

Perspective

Not just a case of a passing 'Recessionary Flu': The Budget must also address an underlying lack of economic fitness

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29 April 2009

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Executive Summary

This is the fourth and last New Zealand Institute article in a series on the financial crisis and global recession. In this paper we look at the impact of the recession on the Government's fiscal position, and propose principles that should drive the Government's fiscal strategy in its 2009 Budget.

The health of the government's books will deteriorate rapidly during the recession if current policies are continued. This is not expected to be a temporary episode that the books will recover from when the recession begins to lift, with Treasury predicting that large deficits and large and growing levels of debt will persist over the medium- and long- term if New Zealand continues on a current policy track. The public accounts have caught a case of recessionary flu, but that is not the patient's only ailment: preventative medicine – perhaps difficult to take – is required to stop the government's fiscal position and the New Zealand economy from degenerating over the long run.

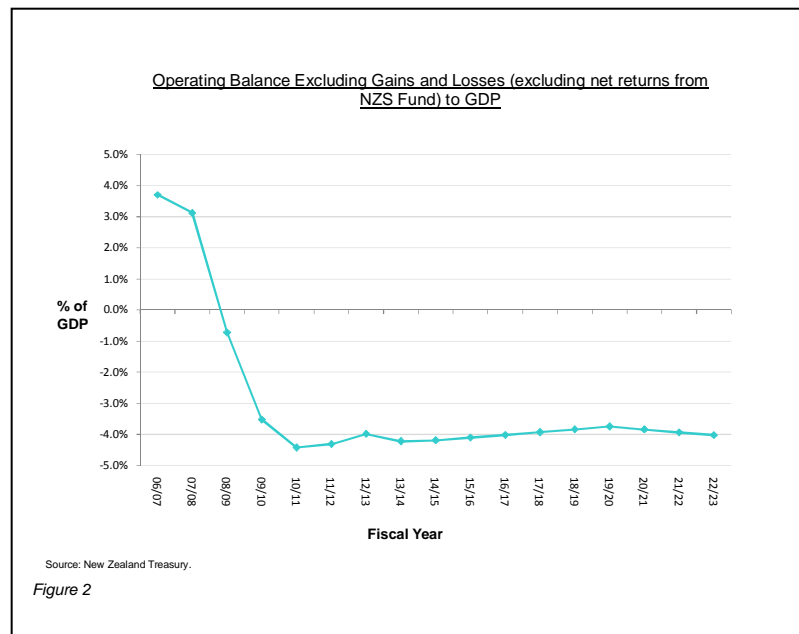
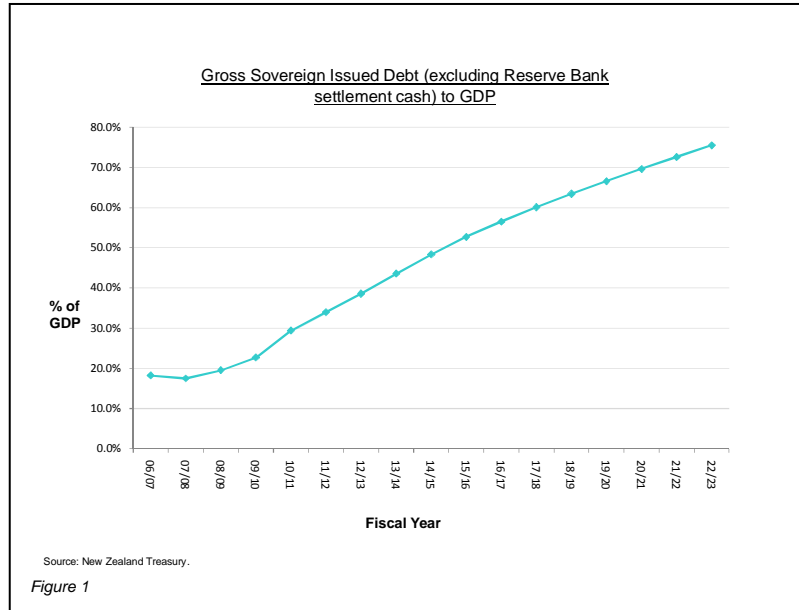
The Government's first budget, to be released on the 28th of May, will indicate whether or not it is prepared to act with leadership and vision to set a direction for New Zealand's long term growth, and make the hard decisions that will be needed to avert the decline in the fiscal position that Treasury predicts would otherwise occur.

