A High Growth-Low Tax Welfare State

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Since September, politicians and the media have become increasingly concerned about the state of our economy.

Predictions of no economic growth in 2009 have moved from being the worst case scenario to the reality facing New Zealand. As the truth of the recession and higher unemployment hits home, politicians and households have become alarmed. Although rightly concerned about our economic prospects, New Zealanders are wrong to see our woes as largely being driven by the global financial crisis.

The challenges that New Zealand will face due to the international crisis will, no doubt, be great - but we mustn't fool ourselves: New Zealand has been in a recession - getting poorer - since the first quarter of 2008. We were in a recession before the fallout from the global financial crisis arrived on our shores; we were in a bad economic situation, and the financial crisis has simply made that situation worse.

Today I want to set out the economic troubles facing New Zealand, and then set out a way to redesign our tax and welfare system to achieve a high-growth low-tax welfare state.

First, let's consider the deteriorating economic situation after nine years of Labour control.

In the private sector, our current account deficit has ballooned to its largest since the last major recession in 1975. This large increase in the current account deficit - now equal to 8.5 percent of GDP - occurred despite the most advantageous terms of trade since the early 1980s.

As our current account deficit grew larger, we told ourselves that a significant drop in the dollar would help eliminate it. Unfortunately for us, the drop in the dollar has been accompanied by a significant reduction in commodity prices.

What does this mean?

It means that, unless we make major changes to our policy settings to increase our international competitiveness, then the current account deficit is here to stay. And this deficit will require ongoing financing. But such financing is increasingly scarce because of the global credit crunch and, on top of this, recent trends in Europe towards more trade protectionism will threaten New Zealand's exports. This will only worsen our situation.

On the household level, the situation does not look pretty either. During Labour's rule household income increased - but the increase was largely driven by New Zealanders working harder, not smarter. Our labour productivity growth is today lower than it has been since the early 80s. Low productivity growth is causing low wage growth, and we have now become one of the lowest growth countries in the world.

There is only one way to increase wages: increase productivity. This economic fact must be understood before we can design policies to boost average income. Despite this reality, we have unions - like the Engineering, Printing, and Manufacturing Union - publicly announcing that it will continue seeking real wage increases. Any increase that workers receive beyond productivity increases will merely exacerbate unemployment.

While we know what creates wage growth, the Labour Government blinded itself to the importance of productivity. During the Clark and Cullen era, average productivity growth was 0.7 percent. Under what Cullen describes as the failed policies of the past - the reform period - it was three times that. Despite setting a goal of making it back in to the top half of the OECD, Clark and Cullen dreamed up and tested for nine years the failed policies of the present. This has caused us to slip further down the OECD ladder.

But while household incomes have not risen significantly, household debt certainly has. Despite slow wage growth, we have continued to live beyond our means. To finance our wants, we have turned to debt. Household debt has soared to over 150 percent of disposable income. With credit cheap, we mortgaged our houses to buy consumer products. With the prospect of increased unemployment, many families will struggle to pay the interest on their debts.

That's the economic situation in the private sector. Let us now examine the public sector to see what kind of fiscal situation we face there.

When Labour was elected in 1999, the New Zealand economy was recovering strongly after the Asian financial crisis. Growth had been high and was expected to continue to be high. The solid economic framework New Zealand had developed during the reforms of the 80s and early 90s ensured that we would grow. We had a simple taxation system where the Inland Revenue Department was a tax department, not the administrator of complex welfare schemes. We had defeated inflation through a tighter monetary policy that focussed on inflation targeting. Privatisation had created efficient businesses targeted at meeting consumer demand, in direct contrast to the arrogant monopolies that preceded them. These structural reforms set the stage for strong economic growth. The opportunities that this presented have been squandered by nine years of an interventionist Labour Government.

Consider these facts:

1) Labour started in 1999 with one of the most simple tax systems in the world with a broad tax base. It destroyed this simplicity by introducing complex Working for Families tax credits, re-introducing failed subsidy programs like the Research and Development tax credits, and making the taxation department responsible for transfer programmes like KiwiSaver. These complications have increased compliance costs and enriched tax lawyers, while doing little more than distorting incentives to work and save. We now have a rollercoaster set of effective marginal tax rates, which ensures people worry more about how much of their benefit they will lose rather than how they can better their career.

