

EMBARGOED UNTIL 8.00 P.M. MONDAY 12 MAY 1997

Rotary Club of Richmond

THE 1997 BUDGET

**ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE**

**RICHMOND
12 MAY 1997**

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In just over a month's time, the coalition government is expected to deliver its first budget. This will be an unusually important document. The outlook for the economy will be strongly influenced by whether the government takes decisions which arrest the loss of economic direction, the policy slippage and the downward trends in business confidence that have set in since the October 1996 election.

Recent developments bring to mind the words of the Paul Simon song: "the nearer your destination, the more you're slip-sliding away." The first half of the 1990s saw the remarkable turnaround in the New Zealand economy as a consistent economic policy framework and a clear sense of economic direction was achieved in the reform programme. Growth, investment, employment and the government's budget position all improved dramatically. More recently we have failed to push ahead and the slide has been accentuated since the election. Not surprisingly, the number of people who think New Zealand is on the right track has fallen every month since the election and now more people think it is on the wrong track than the right one.

It is important to get these developments into a proper perspective. It was perhaps not surprising that the economy slowed somewhat after the high growth rates of 1993-95. Opponents of the reforms could hardly wait to pronounce that all we had seen was a short-lived growth spurt rather than any sustainable gains. This is a ridiculous view: we are still experiencing the longest expansion of economic growth since at least 1965, inflationary pressures have been kept well in check, and more than 240,000 jobs have been created since 1991. If all these people resided in the same area they would constitute the largest city in New Zealand after Auckland, Christchurch and Manukau.

Nevertheless, recent progress has been unexciting. Believe it or not, we have been in an economic trough now for about two years, with annual growth running at about a 2.5 percent pace. Still, that growth at the bottom of a cycle is better than the *average* growth in the 10 years to 1980 of around 1.5 percent, and it has been associated with a continuing decline in public debt levels, not a build-up of debt.

The main point to make, however, is that a 2.5 percent growth rate falls far short of the economy's potential, and the coalition's growth objectives. The National Party has a target of 3.5-5 percent annual growth to the year 2010, and New Zealand First aims to raise the growth rate to 6 percent by 1999. Neither target is remotely plausible on present policies. The key thing to look for in the budget will be the coalition's indications of how it proposes to achieve its stated growth objectives.

What are the reasons for the much more subdued growth outlook and the fall in business confidence? The first and most important is the progressive loss of fiscal discipline in the last parliamentary term and since the election, particularly the massive rise in government spending.

Over-spending by New Zealand governments was a chronic problem throughout the 1970s and 1980s, and a major factor in the poor economic performance of those decades. Central government's share of the economy rose from its level of 25-30 percent in the 1960s to a peak of over 41 percent in 1990/91. This relentless upward trend squeezed private sector growth, put pressure on monetary policy and internationally competing industries, and resulted in higher taxes and borrowing, inflation, rising debt levels and falling credit ratings.

Despite Roger Douglas's efforts, the Labour government never succeeded in reimposing strong fiscal discipline in key areas. That only happened with the 1991 budget which reduced the pressure on financial markets and the exchange rate and laid the basis for the export- and investment-led recovery which followed. Now we are at risk of losing many of those gains.

Consider the following figures. The previous government's success in turning a large operating deficit in 1990/91 into a substantial surplus four years later reflected two factors. First, it was able, largely through economic growth, to raise \$5.2 billion more in revenue in 1994/95 than in 1990/91. Secondly, the government was able to hold the increase in non-finance expenses (that is, spending other than on debt servicing) to \$1.1 billion in nominal dollars (i.e. before inflation), while financing costs fell by \$1.5 billion due to lower debt.

In sharp contrast, in the five years to 1999/00, government spending other than on debt servicing is projected to rise by nearly 16 percent or \$4.2 billion in real terms - nearly four times as much as in the previous 4-year period. We have

already seen some of the consequences of these decisions. High interest and exchange rates have been squeezing the export sector, the 1997 tax cuts which would have brought relief to many low income earners have been deferred, and in the next three years taxes will be \$5 billion higher in total - or nearly \$25 a week for every household over that period - than they otherwise would have been. In addition, the widening of the Reserve Bank's target range appears to have added half a percentage point to long-term interest rates and therefore to the costs of borrowing of firms and households.

Moreover, much of the new spending is misdirected and of low quality. With the exception of a few of its members who still seem to be attracted to government hand-outs, the business community has rejected the proposed \$100 million of business assistance. However, it seems that the government has merely turned around and decided to spend the same amount on a new building for politicians. Much of the proposed spending in the package will benefit well-off people, not those in genuine need. For example, around 93 percent of the proposed increases in tertiary student allowances will go to people from families earning over \$50,000 a year. The removal of the superannuation surcharge and the decision to make doctor visits free for children under five are also regressive in their effect. Overall, this is the most poorly conceived fiscal package we have seen for many years.

There has been almost universal criticism from economic and business commentators of the loss of fiscal discipline and the growing imbalance between monetary and fiscal policy which has contributed to the economic slowdown. The government's attempts to defend it have seemed half-hearted, and the points it has made have been unpersuasive.

First, the government has pointed out that it continues to plan for substantial surpluses and to repay debt. It is true that excessive government borrowing is no longer adding to New Zealand country risk and absorbing private savings, but unsustainable deficits are only one aspect of bad fiscal management. Increases in government spending have independent effects, particularly by adding to demand pressures and hence cost increases in the non-traded goods sector of the economy. It is these cost increases which are causing the real exchange rate to rise and squeeze the export sector, and it is wrong to blame monetary policy for this outcome.

Secondly, the minister of finance has pointed out that the ratio of government spending to gross domestic product is still projected to decline despite the extra \$5 billion in spending, from 34.7 percent of GDP this year to 32.1 percent in 1999/00, partly due to the continuing fall in debt servicing expenses. But what Mr Birch has not acknowledged is that his projections of only two years ago had government spending falling to 30.5 percent of GDP this year. The government's target of reducing expenses to below 30 percent of GDP has been rapidly slip-sliding away. I would not be surprised if the budget reveals a weaker growth outlook than the March Budget Policy Statement, in which case the target may recede further.

Thirdly, the government has been rather lamely arguing that if Labour and NZ First had ended up as coalition partners, the fiscal outlook would have been even worse. This may be a fair point: Labour still describes itself as a spending party whereas Tony Blair's Labour Party has pledged to be at least as tough on public spending as its predecessor and to cut income tax rates further. If the political alternative would have been worse, this simply underlines how far all our major parties have abandoned policies of sound fiscal management.

When one looks around the world today, there can be little doubt that the countries that are doing most to create jobs and raise incomes are, generally speaking, those that have kept their public sectors small and their tax rates low. By contrast, high-spending, high-taxing countries, such as those in Europe, are stagnating with high levels of unemployment and increasing social stress.

A recent International Monetary Fund working paper looked more closely at the growth of government spending and its effects over the last century. Prior to World War I, government spending in industrialised countries averaged less than 10 percent of GDP; in the United States it was under 2 percent. The ratio rose with the two World Wars and the Great Depression, but was still only just over 25 percent by 1960. However, the biggest rise in government spending came with the subsequent expansion of the welfare state, which took the average ratio to 45 percent by 1990. The growth in the size of government in the New Zealand economy followed a broadly similar pattern.

The IMF researchers examined a range of economic and social indicators and found that recent government growth has not brought about much economic or social progress. Countries with the lowest increase in public spending tended to be more efficient and innovative and enjoy lower unemployment. Nor did

the wealthy industrialised countries have significantly better performance on measures of education and health than newly industrialised countries where spending averages only 18 percent of GDP. The authors concluded that "most of the important social and economic gains can be achieved with a drastically lower level of public spending than what prevails today", and predicted the next few decades would see important reductions in the share of public spending in advanced economies.

It is also worth noting that there are few signs of growth in the relative size of the public sector in the low tax countries. Hong Kong, for example, has followed a rule of not allowing government expenditure growth to exceed the growth rate of the economy. This seems unlikely to change: in the lead-up to the recent Hong Kong budget, China, the world's last great communist power, was urging Hong Kong to contain its welfare spending. This has increased in recent years and there are signs of a dependency problem developing. Hong Kong's top marginal tax rate is 15 percent and there is pressure to cut the 16.5 percent corporate tax rate on the grounds that its economy is becoming uncompetitive.

The IMF research focused mainly on the poor returns from many government spending programmes. A separate factor which impacts on economic performance is the taxes required to finance them. At current levels, the economic or 'deadweight' costs of taxation are high. The costs in question are not just the administrative and compliance costs involved with any tax system; the more important economic costs result from the disincentives to work, save, invest and take risks. Because of these effects, transferring a dollar of income from Peter to Paul costs more than a dollar of national income - the process is like transferring water in a leaky bucket. Studies for New Zealand suggest that an additional dollar of spending could cost the community anywhere between 14 cents and 270 cents of lost income. If a deadweight loss of 20 cents per dollar applied to the coalition's \$5 billion spending package, we would lose \$1 billion of potential national income or over \$800 each year for every household.

A recent study by Professor Gerald Scully for the Department of Inland Revenue concluded that the growth-maximising spending ratio for New Zealand is about 20 percent. It is hard to see how government spending on genuine public goods and a well-designed social safety net would amount to 20 percent of GDP in a well-functioning, high income economy. Nevertheless, as a conservative target the Business Roundtable, in association with the

Auckland and Wellington chambers of commerce, advocated last year in a report entitled *Moving into the Fast Lane* a medium-term ratio for total government spending of 20 percent or below by 2005. Combined with other measures, we firmly believe such a reduction of the government spending and taxing burden would lift New Zealand's growth performance to the levels targeted by the coalition parties.

Achieving such a ratio does not necessarily require large cuts in government programmes; the falling ratio of recent years has occurred largely because government spending growth has been held below growth in the economy. But there is clearly enormous scope for reducing government spending that is not cost effective or well targeted. In many instances activities and functions should be eliminated or privatised. A large number of possibilities were put forward in *Moving into the Fast Lane*. In tandem with lower taxes, there is clearly room for significant privatisation of pensions, education and health care, since a large proportion of the outlays go to people who paid the taxes to provide them in the first place. Such 'churning' of income only adds to deadweight losses while inhibiting choice, flexibility and accountability. The government's focus should be on assisting those who would not otherwise be able to access basic social services. And I can assure you from first-hand experience that there is still a great deal of wasteful bureaucracy and regulatory administration in both central and local government.

There are other factors within the government's control which are contributing to the rather mediocre economic outlook. They include the growth in meddlesome - and often utopian - regulation of the private sector, the reluctance to expose state activities like ACC and the producer boards to greater competition, the standstill on privatisation of government-owned businesses, and the proposal to introduce a compulsory saving scheme. All these are, or would be, a handicap to growth. The decisions against privatisation seem to have been made on ideological grounds - ministers make no attempt to defend them on national interest grounds. The proposal to regulate private savings is being put forward at a time when the government is spending more and reducing its own savings: a 'do what I say, not what I do' approach. The proposed deregulation of postal services is a welcome move and seems to have been accepted with little fuss, but it is a move we have been advocating since an initial inquiry in 1988. As well as moves to restore firm spending discipline, the business community will be looking for indications in

the budget that the government will be making up for lost time on microeconomic reform.

In an optimistic review of the world outlook earlier this year, the former deputy editor of *The Economist*, Norman Macrae, wrote:

Twilight will start to fall on the era of big government across the world in 1997. ... Good governments will spend less of their people's money ... and so start providing a much better welfare state.

These lessons from experience are still not accepted in many quarters in New Zealand, and seemingly by our main political parties. Spending lobbies like to quote Oliver Wendell Holmes and tell us that "Taxes are what we pay for civilised society". When Justice Holmes made that remark the average American's tax burden was about 7.6 percent of personal income. Today people on close to the average wage in New Zealand pay an income tax of 33 percent and a further 12.5 percent in GST on their spending. Many people effectively work two days in every working week for the government. How many people today think that the higher our taxes the more civilised we are likely to be?

Similarly, how many think that spending another billion dollars on our dysfunctional health and education systems will make any more difference than spending a billion dollars on the Post Office or the government electricity department would have made to our telecommunications or electricity services in pre-reform days? Education and health services (with the exception of primary health care, which is mainly provided by private general practitioner businesses and is largely free of complaints) will remain prime sources of public dissatisfaction so long as they are state-provided, sheltered from competition, and dominated by unions. We don't hear similar complaints about private sector services such as those provided by supermarkets, service stations, accounting firms or insurance companies, but the penny doesn't seem to drop. Without basic reforms, no amount of extra spending will make much difference to education and health. And yet spending up on government-provided social services is precisely what the government seems likely to do in next month's budget.

It is difficult to see that Macrae's optimistic outlook extends to New Zealand. World growth this year is expected to be of the order of 4.4 percent but New

Zealand will clearly not match that figure. The expected pick-up in activity looks to be weaker and slower in coming. Last week's unemployment figures suggest the fall in unemployment has come to an end for the time being. A disappointing budget would depress business confidence and activity further.

Regrettably, the government seems no longer to be listening to those who have been arguing that its policies are going in the wrong direction. In March the National Bank asked the question: "Can we say that the March 1997 Budget Policy Statement is fiscally prudent?" and replied: "The answer is emphatically No!" The response by the minister of finance was: "I think they grossly overstate their case. That's not helpful to anyone."

Similarly, the Business Roundtable recently warned that the prospects of New Zealand regaining a Triple A credit rating were receding. Mr Birch rejected that assessment and accused us of "needlessly and irresponsibly fuelling overseas concern". But what the business community would like to hear from the government is how its decisions to spend an extra \$5 billion and relax the Reserve Bank's target band, and its lack of vigorous action in pressing on with necessary microeconomic reforms, are advancing the prospects of a Triple A rating. It is a matter of simple logic that these factors will make financial markets and rating agencies more cautious about New Zealand. The government has not demonstrated its confidence by setting a target date for achieving a Triple A rating. Contrary to Mr Birch's optimism, Standard and Poor's last week scotched the idea that there is likely to be any upgrade in New Zealand's credit rating in the immediate future.

In some ways the present economic and political environment is reminiscent of the period 1988-90. After four years of bold and overdue reforms, the government of the day called for a cup of tea. Business confidence slumped. The Business Roundtable and others repeatedly warned about the damaging effects of the loss of fiscal discipline and economic direction, but to no avail. New Zealand suffered a prolonged recession and a downgrading of the credit rating in 1991, and a further downgrade was only narrowly averted by the budgetary and other measures of that year.

Are we condemned to repeat history? One thing that has changed from the Muldoon years and the associated 'economy of fear' is that critics of government policies are unlikely to be silenced simply by reactions that they are 'unhelpful' or 'irresponsible': more people are prepared to stand up and be

counted. Another is that the country has become more economically literate, as the polls indicating a lack of confidence that the government is on the right track confirm. Sooner or later politicians are likely to notice such signals.

As for the budget, the business community must hope for the best and prepare for the worst. If there are no new initiatives to control government spending and promote growth, my assessment is that business will remain quite defensive in its investment plans and that the weak phase of the last two years will be extended. If, on the other hand, the government has been listening to those who are keen to see it build on New Zealand's achievements in the last 12 years and achieve its growth objectives, we should expect a new phase of reform which would move the economy forward again. In about a month's time we will know which scenario is more likely.