Key Findings

- Treasury forecasts show that if current policies are continued the government's books will deteriorate markedly and rapidly, and remain in bad shape even when the economy is in recovery. Persistent deficits and high debt levels would stunt growth, reduce the government's ability to invest in critical social and economic needs, and increase New Zealand's vulnerability to future economic shocks.
- Key, interrelated causes of the forecast deterioration are: (1) GDP growth remaining anemic even after the recession; and (2) a decline in tax revenues as a percentage of GDP, partly because of proposed permanent income tax cuts.
- Achieving a step change in New Zealand's economic growth rate is essential to improve the fiscal position. Unless New Zealand radically improves its growth prospects, basic amenities such as quality free education, health services, environmental protection measures and security in retirement may be at risk.
- The time to move to create growth is now: New Zealand has a fleeting opportunity – about two years – to use the recession as a way to "re-launch" itself in the world economy as a magnet for business and talent.
- Both tax and spending measures should also be on the table to control the deficit, to make room for growth-boosting policies, and to maintain and strengthen support for at-risk individuals through the recession to avoid creating a future social deficit.
- The next two proposed tranches of income tax cuts should be cancelled on the grounds that they would contribute to the structural deficit and likely do very little for growth. Some of the savings could be redirected to temporary measures to ensure that the most at-risk individuals (including unemployed youth) are supported to engage in productive work or training through the recession as a way to prevent future costly negative social outcomes.
- Other spending areas that have contributed to the increase in government spending between 2003 and 2008 of 1.6% of GDP should be carefully reviewed with the aim of achieving their objectives more effectively at lower cost going forward. These include: the Working for Families tax credit system, and health expenditure.
- The tax mix should also be on the table as part of a long-term rebalancing exercise. Creating new sources of revenue (such as from taxes on property) will create room to finance the cost arising from future demographic pressures. Another objective is to more lightly tax productive investment and savings (for example through gradual reductions in company tax and taxes on savings overtime), while making residential property investment less attractive. This will help to address the structural imbalances in the New Zealand economy.

1. Treasury predicts that the fiscal position will deteriorate rapidly and markedly

In 2008, the New Zealand government ran a *surplus* of 3.1% of GDP, but Treasury projects a *deficit* of 4.1% of GDP (\$8.6 billion) in 2013, and deficits of about 4% of GDP continuing through 2023 if the government continues down its planned policy track (see Figure 1).¹ In 2008 the government had gross debt of 17.5% of GDP, but by 2013, Treasury forecasts that gross public debt could reach 38.6% of GDP (\$82.7 billion) in 2013, swelling to 76% of GDP in 2023 (see Figure 2).² By 2013, debt service payments alone (interest on the public debt) could cost \$4.6 billion, more than the government is expected to spend on Law and Order that year.³ The forecasts cited above are from Treasury's December 2008 Economic and Fiscal Forecast ("December Update") "downside" scenario. But, given subsequent global economic developments and more recently published data, these "downside" estimates (the most pessimistic forecasts included in the December Update) may in fact prove rosy. For example, the March 2009 Treasury Economic Indicators report showed that the New Zealand economy contracted by 0.9% in the last quarter of 2008, lower than even the downside scenario in the December Update.⁴ The report stated that "due to deteriorating conditions



in the international outlook, economic growth is now expected to be lower than Treasury's downside scenario in the December Update in both 2009 and 2010....[the] past month has seen the release of data that confirm an intensifying contraction in economic activity, greater than expected in the December Update downside scenario."⁵ Recent OECD and IMF reports reinforce the bleak growth