2) Labour increased the costs to hire and employ workers, and told us these policies were employee benefits. They were benefits for people in jobs, but hurdles for those out of work. They will now act as a major barrier to re-employment for those who lose their jobs.

3) Labour engaged in widespread regulation of network industries - like telecommunications - which impaired the incentives to invest in key infrastructure. It burned millions of dollars of value in Auckland Airport to score a cheap political point and destroyed the savings of many mum and dad investors when it sunk Telecom's share price.

4) Labour embarked on a massive expansion in the breadth and depth of Government services. Whenever spending increases, we must ask ourselves whether the cost is worth the benefits it provides. Perversely, Labour measured the benefits by how much taxpayer money it was spending. It turned government waste into a positive. Despite warnings from Treasury that much of the spending was low-value, the Government continued to take money off taxpayers only to filter it back to them through incentive-destroying schemes.

Throughout this period the Government claimed a higher percentage of New Zealanders' incomes and, as a result, ran fiscal surpluses. The books are now in the red and the Government has joined New Zealand households in indebtedness. When international credit is particularly tight, the Government has announced plans to borrow and spend on infrastructure projects. We have now been put on notice that our credit rating may be downgraded. Investors see our debt as risky - they fear we may default.

The past nine years have shown what happens when the Government lacks direction. Policies have been implemented with no clear goals. Some policies even work in the opposite direction of stated goals. For example: if you believe the rhetoric surrounding the Working for Families scheme, it was introduced because the Government was concerned about high effective marginal tax rates. To solve this, it introduced a new benefit scheme for those in work. This merely created high effective marginal tax rates for those in low-skilled employment, impairing their incentive to get ahead.

Or take the Government's concerns over the high level of student debt. It decided to make the taxpayer bear the risk of default, and declared that the students who benefited from tertiary education should not pay interest on their loans. This has had the predictable effect of increasing the amount students borrowed and decreasing the amount paid back.

Labour let the softness of its hearts spread to its heads. We need to unite policy behind a goal. That goal should be to lift our growth rates and provide opportunity to those of all income levels. Policies should be judged not against their intention, but how effective they are in achieving the stated goal.

Labour squandered its opportunity to cut taxes and return spending decisions over health, education, and superannuation to those most affected - the individuals. The effect of not making individuals responsible for spending has been to massively increase the amount of money spent by central government for little tangible outcome. Had Labour only increased spending in line with inflation and population growth, it could have completely scrapped the personal income tax on all New Zealanders. While this is not a policy that ACT supports at this point of time, it suggests the kind of trade-off that has been made. Has the spending binge really been worth it compared to the economic benefits of no personal income taxation?

All of these problems suggest we need a new approach. Worryingly for New Zealand, however, most politicians are continuing down the path that has led us to the situation we are now in. The last election represented a choice between more spending, or more spending and lower taxes. We offer a third option: less spending and lower taxes.

National purports to represent limited government, but does no such thing. The size of government is determined by the amount of government spending, not government tax revenue. All government spending must be paid for ultimately by taxpayers, be it through current or future taxes.

And, in that sense, the size of government is set to grow under National. The latest Budget Policy Statement from Treasury shows that Core Crown expenses will increase from below 30 percent of GDP to 35 percent. In other words: the tax cuts are currently being financed by higher government borrowing - borrowing that will eventually be paid back with interest by future generations of taxpayers.

We privately mortgaged our houses to buy consumer goods. The Government is now mortgaging our children for the next round of spending increases. And the response from our children has been clear: they're leaving our shores in ever increasing numbers to seek higher paying jobs in countries like Australia. Unless tax cuts are matched with cuts to government spending, we are merely redistributing the tax burden across time.

The lack of vision is clear if we examine the ideas that some politicians have come up with to deal with the financial crisis. With unemployment set to rapidly rise, the Government announced a temporary benefit scheme for people with mortgages. The Government has resigned itself to increases in unemployment.

