

The 2010 Budget

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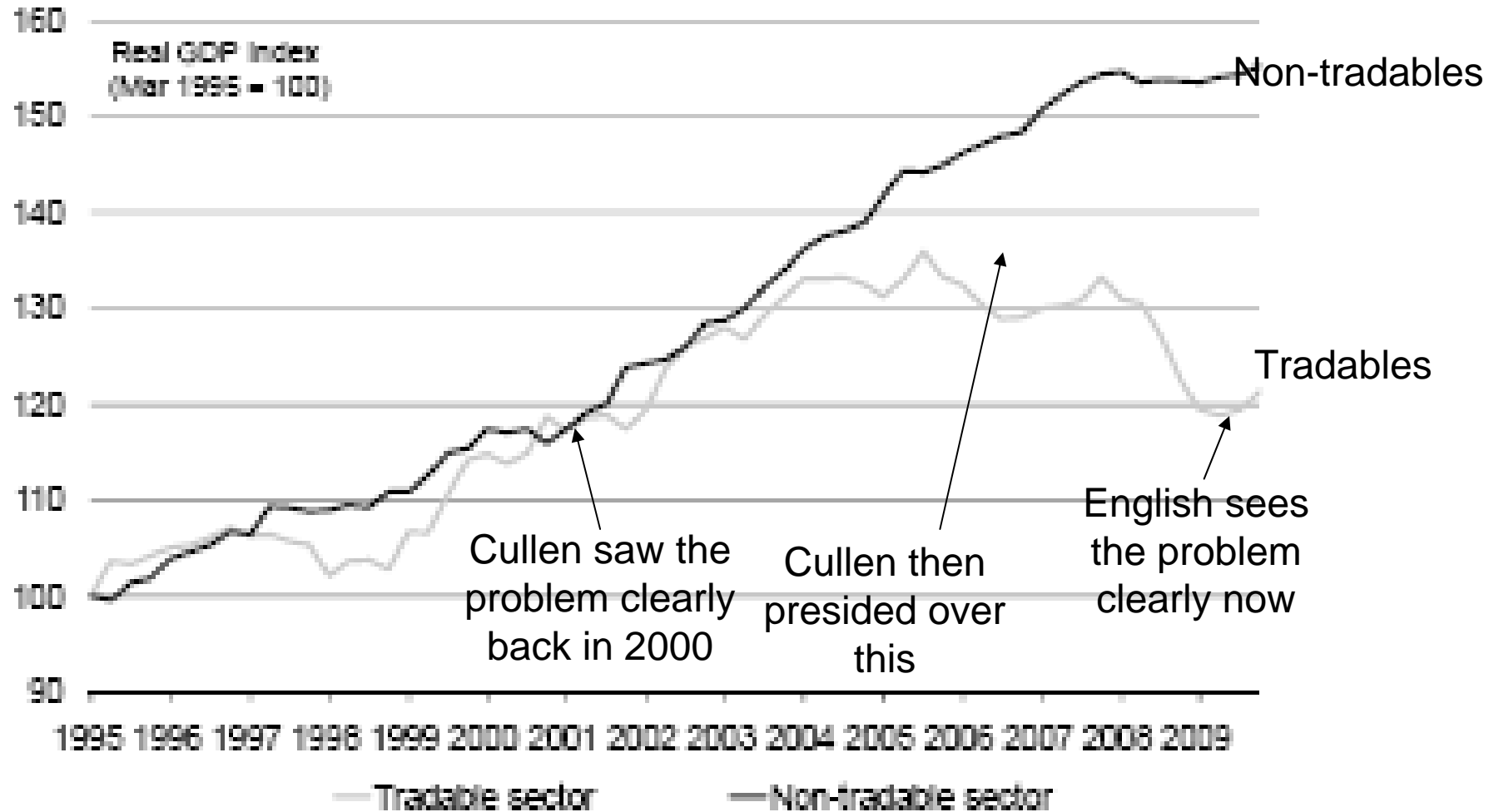
Macro aims and likely outcomes

- **Declared aims, under the rubric of promoting “growth”, are to**
 - **Rebalance the economy “away from consumption and borrowing towards saving and investment”**
 - **Rebalance the supply side towards [relatively] more “productive” or “tradable” output and [relatively] less non-tradable**
 - **Make the tax system “fairer, more sustainable, and more supporting of economic growth”**
 - **Improve delivery of public services and keep firm control of Government finances.**

'Rebalancing' towards investment via tax switching?

- **The shifts in investor incentives are minor: rental-property investors suffer a small negative, other investors get a tax-cut windfall**
- **Whether that leads to a rise in domestic private-sector investment remains to be seen; the Government is obviously hopeful, but both theory and empirical evidence leave the outcome uncertain (the mid-1980s tax cuts ushered in an decade of slow growth)**
- **The relationship between tax rates and growth performance is contested territory – there is no automatic link in the open economy setting**
- **“The tax package will improve incentives to save and help direct investment into more productive areas” (*Fiscal Strategy Report* p.36) sounds like hope more than analysis**
- **One requirement is that the Government has a lower savings rate than the private sector at the margin, so that shifting a slice of income from the former to the latter raises total national saving.**
- **A second is that relative prices have to shift to attract any new investment into the desired activities. The assumption is that “freed up resources” will go to the tradable sector (*Fiscal Strategy* p.37) - but they could equally well go to non-tradables unless something fundamental changes**

Figure 2 – Tradables and non-tradables output



Source: The Treasury

Rebalancing towards tradables

- The Budget's stress on the private sector's large external debt, and the persistent current account deficit, are good to see (agree with BERL)
- But it's not clear how this fiscal strategy sits with a structural change towards tradables
- The tax changes seem designed to leave the real consumption wage unchanged, while the mild fiscal stimulus will open the way for interest rates to rise a bit more than they otherwise might
- That means the real exchange rate will tend to go up if anything, reducing competitiveness and net exports
- So the desired surge in tradables-led growth depends on things the Budget doesn't influence much: world commodity prices; the effect of high unemployment in keeping inflation down here (so that the Reserve Bank's pending OCR hikes are moderated); the possibility that the EU may manage to get its inflation rate up (but monetising sovereign debt may have no impact in the current recessionary climate)

With that sort of structural problem, you really want a policy instrument that discriminates between the two sectors

- **Reductions in income tax rates definitely don't – especially if high-income groups are concentrated in non-tradables and low-income groups in tradables.**
- **The Budget speech correctly states that “sectors with low effective tax rates have expanded at the expense of the rest of the economy” (p.22) but there's only one rather small targeted tax move against non-tradables, in property**
- **Capital gains taxes might contribute, if the big capital-gains incomes are in non-tradables more than tradables**
- **Tax breaks for tradables producers might be relevant, but far better would be policies that brought the real exchange rate down and so improved the relative competitiveness of tradables**
- **If the real exchange rate can't be affected favourably at present by fiscal policy, and the Minister is unwilling to rewrite the Reserve Bank Governor's contract to direct monetary policy to target the exchange rate, or competitiveness, of tradables output, or some other measure to do with economic performance, then don't claim the Budget is solving the identified problem**
- **The past two decades have demonstrated the familiar economists' problem with price-capping: it distorts resource allocation. Inflation targeting caps the price of tradables, while financial deregulation leaves asset bubbles to fly high, with associated high profits for non-tradable rentiers and their retainers**