¹ *New Zealand Treasury*, 'Economic and Fiscal Forecasts December 2008', December 18 2008 (downside scenario).
² *New Zealand Treasury*, 'Economic and Fiscal Forecasts December 2008', December 18 2008 (downside scenario); *John Whitehead*, '2009 Job Summit Presentation', presented at the 2009 Job summit, Auckland, February 27 2009. Gross debt is a summary of the government's debt exposure to third parties, and the OECD states that "Gross debt is often considered to be more relevant than net debt for gauging the impact of public borrowing on financial markets"; *OECD*, 'Economic Outlook: Interim Report', March 2009, p118. In recent years government policy has been to maintain gross debt at around 20 percent of GDP: *Felicity C Barker, Robert A Buckle and Robert W St Clair*, 'Roles of Fiscal Policy in New Zealand' *New Zealand Treasury working paper 08/02*, *New Zealand Treasury*, June 20, 2008. By contrast, the ratio of net debt to GDP summarizes the New Zealand government's ability to cope with future shocks given the stock of financial assets that the government holds. Net debt to GDP is also expected to deteriorate over the medium term, rising from 0% of GDP in 2008 to 21% of GDP (\$54.2 billion) in 2013.
³ *John Whitehead*, '2009 Job Summit Presentation', presented at the 2009 Job summit, Auckland, February 27 2009.
⁴ *New Zealand Treasury*, 'Monthly Economic Indicators: March 2008', 6 April 2009, p1.
⁵ *New Zealand Treasury*, 'Monthly Economic Indicators: March 2008', 6 April 2009, pp 1-2.

outlook for New Zealand over the next two years.⁶ This lower growth can be expected to flow through to lower tax revenues and an even more serious fiscal deterioration than that projected in the December Update. Indeed, Finance Minister Bill English recently indicated that the “main forecast” to be released with the May 28 Budget will predict debt of 45% of GDP by 2013 if no policy changes are made: more than 6% of GDP worse than the level of debt predicted under the downside scenario in the December Update.

New Zealand’s public deficits and its accumulated stock of debt are expected to persist even when the economy is rebounding. Treasury’s “downside scenario” predicts GDP growth in 2011, yet deficits of around 4% of GDP are expected to continue through to at least 2023 (the last year of Treasury’s projection window).⁷ (See Figure 1.)

New Zealand’s projected public deficits are deeper and more persistent than those expected by some of our significant trading partners. For example, in estimates released last month the Australian government projected deficits of no more than 2.8% of GDP during the next five years, with a deficit for Fiscal Year 2011-2012 of 1.8% of GDP.⁸ While the UK is predicting deficits peaking at 5.3% of GDP in Fiscal Year 2009-2010, by FY2013-2014 the deficit is expected to fall to around 1.5% of GDP.⁹ By contrast, as noted above, the New Zealand Treasury is anticipating persistent deficits of about 4% of GDP from 2010 through to 2023.¹⁰

2. Large, persistent deficits, and high and growing debt levels would constrain New Zealand’s long-term economic growth and social progress

Over the long term, large persistent deficits, and high, growing levels of debt would likely be harmful:

- They are a drag on economic growth. Persistent deficits and high public debt levels can be expected to reduce national (government plus private) savings (mainstream economic theory and the best evidence does not strongly suggest that private domestic investors would increase their saving rates enough to make up entirely for large and persistent government dissaving).¹¹ A reduction in national savings can hurt the economy in the long run by: (1) making fewer funds available to invest in productive assets within New Zealand, hence decreasing the productivity of New Zealand workers; and (2) causing New Zealand to borrow more from other countries, hence reducing future national income because the income earned on investments made by foreign lenders is sent offshore, rather than remaining in New Zealand investors’ hands. (A combination of the two effects is the most likely scenario.) The drag on economic growth created by high public debt levels in turn makes it less likely that the economy will be able eventually to grow its way out of that debt.
- Continuous deficits and ever-increasing levels of public debt relative to GDP will lead to an ever-larger debt service burden on the government, likely restricting the government’s ability and willingness to invest in critical economic and social improvements. Finance costs alone are expected to consume \$4.6 billion of the government’s resources by 2013¹² under Treasury’s downside scenario, more than the government is expected to spend on Law and Order that year (for comparison). Further, the higher the debt level grows, the more concerned creditors are likely to be about the risk that the New Zealand government will default on that debt, leading those creditors to demand higher risk premiums on their return to lending (higher interest rates), further inflating debt servicing costs. The underlying debt itself must also eventually be paid, with future tax increases, spending cuts, or a combination of the two.

⁶ See *OECD*, ‘Economic Survey: New Zealand’, April 2009, forecasting for New Zealand a 2.8% GDP contraction and unemployment of 6.8% in 2009, .5% GDP growth and unemployment of 7.8% in 2010. See also *IMF*, ‘World Economic Outlook: Crisis and Recovery’ forecasting for New Zealand a 2% GDP contraction and unemployment of 6.5% in 2009, .5% GDP growth and unemployment of 7.5% in 2010.

