the current Taxation Amendment Bill. As the bumper stickers about the United States fiscal problem have been telling President Clinton, "It's the spending, stupid."

No one can pretend that a good deal of what the government spends is well justified or in line with policies in comparable countries. I have yet to hear an argument against the conclusion of the Royal Commission on Social Policy that the rate of national superannuation should be the same as the long-term invalids benefit. No one can tell me why we do not apply an assets test to superannuation as in Australia. The OECD report has recommended that subsidies to tertiary education should be reduced, since they largely benefit people who go on to earn higher incomes later in life. It also questioned New Zealand's policy of open-ended benefits; many OECD countries limit their duration so that the unemployed, for example, have stronger incentives to accept work. Other ways of shrinking the budget include further SOE initiatives, privatisation, elimination of unnecessary functions and contracting out the delivery of necessary activities to the private sector. The list of possibilities remains a very long one.

The Business Roundtable has argued that to increase the credibility of its fiscal policy, the government should commit itself to explicit targets for government spending, deficits and debt. Specifically we have recommended:

- First, that government spending should be reduced to around 25-30 percent of national income by the year 2000. This target, which would reduce the government share in the economy to its pre-1970 level, has also been suggested by the Wellington Chamber of Commerce and others.
- Second, that the financial balance as a percentage of GDP should be improved by around 2 percentage points a year on average. This would mean achieving a balanced budget position in two years' time, and surpluses thereafter for a period to repay debt.
- Third, that net public debt relative to GDP should be reduced to the average ratio of the OECD countries by 2000. Mexico, one of the world's worst debt cases a decade ago, has achieved this goal.

The emerging Crown accrual accounts may provide, in due course, better or additional benchmarks for fiscal performance. For example, it would be valuable to have upgraded projections of changes in net worth. Similarly, an operating balance, which is akin to a firm's profit and loss statement, might be a better measure of current financial management than the financial balance, which is a cash measure.

The reality is that New Zealand has a structural problem in its public finances. Economic growth alone will not solve the deficit problem. Further fiscal correction is inevitable. The only choice is whether we bite the bullet now or defer the action with all the risks that that option entails.

Governments are not essentially different from corporates in respect of their finances and the attitude of creditors and rating agencies toward them. When corporates get into trouble the golden rule is : Act now! During the last six years of economic reform many companies have had to sell assets, close loss-making businesses and retire debt. Most have survived and are now in a position to expand. Those companies that remained over-gearred are still struggling or are no longer with us. In reality governments face the same pressures. Notwithstanding their power to tax, the day of reckoning just takes a little longer to arrive.

Last year the government argued that further fiscal adjustments should be deferred to avoid stifling the economic recovery. This argument was inconsistent with the claim that the recovery was soundly based and is now clearly invalid. To the contrary, more decisive action would now be fully justified to avert the risk of undue growth in domestic consumption, strengthen international competitiveness and help prevent a deterioration in the balance of payments. I hear no argument on this score amongst economists. Those of wet and dry persuasions alike all seem agreed that the fiscal position is now the major weak point in economic management.

The fact that this is an election year only adds to the concerns. Fiscal adjustment has been stalled for some time now; effectively we have had little more than a 1-year parliamentary term. To wait until the 1994 budget to make more progress would be irresponsible. What might appear a low-risk political strategy would be a high risk one for confidence and the economy.

Thanks to the government's 1991 decisions, New Zealand has fared well in the past 18 months in a turbulent international financial climate. We cannot expect that degree of stability to last if credibility is not maintained. Postponing action that everyone knows is necessary, or closing off unpalatable options which then have to be reopened after the election, would be a failure of stewardship and a further blow to political legitimacy.

All major parties will rightly come under scrutiny this year over fiscal policy. The opposition parties will need to do even more than the government to convince markets and the electorate that they have genuine solutions. The electorate should demand firm commitments on spending, borrowing and debt reductions along the lines I have outlined. These can be set in a medium term framework so that they are not invalidated simply by cyclical swings in outlays or receipts, but they need to be backed up by concrete plans and a political mandate for change. Vague talk about a balanced budget several years down the track, about a triple A credit rating objective, or about economic growth being the solution to the problem will not be good enough.

As the OECD report points out, failure to deal with the problem now, when the economic outlook is good, means more urgent and disruptive savings could be forced upon us in less favourable circumstances. We should not engage in such a reckless gamble. It would be a betrayal of all the sacrifices the community has made in recent years. After all that has been achieved, the community at large deserves better than to see it all end in tears.