Catching Australia by 2025: An Alternative Approach

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Summary

If New Zealand wants to match Australia's Gross Domestic Product (GDP) per capita by 2025, then we will need radical changes to our current fiscal and regulatory policy settings. This is especially true because we are aiming for a moving target – Australia never entered recession and has been growing while we have been going backwards. In fact, substantial changes will need to be made to merely avoid a fiscal catastrophe – with forecast Government expenditure set to increasingly outstrip forecast Government revenue in future years.[1] The problem lies not so much in determining the appropriate path, but in convincing the Government to actually undertake the required actions. Finance Minister Bill English has often spoken of the need for fiscal restraint, of the problems caused by excessive levels of Government expenditure, and of the urgent need for greater levels of efficiency in the public sector. Unfortunately, we have seen little action.

A Government that seeks to protect property rights, ensure contracts are honoured, and provide a fair and impartial system of arbitrating disputes will go a long way in providing an adequate framework for entrepreneurs to create economic value. When the Government moves beyond these core functions, problems arise. The revenue required to administer the current size of Government creates massive deadweight losses – the deadweight loss associated with taxes increases at a faster rate than revenue itself.[2] In addition, Government expenditure has decreasing marginal returns – an increasing size of Government returns less on each marginal dollar spent. Moreover, as the level of expenditure grows, so do the personal benefits of engaging in negative-sum rent-seeking behaviour as compared to the benefits of engaging in positive-sum entrepreneurial activity. It has been estimated that a ten percentage point increase in Government expenditure as a share of GDP reduces the annual rate of growth by 1 percentage point per annum.[3]

This alternative budget presents a way to decrease the overall level of Government expenditure from its current 37.3 percent of GDP to 27.7 percent of GDP within one year. In addition, the size of the deficit would be reduced from the Budget forecast of $7,948 million to $802 million. This deficit is smaller than the size of the cyclical deficit, and is

[1] Treasury (2009) "Challenges and Choices: New Zealand's Long-Term Fiscal Statement" page 9.
[2] Browning, E.K. (1987) ''The Marginal Welfare Cost of Taxation.'' *American Economic Review* 77: 11–23.
[3] James Gwartney, Randall Holcombe, and Robert Lawson (1998) "The Scope of Government and the Wealth of Nations" *Cato Journal* 18(2): 169.

therefore not a long term problem. In future years, Government expenditure would increase at a slower rate than economic growth, seeing the Government's share of GDP fall below 25 percent relatively quickly. Government expenditure would be expected to be below 20 percent of GDP within 15 – 20 years, as it would grow in line with inflation rather than overall levels of economic growth.

Such large reductions to the current level of expenditure would enable a massive overhaul of the taxation system. There would be a flat rate (16 ⅔ percent) of income tax on all income earned over $31200 ($600 per week), with a higher tax-free threshold for those with dependents. There would be a temporary three year surcharge of 10 percent on all income earned over $100,000. The Goods and Services Tax (GST) would be increased to 16 ⅔ percent. A new tax on the total value of capital would be introduced for all commercial enterprises and households, although each household would have a deduction of $1 million. Corporate income taxation would be abolished. The new capital tax would encourage people to productively employ their capital – and provided that individuals sought a return on investment of over 2.5 percent, they would be better off with the capital tax than under the current tax system. Indirect and other taxes would remain as they currently are, and would be boosted by revenue from selling immigration permits and a carbon tax, the revenue of which would mostly finance cuts to other taxes.

Expenditure would primarily be reduced as individuals would more directly bear the cost of health, education, and welfare costs – which would be affordable given the lower level of taxation. Individuals would be expected to take out catastrophic health insurance, and meet other more minor health costs (e.g., GP visits) out of pocket. Individuals would be expected to pay for their child to be educated at both primary and secondary level, while the public subsidy for tertiary education would be reduced. Tax credits would be available for those whose tax reductions are insufficient to cover the educational costs related to primary and secondary school. Individuals would also be expected to take out accident, sickness, and unemployment insurance. Because individuals have a greater incentive to seek savings – and private companies have a greater incentive to administer welfare, health, and education services more efficiently – substantial cost savings could be made. The Government would act as an insurer of last resort in certain circumstances (some may be uninsurable in the market). The productivity gains to be made from private provision –

combined with a substantial reduction in deadweight losses arising from taxation – would provide substantial economic dividends.

It is important to note that this system only works if it is implemented as a package. It is impossible to reduce taxes without reducing expenditure, and it is impossible to reduce expenditure without giving people the wherewithal to provide for themselves. By packaging tax and expenditure reform, we are able to cushion the impact of reducing expenditure by increasing people's take-home pay, while allowing much greater levels of consumer choice and the consequent gains in efficiency.

Reductions in expenditure alone would not be sufficient to enable us to catch Australia. All barriers to trade should be immediately and unilaterally removed – enabling us to buy from the cheapest markets and sell in the most expensive. Use of land restrictions – both zoning and Resource Management Act impediments – should be removed, allowing individuals to freely determine how best to use their capital assets, subject to common law restraints. Labour markets should be further deregulated – including an examination of the need for professional licensing in many areas – to restore freedom of contract and end barriers to job growth. Immigration restrictions should be radically changed, allowing hard-working and entrepreneurial immigrants to freely enter New Zealand.

Another way to assess this alternative budget is to consider how it stacks up with the truths we know about economic growth. We know that economic growth requires private ownership of the means of production. Private ownership ensures that the rewards for hard work are delivered to those who deserve them, and also enables those with the most information to make decisions. This budget would see a much larger role of private ownership in the areas of health, education, superannuation and welfare.

We know that economic growth requires a competitive marketplace. Competition between firms encourages individuals to find alternative methods of production that improve quality or reduce costs. Competition gives consumers the capacity to choose for themselves. Profits reward those who deliver products that people want, while losses weed out those firms that consumers no longer want or need. This budget would end the monopoly-dominated areas of health, education, superannuation and welfare, and enable innovation to be driven by the marketplace.

We know that economic growth thrives when we have lower taxes. If individuals own the means of production but do not receive adequate reward for utilising their skills well then there is little incentive for them to act in a socially beneficial way. Lower taxes provide incentives for people to work hard, to up skill, and to seek promotions. This budget oversees a drastic reduction in the overall level of tax and tax rates. It also reduces the current distortionary distinction between personal income and capital gains by introducing a very low and flat rate asset tax.

We know that economic growth is more likely to occur when capital can freely flow to new growth opportunities. Under laissez-faire, we would expect capital to flow into those areas which would generate the greatest return – in others words, where consumers most valued the contribution of capital. This budget increases the capacity for capital to be allocated across all sectors of the economy – allowing capital to flow more freely into health and education. Return on capital will also be increased by properly charging for its use – for example, through congestion pricing.