⁷ *John Whitehead*, ‘2009 Job Summit Presentation’, presented at the 2009 Job summit, Auckland, February 27, 2009.

⁸ *Hon. Wayne Swan MP, Treasurer, and Hon Lindsay Tanner MP, Minister for Finance and Deregulation*, ‘Updated Economic and Fiscal Outlook’, February 2009.

⁹ *HM Treasury*, ‘Facing Global Challenges: Supporting People Through Difficult Times’, *Pre-Budget Report*, November 2008.

¹⁰ While it may be the case that the New Zealand Government books are more transparent and realistic than those of some other countries, as discussed at p6 below the composition of New Zealand’s fiscal stimulus package compared to other countries also indicates that New Zealand could expect a fiscal deterioration that is more persistent than that of some other countries.

¹¹ See, for example, D. Andrew Austin, ‘Running Deficits: Positives and Pitfalls,’ Congressional Research Service, January 2 2008.

¹² Growing from 1.4% of GDP in 2009 to 2.1% of GDP in 2013.

- A large debt burden and continuing large deficits would leave the government less able to respond to future economic shocks. Indeed, they may increase the risk that such shocks will occur by harming confidence in the economy: a large debt is a credit rating risk, and “ongoing deficits may severely and adversely affect expectations and confidence, which in turn can generate a self-reinforcing cycle among the underlying fiscal deficit, financial markets, and the real economy.”¹³ Indeed, in January ratings agency Standard & Poor’s warned that New Zealand’s foreign currency rating is at risk of a downgrade if current and predicted fiscal imbalances are not addressed, and “market confidence may wane until policymakers articulate a plan for medium-term fiscal consolidation.”¹⁴ Moody’s Investors Service and Fitch Ratings have both also noted New Zealand’s large predicted fiscal imbalances.¹⁵ The IMF too has expressed “concerns about the expected deterioration of [New Zealand’s] fiscal position,” noting that, “New Zealand’s high external debt constrains fiscal policy’s room for maneuver, given the risk of undermining investor confidence....[p]reserving investor confidence will require a credible strategy to reduce the deficit over the medium term.”¹⁶

Persistent deficits are different from temporary deficits

This section summarises the impact of persistent deficits over the long term. By contrast, deficits may be beneficial if they are temporary and are used to stimulate the economy during a recession.

However, as noted above, Treasury predicts that deficits will continue through at least 2023 (the end of Treasury’s projection window), even when the economy is expected to be recovering from the current recession. As Treasury concludes, these expected continuing deficits “illustrate not simply a shock but a structural deficit.” A continuing structural deficit of this nature cannot be justified on the basis of being a temporary and necessary boost to aggregate demand during a recession.

- Large and persistent deficits in the medium-term will erode and eliminate the fiscal buffer that New Zealand will need in order to pay for future long-term health and superannuation costs related to the ageing population.

The current policy track – resulting in large, persistent deficits and a large and growing public debt over the long term – is clearly one in which New Zealand faces an unappealing long-term economic outlook. While there is no optimal size of government deficits or debt (with the chosen levels involving judgment calls about current priorities and the likely state of the economy and public needs in the future), the levels of debt and deficits predicted are well outside the range that the current and recent governments have considered acceptable. In recent years government policy has been to maintain gross debt at around 20 percent of GDP.¹⁷ The Government has already stated that the predicted debt levels (reaching more than 70% of GDP in 2023 under Treasury’s downside scenario) are “outside the range that the Government considers prudent,” and has promised to “take steps to ensure that debt and net worth do not deteriorate to the extent projected.”¹⁸ The policy changes that the Government makes in its attempt to avoid fiscal deterioration should be driven by a clear understanding of why an undesirable fiscal position would emerge from the current policy track.

3. Diagnosing the cause of the predicted long-term fiscal sickness

There are two key drivers of the predicted emergence of persistent, large deficits and large, growing debt levels over the medium term.

First, given the depth of the economic contraction now forecast, it is clear that even with the stimulus measures taken by government over the short term, GDP will not recover to the levels that were

¹³ Robert E. Rubin, Peter R. Orszag, and Allen Sinai, ‘Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray’, January 4, 2004.

¹⁴ Reuters, “New Zealand Faces Risk of Credit Rating Cuts”, March 3, 2009.

