NEW ZEALAND FABIAN SOCIETY

Fabian lecture on 2010 Budget

The first point to log in commenting on any Budget, past, present or future, is that it shouldn't be overloaded with expectations.

Budgets list best guess estimates of where the money to run central government services comes from, and what it is being spent on. They often contain a fair amount of rhetoric about high sounding ideals and intentions, but inevitably the substance falls far short of the promise.

This is particularly true for comments and initiatives that relate to the performance of the wider economy. There are two reasons for this. First, despite the postures and pretence to the contrary, governments have very little real discretion on spending, particularly within any one year. Second, fine tuning fiscal allocations are a very distant second order influence on what drives any economy.

Let me take the first.

The basic functions of social security, health, education, law and order, defence and servicing government debt absorb 82 percent of all spending. Before people start beating the welfare drum and blaming it all on the unemployed, it needs to be pointed out that New Zealand Superannuation and Family Tax Credits are far and away the big ticket items in the social security system. Even taking an expansive approach to what might be called economic development – and lumping in transport and communications, economic and industrial services, Kiwisaver subsidies, R&D tax credits, employment initiatives, primary services and even housing and community development expenses - we just creep past 10 percent of government spending, or something like 3.5 percent of GDP. Rejiging those allocations will never let this particular tail wag the whole economic dog.

On the second issue – what drives an economy – it is sobering to reflect back on the nauseating mantra that New Zealand used to have the third highest per capita income in the world and it is now whatever. Within that ritual wailing lies a harsh truth – the historical performance high was at a time when the economy was massively protected and regulated, and government ownership and direction of economic activity was pervasive.

Realistically, economies perform at different levels for different reasons at different periods of time. IN the 1950s, New Zealand was in the right place at the right time with the right endowment of resources. We were far enough away from the theatres of war to have avoided destruction of property and infrastructure. We produced protein and fibre when northern economies recovering from war needed them, and when additional demand ramped up during the Korean War. Similarly, Australia is now producing raw materials for a materials rapacious Chinese economic expansion.

The Brash Taskforce recently lamented the fact that New Zealand's per capita income had been outstripped by Taiwan, Slovenia and South Korea, and recommended a (repolished) silver bullet solution in cutting government spending, deregulating and privatising state trading enterprises.

I am going to come back to the spending cut as economic elixir later, because this discussion is about the Budget, but let me digress and look at the drivers of those three exemplar economic transformations.

Clearly, the level of government spending is does not explain common performance. Slovenia has a much higher government spending per capita than we do, Taiwan has a much lower one, and South Korea is in between. They all have very different economic structures. IN Slovenia, state owned trading enterprises control about 40 percent of the market. IN South Korea, large state sponsored, privately owned conglomerates dominate. In Taiwan, small businesses dominate a landscape shaped by massive and regular state funded development projects and infrastructure builds.

In all of those economies, the labour market in particular is heavily regulated. In getting a measure of regulatory weight, I have gone to the source of pure regulatory thinking: the Heritage Foundation. The foundation publishes an Index of Economic Freedom, which is a composite of various measures. New Zealand is relatively deregulated in this company, ranking #4 on the global league tables. Taiwan is 27, South Korea 31 and Slovenia 61. So if regulation inhibits growth, we cannot explain either the lesser performance of the New Zealand economy, nor the superior performance of the others.

In the labour market, the Heritage Foundation rates the degree of labour market freedom in New Zealand at 88.8 percent. IN Taiwan it is 47.7 percent, in South Korea it is 47.1 and in Slovenia 43.5. Their labour markets are massively more regulated than ours, particularly around the ability of employers to fire workers.

If we look at the economic transformation paths these economies took, two common features stand out among the many divergent byways. These are a highly centralised decision on the required end destination of economic activity – in essence a socialisation of direction, and with it the socialisation of commercial risk, and much more substantially a very strong control over the allocation of credit. IN 1961, South Korea nationalised the banks and directed the allocation of credit, linked to recipients meeting export targets. Even now, government controlled banks account for 50 percent of the assets of the Taiwanese and Slovenian banking systems.

My point here is not to try and import lessons from these three better performing economies into New Zealand, but to reinforce the lesson that standard libertarian economic formulae have not been applied, let alone worked, in the success stories their champions berate us with. Indeed, I find it hard to identify one in which they have! Hong Kong is often cited as an example, but before we go there, we would need to disentangle the impacts of its special status as an entreport for the west to China.