We know that economic growth will occur when individuals are free to engage in economic exchange. Provided there are no negative externalities, then free exchange must *ex ante* be thought to benefit both parties. Current limitations on free trade, entrance into certain professional occupations, restrictions on the use of land, all impede freedom of exchange. This budget would seek to remove these regulatory impediments to freedom of exchange, increasing economic welfare.

With these policy settings, New Zealand would become a land of genuine opportunity – where hard work would lead to success. That atmosphere of incentive would make New Zealand an exciting and dynamic place to live – attracting many of those who have left back to our shores. We would be able to provide the kind of living standards that we all think we deserve. Most importantly, individuals – not the Government – would determine the goals they wanted to achieve.

Where Are We Heading?

The National Government is currently borrowing $400 million a week. Over the next four years, they will borrow an average of $250 million a week. That's the cost of a new hospital being borrowed every week. That borrowed money will be used to fund the current day-to-day services delivered by Government. In other words, we are borrowing to pay the grocer. It will be ten years before we start recording surpluses – i.e., until we start repaying our debt. Although National talks a lot about fiscal prudence, Finance Minister Bill English's first budget oversaw an increase in Government expenditure of over $3 billion dollars. To the extent National are fiscally prudent, they have modestly trimmed the planned increases to future expenditure. Where those cuts will come from is unclear, because Prime Minister John Key has essentially ruled out reductions in overall Government expenditure. He has ruled out changes to the superannuation age or the level of entitlement. He has also ruled out restructuring that would see individuals directly bear more of the cost of health and education. He has also ruled out any further sale of state assets to reduce debt. The Prime Minister has not only prohibited changes to the largest areas of Government expenditure, but has also refused to budge on tax – effectively ruling out both a capital gains tax and a flat tax. There is talk from Bill English of possible changes to taxation rules relating to property, but there seems to be no substantial changes on the horizon, despite the current structure of Government finance being clearly unsustainable.

For the last thirteen years, New Zealand has drifted. We have stopped aiming for the economic growth that does so much to improve the living standards of ordinary individuals, and started to introduce policies aimlessly. Labour said it wanted to grow our economy to get us into the top half of the OECD – then they went cold and increased taxes. Labour said it was concerned about high effective marginal tax rates for those on benefits – so they introduced further benefits for those in jobs (Working for Families), merely moving the problem further up the income ladder. Labour said it wanted to increase our exports – but then increased Government expenditure that created conditions that required tight monetary policy, forcing up interest rates and the New Zealand dollar. This damaged exporters. The last thirteen years have seen New Zealand return to the kind of politics that we experienced prior to 1984, with large increases in Government expenditure. It has been dominated by schizophrenic Governments saying one thing and doing another thing.

In 2004 the share of GDP consumed by central Government was just over 29 percent. Today, it sits at over 37 percent. If no changes are made, then the size of Government will continue to expand. In fact, the recently released Treasury report "Challenges and Changes" makes it clear that the current level of tax and expenditure is unsustainable. If taxes remain where they are and Government expenditure continues to rise in line with its historical average, then net debt will rise to over 220% of GDP by 2050. If we want to avoid that scenario by increasing income taxes, then those who pay the lowest tax rate will see their tax rate increase by 40 percent; those who pay the next highest tax rate will see it increase by over 23 percent. If we were to fund the difference through increases to GST, then it would have to rise by 60 percent. Doing nothing and leaving reform for another day is clearly not an option. Doing nothing will get us into a debt bind – debt will expand so rapidly that any surpluses we eventually run will struggle to repay anything more than interest. In the scenario presented by Treasury, debt servicing will expand to consume 25 percent of central Government expenditure. This would be worse than the country faced at the time of crisis in 1984.

There is a direct relationship between Government revenue and expenditure. If we want tax cuts, we need lower levels of Government expenditure. If we want the Government to continue spending as it is, we will need to drastically increase taxes. Only if Government revenue is examined together with Government expenditure can a proper picture be painted of the Government's burden. The full burden of Government expenditure is not just the revenue that is raised. It includes all the behavioural changes that occur when we have high taxes on productive activity. It includes all the costs that individuals bear when they try to restructure their income to avoid taxation. Imagine that a person preferred drinking sherry to port, but that the Government introduced a much larger tax on sherry. Some of the sherry drinkers may decide to start drinking port because of the high taxes on sherry. If this happens, the individuals are worse off (they'd rather drink sherry), and the Government has collected no revenue (the person has opted to drink port). That kind of behavioural change creates what is known as deadweight economic loss – when people change their behaviour because of taxes, making both themselves and the Government worse off. This same process occurs when the Government taxes incomes, because individuals may begin to make different decisions over what qualifications they should

seek, where they should work, and how many hours they should choose to work. These costs increase proportionally faster than the level of revenue.

A smaller level of Government expenditure is required if tax cuts are to be taken seriously. If taxes are lowered and individuals are then required to purchase some of the services previously provided by Government, many consider there to have been no economic advantage gained. Such thinking ignores the benefits that come with greater consumer choice and the savings to taxpayers that result from competition and productivity growth. Another major benefit is that a user-pays system avoids the huge bureaucratic costs associated with the raising of revenue. Moreover, the deadweight economic loss on the marginal dollar raised has been estimated to be around 40 percent, and as much as 100 percent.[4] Lower levels of taxation will substantially reduce this deadweight economic loss.

Where Do We Want To Be?

When a Finance Minister sits down to write a budget, political considerations should not be top of mind. Instead, he or she should consider where New Zealanders would like to be in 15 years. I doubt there are many New Zealanders who aspire to see their children live their adult lives overseas, having left a nation with excessively high taxes and reduced opportunities. I doubt there are many New Zealanders who want to live in a nation that cannot continue to provide the living standards we have come to expect. I doubt there are many New Zealanders who believe that an economic miracle will be delivered by politicians who simply spend more on the failed policies of the last thirteen years.

The Inland Revenue Department has emphasised that high income taxes and a high rate of corporate income tax are leading to increasingly-mobile money and workers heading offshore. Unless our tax structure incentivises people to stay here and work, then those with skills will continue to leave. If we combine the fact that many of our most skilled have already left with the projected increases in superannuation and health costs for the baby boomers, then the numbers of people leaving our shores will sky-rocket.

[4] Alex Robson (2007) "No Free Lunch: The Costs of Taxation" New Zealand Business Roundtable, page 20.

Looking ahead to 2025, I think most New Zealanders would like to see a prosperous country – a nation that creates genuine opportunity for people to get ahead in life, and rewards those who work hard. Without creating a framework for economic growth, then one person's gain is another person's loss. If we continue to try to redistribute the ebbing wealth we have, then people will continue to leave and the wealth will no longer be there to redistribute. If we create the right framework and incentives, then people will want to work, to succeed, and to take responsibility for themselves and their families. These are elementary facts of life that should always be kept in mind.

How Do We Get There?

How do we retain and attract those with skills, as well as the capital needed to invest in productive enterprise? We must create an environment that encourages economic progress.