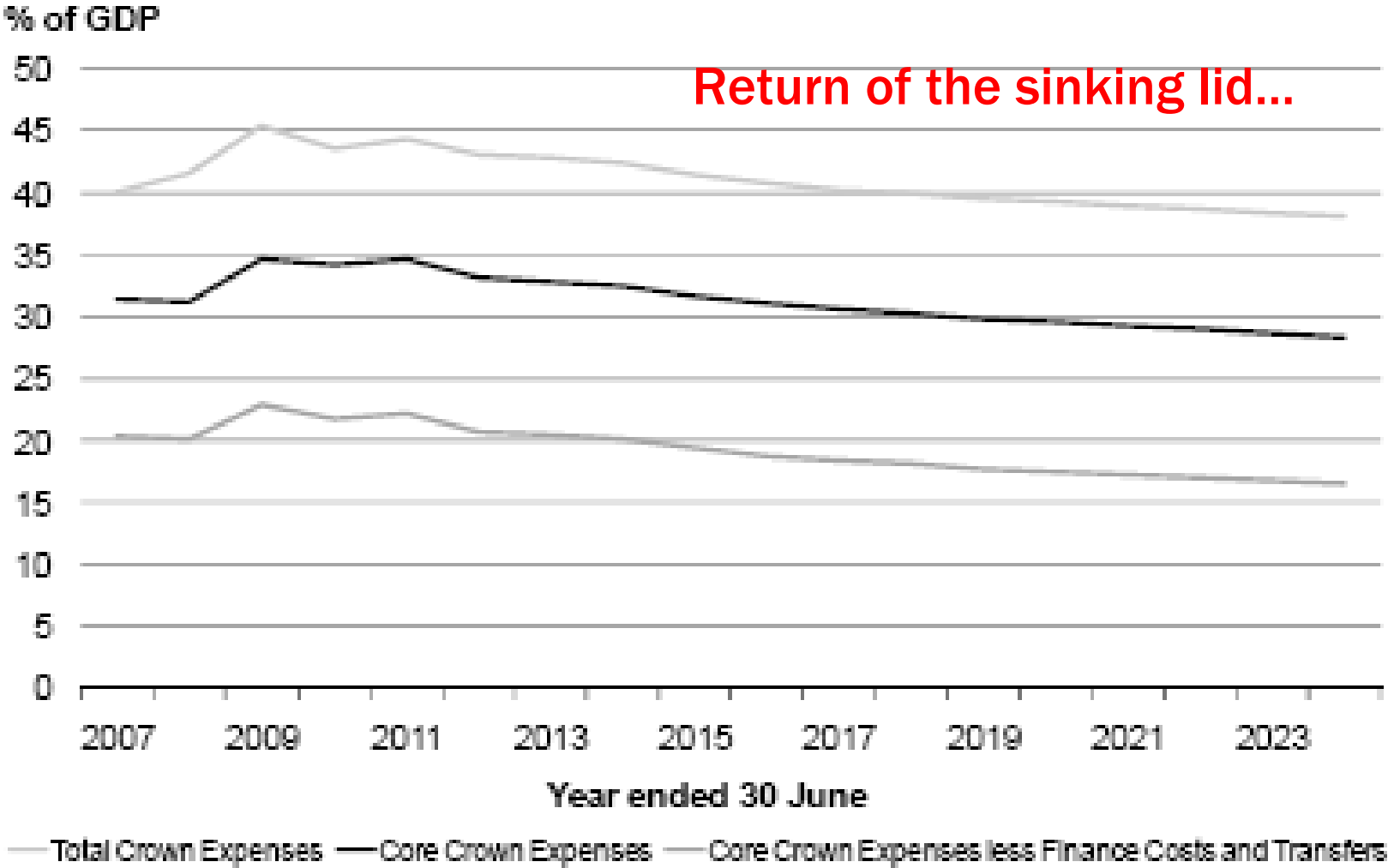
The Fiscal Strategy claims that cutting government expenditure “help[s] shift the makeup of growth from the nontradable to the tradable sector” (p.36)

- This must depend which expenditure is cut, because some is complementary with tradables growth and some is not
- In aggregate, greater “fiscal discipline” may lower interest rates and hence the exchange rate – but if done wrong it could also trigger trouble in the labour market [check out Greece]
- Also, “discipline” is not to be confused with lower expenditure – they may coincide or they may not

Take another look at that “fiscal discipline” line

- Is that code for running a tight ship, or just for shrinking Government indiscriminately?
- Sinking lids operated with blindfolds, or with a covert ideological agenda, can degrade rather than sharpen the public sector’s performance
- Putting the top tax rate at 33% is not really very disciplined – it just suggests you don’t really care that much about fairness

Figure 5 – Operating expenses



Source: The Treasury

Fiscal Strategy p.41

The spending cap

- One of the cherished dreams of the neoliberal camp is a sinking lid on government spending to force down the GDP share of the state (including the welfare state)
- ACT plans a “taxpayer bill of rights” to echo Colorado
- Business Round Table’s call in the media for this were ostensibly rejected by Key a couple of weeks back
- We may have been spared the worst, but the concept is now in place
- “New operating allowances” limited to \$1.1 billion, with 2% growth from 2011/12, in nominal terms
- Fiscal Strategy p.40: “Continuing to remain within the \$1.1 billion limit on new spending over time will become increasingly challenging” - YOU BET
- GDP growth is projected at around 3%
- So government spending is to fall relative to GDP on a steady track in the name of “responsible government spending”

In summary, the Budget doesn't engage with serious relative-price change

- A revenue-neutral tax switch that reduced rates on capital and labour income and sharply increased the rate on non-mobile property income would be expected to help growth – but a land tax annoys rich property-owners so is off the agenda
- Capital gains tax ditto.
- A serious carbon tax would get the economy rebalancing out of non-renewables and emissions-intensive activities – but annoys farmers and big industrials, so wasn't even on the agenda for the Tax Working Group

