

Submission

by



to the

Ministry of Economic Development (MED)

on the

Expenditure Review of Business Assistance Programmes

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EXPENDITURE REVIEW OF BUSINESS ASSISTANCE PROGRAMMES

SUBMISSION BY BUSINESS NEW ZEALAND¹

1.0 Introduction

- 1.1 Business New Zealand welcomes the opportunity to comment on the Expenditure Review of Business Assistance Programmes (“the review”). Business New Zealand supports the regular review of all government expenditure to ensure that the objective of the expenditure is still relevant, and also that the taxpayer is getting value for money.
- 1.2 Business New Zealand has already met with the review team and the purpose of this submission is to clarify some of the issues raised at our earlier meeting. It is not the intention of this submission to comment on specific programmes as the relevance or otherwise of particular programmes will depend on a number of factors. Rather more importantly in Business New Zealand’s view, this submission will comment on the rationale for funding business assistance programmes and the types of questions which need to be answered as part of a thorough review process.

2.0 Summary of Key Points

- The fundamental issue is not whether spending on business assistance programmes can be funded on some sort of sustainable basis but whether spending, properly assessed, constitutes a worthwhile use of resources from an overall community perspective.
- It is important to determine conceptually what might be potential areas of “market failure” in business which might justify government involvement via business assistance programmes. Without analysing potential areas of market failure it is impossible to determine whether market failure is present, the extent of market failure, and what might be most appropriate to address such failures.
- “Market failure” in terms of business transactions potentially justifying government (taxpayer) involvement in business assistance programmes will tend to focus on the issues of “public goods” and “information failures”.

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

- Trade and export promotion activities meet the principles of a public good in that it is impossible to exclude people from their benefits (similar to the classic public good - national defence) and use by one person doesn't necessarily detract from use by another.
- Conversely, many domestic assistance measures generally, but not always, tend to provide larger private benefits to the particular firm obtaining the assistance rather than having the wider spillover effects associated with public goods. This is not to say that there are not commensurate benefits to the public associated with domestic assistance measures, but they are usually more closely targeted and captured by the firms obtaining such assistance.
- Domestic business assistance programmes should be targeted at providing information which does not discriminate between particular businesses or business form (i.e size or location of business). In this respect they should have widespread benefits and be as non-distortionary as possible.
- Assistance measures should be subject to consultation and consensus (politically where possible) to ensure the rationale for such assistance measures is widely supported throughout the community, not just by those seeking assistance. Greater acceptability by the community should ensure that any business assistance is well thought through and will stand the test of time.
- Government business assistance programmes should focus on public goods that only the government can fund and/or deliver. It is crucial that government-funded business assistance measures do not crowd out private sector involvement or investment in providing information, advice and services as demanded by the market. Domestic business services are essentially private good activities that should be provided privately (which is largely the case) and funded in the normal way through prices paid by users.
- Government continues to compete with the private sector by creating resources within Government Departments to fill what it perceives as "gaps" rather than working with private sector organisations to encourage the provision of desired services. There needs to be greater discipline introduced into the provision of new government funded services to ensure that (a) the services are not already being delivered through the private sector, and (b) they are provided in a flexible manner, preferably through contracting with private sector agencies to ensure efficient delivery relevant to the needs of the target market.

- In total, expenditure on business assistance programmes outlined in the review is around \$200 million annually, spread relatively thinly amongst a wide range of programmes. While recognising the need for targeted assistance in some cases, Business NZ would be concerned that a proliferation of business assistance programmes with little funding committed to each one might well result in greater compliance and monitoring costs than the amount spent on each programme. In this respect, a smaller number of programmes with greater funding commitments might provide for some economies of scale.
- An area which may possibly be explored further is whether there may be potential for a further fund (either part of current business assistance expenditure or new expenditure) which could be better provided through a “contestable fund” basis delivering greater flexibility for both administrators and the wider NZ public. Such a fund might be modelled on the current Public Good Science Fund, administered by the Foundation for Science, Research and Technology.

3.0 General Discussion

- 3.1 In order for there to be justification for government involvement, via targeted expenditures, there must be a clear case of market failure, and the problem of market failure must be significant. It is not appropriate to simply argue whether or not current expenditure is sustainable from a budgetary perspective or whether more or less funding should be appropriated. Expenditure on business assistance programmes, like all other areas of government expenditure, is competing with tax cuts and/or reduced government debt.
- 3.2 Business New Zealand considers that some of the key questions which need to be asked in respect to taxpayer funded business assistance programmes include, but are not limited to:
- (a) Is there a fundamental problem (*e.g. market failure*) which requires government intervention/funding in this market?
 - (b) If there is a problem, is the problem significant?
 - (c) What are the costs and benefits of government expenditure?
 - (d) What potential options are there to improve business outcomes which don't impose significant costs (*e.g. improving information flows*)?

- 3.3 To an extent, all expenditure (just like taxes) is distortionary and impacts on economic behaviour. Nevertheless, there are a number of principles that are generally accepted as important elements of good tax and expenditure systems.
- (1) *Economic efficiency*: the tax and expenditure system should not unduly interfere with the efficient allocation of resources by favouring one particular sector over another.
 - (2) *Administrative simplicity*: the tax and expenditure system should be relatively easy to administer and comply with.
 - (3) *Flexibility*: the tax and expenditure system should be able to respond to changed economic circumstances.