But we don't need to. One of the reasons that so many will be made unemployed is because our relative labour costs have increased 60 percent since 2000. That fourth week of holiday may have seemed like a nice benefit at the time, but taking those decisions out of employers' and employees' hands will worsen and deepen the recession. The Government should respond to fears of unemployment by reducing the compliance costs associated with hiring and employing.

While the vision of most politicians is lacking, we don't have these problems because of politicians. Politicians merely mirror the sentiment of New Zealand voters. As citizens, we've become more concerned with dividing the pie rather than growing it. We've continued to sample the free lunch that politicians on both sides of the House have offered us, but it is now obvious that the price we are paying has become too high. The price will be higher still for future generations. The reality is that we have only ourselves to blame.

As voters, we seem to have bought the false notion that we can all be made wealthy through government. Elections have become an opportunity for politicians to promise they will take more money off you, only to give it back to you in another way - a gold card for superannuitants, a tax credit for working families, or an interest write off for students. If we each pretend that we can be made wealthy through taxing others, then we're destined for poverty. We are increasingly relying on others - be they foreign lenders or domestic taxpayers - to sustain our way of life.

At the same time, people are well aware that government-run services are failing us. We know this because we see the effects of government failure every day. We are forced to ration healthcare, but are never forced to ration cars. We pay meagre benefits to superannuitants, but if we had put their tax money in the bank they would be a lot wealthier. We knew that education standards were slipping, but we decided to change the standards so it didn't look that way. Government failure surrounds us.

The problems we face are many and great - but we should not be without hope. There is one Party that recognises the size of the problems and has a real solution - rather than more of the same.

Having established the problems, I now want to move on and present to you my vision of achieving a high-growth low-tax welfare state. I believe the only way to change our economic prospects is to radically redesign our income tax system in concert with our social welfare system. Individuals should have the ability to opt in to the new system. Individuals who like high tax rates and monopoly-run health, welfare, education, and superannuation services can stick with the old system. But if you want to opt out of that failing system, then you should be able to have a lower tax burden in exchange for taking personal responsibility over your life.

This system will work as follows.

On the tax side, an individual's first $30,000 will be tax free. Above this tax free-threshold, individuals will pay tax on the basis of a flat tax rate. Over the next 15 years this flax tax rate will be steadily reduced, along with the corporate tax rate, to 15 percent. The Labour Government made money for the tax planners by adopting different rates of personal, corporate, and trust tax. We must end this kind of ad hoc tax approach and restore simplicity and fairness to the tax system.

The Government talks about inflation indexed benefits, but we think it is time to treat the taxpayer in the same way. As such, the $30,000 tax-free threshold will rise to keep up with inflation. This ensures that low-income earners receive a significant tax cut that will not be taken away by inflation.

Families with dependent children will have a different tax-free threshold. For a couple with one child it will be $50,000. The thresholds will increase based on the number of dependent children.

To ensure that families are able to adequately provide for themselves, there will be a guaranteed minimum income for families. The guaranteed minimum income will ensure that, should they find themselves earning less than the tax-free threshold, families will receive a tax credit to boost their income.

The purpose of the flat rate is to remove the current disincentives to work and save. The current tax and benefit systems mean that working more will sometimes not improve the position of the individual. Effective marginal tax rates are too high. We believe that individuals and families should be rewarded for their work and effort, not punished.

So far it probably sounds like I'm trying to sell you the free lunches all the other politicians do. But with the increase in after-tax incomes, individuals will be expected to accept responsibility for their own retirement, healthcare, and insurance. This responsibility means that the provision of these services will be controlled by the individual, not the bureaucrat; that individuals have an incentive to keep costs down, not put large costs onto taxpayers; and that the service providers have an incentive to serve customers and innovate, not capture politicians and bureaucrats through lobbying.