The first way to encourage economic progress is through private ownership. If assets are privately owned, then people are encouraged to use them wisely – if they neglect them, then they suffer the consequences through lower asset values. State houses are typically poorly maintained because the tenant has little incentive to look after them, while the landlord has poor information about the state of its large property portfolio. Private ownership provides incentives to develop property and use it productively – to increase its value by making it attractive to others. It also enables entrepreneurs to develop and distribute resources through time – if a resource will be more valuable in the future than it currently is, then it makes sense to hold onto it for future use. The areas which are in dire need of more private involvement are in the areas of health, education, superannuation, and infrastructure. Some of New Zealand's most significant assets – school property, hospitals, and the roading network – are underutilised. If hospitals were open for elective surgeries through the night, if schools were operating two shifts a day (as suggested by Trevor McIntyre, Headmaster at Christchurch Boys' High School), and if road usage were priced properly, then productivity and the rate of return on these investments would soar. If private ownership were introduced to these areas, it would also disperse power – away from meddling politicians and back to the individuals who are better placed to exercise it.

The second way to encourage economic progress is through competitive markets. Competition promotes the efficient allocation of resources. It rewards those who can reduce costs or improve quality. It also provides continual pressure for innovation by rewarding entrepreneurs who discover new ways of doing things or who develop new products. It ensures that consumers call the shots – competition gives choices to consumers and the exercise of those choices forces companies to respond. Consider the fact that insurance markets for the contents of a house include options for different levels of excess and no claims bonuses to discourage claims for trifling sums. Contrast this with ACC, which has poor risk-mitigation strategies, and forces safe workplaces to subsidise those which are unsafe. Areas which are not the domain of competitive markets tend to stagnate, denying individuals choice and diversity, and increasing costs. In recent years, Health and Education spending has surged, and yet there has been little improvement in real outputs. Monopolies, be they owned by Government or private investors, invariably fail. This is one of the facts of life that we ignore at our peril. Should Education and Health be opened up to more competition, it is highly probably that the outcomes we seek – better quality healthcare and education – would emerge, while costs would be constrained. This has been the experience in all other Government services that have been open to competition, both here and overseas.

The third way to encourage economic progress is through lower taxes. Low taxes reward those who work hard to get ahead. New Zealand currently has very high effective marginal tax rates. The effective marginal tax rate measures the full impact of earning an extra dollar – i.e., the tax on that dollar, as well as any abatement of benefits that might be involved. When we look at effective marginal tax rates, many individuals face tax rates of above 50 percent. This is especially true for those in the middle of the income distribution or for those receiving Working for Families. Lower taxes reward those who up skill, who seek promotions, who work extra hours. Lower taxes also reward those who save. Currently, the wealthy tend to save or invest in areas that often do not attract tax – shares or property. It is those on moderate incomes – who may be saving for their first house – who put the money in the bank. Unfortunately, inflation eats away the return, and the tax applies to the income earned through nominal not real income. In other words, the current tax structure disadvantages those who put their money in the bank, rather than those who save through property or shares. Lower taxes across the board will significantly decrease this distortion, and reward average New Zealanders for their hard work.

To create low effective marginal tax rates, benefits need to be smaller or abate more slowly. If we give people large benefits, then we will need to abate them quickly to avoid them becoming costly. That means that people face high effective marginal tax rates and have little incentive to seek work. If we give people smaller benefits, then we will be able to abate them more slowly without them becoming too costly. That means people have greater incentive to find a job, but also means that those on benefits will be worse off. The key is that any reduction in the size or scope of benefit payments needs to be presented as part of a package that sees overall levels of taxation decrease. Those that lose because of the reversal of one policy win by changes in another area.

The fourth way to encourage economic progress is by ensuring that capital is efficiently allocated – that capital markets are well-functioning. Generally speaking this occurs at the moment, but the allocation of resources in health and education from capital markets is sorely needed. Currently, capital will be directed towards a hospital or a school if a community can create enough fuss that politicians are forced to respond. Political solutions usually involve big delays. However, in the private market, it would be natural for private capital would naturally flow into those areas that will most benefit from the investment – as reflected in the return on investment.

As a matter of principle, the proper treatment of capital for income tax purposes is very simple. Capital gain is a form of economic income, and since we have a tax system designed to tax income then it should theoretically be taxed to stop distortions in investment patterns. Currently, there is a bias towards investments that produce capital gain rather than annual income. However, the implementation of a neutral capital gains tax is very difficult, and even the Inland Revenue Department has advised against it. One way to tax the capital base of the nation is to reduce (or abolish) corporate income tax and replace it with a tax on the assets of all commercial enterprises. This would mean that companies with the same asset value would pay the same amount of tax – while all income would be retained for reinvestment or distributions. Companies which more productively utilised their capital would be rewarded; those who left it unused would be punished. Moreover, given the significant asset base in New Zealand, moderate asset taxes (less than 1 percent) would raise substantial revenue.

The fifth way to encourage economic progress is to allow individuals to engage in free economic exchange. At the most obvious level, this means free trade – the capacity to sell in the market with the highest prices and the capacity to buy in the market with the lowest prices. Although we have few restrictions on international trade, we should end those we do have – for example, there are remaining tariffs on some clothing. At a deeper level, it requires that consumers make decisions for themselves, rather than prohibiting trade that both parties believe will benefit them. This would mean removing restrictions that prohibit the hiring of teachers who do not have a particular qualification, or once again allowing GPs who have a Diploma in Obstetrics to deliver babies. Immigration restrictions should be relaxed to ensure people with skills can migrate to New Zealand. In addition, zoning restrictions and urban metropolitan limits arbitrarily affect the value of land, and often lock young people out of purchasing their first home. These regulatory issues should all be addressed under the principle of enhancing consumer choice and freedom of exchange.

These five principles, combined with (more) stable monetary policy, would create the right incentives for the management of assets, the right incentives to encourage productive activity, and the right incentives to provide opportunities for all. Moreover, many of the principles that deliver economic progress work together – private ownership means that the individual not the politician calls the shots, which means that consumers are in control, and also allows for lower taxes. Applying these principles would unleash a torrent of innovation and productivity, and it is likely that this would be most apparent in those areas currently dominated by Government.

How Will Taxes Be Reduced?

Lower taxes require lower levels of Government expenditure. Given that a lot of revenue is raised from the middle class, and a lot of Government expenditure is redirected back to the middle class after the high costs of public bureaucracy have been deducted, there is the capacity to trade off spending for tax cuts, while eliminating the painful disincentives that come with high taxes. The reality is that the largest areas of Government expenditure occur in Health, Education, and Social Welfare (including superannuation). Any Government that wants seriously to cut taxes needs to address these spending areas. The table below outlines the largest areas of Government expenditure, the level of expenditure

that we believe is reasonable, and the net savings that would arise from the proposed reductions:

Government Expenditure	Current Expenditure (millions)	2010 Budgeted Expenditure (millions)	Net Savings (Year 1) (millions)
Superannuation	8,246	7,000	1,246
Welfare	12,893	8,393	4,500
Health	13,397	8,397	5,000
Education	11,284	7,284	4,000
Finance Costs	2,470	2,470	0
Other	16,992	14,992	2,000
Total	**65,282**	**48,536**	**16,746**

Part of the savings above come from lower taxes on the payout of benefits, but the main savings arise by encouraging greater levels of private provision of services. Below we will approach each area and explain where the savings are made, but before that we will show how we can raise the required revenue with major tax adjustments.

