

Christchurch Businessmen's Club

No Time To Coast

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There used to be a time when it was possible to reserve judgment over the merits of New Zealand's economic reforms. That time is now long in the past. The success of the reform programme is now so palpable, and is apparent across such a wide range of economic indicators, that to argue it was all a mistake is to take on the near impossible.

That doesn't stop some commentators from trying. But it takes quite a feat of mental gymnastics to make the attempt these days, and the efforts of these latter day Jeremiahs look increasingly desperate. Indeed, they usually reveal more about the human capacity for self-deception than about anything that might actually be going on in the real world.

Our present economic upturn began in 1991. Over the four years since then, the economy has expanded by over 18 percent - a growth performance well above the average for OECD countries over the same period. The economy has grown by considerably more in just those four years than it did in the course of the entire nine years of the Muldoon administration.

The story on employment is just as impressive: we have experienced one of the fastest rates of job growth of any country in the OECD. Since the middle of 1991, when the Employment Contracts Act 1991 took effect and the economic upturn began, employment has increased by around 187,000 people or 13 percent. Our unemployment rate is now one of the lowest in the OECD.

The raw figures are impressive enough. But short-term developments are never the whole story. Just as important is whether short-term trends are capable of being sustained into the future.

We all remember the unsustainable economic 'recoveries' of the pre-1984 period. Economic expansions in those days were driven either by a temporary improvement in the terms of trade or an artificial stimulus by the government. Such recoveries could only be short-lived. The tell-tale signs that a recovery was petering out became depressingly familiar - rising inflation or a deteriorating balance of payments position. In the search for quick fixes we created a ruinous inflation record, ran chronic budget deficits, and were plagued with balance of payments problems. We piled on debt as if there were no tomorrow.

The contrast with today could not be greater. The Reserve Bank pursues its mandate for price stability, while for the first time in a generation the government is running a surplus on its own accounts. Instead of borrowing, the government is making inroads into its debt burden. Instead of experiencing a deterioration in our international credit rating, we have reversed the trend and now have the prospect of further upgrades.

It is true that growth has slowed this year as a result of the tighter monetary policy imposed by the Reserve Bank. However, we have every reason to believe the economy will continue to expand next year and the year after, provided the policy framework remains sound. The tax cuts will be positive for the economy because they have been 'earned', while monetary policy will most likely ease gradually as the

inflation rate settles back into the 0 - 2 percent range. The expansion looks sustainable, much more so than in the past.

Yet if the doom-mongers have been proved utterly wrong about the performance of our economy, it would be equally wrong for us to fall into a different trap. That trap is to suppose that all the adjustment now lies behind us, and that little scope remains for further reform and the rewards it would bring.

That would be a serious mistake. Experienced business people appreciate that change and the search for improvement are constant factors in their business lives. In business we must always be on the lookout for better ways of doing things, and for changes to the environment in which we are operating. We need to seize opportunities that come our way, and create for ourselves as many new chances as we can. If we don't, we know that our competitors will. Inertia is not a recipe for holding on to one's gains; it is a recipe for losing them. Likewise with government policy: standing still is not good enough. At best it represents stagnation; more likely it represents retreat through a thousand small compromises.

Success is, in any case, a relative concept. The New Zealand economy has been transformed from its near-terminal condition of a decade ago, and we can be proud of that. But this does not mean that we should stop here. More remains to be done. It is true that we are growing faster and the unemployment rate is falling more rapidly than in any of the countries of the European Union. That comparison, however, is hardly a challenging one. The European economies are over-regulated, bureaucratic and inflexible; they provide no decent model for anyone. It's no surprise at all to see these economies exhibiting sluggish growth and high unemployment.

Comparisons with geographically closer neighbours are more instructive. The most dynamic economic region by far is East Asia, and many of the East Asian economies remain out in front in the growth league. They still have many lessons to teach us. New Zealanders have legitimate aspirations for higher living standards. Yet we will only fully realise those aspirations if we can do more to match the growth rates of the most successful of the Asian economies. Current policies will not achieve that. Right now we appear to be coasting along on the strength of the policy reforms of the recent past.

If, for instance, we are seriously concerned about further improving our growth prospects, we should complete the privatisation programme started by the previous government and continued by the present one, but which now appears to be largely stalled. There have been large benefits from the revitalisation of state trading activities through corporatisation and - in many cases - privatisation. It has led to better services and large cost reductions in sectors such as communications, transport and energy. Why then is the government not pressing on to complete the job? If it was right to sell Telecom and the Bank of New Zealand, why would it be wrong to allow private owners to make similar improvements to the performance of our electricity enterprises and New Zealand Post? The government and opposition parties should be informing the public of the well-established benefits of privatisation, not adopting ideological stances or leaving the issue in the political 'too hard' basket.