For superannuation, the Government will create a situation where dedicated accounts in the name of every New Zealander aged 18-64 can be opened. New Zealanders who opt in will be guaranteed that they will not receive less in the new system than they would have in the old system. Through a combination of private and employer contributions, individuals will retire with more generous annuities and/or capital than those currently granted to them under our existing government scheme. Control of superannuation payments will be taken out of the hands of meddling politicians, enabling individuals to adequately plan for their retirement.

For healthcare, individuals and families will be expected to take out catastrophic health insurance to ensure that they have access to medical services when urgently required. They will be free to choose the appropriate level of insurance coverage for their situation. When seeking health services they will be incentivised to reduce costs, rather than ignore them. At the same time, they - not some bureaucrat in Wellington - will decide what healthcare needs they have.

For insurance, individuals would be expected to take out risk coverage against injury, sickness, or job loss. Competition needs to be restored to this area, which has been dominated by failing government-owned monopolies. The reduction in costs arising from competition in these areas will be immense. The average claim under the ACC system suggests that the average accident causes over 80 days of work to be lost. Contrast that with private providers of accident compensation, where the average number of days lost is just over 12. Private providers cannot be matched in performance by cumbersome monopolies.

How would this policy package in practice then? Let's take the example of a single person with an annual income of $30,000 - that is, a person earning below the average wage.

That person currently pays $6,150 in taxes. Through their life they're entirely dependent on the Government to provide healthcare - they cannot afford private health insurance. This may see them queue along with thousands of others for medical treatment. Decisions over their health will not be made by them, but by some bureaucrat they'll never meet.

With what's left of their after-tax income, they will scarcely be able to afford to save any money for retirement. When they retire they will be reliant on the state. Single superannuitants currently receive about 40 percent of the average wage. That is likely to reduce in the future as demographic changes - fewer workers and more superannuitants - make it unaffordable.

In terms of accident, sickness, and unemployment insurance they will be completely reliant on the whims of politicians.

Under the new system, that person would receive their first $30,000 of income tax free - beyond $30,000, a flat tax rate would apply. With the private savings account, which receives top ups from their employer, they will retire with $1.8 million in the bank - or $850,000 adjusted for inflation - after a lifetime in the workforce. They will be entitled to this because it is their money - they don't need to hope for the generosity of other taxpayers.

When it comes to healthcare, they will make decisions for themselves over what medical treatments they require. With the tax cut, they would easily be able to afford a high quality catastrophic insurance policy. With the actual consumer spending the money, the health system will respond to consumer needs - not to the whims of bureaucrats and politicians.

In terms of risk insurance, individuals will be able to determine the appropriate scope of coverage. By restoring price signals to insurance premiums, workers and employers will be encouraged to make workplaces safer. Claims will be made based on demonstrating need to the insurance company, rather than payouts becoming an entitlement and a way of life.

Some will say this kind of system will help the wealthy. It will. But not as much as it will help the poor. It is the current system that denies opportunities and options to the poor. The poor are forced to queue for healthcare, while the wealthy get it when they need it through private provision. The poor are reliant on the goodwill of taxpayers to provide for their retirement, but if we just allowed them to direct some of their taxes to a bank they would retire with more money. By taxing people and taking away responsibility for healthcare, superannuation and risk insurance we have taken away from the poor the opportunity to make the decisions that most affect them.

The problems that we face are daunting, but they also provide us with opportunities. We know that monopoly control ensures that service suppliers do not respond to consumer demand, while the costs only increase. We know this because that is what we have experienced with our failing high-tax welfare state. We understand our problems, but we also know what to do about them. There's no point waiting for things to get worse - let's get on with it. We need to use the expertise that New Zealand has. We have become petty and small-minded when it comes to accepting the advice of talented individuals like Roger Kerr, Roderick Deane or Graham Scott. This small-mindedness has allowed us to shut ourselves off from the reality of our relative poverty as a nation - but it has not solved the problem.

There is only one way to solve the problem. Only by restoring responsibility to individuals will we be able to tame the increasing cost of Government services. Only by restoring choice to individuals will they become independent, rather than dependent. Only by creating a low-tax welfare state will we be able to achieve economic prosperity. We can do it, if we have the guts to do what's right.