How Will Tax Revenue Be Raised?

The current system of raising revenue is creating significant distortions. The top personal income tax rate is 38 percent, while the tax on portfolio investment entities (PIEs), trusts, and companies is lower. This is creating incentives for people to engage in (legitimate) tax avoidance, as they restructure their affairs to lower their tax burden. This is made obvious by the substantial spike in the number of people who contrive to earn just below the income threshold for the top tax rate, and the substantial increase in trustee income in recent years. In addition, the distortion that is occurring by taxing capital gains differently from how we tax income is decreasing cash savings, which is leading to higher interest rates and a higher dollar than is desirable.

The table below outlines how revenue would be raised in an alternative budget, including the rates (where applicable), and the total revenue raised from an alternative tax system:

Revenue Area	Tax Rate	Tax Thresholds	2010 Revenue Raised (millions)	Current Revenue (millions)
Goods and Services Tax	16.66%	N/A	15,000	11,161
Personal Income Tax	16.66%	$31,200+	6,500	24,922
Personal Income Tax Surcharge	10.00%	$100,000+	700	0
Corporate Income Tax	0.00%	N/A	0	7,852
Capital Tax (individuals)	0.80%	$1,000,000+	15,600	0
Capital Tax (companies)	0.80%	$0+		0
Other Tax (Direct)	N/A	N/A	1,500	2,262
Other Tax (Indirect)	N/A	N/A	5,000	4,855
Other Sovereign Revenue	N/A	N/A	1,634	4,860
Interest and Dividends	N/A	N/A	1,500	3,159
Immigration Charges	N/A	N/A	200	0
Carbon Tax (net)	N/A	N/A	100	0
Total Revenue			47,734	59,071
Deficit			**802**	**7,948**

To summarise, under my proposals there would be a flat income tax of 16⅔ percent on all income earned above the tax free threshold of $31200 (for single taxpayers), with a higher tax free threshold for those with dependents. This would be based on how many dependent children there were, and whether there was a dependent spouse. In the short term (three years), there will be a tax surcharge of 10 percent on all income earned over $100,000. It should be noted how little revenue this actually raises. This surcharge will be abolished at the end of year three as the need for it reduces when Government revenue increases faster than expenditure. Large expenditure increases in health, welfare, and education will no longer be needed because of sharp increases in productivity. GST will be increased from 12.5 percent to 16⅔ percent. Consumption is actually a better indicator of lifetime wealth than transitory income is, and therefore this tax is not regressive. Other taxes, such as taxes on petrol, alcohol, tobacco, etc., will remain unchanged. Income from other taxes will be slightly boosted by congestion pricing on New Zealand's roads, along with the sale of immigration permits and a moderate carbon tax, the revenue of which will mostly be offset by other tax reductions. The other main change is that all individuals, commercial enterprises, and other entities, will have a flat rate of tax (0.80 percent) on all their assets (the capital tax), with a deduction of $1,000,000 for households. In other words, households which have less than $1 million worth of assets will not pay any asset tax,

while those with more than $1 million will pay a very low rate on the difference. The main effect of this will be to encourage people to productively use their assets – be it land, an additional house, a luxury yacht, or a factory. Because there is no corporate income tax, we are shifting the tax burden from those who productively use their assets to those who underutilise their assets. The two examples in Box A and Box B below outline how the tax would operate.

Box A:

Farmer A and Farmer B both have land worth the same overall value. Farmer A does not utilise all of his land – he leaves many of the fields unploughed, intending to make untaxed returns on the sale of his farm. Farmer B is particularly hardworking and industrious. The below table sets out what their tax liability and net incomes would be under the alternative tax system:

	Farmer A	**Farmer B**
Property Value	$10,000,000	$10,000,000
Net Profit	$100,000	$1,000,000
Tax	-$80,000	-$80,000
Net Income	**$20,000**	**$920,000**

This example shows that those who utilise their capital most efficiently are rewarded – the tax on the farming operation is the same for both farmers, but the one who uses the farm to maximise his or her income receives all the net income tax free. This will encourage people to productively employ their capital.

Even for householders, this tax encourages people to shift resources into the productive sector, rather than accumulating property or assets that are often poorly utilised. The example below shows two householders, each with the same value of assets, creating very different incomes and tax liabilities by virtue of how they choose to invest:

Box B:

Householder A and Householder B have the same total value of capital assets – but Householder A has a lot of that capital tied up in two holiday homes which he does not rent out, while Householder B has chosen to invest his capital in income-earning shares. Under the current tax system, Householder A would not pay tax on the economic income he derives from capital gains, while Householder B would pay tax on the economic income he receives from share dividends. The below table sets out what their tax liability and net incomes would be under the alternative tax system:

		Householder A	Householder B
Assets	**Housing**	$2,000,000	$500,000
	Shares/Bonds etc.	$2,000,000	$3,500,000
	Total assets	$4,000,000	$4,000,000
	Net taxable assets	$3,000,000	$3,000,000
Income			
	Income on shares	$160,000	$280,000
	Capital tax	-$24,000	-$24,000
	Personal Income Tax	-$27,458.08	-$59,450.08
	Net income	**$108,541.92**	**$196,549.92**

If Householder A were to move some of his or her capital into shares, rent out part of their property, or set up a business, then he or she would be rewarded for moving the capital from non-income earning areas to income-earning areas.

How Will Spending Be Reduced?

The areas of Government expenditure that most need reform are those which can only be changed gradually – with reasonable notice – so that individuals have the capacity to alter their behaviour. Rapid changes to programmes like superannuation are simply not possible without harming large sectors of the population, primarily because people have structured their affairs on the expectation that such benefits will continue. Therefore, in health, education, and welfare, there are three kinds of savings arising from policy changes. The first saving arises from lower tax on benefits – essentially an accounting change – along with changes to the administration. This is a short term saving. The second saving arises

from changes to eligibility and the structure of Government provision – primarily cost-savings as the size and scope of benefits are gradually changed, as well as productivity gains associated with less Government interference. The third saving arises from the long term phase-out of the programs – the conversion from a pay-as-you-go model to a fully-funded model, with individuals rather than politicians making decisions.