My message so far, in the context of looking at the May Budget, is that it will not, indeed cannot, lay out a blueprint for a better economic future.

Economies grow and transform through an incredibly complex, but especially an incredibly long term interplay of forces. These include resource endowment relative to global demand for them, the impact of new technologies, shifts in global market power, trade access and trade alliances, skills, infrastructure and simple price shocks – positive as well as negative.

Of course governments can impact these forces. But they do so indirectly, and slowly. It takes a decade or more for changes in training and skills development to be even noticed in the labour market. Infrastructure upgrades take at least five years to get from decision to commissioning, via planning, design, consent and construction. Science takes decades and a hazardous negotiation of the valley of death to get to commercialisation. And so on.

It is hard these days to get through any dissertation on economic growth, transformation or development without coming across the new obsession with institutions. Institutions is the new black. Good institutions equal economic success. Bad institutions equal failure. Witness North and South Korea so the mantra goes.

There are two problems with institutions. Absent some common core like a decent court system and lack of corruption, good institutions before the event is what I say they are! After the event, they are validated with hindsight. Who would say now that nationalising the banks and state sponsorship of conglomerates is a good institutional configuration? But they were good for South Korea. Don Brash and friends say working for families and an intrusive role for the state are institutional anathema. But in the fifties, it was state housing, a family structure related income tax system, import licensing, a pervasive state ownership of financial institutions, training and skills development delivered through state owned infrastructure and utilities supply and public service departments and all the rest of that paraphernalia that constituted an institutional mix that delivered low inflation and unemployment, a reasonable degree of social cohesion and relatively high living standards. Of course it wasn't a golden age, for obvious reasons. And of course it can't be replicated in today's conditions with mobile finance capital, and demands for more extensive personal choice, but my point is that if we are looking to construct an institutional arrangement that is supportive of growth, avoid formulaic solutions.

Fundamentally, do not expect them in any Budget, let alone Budget 2010.

We can look at any Budget through three separate but complementary lenses: what it spends, the revenue it collects, and the way it shapes the lives of the citizenry through the use of the authority of the state. This last often gets the least attention but has the most pervasive impact. It is also often an activity that takes place off balance sheet so to speak: outside of the formal fiscal framework.

The level of total government spending – specifically in relation to GDP – is a favourite focus of fundamentalist libertarians. The focus is, in strictly economic terms, barren.

For a start, the ratio of spending to GDP is a product of a numerator and a demoninator. As GDP rises and falls, so the ratio falls and rises, independently of the level of spending itself. The recent Brash Taskforce fixated on a holy grail of returning government spending to the relative level of fiscal 2005.

"If the New Zealand government could function in 2004 spending 30 percent of all this economy produces, it is difficult to see why it could not also do so again three years from now."

"Getting spending as a share of GDP back to 2005 levels would be a good start, but no more that a good start."

This selective use of 2005 (or 2004 – the Taskforce is not consistent), ignores three things:

> The ratios depend both on what is happening to spending **and** what is happening to GDP: divergence can just as easily be a result of different directions of movement of GDP. If the government chased its tail – cutting back spending to preserve a spending:GDP ratio in a downturn – it would compound the downturn and make the ratio worse requiring greater cuts etc etc.
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> In 2004 and 2005, the government was making contributions to the NZ Superannuation Fund: of 1.4 and 1.5 percent of GDP respectively.

Accounting conventions do not classify this as "expenditure" when in every conceptual and analytical sense it clearly is. The government is taking money out of the economy and putting it to use for a public purpose: providing pensions, albeit with a lagged impact. Comparing like with like needs to inflate the 2005 ratio by 1.5 percent, but not the 2010 ratio because no contributions are being made in that year.

New Zealand – and almost all other developed economies - made deliberate stabilisation decisions to stimulate and sustain economic activity as a response to the global recession. It is a separate matter as to if, when and how stabilisation measures will reverse out, but it is analytically lazy – if not dishonest – to assess an existing level of expenditure as somehow being the benchmark from which a cyclically neutral level of spending needs to be adjusted.

In 2004 government spending went up by 5.0 percent, but because nominal GDP grew by 6.8 percent, the ratio of spending to GDP fell.[1]

2005 flat lined: spending and GDP up by the same proportions.