¹⁵ Reuters, “New Zealand Faces Risk of Credit Rating Cuts”, March 3, 2009.

¹⁶ IMF, ‘New Zealand 2009 Article IV Consultation: Preliminary Concluding Statement of the IMF Mission’, March 23, 2009

¹⁷ Felicity C Barker, Robert A Buckle and Robert W St Clair, ‘Roles of Fiscal Policy in New Zealand’ New Zealand Treasury working paper 08/02, New Zealand Treasury, June 20, 2008.

¹⁸ Hon Bill English, Minister of Finance, ‘Budget Policy Statement 2009’, December 18, 2008.

predicted before the recession took hold. There will be a permanent shift downwards in the predicted GDP path: the recession's impact on New Zealand's GDP path will not be temporary but permanent. This anemic long-run GDP growth will flow through to lower tax revenues as a percent of GDP over time.

Secondly, New Zealand's announced net economic stimulus package is composed entirely of *permanent* tax cuts, and the permanence of these measures will further widen the gap between revenues and expenses over the long run. The Government has proposed and partially implemented substantial individual income tax cuts, and a suite of business tax cuts. The tax measures that constitute this stimulus package are *not* set to expire when the economy is in recovery. Under Treasury's December Update "downside scenario", tax revenues are estimated to fall from 31.5% of GDP in 2008 to 28.6% of GDP in 2013. A predicted fall in revenues from taxes on individuals is responsible for the largest part of that decline, falling by 1.2% of GDP from 2008 to 2013 (the suite of business tax cuts is counterbalanced by the repeal of the R&D tax credit). Indeed, Government's December 2009 Budget Policy Statement acknowledges the key role of these tax cuts in reducing tax revenues, stating that "fiscal forecasts incorporate personal tax reductions. As a result, core Crown tax-to-GDP is forecast to decline..."¹⁹

The Government has also announced some new infrastructure and investment spending in addition to the expected "automatic" increases to aggregate spending on benefits, but these spending increases are entirely offset by its cuts to other spending items including KiwiSaver subsidies. Going forward, growth in core government expenses as a percent of GDP — excluding the cost of financing growing levels of debt - are not as significant a driver of the deterioration in the fiscal position as are changes to revenue levels.

The loading of New Zealand's net stimulus package into tax cuts is notable internationally, and one of the likely reasons that New Zealand's fiscal position is expected to continue to deteriorate while those of countries such as Australia and the UK are expected to recover somewhat along with the economy. Measured in terms of impact on fiscal balances over 2008-2010 as a percent of 2008 GDP, New Zealand's fiscal stimulus package is the fourth largest in the OECD (behind the US, Korea, and Australia) but the only package that has a net fiscal impact *solely* in net tax measures.²⁰ As a share of GDP, New Zealand is giving the largest personal income tax cuts of any OECD country.²¹ The net impact of other OECD countries' stimulus packages comes from a combination of tax and spending measures, with the weighted average of net OECD stimulus packages being 44 percent on the spending side.²²

Two factors that are *not* as significantly affecting the deterioration of the fiscal outlook within Treasury's projection window are also particularly notable.

The fiscal pressures from demographic changes related to the "baby boom" generation retiring (including lower income tax revenues, higher pension costs, and higher healthcare costs as a share of GDP) are not yet having a large fiscal impact over the next 14 years (Treasury's projection window). Over the projection window, although the "aged dependency ratio" (the ratio of the population aged 65 and over to the working-age population aged between 15 and 65) does begin to rise significantly, this does not cause a dramatic increase in government spending because demographic-driven increases to items such as superannuation are partially offset by demographic-driven *decreases* to items such as education. It is only after the end of the projection window that the demographic-driven cost increases begin to overwhelm demographic-driven cost savings.²³ Therefore, while the fiscal track under current policy looks bad in the medium term, it is likely to deteriorate *even further* when demographic pressures start to skyrocket outside the projection window, adding further urgency to the need to address the medium-term fiscal outlook. Not only does the Government need to reduce deficits over the medium-term, but also increase the surplus of financial assets in funds such as the Government Superannuation Fund. As the OECD recommends, such a surplus "would need to be sufficiently large to ensure significant net public-

¹⁹ Hon Bill English, Minister of Finance, 'Budget Policy Statement 2009', December 18, 2008.

²⁰ OECD, 'Fiscal Packages Across OECD Countries: Overview Country Details', March 31, 2009, p 110.