It should be noted that the level of Government expenditure is still relatively substantial. The primary reason for this is that there will be many people who are unable to finance education, healthcare, and welfare insurance only from the tax savings that arise. In these instances, the Government will purchase insurance on their behalf, or provide them with the wherewithal to do so through tax credits. This ensures that the system is still equitable, but also runs relatively efficiently and without creating perverse incentives.

Superannuation

The level of immediate reliance on benefits like superannuation means that changes need to be signalled in advance. For this reason, there are no immediate real reductions in expenditure on superannuation – the $1,246 million of savings are essentially accounting changes arising from the changes to tax rates. Over the medium term, changes can be made to eligibility and coverage that reduce costs.

In the medium term, savings will be made by altering the age of eligibility. The current age of eligibility is 65. Over 15 years, starting in 2011, the age of eligibility will be lifted at regular intervals from 65 to 70. New Zealand operates one of the most generous superannuation schemes in the world, and the fact that the age of eligibility has not tracked in line with life expectancy is set to create large problems. In fact, the current age of eligibility is set at the same level it was in 1898 – when life expectancy was around 60 years and few people qualified for Old Age pensions. People need to be given time to alter their expectations and behaviour. The current approach, which seems to be to ignore the problem until politicians are forced to confront it – at which time they will have few options – indicates the longer-term desirability of removing politicians from decisions regarding retirement.

In the longer term, replacing the current Government scheme with one in which individuals save for their own retirement is crucial. This takes politicians out of the equation. To do so requires a change from the current pay-as-you-go system to a fully-funded scheme. To do this, every individual should be required to open a savings account to be accessed upon retirement. These accounts will be immediately boosted by moving all the current savings in the Cullen Fund into these individual accounts. In addition, the shares in all central and local Government businesses would be added to each individual's savings account. This *de facto* privatisation is likely to bring significant efficiency gains in the management of all the Government-owned corporations. The World Bank has estimated that it would increase our growth rate by 1-2 percent. In addition to these share and savings distributions, personal savings will be deposited into the individualised accounts. These savings will be calculated by taking the total amount of tax that is no longer being collected from personal income, and deducting the costs for healthcare and risk coverage (ACC, sickness, unemployment). Mandatory savings would continue until a minimum savings level has been reached. This would be set at the cost of an annuity equal to Government superannuation, plus the cost of catastrophic health insurance in old age. Many individuals would voluntarily choose to save more than the minimum requirements through this scheme.

Obviously it will take many people a substantial portion of their working years to save adequate funds for their retirement. The current superannuation system cannot therefore be done away with quickly – it will phase down over forty years. Rates of superannuation should be reduced, taking year 2013 as the base year. A suitable year-by-year reduction that enables people to begin saving for retirement is necessary. Beginning in 2013, individuals would essentially receive two pensions. The first is the current Government superannuation system, which will reduce over time. The second is the pension drawn from the individualised accounts, which in the beginning would be only a modest amount. The reduction in the level of Government superannuation would hasten over time, but this will be counteracted by the effects of compound interest on the individualised accounts. In other words, the phase out system should ensure that few are left worse off than they would have been, even assuming that the current system of superannuation were affordable in the future. The rate of reduction over the forty years is presented in the table below:

Year	Percent of 2013 Superannuation	Lump sum from savings
2010	100.00%	$14,000
2011	100.00%	$18,700
2012	100.00%	$23,635
2013	100.00%	$28,817
2014	99.87%	$34,258
2015	99.63%	$39,970
2016	99.26%	$45,969
2017	98.77%	$52,267
2018	98.16%	$58,881
2019	97.43%	$65,825
2020	96.57%	$73,116
2021	95.59%	$80,772
2022	94.49%	$88,810
2023	93.27%	$97,251
2024	91.93%	$106,114
2025	90.46%	$115,419
2026	88.88%	$125,190
2027	87.17%	$135,450
2028	85.33%	$146,222
2029	83.38%	$157,533
2030	81.31%	$169,410
2031	79.11%	$181,880
2032	76.79%	$194,975
2033	74.35%	$208,723
2034	71.79%	$223,159
2035	69.10%	$238,317
2036	66.29%	$254,233
2037	63.37%	$270,945
2038	60.32%	$288,492
2039	57.14%	$306,917
2040	53.85%	$326,263
2041	50.43%	$346,576
2042	46.89%	$367,904
2043	43.23%	$390,300
2044	39.45%	$413,815
2045	35.55%	$438,505
2046	31.52%	$464,431
2047	27.37%	$491,652
2048	23.10%	$520,235
2049	18.71%	$550,247
2050	14.19%	$581,759
2051	9.56%	$614,847
2052	4.80%	$649,589
2053	0.00%	$686,069

While access to a universal superannuation system will be progressively removed, it will be replaced with a means-tested superannuation scheme for those who have been unable to save a sufficient amount in their personal superannuation account (in particular, this is likely to be people who have been unable to work for large periods of their life). This

means-tested system will be introduced as universal superannuation is removed, to ensure that those least well off suffer no major adverse consequences. The means tested system would be introduced in 2025, and brought into line with the Australian pension system.

There are many benefits of moving from a collective pay-as-you-go scheme to a fully-funded individualised accounts scheme. First, it removes politicians from the equation. No longer will politicians be able to offer cheap political bribes at election time. Nor will the politicians, who have little interest in the long term sustainability of superannuation benefits, be calling the shots on the goals of superannuatuion policy. Even the National Government is using superannuation policy to advance goals that are completely irrelevant to superannuation issues. For example, Ministry of Social Development staff have confirmed that recent changes which extend to those retiring to the South Pacific much more generous levels of superannuation is in fact a *de facto* foreign aid policy. The politicisation of superannuation coverage has led to ad hoc policy decisions.

Second, it will materially improve New Zealand's savings' rate, which will provide much-needed capital for investment. Pay-as-you-go systems destroy many of the incentives to save by funding superannuation from future generations of taxpayers, rather than existent savings. It has been estimated that this lowers the national savings rate by as much as 20 percent, and the flow through effect to GDP is as high as 5 percentage points.

Third, fully-funded systems are much less costly in the long term. Because of the much higher return on real capital relative to the very low rate of return on a mature pay-as-you-go program, it is estimated that the benefits could be financed by about one sixth of the total current cost.[5] That is, individuals would need to save only one sixth of the current sum of tax currently being used to fund superannuation in order to provide the same level of entitlement as currently promised by New Zealand Superannuation. Such a reduction – from mandated payments to current retirees to mandated savings for oneself – materially reduces the deadweight loss associated with raising tax revenue.

Fourth, the individual accounts also allow for more packaged and comprehensive policies surrounding private insurance coverage for health, welfare, and accidents. Superannuation

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[5] Martin Feldstein and Andrew Samwick (1996) "The Transition Path in Privatizing Social Security" National Bureau of Economic Research, page 7.

accounts could be the first safety net mechanism for those who find themselves in distress – they could draw down on their superannuation funds to make ends meet while they searched for a new job. Obviously, drawing down on a superannuation account would only occur until the amount left reached some minimum which still enabled the purchase of a sufficient annuity and catastrophic healthcare coverage in retirement.