The "virtue" of the low spending ratio as at 2005 was almost entirely a consequence of strong nominal GDP growth.

Fast forward to the present. In the two years to 2010, spending is forecast to grow by 15 percent. But nominal GDP rises by less that 3 percent, so the ratio surges.

It is very difficult to get a firm grasp on what elements of any increase in government spending is a conventional response to recession ("stabilisation").

(a) Not all increases in spending are necessarily stabilisation measures: some are policy based and meant to be permanent;
(b) Some are simply "automatic stabilisers" and will reverse out naturally as the business cycle returns to normal (unemployment benefits etc.);
(c) Not all stabilisation measures involve government spending (tax cuts; loans to banks; equity injections; deposit guarantees etc.)
(d) Stabilisation measures may not reverse out easily (eg tax cuts), or could convert into spending (when guarantees are called up).

[1] The numbers are both nominal (i.e. not adjusted for inflation). The fiscal year runs to June, and the national income accounting year to March, so there is a slight mismatch of time periods. Treasury standardises timing to produce the annual ratio figures in the Budget.

For all of that, it is possible to get a rough feel for the order of magnitude of what recent increases in government spending should be tagged as “stabilisation” interventions in two ways:

(i) By looking at how much spending has increased in other OECD countries in 2009 and 2010 at the same time as the recession has impacted; and
(ii) By using the OECD classification of what constitutes stabilisation and applying that to New Zealand.

Across the OECD, “general government total outlays” (the internationally and historically consistent measure that the Brash taskforce – correctly – prefers) rose from 41.5 percent of GDP in 2008 to an estimated 45.7 percent by 2010: an increase of 4.2 percentage points. New Zealand was slightly ahead of that (5.3 percentage points), but is not a spending outlier. As ever, averages are distorted by outliers.

In areas we tend to compare ourselves with, we are pretty much in the middle of the pack. Australia and the USA were lower (3.4 and 3.8 percentage points respectively), but then the USA put a lot of its stabilisation emphasis on bank bailouts, and Australia relied more on tax concessions.

Ireland, Sweden, Spain, the UK etc were higher, and many were there or thereabout the New Zealand response (Belgium, Denmark, Japan, Netherlands, Portugal as examples).
On the OECD stimulus classification, the stimulus in New Zealand was 4.3 percent of GDP over the 2008 – 2010 period: about 89 percent of the level in Australia, but with different components.

Pulling together :

- the influence of high nominal GDP growth in shrinking the ratio in the “golden” period of 2004/05
- the unlike “with and excluding NZSF “ comparisons over time
- the fact that no attempt has been made to normalise periods cyclically, and to strip out short term stabilisation interventions

the conclusion that remains is that the core “finding” of the Brash taskforce has no analytical rigour.

It is simply gossip.

There have been some high profile examples of spending cuts such as for adult education, but by and large this government has not been severe on spending. It has tried to constrain rather than cut overall spending.

In practice, we are not likely to see much in the way of cuts on the expenditure side in this Budget. This is appropriate for two reasons. Firstly because it is counter-productive to contract government spending in a period of low growth, but much more importantly because the case for more fundamental change has not yet been made.

What we are seeing, though, is a rise in the chatter so it is important to engage in a robust examination of the merits of the case or cases for future inroads into established programmes.

This is not the time to go through government spending in detail, but that should eventually be done. When it is done, we need to have some analytical rigour applied. As an example, let me look at New Zealand Superannuation: a standing target for the IMF, the Treasury and every economic libertarian who tut tuts about our so-called profligacy. If people say often enough that super is generous and unaffordable, that becomes the received truth. But in fact our state pension system is mild. It is mild for three reasons. Firstly, it a basic pension: one-third of the average wage per person, is not exactly caviar and champagne fare. Second, unlike many European jurisdictions, we do not try and replicate in retirement a basic relativity to income earned during working life. Finally, unlike many other jurisdictions, we do not have compulsory contributory superannuation during working life. This is the point I am stressing. Just because Super is funded out of general revenue, it is no less an exercise of the authority of the state to command the application of resources for particular end purposes than, for example, is the personally allocated 9 percent payroll levy in Australia.