²¹ OECD, 'Economic Outlook: Interim Report', March 2009, p113. Assumes that the scheduled personal income tax cuts are implemented as previously announced.

²² OECD, 'Fiscal Packages Across OECD Countries: Overview and Country Details', March 31, 2009, p 110.

²³ See Paul Rodway and Peter Wilson, 'Modelling New Zealand's Long-term Fiscal Position', New Zealand Treasury Policy Perspectives Paper 06/01, February 2006.

sector assets before demographic pressures intensify or else the government would need to begin to scale back future health and pension spending”.²⁴

It is also noteworthy that while volatility in the valuation of financial assets held by the government flows through to volatile net debt measures, the underlying operating balance *excluding* gains and losses is also expected to deteriorate from an operating surplus of 3.1% of GDP in 2008 to an operating deficit of 4.1% of GDP in 2013 under Treasury’s downside scenario.²⁵ That is, the government’s books will deteriorate significantly even when excluding movements in the valuation of government debt and assets.

In sum, anemic growth and declining tax revenues are the key drivers of the long-term fiscal position under a current policy track, and this suggests some policy responses to prevent this bleak fiscal prognosis from materialising.

4. Policy Prescriptions

This analysis has shown how sensitive the fiscal position is to changes in New Zealand’s medium-term growth path. The key conclusion drawn by the Institute from this analysis is that the stakes are suddenly so much higher on New Zealand having a well conceived strategy for aggressively growing the economy. Unless New Zealand radically improves its growth prospects, basic amenities such as quality free education, health

services, environmental protection measures and security in retirement may be at risk. This is no longer an academic debate about rankings in OECD tables of GDP per capita, but strikes right at the heart of the affordability of social and other government services in New Zealand.

The Government is already coming under pressure from rating agencies and international organisations to use the May 28 Budget to show a path back to fiscal surpluses in the medium term. The temptation will be to introduce austerity measures – a slash and burn approach to government expenses. An alternative would be (while not ignoring cost control) to create a compelling path to sustained productivity and growth.

There is a direct parallel with the way a business might look at strategic options for managing through the recession. One option is to focus on managing down costs – selling non-performing business units, paring labour costs back to the bone and so forth. Another option is to focus on growing revenue – investing in innovation to redesign business processes, and seeing the recession as an opportunity to aggressively grow market share. The Institute recommends the Government

What the Budget should do

Seek to improve radically New Zealand’s growth prospects, e.g.:

- Invest in key services and infrastructure that will be needed for New Zealand to engage and compete internationally with the rest of the world (such as broadband, transportation of exports).
- Boost business innovation.
- More aggressively manage government assets such as those held in SOEs to support domestic growth.

Reduce deficits by addressing both the tax and spending sides of the ledger, without creating future costly social deficits, e.g.:

- Ensure that existing policies designed to support vulnerable communities and create work incentives – such as Working For Families – are well-targeted.
- Control cost growth in areas such as health where recent growth in spending has not been matched with higher output or quality.
- Cancel the planned individual income tax cuts, which are poorly designed either to support vulnerable communities or stimulate growth.
- Consider redirecting some cost-control savings into temporary measures to prevent future costly social deficits, e.g. programs to ensure that the most at-risk individuals (including unemployed youth) are supported to engage in productive work or training through the recession.

Address under-investment in productive areas such as business capital investment, e.g.:

- Retain and enhance savings policies such as KiwiSaver.
- Consider reweighting the tax mix away from investments in productive, mobile assets and towards consumption, and investment in immobile assets such as real property.

²⁴ OECD, ‘Economic Survey: New Zealand’, April 2009.

²⁵ New Zealand Treasury, ‘Economic and Fiscal Forecasts December 2008’, December 18 2008.

focus on the revenue side of the economy in its coming budget and make bold and creative decisions about the type of economy that New Zealand wants to have in the long term. However, the fiscal challenges are so large, that the Government must in parallel review the effectiveness of government spending and the mix of tax measures. The New Zealand Institute consequently has three sets of recommendations for the Budget.

First, in focusing on growing the revenue side of the economy, the aim must be an ambitious one to get back to, and then *above*, the growth path that was predicted before the recession. Merely getting back to the previous growth track would be insufficient to secure a healthy long-term fiscal and economic future: that previous growth track would have seen New Zealand slipping even further down the OECD rankings (to 24th out of 30 countries by 2030), and would not allow New Zealand to recover the output lost during the recession.²⁶ Meaningfully boosting New Zealand's growth prospects involves articulating the basis on which New Zealand will compete with the rest of the world, and how the government intends to invest behind these areas of competitive advantage.

Past and current research at the Institute indicates such investment should be made in areas that strengthen New Zealand's exporting and overseas investment performance and in areas that boost business innovation and its translation into higher value products and productivity enhancing business processes.²⁷ In this respect, the Government's announcement of a \$1.5 billion investment in securing broadband access for 75% of the population (to be accommodated in the upcoming budget) is welcome, given the New Zealand Institute's previous estimates that a high-speed broadband network could generate additional economic value of \$2.7-\$4.4 billion each year for New Zealand.²⁸ The Government should also seek to strengthen other infrastructure that will aid New Zealand's engagement with overseas businesses, for example investments around New Zealand's infrastructure for transporting physical exports could also be considered, including improving overland transport corridors to key ports. In seeking to make room for these investments, government could be strategic about extracting value from assets currently on its balance sheet, for example more aggressively managing the assets held in SOEs.

The need for the Government to take bold measures to increase growth is immediate. In recent years New Zealand has slipped further down the OECD income rankings of GDP per capita, and the income gap with Australia has been getting wider and wider.²⁹ Measures to reverse this trend should be delayed no longer, and the global recession has created a small window of opportunity in which bold, immediate steps could be particularly effective. The global recession is a disruption to the established pecking order and growth paths of countries. When the world economy starts to recover, businesses and skilled talent will be reassessing old ways of doing things, and will be aggressively seeking new opportunities and engines of growth. New Zealand has a fleeting chance to take advantage of this disruption by repositioning itself ahead of other countries coming out of the recession, and attracting the business opportunities and skilled workers that it will need to fuel a step change in New Zealand's growth. For New Zealand to use the recession to "re-launch" itself as a magnet for business and talent, it must immediately start putting in place high-impact policies to make that happen. The world economy is expected to be in recovery in 2011 (even if that recovery proves to be slow), so New Zealand has just two years to reposition itself. The upcoming budget should seize that opportunity before it is gone.

Unfortunately, the temptation will be for the Government to ignore this need for strong leadership and vision about how New Zealand will position itself to compete, and instead focus the Budget exclusively on cost control measures and tightening existing policies. While it is hard for governments to exercise fiscal restraint (with restraint measures on both the tax and spending sides of the ledger being necessary, as discussed below) it is even more difficult to decide upon and take the sorts of bold and visionary steps that are needed to ensure that New Zealand uses the recession as a springboard for growth. The Budget will be a strong indicator of whether the Government will face this challenge, or instead let the opportunity slip past.

²⁶ If New Zealand and other OECD countries continue to grow at the same compound annual growth rate as they did during 1990 to 2008, by 2030 New Zealand will have slipped to 24th out of 30 OECD countries in terms of GDP per capita, with Australia's GDP per capita being 58% higher than New Zealand's.

²⁷ See New Zealand Institute work programmes on New Zealand's Global Engagement (<http://www.nzinstitute.org/index.php/globalnzeconomy/>) and the Weightless Economy (<http://www.nzinstitute.org/index.php/weightlesseconomy/>).

²⁸ *The New Zealand Institute*, 'Defining a Broadband Aspiration', Sep 26, 2007, <http://www.nzinstitute.org/Images/uploads/Broadband%20aspiration%20Sept%202007.pdf>.

²⁹ *Ibid.*

Secondly, current policies on both the tax and spending side of the ledger should be on the table as deficit reduction possibilities. As the IMF noted, the “size of the required adjustment is large”. Only limited spending control will be feasible (without cutting deeply into core programs such as education, welfare, and health³⁰), so, as the IMF concludes, “revenue measures will be needed to close the gap”. It may therefore be timely to review policies such as Working for Families and the promised additional personal income tax cuts, to ensure that they are crafted effectively to deliver support to those most in need, and extend incentives to work to those most likely to respond to them. A key principle that should underpin such reviews is the importance of enhancing support for vulnerable communities during the recession (for instance protecting assistance for low income families), in order to avoid creating a social deficit in the future.