Health

Between 1999 and 2008, health expenditure increased by over 55 percent in real terms. Increased service delivery caused by better technology and an aging population do not explain the substantial increase in health expenditure. The increase is occurring because the health sector is dominated by perverse incentives. The consumer does not bear any of the cost of public healthcare directly, and so it is in their interest to try and maximise their personal level of benefit. The bureaucrat has little interest in restraining costs because he is not spending his own money. Spending someone else's money on another party is a poor way to incentivise either frugality or quality. The doctor does not need to compete on price to attract customers. The perverse incentives have seen a decrease in the productivity of hospitals of around 8 percent – 15 percent for doctors and 11 percent for nurses. The only group for whom productivity increased was janitorial staff, whose roles were contracted out to the private sector. Against this backdrop of rapidly increasing prices, the only alternative left to restrain costs is to ration services. Surveys have revealed that most New Zealanders do not think they are getting better services as a result of the substantial rise in expenditure.[6]

National says that we need to maintain the current funding arrangements but focus on decreasing the costs of medical care. Such an approach will only increase the distortions in the healthcare market impossible. As David Goldhill points out:[7]

> The government regularly tries to cap costs by limiting the reimbursement rates paid to providers by [the Government], and generally pays much less for each service than private insurers. But as we've seen, that can lead providers to perform *more* services,

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6 Simon Kemp "Public perception of actual changes in New Zealand government spending" New Zealand Economic Papers 43(1) April 2009, page 59.

7 David Goldhill, "How American Healthcare Killed My Father," accessed at http://www.theatlantic.com/doc/200909/health-care.

> and to steer patients toward higher-priced, more lightly regulated treatments. The government's efforts to expand "access" to care while limiting costs are like blowing up a balloon while simultaneously squeezing it. The balloon continues to inflate, but in misshapen form. Cost control is a feature of decentralized, competitive markets, not of centralized bureaucracy—a matter of incentives, not mandates.

We have budgeted to save $5 billion in healthcare costs. Savings can be made by restructuring the health bureaucracy – by separating the purchase of healthcare from the delivery of health services. The main savings arise as individuals purchase their own catastrophic coverage for healthcare. Day-to-day expenses (such as visits to the GP) will be paid for out of pocket. Insurance companies have incentives to shop around for the most cost-effective treatment – be it in a public or a private hospital. Individuals have an incentive to shop around for the most reasonably priced insurance plan – ensuring that cost savings are passed on to consumers through lower levies. Medical practitioners would soon be operating within a genuine marketplace, seeking to attract customers by innovating to improve quality or by reducing costs. This atmosphere will keep costs down and rapidly improve productivity. It is impossible to predetermine the level of productivity gains for the exact same reason that it is impossible to efficiently centrally plan an economy. However, the history of corporatisation and privatisation indicates that the gains in productivity will be substantial. As Dr Brash summarised in a speech to the Institute of Economic Affairs in London:

> The 14 SOEs corporatised in 1987 achieved some spectacular gains in productivity and profitability. For example, between 1987 and 1990, Telecom reduced staffing levels by 47 percent, increased productivity by 85 percent, and increased profits by 300 percent. Railways cut its freight rates by 50 percent in real terms between 1983 and 1990, reduced its staff by 60 percent, and made an operating profit in 1989/90, the first for six years. New Zealand Post reduced its workforce by 30 percent, and increased the rate of next-day delivery within the country from 80 percent to 98 percent. Coal Corporation increased productivity by 60 percent and cut its real prices by 20 percent.

There is no reason to suggest that similar gains could not be made in healthcare during the early years of operating the new system. Over the long term, it is likely that healthcare

costs will increase faster than general rates of inflation. This will be caused by two factors – first, the aging population, and second, the propensity for wealthier nations to increase healthcare costs in line with technological improvements. Increasing healthcare budgets – driven by individuals pursuing their own self-interest and meeting the costs either out of hand or through higher insurance premiums – is not something that we should seek to avoid. The best way to ensure that individuals have the capacity to purchase the kind of healthcare they want is by ensuring that a more dynamic economy produces opportunities and increases growth. To do that, tax rates and the burden imposed on productive individuals need to be reduced, and replaced with a system that encourages greater self-responsibility.

Education

Education expenditure has increased at a slightly slower rate than healthcare – up over 43 percent in real terms between 1999 and 2008. Despite this increase in expenditure, educational results have not improved – in fact, some studies show that education achievement is declining rather than increasing. Higher expenditure on education will continue to be a poor way of lifting education achievement so long as there are few incentives for staff to improve services, and as long as innovation is inhibited by a centralised and therefore risk-averse bureaucracy.

We have budgeted to save $4 billion from education – a portfolio that includes the primary, secondary, and tertiary education sectors. The first major saving that will occur is through a large cull of the current bureaucracy. The role of the Ministry of Education should be changed from one of central control to one of approving primary and secondary schools for service delivery, and high-level regulation. There is little need to undertake the impossible task of trying to centrally determine the appropriate size, position, or character of particular schools. Instead, the school network should be flexible in responding to the demands of parents and children – the consumers. Schools should be free to expand or shrink, to have particular educational aims, and to adopt innovative teaching methods. The role of the Ministry of Education should merely be to approve a school as a registered educational establishment. Overall, these changes would see a sharp decline in the number of bureaucrats. Other departments, such as the New Zealand Qualifications Authority or the Education Review Office could be immediately scrapped, while companies such as

Learning Media would be sold. Schools would opt for a variety of internationally-recognised qualifications; parents, not bureaucrats, would review the educational performance of school; and the private sector would develop resources for school use. The second major savings would come from parents buying education directly as a result of the tax savings, while tax credits would enable all parents – including those with little or no income – to be able to buy education in the marketplace.

This would have several advantages. First, since parents would be in control of a larger portion of the money currently used to pay for schooling, they would become more demanding customers – seeking value for money. When combined with the fact that there would now be up to two ways to send a message regarding the kind of schooling they want – both through exit (enrolling in another school), or voice (joining the school board, meetings at the school) – it is highly likely to increase the quality of school substantially.

Second, it will benefit most of all those who currently get a raw deal from state education. Wealthy parents essentially have choice – they can move into an area with a good school, or they can pay twice – once through taxation and once through tuition. That is why schools in high income areas perform relatively well – because the market does actually operate to incentivise quality education. It tends to be those at the other end of the income spectrum that receive poor schooling – and the best way to liberate them is through a tax credit/voucher program.

Third, the increased incentives for schools to perform well should decrease the expected future increase in education expenditure. With the current system, the least politically costly way for politicians to be seen to be dealing with educational failure is for them to promise more money. This will not face any opposition from any educational interest groups, and many have faith that more money rather than better institutions will drive innovation and improvements in educational outcomes. The current structure fails to reward teachers for their performance, and often leaves successful schools with waiting lists. Capital investment in successful schools is often not forthcoming, primarily because it would lead to under-utilised buildings in other schools. With a system that encouraged success, it is unlikely that substantial increases in the level of educational subsidy would be as necessary as they currently are.

