Submission

By

BusinessNZ

to the

Finance and Expenditure Committee

on the

Budget Policy Statement 2006

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BUDGET POLICY STATEMENT 2006
SUBMISSION BY BUSINESS NEW ZEALAND[1]

1.0 Introduction

1.1 Business New Zealand is pleased to have the opportunity to comment on the Budget Policy Statement (BPS) 2006. While welcoming the Government's stated commitment to careful fiscal management as outlined in the BPS *("We will need to manage the fiscal position tightly to avoid exacerbating the pressures in the economy")*, Business New Zealand are concerned that spending and the tax burden both remain too high (and are projected to rise further over the forecast period). Moreover, we consider that more should be done to facilitate higher rates of sustainable economic growth. In particular, Business New Zealand submits that all policies should have a growth promoting focus, with all proposals being rigorously assessed on their positive or negative impacts on productivity and economic growth.

1.2 This submission is in two sections. Section one provides an economic backdrop to the BPS, including the importance of lifting productivity. Section 2 comments specifically on the content of the BPS.

Recommendations

Business New Zealand **recommends** that:

all policies should have a growth promoting focus, with all proposals being rigorously assessed on their positive or negative impacts on productivity and economic growth.

Business New Zealand **recommends** that:

the recommended policy outcomes advocated in Business New Zealand's Brief to Government (December 2005 - attached) be implemented, to the end of achieving higher productivity and greater economic growth.

[1] Background information on Business New Zealand is attached as Appendix 1.

2.0 <u>Section 1:</u> <u>Economic backdrop to the Budget Policy Statement (BPS) 2006</u>

2.1 Over the past six years real GDP growth has averaged around 3.6% per annum. This has been associated with improved real incomes through strong employment growth and low levels of unemployment (by historical standards). However, economic growth is now slowing and is forecast to decline to 1.7% and 2.5% for 2006/07 and 2007/08 respectively.

2.2 Further significant declines in business confidence, interest rate rises that have underpinned a strong (and over-valued) NZ dollar and potential intervention with monetary policy are painting an increasingly nervous picture for the economy. On the other hand, consumer spending is still high, given buoyant labour market conditions, particularly employment and wages/salaries growth. This emphasises the 'split' nature of the economy at the moment, with exporters under intense pressure through an overvalued dollar, while consumers continue to spend despite the recent decline in consumer confidence.

2.3 The Reserve Bank and the Government face the challenge of the trend of rising consumer debt driven by increased consumption. Interest rate rises, to date, appear to have had little impact on domestic consumption, with households continuing to have confidence about future prospects. At least four factors are underpinning current consumer spending. First, unemployment is at its lowest level since the Household Labour Force Survey came into being two decades ago. Second, rising real wages, in spite of higher taxation (bracket creep), are providing for greater disposable income. Third, competitive pressures within the finance industry are forcing lenders to increasingly focus on the lower (more risky end) of the market. And fourth, the bulk of mortgages are on 1-3 year fixed rates which means that increases in interest rates have little or no effect on households until their fixed rate comes up for review.

2.4 The issue for the Reserve Bank is that monetary policy 'needs some mates', however the required 'mates" are likely to be largely unpalatable to some of the Government's key support base. While Government is a strong partner in the drive for productivity improvements, there is less support for further labour market reform, greater competition in the provision of government monopoly services (e.g. ACC and local government), the need to target central and local government spending and a reversal of increasing state regulation.

2.5 In this environment a policy response is required to help businesses remain internationally competitive and provide the growth to maintain good employment levels and living standards.

2.6 With the rapid mobility of both capital and labour, there is a need for enterprise and Government to focus on ongoing productivity improvements. Competition is vital to spur businesses to achieve productivity gains, and Government must aim for a regulatory and tax regime consistent with international best practice.

2.7 Business New Zealand has supported Government policies that we consider would improve productivity, such as those on skills development (e.g. industry training initiatives), talent (e.g. improvements to immigration policy), and global connectedness (e.g. trade negotiations). We have also welcomed the Government undertaking policy work on small business issues, infrastructure development, and improving workplace productivity.[2]

2.8 In the international context, productivity growth is fundamental to retaining our international competitiveness. In short, if resources can be better utilised offshore and used more efficiently, then they will be. This obviously has impacts on output in New Zealand and ultimately our overall standard of living.