In particular, the next two tranches of the proposed income tax cuts³¹ should be cancelled on the grounds that they would contribute to the structural deficit, are unlikely to do much for growth, and do not support the most vulnerable households. Very few of the benefits of these proposed tax cuts flow to the most vulnerable families during the recession: most of the benefits accrue to upper-income households, and the cut that reaches furthest down the income scale (the proposed reduction of the 21 percent marginal tax rate to 20 percent) is not scheduled to take effect until April 2011. Nor are these tax cuts especially well-designed for growth creation, with the top marginal income tax rates left virtually unchanged (marginal income tax rates having significant incentive effects on individual work and production choices).

On the spending side of the budget ledger, spending areas that have contributed to the increase in government spending between 2003 and 2008 of 1.6% of GDP should be carefully reviewed with the aim of achieving their objectives more effectively at lower cost. These areas include the Working for Families tax credit system and health expenditure. In particular, the OECD notes of health expenditures that “[s]ince around 2001...public health-care spending has grown at more than double the pace of GDP... there is scant evidence as yet of much higher output or quality achieved. Indeed, waiting lists and shortages have grown, and measured hospital efficiency has declined.”³² New spending should be considered only on the basis that it will have a transformative impact on growth or effectively meet pressing social needs in a way that prevents costly long-term social deficits from emerging.

Of course deep cuts in spending and tax increases would be unwise while the economy is still in recovery in the short run; exercise is not the right prescription for a patient in ICU. But policymakers must start now making the hard budgeting choices that will need to be implemented when the economy is in recovery in order for New Zealand to avoid the bleak long-term picture that is predicted under the current policy track. Thus measures such as rolling back tax cuts not yet in effect, or scheduling the rationalisation of low bang-for-the-buck aspects of current tax and spending policies to take effect in say 2011 when the economy is expected to be in recovery, may be particularly appropriate. Some of the savings from rolling back these proposals could be redirected towards temporary expenditures to prevent future costly social deficits, For example, relative to other OECD countries a high proportion of New Zealand youth are not in work or education (youth unemployment can be expected to rise during the recession), and disengaged youth are at particular risk for high-cost negative social outcomes such as crime. Ensuring adequate funding of programs to ensure that at-risk individuals including unemployed youth are supported to engage in productive work or training through the recession may be a cost-effective way to prevent negative, costly social outcomes over the long term.

Finally, the Government should look to address the policy imbalances that have contributed to New Zealand’s under-investment in productive areas such as business capital investment, while the housing market has boomed and New Zealand’s dependence on foreign funding of its high current account deficit has grown. The tax mix should be on the table as part of this long term rebalancing exercise. Creating new sources of revenue (such as from taxes on property), for example, will create room to finance the cost arising from future demographic pressures. Another complementary

³⁰ Although in the medium and long term, as the OECD points out, there is a need to ensure that health care costs do not balloon without attending increases in output and quality. See *OECD, ‘Economic Survey: New Zealand’, April 2009.*

³¹ The proposed 2010 tax cuts would increase the start of the 33 percent income tax bracket from \$48,000 to \$50,000, and cut the top marginal income tax rate by one percent from 38 percent to 37 percent. The proposed 2011 tax cuts would lower the 21% marginal tax rate by one percent.

³² *OECD, ‘Economic Survey: New Zealand’, April 2009, p 15.*

approach is to more lightly tax productive investment and savings (for example through gradual reductions in company tax and taxes on savings overtime), while making residential property investment less attractive. Given New Zealand's poor domestic savings record, it is critical that the Budget also retains and enhances savings policies such as KiwiSaver.

5. Conclusion

New Zealand is facing the dual problems of the global recession and under-potential economic growth; both a passing economic flu and an underlying lack of economic fitness. Because it must treat both of these diagnoses, the 2009 Budget is one of the most difficult policy prescriptions that a New Zealand government has had to write in recent years. The recommended course for the government is to take this fleeting opportunity to springboard New Zealand out of the recession by using the Budget to: (1) invest in critical areas needed to boost economic growth; (2) prevent a debt explosion by putting on the table measures on both the spending and tax side of the budget ledger; and (3) address structural imbalances that have led to chronic underinvestment in productive assets. This medicine may be difficult to prescribe and hard to take, but the alternative – which is for the Budget to focus exclusively on controlling the costs of existing policies without addressing the need for bold and transformative action on growth – will not put the patient in good long-term health.