4.0 Market Failure – a case for government involvement in business assistance programmes?

- 4.1 There are a number of reasons why government may decide to intervene in markets on economic grounds. The main reason often quoted is in the case of market failure, whereby in certain circumstances, market mechanisms do not necessarily result in the optimal allocation of resources.
- 4.2 Generally markets work best when left undisturbed by government interventions (e.g. regulation/taxes/expenditures). However, in certain circumstances markets do not perform their functions efficiently.
- 4.3 It is important to determine conceptually what might be potential areas of “market failure” in business which might justify government involvement via business assistance programmes. Without analysing potential areas of market failure it is impossible to determine whether market failure is present, the extent of market failure, and what might be most appropriate to minimise it.

4.4 The following list provides a brief outline of the predominant “market failures” often quoted in economic literature which may have relevance to analysing government involvement through business assistance programmes. It is not exhaustive as often the mere existence of unemployment is sometimes considered to be an example of “market failure”. Moreover, some so-called “market failures” are highly debatable such as “merit goods” which can be challenged on economic grounds. Other examples of market failure such as the case of monopolies are not considered relevant to the specific issue of government business assistance programmes.²

4.5 Three areas of possible relevance to so-called market failure in respect to business are the following:

Externalities;
Public Goods; and
Information failures

Externalities

4.6 Externalities (or spillovers) lead to a divergence between private and social (public) costs or benefits, where private refers to the costs and benefits to those participating in the market transactions and social refers to the costs and benefits to all members of society.

4.7 Wherever there are such externalities, resource allocation provided by the market may not be efficient. If individuals and firms do not bear the full cost of the negative externalities they generate, they will engage in an excessive amount of such activities. Conversely, since individuals and firms do not reap the full benefits of activities generating positive externalities, they will engage in less than a socially optimal amount of these activities.

² Merit goods are goods or services which some members of society do not consume enough of, according to the judgement of a select group. The policy implication is that people should be encouraged (or forced) for their own good to consume more than they themselves would freely choose to consume. Just as there are so-called merit goods, there are also so-called merit bads with proponents advocating less consumption through direct regulation and/or targeted taxes. The merit good/bad argument for intervention is extremely paternalistic.

- 4.8 Government can respond to externalities in several ways. In some cases (mainly involving negative externalities) they can attempt to regulate or tax the activity in question. Alternatively, the government can encourage activities where positive externalities are created, for example, through subsidies or cash payments or other support mechanisms to people participating in such activities. Often these are “output” based to encourage increased production or supply of these positive externalities.
- 4.9 Notwithstanding the above, virtually every activity has spillover consequences which do not necessarily justify government involvement to address such externalities. For government involvement to be justified in any particular case, it needs to be shown that such externalities are particularly large, and that government (taxpayer) support is warranted.

Public Goods

- 4.10 Perhaps the strongest argument of market failure can be found in the case of “public goods”. Public goods are effectively those activities which people cannot be excluded from and the benefits to one person do not reduce the benefits to another.
- 4.11 The issue with public goods is that market participants will under-invest in such activities because they cannot appropriate most of the benefits associated with such investments. In this respect, from society’s point of view, firms will under-invest in such activities to the detriment of the nation as a whole. To overcome this, government will often step in to either produce the goods themselves or contract the private sector to provide such goods for a fee.
- 4.12 A number of cases of public goods can be cited but probably the most talked about example is the case of national defence where the Government seeks to protect its citizens from acts of war or terrorism. All will benefit from the reduced risk of an act of war or terrorism and none can be excluded from that benefit if they refuse to pay.
- 4.13 Clearly, trade and export promotion activities generally meet the principles of a public good in that it is often impossible to exclude people from their benefits and use by one person doesn’t necessarily detract from use by another.

- 4.14 The Government recognises that New Zealand as a whole benefits from international trade (and cannot be excluded from its benefits) and as a result dedicates significant resources to trade negotiations and export promotion. While individual businesses certainly receive benefits from these activities, the Government undertakes them to benefit the country as a whole.

Information Failures

- 4.15 In some markets there can be cases whereby one participant in the market for exchange knows more about the quality of the product than the other participant. This is called 'asymmetric information'. It is often considered relevant in the case of health care where a doctor may be able to disguise the quality of their patient treatment given their superior knowledge.
- 4.16 It should be noted that 'asymmetric information' is not only relevant in the field of health care but also in a host of other 'markets' for goods and services, yet generally government has seen fit not to intervene in these markets.
- 4.17 Given the above considerations, the case of "market failure" in terms of business transactions which would potentially justify government business assistance programmes would tend to focus on the issue of "public goods" and "information failures".
- 4.18 This would tend to support assistance being particularly targeted at offshore markets (trade negotiations/trade missions/trade postings etc), where the benefits are likely to be captured by a wide range of firms (i.e. the benefits dispersed amongst the wider community). At a domestic level assistance should be focused on the area of information provided it does not crowd-out private sector participation as outlined in the summary of key points.
- 4.19 Some domestic assistance measures tend to provide larger private benefits to the particular firm obtaining the assistance rather than having the wider spillover effects associated with public goods. This is not to say there are not commensurate benefits to the public associated with domestic assistance measures, but they tend to be more closely targeted and captured by the firms obtaining such assistance. There are exceptions, of course, for example, the provision of generic information.

- 4.20 In terms of funding policies, the Government clearly needs to differentiate between those areas of expenditure which are largely captured by individual businesses (private benefits) and those activities which are of a public good nature, the benefits of which are dispersed amongst the whole community and which the private sector would be unwilling or unable to invest in.

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 60 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.