Instead we get a six-point growth prescription that's mostly waffle

Figure 3 – Six drivers of stronger economic performance: a snapshot of progress

Driver	Already achieved	Budget 2010	What's next?
An internationally competitive regulatory environment	13 Regulatory Reviews underway. Introduced Bills to remove redundant legislation	Established a Productivity Commission to undertake Independent Inquiries	Ongoing programme of regulatory reform. Consider Regulatory Responsibility Bill
A fair and efficient tax system	Personal tax cuts in April 2009	Package of tax reform to improve incentives to work, save and invest	Maintain competitive tax system
Productive Infrastructure investment	Implementing 2009 Electricity Review; first National Infrastructure Plan published	\$1 billion on Infrastructure: ultra-fast broadband; Auckland rail electrification; KiwiRail	Support efficient infrastructure investment (eg, first Public Private Partnership)
Support for science, innovation and trade	NZTE grants refocused; action plans for key sectors (eg, Food Innovation Network)	\$321 million in new and reprioritised funding over four years for improved R&D	Remove barriers in key growth sectors (eg, aquaculture) and action CRI Taskforce review
Higher skills	National Standards and the Youth Guarantee being implemented	\$1.6 billion extra over four years for education; first steps on tertiary sector reform	Raise student achievement and completions
Better, smarter public services	\$2 billion over four years reprioritised to front line services in Budget 2009	\$1.8 billion redirected to front line. Constraining debt by delivering 1.1 billion allowance	Drive continual process to deliver smarter, better public services

This really just shoe-horns the Government's policy preferences into an alleged growth framework. There's no substantial analysis

- Infrastructure spending is a real potential growth booster but isn't worked into the story well.
 - Much of the Railways spending is deferred maintenance catchup and will help growth only if other things are aligned
 - Broadband and better commuter trains are positives, but could end up as lifestyle gains more than growth inducers – fingers crossed
- The Regulatory Responsibility Bill as a growth promoter leaves something to be desired....

The NZ diaspora

- Allegedly the lower tax rates are supposed to address the position where (*Executive Summary* p.6) “around 17% of skilled New Zealanders now live abroad”.
- But it’s not clear what the long-term growth implications of this are.
- Much depends on churn – do they rotate back here, bringing skills and funds with them?
- Also on remittances – do they save and invest in NZ assets out of their overseas-earned incomes? Do migrants eventually return their wealth to NZ? We don’t seem to know.
- A diaspora is a national asset, but the Budget sees it only as a problem

The ETS

- Free allocation of NZUs is budgeted at \$1.034 billion (*Estimates* p.31), up from \$750 million in the 2008-09 Estimates (reversed when National took office – it ended up at \$23 million for that year and \$140 million for 2009-2010). Not entirely clear what this represents, accounting-wise. There is a story to be told but it isn't spelled out in the Estimates.
- It looks as though the “expenditure” on NZUs is just setting the scene to count surrendered NZUs as “revenue” in future years – an accrual-accounting manipulation of the budget balance now and then, not genuine cash flows either way
- Contingent liability for using up forestry credits in CP1. *Economic and Fiscal Update* pp.105 & 109 puts onto the books a \$1.747 billion liability for future harvest of 86.1 Mt of sink credits not taken over by Kyoto forest owners as at 31 March 2010, valued at \$20.29 per tonne

Confused discussion of debt

- Repeated failure to distinguish clearly between private and sovereign overseas debt. Probably because most overseas indebtedness is private sector, but the Government is happy to have a big number to wave around – and overseas commentators generally miss the distinction, assuming the debt is sovereign (e.g. Bloomberg's reportage of Bollards' speech the other day)
- Big feature of the early 1990s was privatisation of the overseas debt as the Government used proceeds from asset sales to pay down foreign-currency debt.
- Outlook now is that tax cuts may enable private sector to deleverage, but important that sovereign foreign-currency debt doesn't rise to compensate.

Odds and ends

- “Identification and implementation of protection for natural and historic places” is up from \$9 million to \$20 million (p.51) – is this going to make the big difference? (But “environmental research” falls from \$101million to \$74 million p.279)
- Biodiesel grants \$12 million (p.122)
- Whanau Ora gets \$23.7 million for 2010-2011 (*Estimates* p.214), and \$124 million over next four years (*Speech* p.28).
- ODA is stationary (*Estimates* p.237)