Again, if New Zealanders are serious about widening growth opportunities, we should be moving to dismantle the network of protection and regulation that governs

agricultural marketing. The arguments for retaining the monopoly powers of the producer boards do not stand serious examination. The justifications put forward by the boards are no more convincing than a thousand other arguments made by special interest groups in formerly protected sectors of the economy. In these areas special pleading eventually yielded to sound analysis. Yet in the case of producer boards, despite some commendable efforts by the minister of agriculture, inertia appears to be winning the day - to the clear detriment of farming and the economy.

I want to turn now to a third area where policy inertia is hampering our economic performance. I refer to the burden imposed on the private sector by the government's own activities - and in particular by the welfare state.

All government spending imposes a burden on the economy. Spending must be financed by taxation, either now or in the future. Even running a deficit is effectively a decision to defer collecting part of the tax required to finance current services until some time later; eventually the bill has to be met by the taxpayer. The level of spending is thus the best measure of the real tax burden.

Spending imposes both direct and indirect burdens on the economy. The direct burden is the loss of disposable income suffered by those from whom the tax is extracted. But there are also a large number of indirect burdens. One of these is the cost of administering and complying with the tax system. A larger one arises from the effects of taxation on incentives across a wide range of activities. There is reduced incentive to work, to save and to invest, and often the choices between different types of investments become distorted. These negative effects, above and beyond the direct effect of taxation, are undoubtedly significant in size. And when, as in this country, central government spending remains equivalent to over one-third of total gross domestic product, there can be no question that it imposes a very substantial burden on New Zealanders.

In justifying the expenditure of public money in any given area, it is thus not sufficient to argue that a dollar spent on a government programme yields benefits equivalent to a dollar taken from the private sector. Because of the indirect burdens of government spending, the dollar spent must yield considerably more than one dollar in benefits, if it is to be a valid use of taxpayers' money. A New Zealand Business Roundtable study conservatively estimated that at least \$1.18 of benefits need to be generated. A separate study by Canterbury University researchers found that the benefits needed to be between \$1.24 and \$2.46. Given the poor focus and quality of many government programmes, often the cost-benefit test is not met.

In New Zealand we have made some progress in turning around the rising trend in government spending. Total spending now stands at around 34.5 percent of GDP compared with 39 percent in 1991/92. This fall is partly due to some limited expenditure savings in the early part of the decade, and partly to lower debt servicing costs and other fiscal benefits resulting from the upturn in the economy. Mainly, however, it is due to better economic performance, with GDP growing faster than government spending. But government spending remains too high and it is still growing in real terms. This becomes especially apparent if one compares government spending today with its historical levels. Prior to the 1970s, spending was in the region of 20 - 25 percent of GDP. Yet we do not tend to think of the fifties and sixties as an era when government services were underfunded.

In the dynamic East Asian economies, government spending is typically under 20 percent of GDP. The low burden on the private sector in many of them has undoubtedly been a factor in their spectacular growth rates. If we are seriously interested in matching their performance, we will need to begin changing our thinking about the role of government. Unfortunately, there is little sign at present among many of our parliamentarians of a readiness to do this. The current government has substantially increased social spending in its last two budgets, while virtually all the opposition parties are proposing further increases of various magnitudes.

By far the largest area of spending is social welfare, which currently accounts for around 38 percent of total government outlays. In the early 1970s, social welfare accounted for only 20 - 25 percent of total spending. Social welfare spending today is equivalent to over 12 percent of GDP; in the early seventies it was only around 6 percent.

There is a myth propagated by some commentators that the government has dismantled the welfare state. As these numbers show, that idea is without foundation. Vast sums are being spent on the welfare state today, and we are spending twice as much as a generation ago. It would be extremely hard, however, to argue that society as a whole is benefiting from this increased spending. The problem cuts in two directions. First of all, and most obviously, welfare spending needs to be funded - by the businesses, the wage earners and the self-employed New Zealanders who pay the taxes. Secondly, many of the social outcomes associated with the welfare state are - at the very least - a mixed blessing.

The domestic purposes benefit (DPB) is a good example. A generation ago this benefit was not available. After it was introduced, the numbers eligible for the DPB expanded much more rapidly than its designers can ever have anticipated. In 1975 there were 17,000 people on the DPB; today there are 104,000. This outcome has been very costly just in fiscal terms; around \$1.4 billion annually is now spent on the DPB. But the increase in DPB numbers has also been accompanied by a worrying deterioration in many social indicators. The number of ex-nuptial births has risen strongly, and now stands at 39 percent of total births. The number of one-parent households is increasing. At the time of the 1976 census, around 13 percent of families with children were sole parent families. By 1991 that figure had doubled to 26 percent. Next year's census may well reveal another rise.

I am not arguing that these trends are solely due to the DPB. However, the introduction of the benefit must have been a factor behind the increase in one-parent households. The availability of a sole parent benefit has permanently changed incentives - especially for those on low to moderate incomes. We cannot view this situation with any complacency. Studies show that one-parent families are considerably poorer than two-parent families. Children from sole parent families perform worse on a wide range of social indicators, from health status to propensity to commit crime. Children who have never known a father do worst of all on these measures.