In the tertiary education area, there are serious problems – there is questionable value for money when it comes to many parts of our tertiary education sector. There has been a sharp increase in the number of people seeking a tertiary education. While there are benefits of tertiary education, most of the benefit is a private benefit – graduates receive higher incomes in later life. This makes the case for extensive subsidies questionable. In addition, the data show that students who first enrolled in 2002 had a below 60 percent chance of completing or still being enrolled to complete their Bachelors degree four years later. In other words, at least 40 percent of the public subsidy is spent on people who fail to gain any qualification within four years. Across the whole tertiary education sector, the rate of graduation is below 54 percent. The degree of public subsidy is now costing taxpayers – many of whom do not have the opportunity to go to University – a substantial sum of money (tertiary education costs over $3 billion). The Government spends almost four times the OECD average on tertiary education as a percentage of GDP. There are also large opportunity costs of attending University – foregone wages and productive activity – that are not being factored in given the generosity of the student loan scheme. Recent changes – such as the interest free student loans – have led to a sharp increase in the amount of money being borrowed by students, with a predictable sharp decline in the amount of voluntary repayments. The increase of students attending University is also forcing the most talented to undertake postgraduate study in order to adequately distinguish themselves from the large number of other graduates, many with indifferent qualifications.

The level of public subsidy needs to be reduced – reversed from the current system where about 75 percent of the cost is subsidised to one where about 25 percent of the cost is subsidised. Loans of up to 50 percent of the cost should be available. Bonding schemes which subsidise education further could be offered in areas which face shortages or have large public gains (e.g. medicine). As in the primary and secondary sector, this will make for more demanding consumers. Interest on loans should be reintroduced – and it would be preferable for loans to be made through private banks, perhaps with a Government guarantee. That way, should the Government wish to reduce interest rates on the loans it has to do so by means of a transparent subsidy. This will have the effect of decreasing the number of people seeking tertiary education, while also decreasing the cost to the taxpayer of those who choose to attend. It ensures that those who do seek tertiary qualifications are doing so because of genuine economic returns on the investment, rather than as a lifestyle choice.

Welfare

In the nine years to 2008, the number of people on the unemployment benefit declined rapidly due to increased job opportunities. However, the number of people on the Invalids benefit increased by 61 percent and the number of people on the Sickness benefit increased by 41 percent. Claims that the increase was caused primarily by ageing are unfounded - the number of people between the ages of 18 and 65 increased by only 12 percent, and the number of people aged between 40 and 65 increased by only 23 percent. Despite a much higher level of wealth, the amount of Government expenditure spent on transfer programs has risen by over 330 percent in real terms since 1972. Welfare in New Zealand was once a means of temporary assistance for those who were suffering short-term financial distress. That is no longer the case today.

We estimate that savings of $4.5 billion could be made in the welfare area. Some of the current welfare programs – such as the in-work tax credit – will be able to be abolished, having been replaced with a much simpler and lower rate of tax, including the large tax free threshold for families. Welfare that targets the middle class – such as the entire Working for Families program – will no longer be necessary because of the tax system outlined above. Welfare programs that are targeted at helping the poor will continue, but the management and purchase of the forms of social insurance will change dramatically.

The way to reduce welfare spending will depend on the nature of the benefits being discussed. Generally speaking, there are usually two issues – who should bear the cost of social assurance, and who should manage the claims of those claiming social insurance. When it comes to unemployment, sickness, and accident insurance, individuals should purchase their own coverage. This will encourage people to shop around for a good deal, as well as enabling them to structure an insurance package that meets their needs – for example, some people may seek protection of a percentage of their income, rather than a sum of income. Some people may also seek a deductible from their superannuation account before turning to their insurance scheme. When it comes to the management of claims, it should be undertaken by private companies. This includes the management of residual ACC, Sickness, and Invalids claimants. Private corporations have much better incentives to introduce programs that encourage people back to work – and undertake checks of those on benefits to ensure they are not defrauding the system – because of the

savings it makes to the company. The competition for customers will keep costs down. In addition, these programs are likely to reduce in cost in the long term because of the benefits that will flow from moving away from a pay-as-you-go system to a fully-funded model, as outlined in the section on superannuation above.

The Domestic Purposes Benefit (DPB) needs to be treated differently from the other benefits. In this area, reforms similar to those undertaken by United States President Bill Clinton would be a move in the right direction. Those reforms mandated that states manage their case loads such that 80 percent of recipients would receive the benefit for no more than 5 years within their lifetime. This enabled the bureaucracy to focus on those who could be most easily returned to jobs in the short term. The result was large reductions in the welfare caseloads, and also included a sharp reduction in the level of illegitimacy (which is higher that 70 percent in some sectors of the community in New Zealand). If combined with requirements that DPB recipients name the other parent – in order that child support payments are collected – it is likely that a substantial amount of money could be saved. Those who currently receive the DPB under the age of 18 should primarily be the responsibility of their parents. There should also be a review of all those currently receiving the DPB.

Other

Two billion dollars of savings is budgeted for other areas of Government expenditure. These savings are not primarily the result of comprehensive reform, but targeting poor programmes or restructuring that will save money. The Ministry of Economic Development has quickly become a form of corporate welfare, with a variety of grants to business. The Ministry should be abolished, with a redirection of essential functions to other, better-equipped Departments, such as Treasury. Subsidies to KiwiRail should be scrapped, as should assistance to farmers that is necessitated by the ill-considered Emissions Trading Scheme. The Treasury has also mooted the possibility of cuts to the Department of Corrections – primarily through greater use of home detention. Provided that there are sufficient disincentive effects arising from home detention, then such savings are likely to be possible. The area of legal aid is also in need of reform – poor incentives lead to vexatious cases brought by lawyers who are funded through the Crown. Possible reforms would include part-payment or penalties for lawyers who abused the process. A

full review of all Government entities would need to take place – things like the Families Commission could obviously be scrapped.

Where To Next?

As the growth in Government expenditure would track below forecast economic growth, revenue would begin to exceed expenditure. This would enable the income tax surcharge to be removed relatively quickly. After that, the distortionary impact of indirect taxes should be re-examined and any necessary changes made. Finally, reductions in the rate of personal tax could be made to further solidify the gains made by opening the Government monopolies to genuine market competition.

This alternative budget has not considered in great detail changes to the regulatory environment that need to be made. A major issue is immigration. Immigration restrictions need to be significantly relaxed. This will allow us to have access to those with skills – and many will be attracted to New Zealand if we successfully create a vibrant economic environment. Immigration is also necessary to get the kind of innovations necessary in health and education to drive productivity gains – it is unlikely to come from the heavily unionised special interest groups that currently dominate these areas.