There used to be a fourth factor that made our state subsidisation of retirement cheap by international comparison: we did not offer tax exemptions on contributions to pension schemes or exempt the earnings of funds from tax. Kiwisaver has changed that. Ironically, it is not Kiwisaver that is getting attention with respect to the cost of state subsidies of retirement income, yet that is the one change in the fiscal support for pensions that has been material in recent years.

The state determines the allocation of resources in many ways. What passes through the government account at Westpac is merely one dimension, and this has to be top of mind for any review of government programmes

Much more significantly, at this stage of the political cycle, it is tax that is centre stage.

There has been a lot of focus on losses on rental residential housing investments being claimed as deductions against other taxable income. One vehicle for this is the so called Loss Attributing Qualifying Company. The LAQC is a normal company that has special tax status. That special status allows losses to be “attributed” as an offset against a shareholder’s personal income. The Tax Working Group estimated that about $500 million of losses from rental housing were deducted from personal income in assessing tax due, with the consequent loss of about a third of that - $150 million – in tax revenue.

But this is just a part of the story. In 2008, there were 129,000 active LAQCs. Total losses claimed were $2,258 million. My enquiries indicate that in that year $830 million was claimed as losses on rental properties. This is a bit above TWG estimates, which I understand refer to the 2007 year. The point here is rental property accounts for just over a **third** of the revenue that leaks through this particular fiscal sieve. There is a story that is twice as big as the rental property concern, and yet it barely rates a mention.

More worrying is the fact that this is an area of particularly rapid growth. The number of active LAQCs has doubled in the last five years. The amount of losses claimed has more than trebled in that time. We can talk all we like about lowering tax rates and aligning the tax rates of different tax vehicles, but if the income isn’t there to tax, all of this is rather pointless.

It is hard to see attributable losses as innocent. What would cause tens of thousands more New Zealanders each year to enter into arrangements that lost them increasing amounts of money? The only rational answer is tax avoidance. It makes absolutely no sense to lose a dollar to avoid 38 cents of tax, so the only rational conclusion is that the arrangements are artificial.

When I have raised this with colleagues, I get two responses. The first is to question why the company structure is the vehicle of choice. A sole trader pays tax net of losses, so why incorporate? The second is that a loss is a loss, so what is the problem? The facts - rapid growth of the number of LAQCs and the escalating level of losses - seem to imply that there is some inventive accounting engineering going on here, but nobody seems to want to investigate, bar the rental property dimension: which, as I have said, is only a third of the total.

I carry no bag for landlords. But I do have a logical problem with the standard view that New Zealanders are obsessed with property, and that there has been a persistent over-investment in property over many decades. Libertarians believe that the law of supply and demand is stronger than the law of gravity. So how come, after decades of over-investment, the price of houses has not collapsed? It can’t be sustained on a tax air balloon for that long, if the problem is that great. I just note from the Salvation Army’s latest State of the Nation Report that the supply of housing is in shortage, especially in South Auckland, where in Manukau City one new house is being built for every 14 new residents and where the cumulative housing shortage of the last three years now exceeds 3,000.

So much for investment bias.

There is no comprehensive assessment of where the non rental property losses are being made, and what financing or accounting arrangements are generating them. It could be in various forestry or lifestyle farming arrangements like hobby vineyards, but the bottom line is that this area should be attracting twice as much attention as rental property when in fact it is being studiously ignored.

If people want to do things that lose them money that is their own business. Just don't ask me to subsidise it.

Likewise family trusts. The income of trusts is taxed at 33 percent and that is the final tax: there is no wash-up as with the taxing of dividends. The TWG showed that the income of the trusts have increased nearly five fold in the last decade, whereas the incomes of the beneficiaries of those trusts have barely moved at all. This provides a very strong prima facie case that the growing income is being sheltered from the top income tax rates in the comfort of a 33 percent trust tax rate. The estimate is that this cost the government $300 million in 2007: again twice the amount that was lost through claims against rental property losses

I recall Alex Sundakov once saying that rugby is ideally suited to the New Zealand psyche. It needs enormously complex regulation in order for the game to be played. The rules are so complex that nobody really understands them, and certainly there are major inconsistencies in how they are interpreted and applied. Once the rules are set, the main aim of the participants is to devise ways to get around them to gain an advantage over their rivals. When this becomes endemic, the rules are changed. And the process starts over again. At some point somebody needs to say "now look Canterbury…." but nobody does.

And so with tax. Unless we can get past the form and focus on the substance, we are only rewarding bad behaviour and encouraging its next manifestation.

IRD is starting to challenge some of the more blatantly artificial financing arrangements that lead to tax avoidance, and at long last starting to get some support. But at the end of the day the law must look through the form of any legal and accounting arrangement and address its substance. If the principal purpose of the arrangement is to avoid tax, the surplus should be taxable income.

Until we get to that, all of the debate on rates of tax and alignment of the tax rates on different tax vehicles is largely futile.

Which brings me to where I want to end this discussion of the 2010 Budget. If we accept that it is a second order influence on the economic direction of the country, and that it is really not at core going to be – correctly – an exercise in slash and burn, and that if we are looking seriously at the government as an allocator of economic resources we need to cast the net wider than central government expenditure allocations, then this Budget is really, at its heart, going to be about the redistribution of income.

It is who is going to win, and who is going to pay.

We have seen quite a bit of talk about tax rates: is the company or the top personal income tax rate too high? What is the marginal rate of tax on working families? Do tax rates deliver the right economic incentives?

In my book, this is all a ruse: it masks a fundamental intention to reverse the redistributive agenda of the last nine years. It is not quite a revolt of the rich against the poor, which I seem to recall was a Galbraithian expression. But it is potentially substantial.

Let me start with the talk about tax rates. The real focus should be on tax levels.

Nominally the company tax rate is 33 percent. There are just two allowances that reduce the company tax take by 5 percent. These are the depreciation loading on new assets and the thin capitalisation rules. (Thin capitalisation is when a parent company – typically foreign – structures what would normally be equity as a loan, and claims interest as a cost thus reducing tax payable in New Zealand). Just these two devices cost taxpayers half a billion dollars a year. We don't know what other imaginative arrangements lower the effective rate of company tax, but before we lower the rate of company tax we need to do some solid housekeeping to ensure that any rate is substantial, not nominal.

Second, we hear that working families face extremely high effective marginal tax rates. But we also hear – from Treasury and the Tax Working Group, that most low and middle income families pay no income tax. If the level of tax is zero, the marginal rate is irrelevant!

The top personal tax rate is supposed to be 38 percent, but with trusts and LAQCs and PIEs, the actual level of tax is nowhere near that: it isn't even 33 percent when the billions of dollars of losses are deducted from the base on which the tax is paid!

Redistribution is typically shielded under the beneficence of incentives.

We must increase GST to improve incentives to save? Can you run that past me again? Every dollar every New Zealander has saved in their entire lives before due date is just reduced in value by 2.5 percent! It all buys that much less. The incentive? To have future savings taxes at a lower rate. But what sort of incentive is that? It assumes that all demotivating impacts on past efforts to save are immediately forgotten: a 2010s version of the old 60's stoner saying that today is the first day of the rest of my life. But any saving institution already offers a PIE savings vehicle: taxed at 33 percent and therefore there is no new incentive to save.

Reducing the effective marginal tax rate on working families will improve their incentive to save. To coin a phrase from out nation's CEO: bollocks. Most workers do not have options on how many hours they work. They may well feel that working for families fairly rewards honest toil: after all, the net effect is that most don't pay any income tax anyway. We simply do not know, and have not tested, potential responses. My view – based on my reading of behavioural economics - is that the most likely incentive impact is zero. People do today what they did yesterday and the money in the hand is what they build their lives around. This ruse is to cut working for families by stealth: another bete noir of the libertarians.

So to the emancipating impact on giving the better off more. I hate the use of the term the "rich". Be clear: the rich don't pay taxes anyway. That is why they are rich. It is the top quintile that will be the beneficiaries of reducing the top income tax rate. There may be a case for easing that burden, but make it on the merits: incentives is a hollow justification. These income groups can, if they so choose, use family trusts and LAQCs and the like now, so I can't see why there is an incentive – as opposed to an equity – justification for lowering their taxes.

This will not be a 1991 Mother of all Budget. It will be full of rhetoric and hubris. Most Budgets are. The key – sorry – is to get beyond the Budget and to focus on the substantial equity, efficiency and economic performance challenges that the country faces. That is all after the reclamation of the previous share of national income that the middle and upper middle classes used to control. It is about wealth, not equity, not efficiency, not about incentives and least of all about the performance of the economy.

Peter Harris
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