

PUBLIC POLICY— CAUGHT IN A POVERTY TRAP

R K Deppe
Todd Corporation
Wellington

Abstract

The New Zealand economy is currently caught in a poverty trap which appears to have been largely created by public policy. New Zealand cannot grow because real interest rates are too high, in particular caused by a shortage of savings. From 1986 to 1990, instead of encouraging savings, successive policy measures have further discouraged them. This prolonged period of high interest rates has aggravated the recession.

The public policy of promoting government consumption at the expense of private savings has had a direct impact on the petroleum industry.

The government's inability to contain its own high level of consumption, coupled with the high cost of borrowing (also caused by high government consumption) pressured the government to increase its total take from the petroleum industry. This resulted in the 1990 measures to increase petroleum taxes. The pressure for government revenue was apparently so strong that in 1989/90 the government proposed an increase in royalties.

This has had two main effects. Firstly, it has dramatically reduced new exploration. Reduced exploration will mean that New Zealand will not be able to maintain existing production levels. Domestic production is currently worth \$1.5 billion. If New Zealand has to import \$1.5 billion more petroleum this will initially have to come from national savings. Reduced savings means high interest rates and consequently lower growth in the future. Secondly, increased taxes and royalties will directly decrease petroleum corporate savings (retained profits).

The net result of these two impacts will be a further perpetuation of the vicious cycle of scarce savings maintaining pressure on real interest rates causing the government to further increase taxes on corporate savings. This in turn causes further high interest rates. The analysis indicates that in the last few years the government has reneged on its responsibility to establish a long range energy policy, hoping instead for the market to somehow make this policy decision for them. A market is not a decision maker; it is simply an automatic clearing mechanism of good and bad decisions.

Introduction

Over the last decade you would be excused for getting the feeling that every time the Government has tried to improve New Zealand's dismal growth record, the country appears to be getting deeper and deeper into trouble.

While the rest of the world has managed to maintain growth rates of 3 to 4% and our Far Eastern neighbours have managed to achieve rates between 5 to 10% growth, New Zealand has struggled to maintain even a 1% growth rate over the last 10 years. What are we doing so badly that causes us to grow at two to three times less than most other countries.

In the past we have been very quick to blame the economy's poor performance on everything from Think Big, Rogernomics, Reserve Bank to Commercial Banks. Looking for scapegoats though, is just one more symptom of the economic disease facing the economy. For too long we have avoided the real issues facing the economy, and more importantly, for too long have we avoided planning for long term growth.

For example, the Reserve Bank has been blamed for causing high real interest rates. While the Reserve Bank can cause high real interest rates over a short period, New Zealand has had high real interest rates for more than six years. Over such a long period the Reserve Bank could not keep rates as high as they have been even if they wanted to.¹

The New Zealand Economic Disease

The symptoms of the New Zealand economic disease are:

- prolonged low/negative growth
- high unemployment
- high real interest rates
- chronically declining low national savings

This disease is called STAG-SUMPTION. Stagnation is characterised by chronic over consumption (undersaving).

Figures 1, 2 and 3 show firstly, that the precipitous decline in national savings has been matched by a similar rise in real interest rates (on the graph showing the relationship between savings and real interest rates, the real

¹ The only way the Reserve Bank could keep real interest rates high over a 6 year period is by ensuring that money supply grew by significantly less than GDP. Since money supply growth (MI) for most of the period has been

well over 10% while GDP has been around an average of 1%, the Reserve Bank can hardly be blamed for being excessively restrictive.