2.9 It is perhaps not surprising that those countries with higher productivity growth, in general, have higher growth rates and lower levels of unemployment (e.g. Ireland, Korea and the United States). On the other hand, those developed countries with relatively low productivity growth (e.g. Germany, France and Italy) have relatively low output growth and significantly higher unemployment levels.[3]

2.10 New Zealand's labour productivity growth has been consistently less than the OECD from the late 1970s. In fact New Zealand's labour productivity growth has only grown at around 70% of the OECD average over the period 1978 - 2006.

[2] Business launched its own "Productivity Perspectives" publication in December 2005 – a study designed to show the importance of increasing productivity with recommended action points to take us forward toward higher productivity growth and hence an improved standard of living for New Zealanders.

[3] For detailed information on economic comparisons between OECD countries refer to the "OECD Economic Outlook", No.75 December 2004

2.11 Perhaps of more significance is New Zealand's productivity record compared to our major trading partners. New Zealand's average annual productivity growth rate over the period 1998 – 2006 (projected) is only 1.6%, compared to 1.9% for Australia, 2.1% for the United Kingdom, 2.6% for the United States, 3.4% for Korea, and 3.6% for Ireland.

2.12 The OECD "Economic Survey of New Zealand" (2005) was unequivocal about the need to lift productivity:

> **"The primary challenge is to raise productivity growth further, as this will become the more critical driver of growth in the future. Of course, no government can make productivity growth happen; the best it can do is to identify and remove obstacles to growth and provide an economic environment in which firms and individuals can flourish. Despite the extensive reforms already undertaken, some areas remain where further policy improvements could be made, including in the areas of product market competition, business taxation, infrastructure provision, labour markets, innovation and human capital formation" (OECD Economic Surveys New Zealand (2005))**

2.13 It is important to be clear that there is no one silver bullet towards achieving significant productivity improvements. Moreover it is not solely the role of government, business or labour organizations to improve New Zealand's productivity record. Some issues are best addressed by business, some issues are best addressed by government, and some issues must be pursued by individual employees (or collectively in some cases where this makes economic sense).

2.14 The following issues[4] (not an exhaustive list) are fundamental towards improving productivity:

- Competition (productivity grows best in competitive environments);
- Secure and transparent property rights (without these, incentives to invest are limited);
- Regulatory policy (should be free from unintended costs and regulatory uncertainties);
- Tax and expenditure policy (expenditure and tax at levels that do not discourage investment);

[4] For a full description of these issues and importance of them towards improving productivity and economic growth – refer to *"Productivity Perspectives"* (Business NZ, December 2005).

- Infrastructure (ongoing investment in infrastructure assets that are important for travel, communication and doing business);
- Flexible and responsive labour markets (making it possible for resources to shift quickly to more productive uses as these occur);
- Human capital and managerial capability (since productivity improvement is now largely predicated on actions by knowledge workers and at governance and managerial level);
- Global “connectedness” through trade and immigration (since productivity improvements ensue from specialisation, and international trade maximises the benefits of specialisation on a larger scale); and
- Innovation (plays a key role in expanding output beyond the capacity of existing inputs).

3.0 <u>Section 2:</u> <u>Comments on the Budget Policy Statement 2006</u>

(a) Economic Outlook

3.1 The forecasts contained in the Half Year Economic and Fiscal Update (EFU) (December 2005) provide further evidence of a need for the Government to ensure that its policies in all areas have an explicit productivity and growth promoting focus.

3.2 Economic growth is now slowing from an average of around 3.6% for the last six years to a forecast 1.7% for 2006/07 and 2.5% in 2007/08. These results have significant implications in terms of employment growth, unemployment rates and hence the level of government revenue and expenditure. As forecast in the EFU, the growth in the company tax take, which has grown rapidly over recent years on the back of strong company growth and profits, will slow, along with the growth in other tax collected.

(b) Fiscal Outlook

3.3 The Government states that it has been a ‘prudent’ fiscal manager (despite core Crown expenses plus NZSF contributions having increased strongly since 1999/2000 and projections of further substantial expenditure increases over the forecast period). As mentioned above, the strongly performing economy has helped the Government in this respect by providing it with large increases in revenue to cover its substantial spending increases. While its restraint in responding to calls to increase spending by even greater amounts has been admirable, the Government has still overseen a large increase in spending, at least some of which is of dubious or unproven value.

3.4 Business New Zealand is concerned about a growing inconsistency between the Government’s stated goals for economic growth and the policies being pursued in a number of other critical areas that will, if anything, reduce growth rates for productivity and ultimately GDP. Particular concerns surrounds ever increasing government expenditures that are of questionable quality.

3.5 The BPS notes that Budget 2006 will place a high priority on new spending to cover interest free student loans, extensions to the *Working for Families* package, and increased New Zealand Superannuation payments.

3.6 Business New Zealand is concerned about the economic implications of these policies on three grounds. First, they will provide an untimely boost to consumer spending that will put added pressure on inflation and the current account. Second, the increased spending is largely redistributive spending which will do nothing to raise productivity and economic growth. Third, it will constrain Government in terms of making other choices with such money (e.g. tax cuts, reducing debt, or other spending initiatives).

3.7 In particular, Business News Zealand considers the following examples to be areas of imprudent expenditure decision-making by Government:

1. **Increased spending on *Working for Families* -** This effectively makes three-quarters of working families recipients of social welfare. Redistribution policy by Government increases administration and bureaucracy. Tax cuts would provide greater incentives for all families and individuals to work harder and retain earnings for investment or spend as they see fit.

2. **Interest free student loans -** This in effect provides subsidies for students to spend beyond their means without incentives to retire such debts as quickly as possible when they graduate. This will encourage increased debt by students knowing that they will not be subject to the normal pressures of servicing that debt that all other individuals face.

3. **Expanding local government rates rebates to low-income earners, irrespective of assets held -** This is inequitable and will reduce the incentives on local government to seriously examine their current expenditure and determine whether it is all necessary for the public good.

4. **Increasing Superannuation payments –** This decision is not targeted at those in greatest need, given that superannuation is not subject to income or assets testing.

3.8 It is undesirable to allow spending to increase to the level forecast for the medium term in light of the relatively weak economic outlook. Moreover, current levels of government expenditure are increasing inflationary pressures and the current account deficit.

3.9 Business New Zealand welcomes the Government's support for NZ First and United Future's proposal to review business taxation, given its importance to productivity and international competitiveness.

3.10 With the significant lowering in forecast growth over the next 2-3 years, it is crucial that the Government moves rapidly on its tax reduction proposals to shore up weakening business confidence in the near term. Given that Government has introduced a number of new policies for implementation on 1 April 2007 which will impact adversely on business competitiveness (e.g. 4 weeks annual leave and the introduction of the Kiwi saver scheme) it is important that this correlates with tax relief for the business community. In this respect, moves to address the headline rates for company and personal taxation is urgent before addressing some of the more difficult and long-standing anomalies associated with the tax system which will take time to address in a comprehensive manner.

(c) Fiscal and Monetary Policy Risks

3.11 Business New Zealand agrees with the comment in the BPS that the current macroeconomic position requires careful fiscal management when the economy is operating close to capacity:

> **"The current strength of the New Zealand economy, which is operating at close to capacity on the back of sustained domestic demand growth, has placed considerable pressure on inflation and on the current account of the balance of payments. These economic developments are an important factor in planning for Budget 2006 and beyond. We will need to manage the fiscal position tightly to avoid exacerbating the pressures in the economy."** (BPS 2006)

3.12 However, despite recognising this risk, the Government appears committed to increase spending substantially over the forecast period.[5]

3.13 As outlined earlier in Section 1, monetary policy 'needs mates' in order to take some of the pressure off interest rates as the sole instrument for fighting inflationary pressures. The Government's own expenditure and regulatory policies need to be in tune with the needs of the productive export sector in particular.

[5] According to the Half Year Economic and Fiscal Update, total Crown Expenses are projected to increase from just under $61 billion currently to over $77 billion by 2010 – a 26% increase over the period or around 5% per annum.

3.14 Adopting a spending target of 30% of GDP and ensuring that any new spending proposals are tested on the basis of quality and consistency with growth goals would help address concerns about uncertainty over future revenue levels and mitigate tensions between fiscal and monetary policy, while enabling a reduction in tax rates.

Business New Zealand **recommends** that:

all policies should have a growth promoting focus, with all proposals being rigorously assessed on their positive or negative impacts on productivity and economic growth.

Business New Zealand **recommends** that:

the recommended policy outcomes advocated in Business New Zealand's Brief to Government (December 2005 - attached) be implemented to the end of achieving higher productivity and greater economic growth.

APPENDIX 1

BACKGROUND INFORMATION ON BUSINESS NEW ZEALAND

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 57 member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). An increase in GDP of at least 4% per capita per year is required to achieve this goal in the medium term.

The health of the economy also determines the ability of a nation to deliver on the social and environmental outcomes desired by all. First class social services and a clean and healthy environment are possible only in prosperous, first world economies.