Another key issue is restrictions on the use of land. As New Zealanders have become concerned with soaring house prices – which have often locked out young people from buying their own home – we have sought to introduce policies to make it easier to buy your first home (KiwiSaver is an example). These subsidies will tend to merely inflate house prices further. The best way to ensure housing affordability would be to repeal restrictions on land use – to end residential zoning. Property prices would reduce, and more would be able to own their own home.

Conclusion

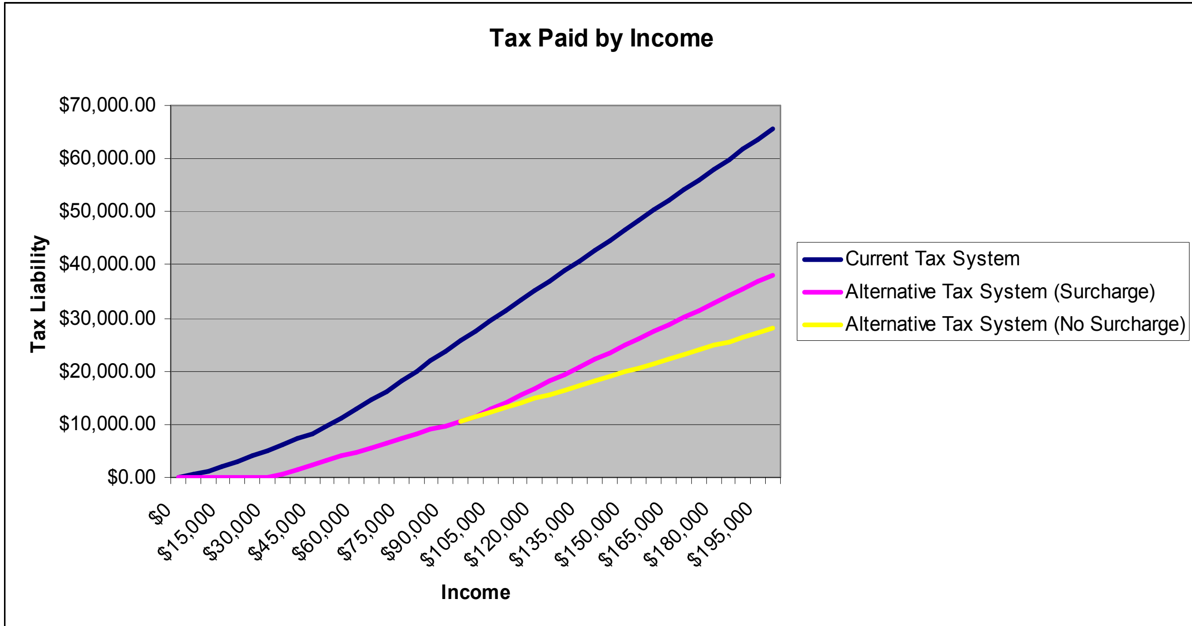
At the moment, we have choices. If we continue with our current tax and expenditure system, then those choices will disappear. We will either have to slash Government expenditure, or we will have to massively ramp up taxes. That means we must make decisions now – to ensure that people can plan and adapt to necessary changes.

The choices we have made over the past thirteen years have set New Zealand up for failure. The economic dividends that the reforms during the 1984 – 1993 period delivered have been squandered. As opposed to lowering taxes and providing incentives for people to lift themselves out of poverty, Governments undertook a massive expansion of the state. This depressed our productivity growth, took increasing amounts of money off people, and ultimately created economic stagnation. The current Government seems more concerned with using the apparatus of the state to massage their political egos and improve their electoral prospects come 2011 rather than putting New Zealand first and improving our future prospects.

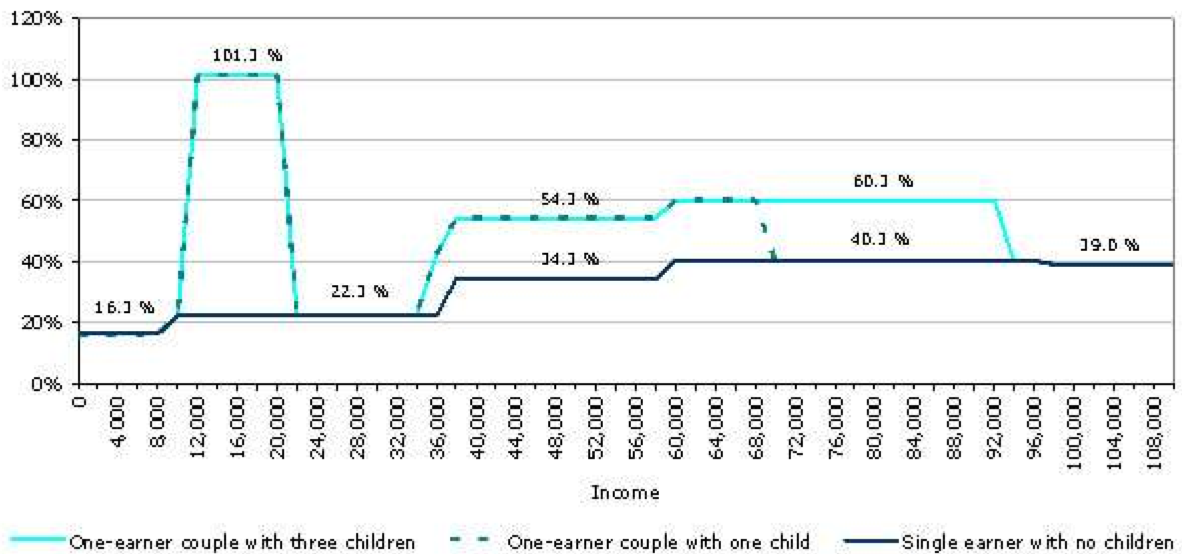
The package of reforms outlined in this budget is not necessarily the only way forward – but it is an example of the kind of radical thinking that is needed to reverse New Zealand's low economic growth trend if we are to have any chance of beating Australia by 2025. At its heart, it is a sensible reform agenda which is based around several truths that we all know in our hearts: individuals spend their own money better than anyone else does, monopolies always fail to deliver value for money, and politicians cannot be trusted to plan for our future. Making some of the changes will be hard – but they pale in comparison to the changes that will eventually need to be made if we continue to mortgage our children's and grandchildren's futures.

Appendix

Below are a series of graphs that compare and contrast our current system with that alternative system. The first is a graph that shows tax due by income:



The second is a graph that shows how the current level of effective marginal tax rates for one earner couples with children compares to a single earner. The high marginal effective tax rates are primarily caused by Working for families:



The third graph shows the overall level of core Government expenditure. It demonstrates that the increase of Government expenditure in recent years is substantially above the trend over the last thirty years – and indeed, during that thirty year period Government expenditure has expanded rapidly: