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**NEW PLYMOUTH CHAMBER OF COMMERCE
ANNUAL GENERAL MEETING**

THE 1998 BUDGET

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In just three weeks' time, the government will be presenting the 1998 budget to parliament. This is the government's most important economic policy statement for the year. All of us in business need to be thinking about its implications for our firms and the economy.

Unfortunately, the implications are worrying. John Clarke (alias Fred Dagg) used to say that there were two types of budget: a good budget and a bad budget. If Fred Dagg were with us now I think he would have no hesitation in predicting that next month's statement will be a bad budget.

We can make this judgment today because, thanks to the Fiscal Responsibility Act, the broad outlines of the budget are already known. The core of the budget is the government's statement of its fiscal plans – essentially its plans for spending, revenue and debt management. The Budget Policy Statement issued in February set out these plans. In our submission on that document, the New Zealand Business Roundtable said:

In our view, the economic strategy unveiled in the 1998 Budget Policy Statement ... is risky to the point of imprudence. It is putting the fiscal position, the country's credit rating and the economy at risk.

Of course, the budget is likely to contain other announcements besides fiscal measures. But there is no way any of its redeeming features will offset the damage the government is doing to the economy by its fiscal policy.

We can see this readily by comparing the likely performance of the economy with the government's own targets. The Treasurer is committed to aiming for a rate of economic growth next year of 6 percent of gross domestic product (GDP). Yet the budget is likely to scale back the government's own forecasts for growth next year. I believe we will be lucky to see growth come in at half that level.

As an organisation, we have been strongly supportive of the Treasurer's ambitious vision for economic growth. We firmly believe New Zealand is massively underperforming relative to its potential. To his credit, Mr Peters has accepted many of the policy changes that were driving the economy

strongly forward in the first half of the 1990s. The problem is that the government has failed to strive for continuous policy improvements and its economic framework has become ragged and unbalanced.

The consequences of this drift are clearly visible. We are now into the third year of an economic trough in which annual growth has been running at about 2.5 percent – the recovery keeps on receding. Unemployment is trending upwards, the current account deficit is at a dangerous level, the exchange rate has fallen by 20 percent against the US dollar, we are on negative creditwatch, and business and consumer confidence levels are low. The fact that the exchange rate has gone down while interest rates have risen may be another telltale sign – a vote of no confidence in New Zealand by financial markets.. The economy is not in good shape to withstand inevitable periodic shocks such as droughts, power crises, wharf strikes in Australia, the downturn in Asia or falls in world sharemarkets.

Of course the government is quite right to say that the country is still in far better shape than it was before the post-1984 reforms. Even in the present slowdown the economy is still growing faster than its previous long-term trend rate of growth, public debt is at much more prudent levels and inflation is not a problem. The reforms produced huge gains, and the evidence of better performance was undeniable by 1995.

Since National's 1990-93 term in office, however, the government has lost its way, the outlook has become mediocre again and the risks are growing. A high rate of growth, such as the one the Treasurer is aiming for, is out of reach on present policies and anything that the budget is likely to deliver. If the Treasurer wishes to restore credibility for his goal, he will have to move quickly after the budget to make major adjustments.

We retain some hope that the government will accept the need to act. The Treasurer spent much of last year maintaining the 'economic fundamentals' were sound when patently they weren't and still aren't, and telling the business community to 'snap out of it'. Today I believe a number of the economic ministers are no longer in denial. We have to hope that the government will 'snap out of it' and work to reverse the decline. One positive sign is that the Treasurer has been speaking of the need to curb government

spending in response to the Asian crisis. This has to be a top priority in any turnaround strategy.

I make this point because runaway government spending has done more damage to the economy than anything else since Ruth Richardson was dumped as finance minister in 1993. The government has committed the mistakes of the Muldoon era all over again. Of course it was reasonable that a share of the benefits of an improving economy were taken out in the form of some increased government spending. But by allowing spending to spiral, the government has been killing the goose that laid the golden egg. There would also have been scope for much larger tax cuts by now if spending had been properly controlled.

The clearest way to see what has happened is to look at government spending trends over the last two parliamentary terms and during the current one. Using the most comparable figures available, the picture is that in the 1990-93 parliamentary term, government spending was cut by \$660 million. In the 1993-96 term it shot up by \$3.3 billion and in the current term it is projected to balloon out by a further \$4.3 billion. This picture is accentuated when you take into account the fact that in the first of these periods the government was having to meet high debt servicing expenses which are now much lower. Inevitably, the cumulative weight of this spending has flattened the private sector and the job market.

This is not a recent or belated assessment. In 1995 the Business Roundtable described the government's spending plans as risky and imprudent even though total spending was then projected to rise only fractionally between 1993/94 and 1997/98. What was happening was that substantial savings in debt servicing were being offset by very large increases in discretionary spending. We have repeated that criticism with greater urgency in submissions on subsequent Budget Policy Statements, and similar criticisms have been made by other business organisations, the OECD, the IMF and many economic commentators. To date, however, they have fallen on deaf ears.

Against that background it can be seen that the \$5 billion spending package in the coalition agreement merely came on top of a rapidly rising trend. In combination with the slowing economy, it has had the effect of arresting the previous fall in the ratio of government spending to GDP. As projected in

1995, that ratio would have fallen to around 30 percent by this year. It is now stuck at around 34 percent. Moreover, the GAAP basis of the financial statements, with its focus on operating expenses, probably understates total central government spending. Including capital expenditures and local authority spending, total general government spending on an internationally comparable basis may be between 38 and 41 percent of GDP.

Moreover, the distinctive feature of the latest package is its low quality. Few people can believe anymore that tipping more taxpayers' money into our education and health systems will do much to improve outcomes given their present structures. Much of the rest of the package consists of what Colin James has called "reverse redistribution" – taking from low income people to give to the better off. An analysis by the Manufacturers Federation of some \$937 million of this spending – on things like the removal of the superannuation surcharge and free doctors' visits for children of better-off families – showed that over half of it was going to the top 30 percent of households. Around 93 percent of the proposed increases in tertiary student allowances will go to students from families earning over \$50,000 a year.

The Treasurer has said that he has put a stop to "Business Roundtable policies" and supports "capitalism with a human face". I am all for capitalism with a human face, but it is hard to recognise it in the coalition spending package. I see the package as much more like the ugly face of vote-catching and wish the Treasurer would spare us the humbug about 'caring' policies.

This pattern of what might be called 'compassion for the middle classes' continues with the Rev Ann Batten's push to halt the reductions in tariffs on clothing and textiles. These are a regressive tax which account for a disproportionately high share of poor people's incomes. You would think her colleagues in the churches would have had something to say about the range of New Zealand First policies which rob the poor to give to the rich, but their silence has been deafening. For the 'social justice and responsibility' movements, just about any form of government spending or intervention, no matter how misdirected and socially harmful, is usually seen as 'caring'. An exception is an article on the superannuation surcharge by Michael Fitzsimons, former editor of *Zealandia*, in the latest issue of *NZ Catholic*. Mincing no words, he writes:

There will be a real knees-up among Grey Power and fasting and mourning for the rest of us at the news that the superannuation surtax has finally been abolished. After years of carping and grizzling, the wealthy have won the day. ... Everybody, from multi-millionaires down, will now draw a pension, funded by the average taxpayer and utterly unaffordable for the country in the long term. ... Where are our priorities? In one spineless action, the Government commits the country to an additional \$240 million expenditure. Those who will benefit will be around 70,000 superannuitants, 16 per cent of the total – made up of retired married couples earning more than \$75,000 and singles on upwards of \$45,000. What misguided and heartless logic is at work here – to top up these considerable sums, using the taxes of low and middle-income earners struggling to raise their families and already burdened with paying for social services which were freely available to their forebears.

Such flashes of economic literacy are, regrettably, all too rare in church newspapers. We need more of them to hold politicians like the Rev Ann Batten to account.

What is also particularly difficult to square with New Zealand First's stated goals is not just the impact of a bad fiscal policy on economic growth, employment and income distribution, but also its impact in relation to the party's concern for New Zealand's sovereignty. Economic sovereignty is ultimately a matter of net claims on New Zealand by the rest of the world. With the mushrooming balance of payments deficit, these claims are rising rapidly. Fiscal policy is driving them up through at least three channels:

- increased government spending is increasing the deficit by pushing domestic expenditures ahead of incomes;
- government spending has increased cost pressures in the non-traded goods sector of the economy and hurt our international competitiveness; and
- government sector savings have fallen with lower operating surpluses which, other things being equal, will have widened the national savings-investment gap.

In addition, the falling exchange rate has made all New Zealand assets cheaper for foreigners to buy. Takeovers and acquisitions are less expensive. These factors should be at the forefront of any general concerns about sovereignty, not a misplaced preoccupation with ownership of specific assets. A continuation of these trends would put New Zealand's economic sovereignty at risk again.

Besides the damaging trends in government spending, the other major factor behind the slowdown in growth and the risky balance of payments position is the virtual standstill on microeconomic reform. Gareth Morgan, one of New Zealand's best economists, summed up the position well when he wrote recently in a *North and South* article:

With all the deregulation, privatisation and reform of government-provided services we have seen, it is easy to assume that it was a once, that now we can get back to normal and live our lives again against a background of a well-functioning economy. If only.

Dr Morgan's comments should have struck a chord with anyone who was following the visit to New Zealand earlier this month of the president of Argentina, one of Latin America's turnaround economies. Argentina has now privatised much of its electricity system, its ports, its postal service and some of its roads. Even China is quitting its state-owned enterprises to make room for the private sector to grow. Australia too has moved well ahead of New Zealand in many areas. New Zealand, which was once a leading economic reformer, is now very much a laggard – and we are paying the price.

Within the coalition, many in the National party are apt to blame the stalemate on New Zealand First. This is far too convenient an excuse. It needs to be remembered that it was National that went into the last two elections promising not to privatise ECNZ and NZ Post. It was National members who stymied the attempts of some of their own ministers to get the assets of the Auckland Regional Services Trust out of political control. It is the National party, not New Zealand First, that has stood in the way of dismantling the outdated producer board structures – and there is still no clarity as to when push will come to shove on this issue. Since 1993, National has not been a reformist party – it has largely been content to coast.

The coalition government has had a number of important microeconomic issues on its agenda – such as ACC, the Employment Court, tariffs, the Resource Management Act, and local government – as well as important social policy issues such as superannuation and welfare reform. Halfway through its term, however, little has happened on any of them. As with the fiasco over ARST, the fear of the business community has to be that others will turn to custard. Experience with issues like the health system, ACC and the Employment Court demonstrates the problems with botched and compromised reforms, which always come back to bite those associated with them.

Even if some of these initiatives come to fruition in the period ahead, other developments will be holding the country back. For example, the minimum wage increase last year probably cost some 2000-3000 jobs, and a further large increase in the rate is on the cards next year. And at a time when many governments are disengaging from the electricity industry, the government is becoming even more involved with its decision to own four generating companies and create many more distribution businesses – an extraordinarily fragmented structure.

Last year Mr Peters advised us that he accepted there were "sound economic reasons" for privatisation of electricity, but he noted that there is much public opposition to the idea. That is a fair point, and governments should ultimately reflect the electorate's view. If New Zealanders have an attachment to political control of businesses and are prepared to forgo the gains of more efficient private sector operation, they should have that choice. What we have a right to ask, however, is that politicians spell out the costs of such decisions to the public, and that those attached to state control do not complain when incomes stagnate and unemployment rises.

Overhanging all this, of course, is the shadow of MMP. As many predicted, it has turned out to be a major factor in the present paralysis. There are still people who think MMP can be 'made to work'. Unfortunately, trying to make MMP work is like trying to invent a barking cat. There aren't many barking cats around. Graeme Hunt's recent book *Why MMP Must Go* makes a compelling case for its early removal if New Zealand is not to slide further downhill.

One of the few positive features of the current environment is that all the representative business organisations are giving the government pretty much a common message about the weaknesses of policy. Those who think that the business community, which was strongly supportive of earlier policy directions, has remained happy with where the country has been going haven't been listening. The Business Roundtable and the Auckland and Wellington chambers of commerce set out what needs to be done in the report *Moving Into the Fast Lane*. It argued that government spending and tax burdens should be reduced to below 20 percent of GDP, and for revitalising microeconomic and social policy reform.

The views of the business sector are in line with external advice. The most recent external advice the government received was the report of the IMF which urged reduced government spending, further deregulation (eg of producer boards), welfare and superannuation reform and greater private sector involvement in areas such as health. Efforts along these lines to wind back the size and scope of government are occurring in practically all OECD countries and many others: there are no serious alternative strategies on offer for governments seeking to raise national incomes. In the period ahead business organisations in New Zealand must redouble their efforts to persuade all political parties to heed such advice.

In the article I quoted, Gareth Morgan pointed out, however, that to date:

The response of the new-look government to the IMF's counsel has been to ignore it.

He added that:

We see the Shipley regime as little different to those National ones which we normally elect – presiding over a so-so economic performance with no compulsion to be radical until a financial market crisis engulfs us once again.

On our current course that point is at least two years away, so why worry?

I agree with the sombre analysis of Dr Morgan's article, and of course his "why worry?" point is not made seriously. The time to be worried is right now. The budget is to be delivered on May 14. It should set out what needs

to be done to repair the damage, and remedial work should already be underway.