The number of people drawing the DPB is still exceeded by the number on the unemployment benefit. There has, of course, been a substantial fall in surveyed unemployment, as officially measured by Statistics New Zealand. Despite this, the

number of people receiving the unemployment benefit remains at an historically high level. At 140,000, it is considerably higher than our most accurate measure of surveyed unemployment. Given the much more flexible nature of today's labour market, the number still on unemployment benefit is puzzling, and may cast doubt on how effectively the work test is being enforced.

Unemployment is at least falling. But the number of people on sickness benefits has risen rapidly, and is still rising. As recently as ten years ago there were only 10,000 sickness beneficiaries. Today there are 34,000. It is not easy to see how the numbers of genuinely sick people can have more than trebled in ten years. Many sickness beneficiaries are no doubt deserving cases. Yet it is hard to avoid the conclusion that some people find that being 'sick' is a very convenient way to avoid a work test and other requirements for obtaining an unemployment benefit.

These trends in New Zealand are far from unique. A new word has entered the international public policy debate in recent years - 'dependency'. Across most western countries, we have seen over the last two or three decades the emergence of a group of people who are dependent on the state for their principal source of income. This group comprises a new underclass. Other western countries have also seen - to varying degrees - rises in illegitimacy, divorce, one parent families, and crime. These trends have been more or less contemporaneous with the expansion of their welfare states.

It is significant that the East Asian economies, which have not created large welfare states, have been mostly free from the trends afflicting European, North American and Australasian societies. Family breakdown, divorce, illegitimacy and crime are much lower in the countries of East Asia. With limited state welfare, they outperform societies such as ours on 'social cohesion', to use a term much favoured by our government. Not too long ago most New Zealanders also viewed dependence on the state as undesirable, and strove to avoid it. Lee Kuan Yew never tires of reminding audiences that the one thing that could undermine the social and economic progress of the successful Asian countries would be to catch the 'western disease' - the development of an expansive welfare state.

There are no easy answers to the problems of the welfare state in New Zealand. But the implications of a growing dependency culture need to be debated widely. In many other western countries - and particularly in the United States - that debate is now well underway. In New Zealand it has scarcely begun.

One of the biggest items of social spending doesn't even come under 'government spending' in the government's accounts, nor are the taxes required to finance it included under 'taxation'. This is accident compensation, which constitutes - through the employers' levy - one of the biggest non-wage costs facing employers. Earners and motor vehicle owners also pay ACC levies. Such levies are compulsory - they are essentially a tax in everything but name.

Our accident compensation scheme was set up two decades ago, in conjunction with the abolition of the right to sue for personal injury. In common with a number of other new social programmes of that time, its costs have escalated far beyond the levels envisaged by its architects. Despite numerous changes to the details of the

scheme, its fundamental character remains unchanged. ACC is essentially a monopoly supplier providing a single, compulsory, one-size-fits-all product.

As the Business Roundtable and other organisations have pointed out, accident compensation as presently constituted provides very weak incentives to take appropriate care and to deal efficiently with risks. It has led to reduced incentives both on workers and on employers to prevent accidents. Once an injury has occurred, there are also weak incentives for people to be rehabilitated back into the workforce as soon as possible.

Given these weaknesses, it should have come as no surprise to see costs escalate as they have done. In the last ten years ACC's expenditure has risen from 0.8 percent of GDP to 1.8 percent. Over that time real expenditure rose by an average of 8 percent a year. An increase in costs had always been expected as new people came on to the scheme. However, even the number of new claims has increased - from around 130,000 annually in the early years of the scheme to around 200,000 in 1992. Despite steadily rising levies, the scheme is currently underfunded. One estimate last year put the unfunded liability of the scheme at \$5 billion. Further rises in levies are inevitable.

The Business Roundtable has repeatedly argued that accident insurance should be opened up to all comers, and that the ACC be first corporatised and then privatised. Most other business organisations have now come to a similar view. A competitive market for accident insurance would provide a far more efficient means of meeting the demand for insurance cover than the current system.

Issues such as the level of benefits, the scope of coverage and the risk categories employed would no longer be decided by central edict. Instead, as in any market, a variety of insurance products would be developed to meet consumer demand. Those seeking accident insurance would receive a deal better tailored to their individual circumstances. There would also be much better incentives on both employers and employees to contain costs.

In accident compensation, as in other areas of the economy, there is little point in sticking with second best policies, or with institutional arrangements that do not stand up to sound analysis. New Zealand has come an enormous distance in the last ten years. But there are still areas clearly needing reform, and obstacles to growth that need to be removed. If we want a world class economy and a stronger society, we will need to move the agenda for reform into these areas. If that is to happen, it will require business people like yourselves to make the necessary effort to understand the issues and articulate the merits of change.