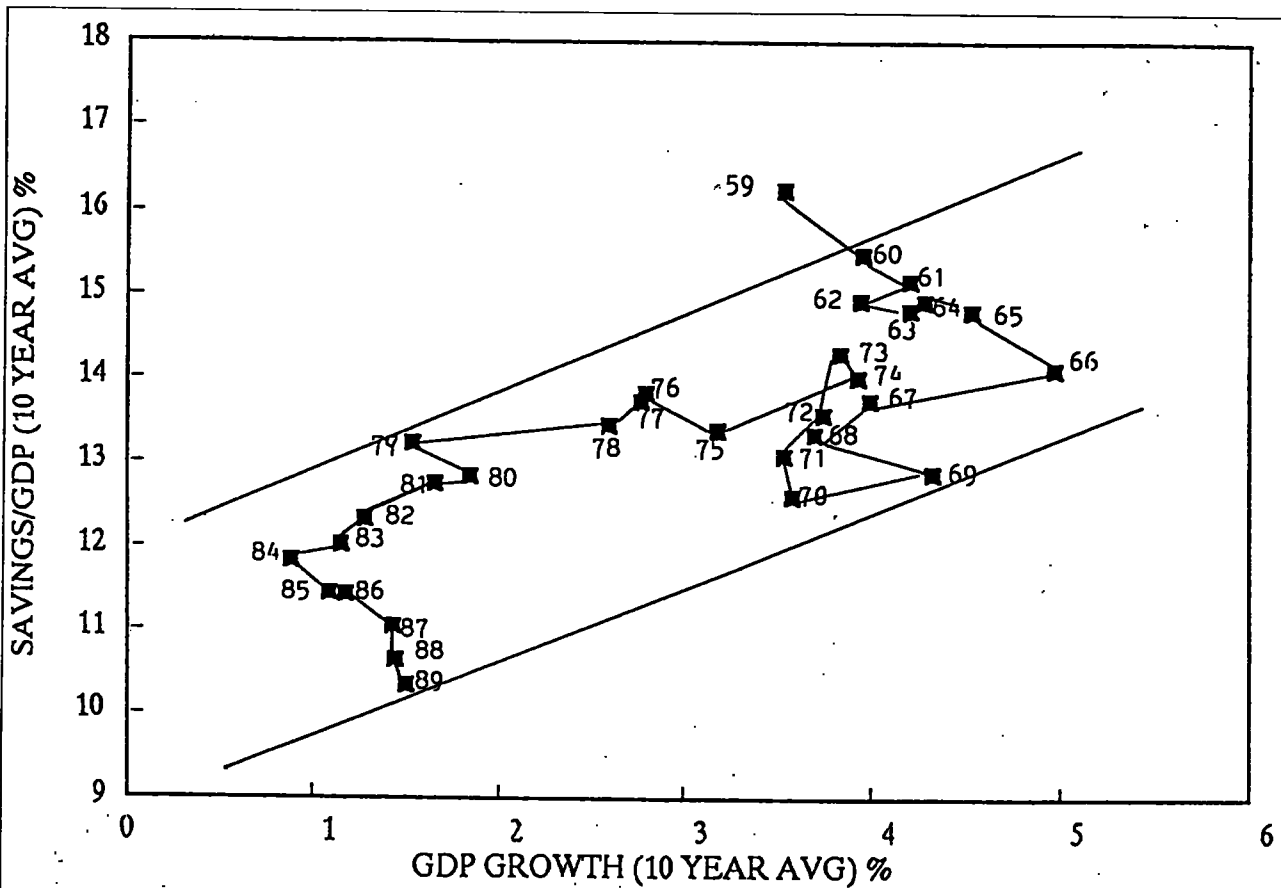


Figure 1: Stag-summation—savings and real interest rates relationship.

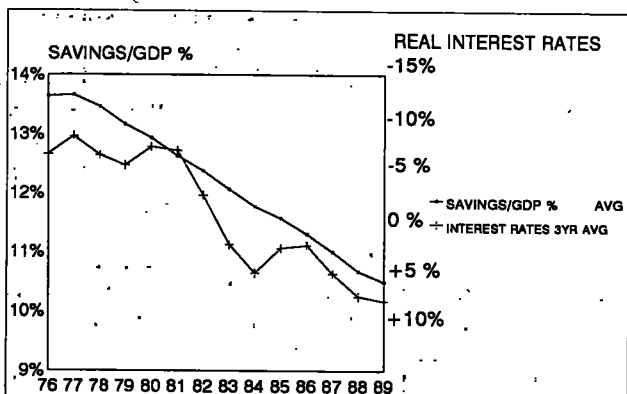


Figure 2: Stealing from the cookie jar—the savings-interest rates relationship.

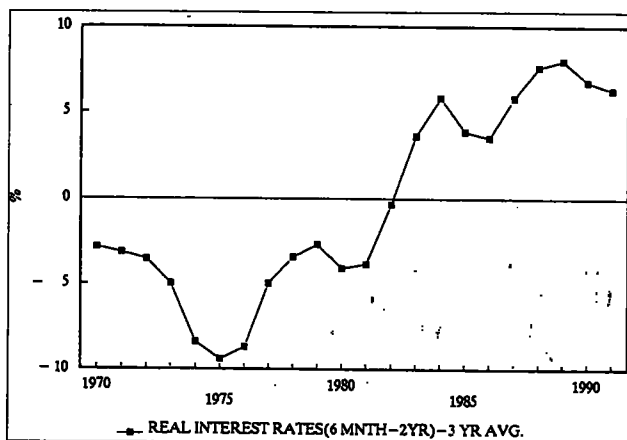


Figure 3: Paying for the free lunch.

interest rates scale is reversed to show the close correlation).

The Government, trying to satisfy an insatiable demand for more expenditure and the public motivated by tax incentives to dis-save, have been dipping their hands in the proverbial "cookie jar" and have literally eaten up the country's nest egg for the future. As a nation, consumption for today has been pursued at the expense of saving for tomorrow. The cost of low savings is low long term growth.

Gone are the days when we can expect other countries to carry on subsidising our excessive consumption. Our debt level at \$50 billion is now 80 % of our Gross National Product. International banks are only prepared to lend to

New Zealand at interest rates which reflect the higher risk that they won't be paid back.

Economic Religion—Economy Heal Thyself

If you go up The Hill and ask why there has been no focus on the obvious lack of savings over the last decade, the most common answer is that in a deregulated market, you don't have to worry about the level of savings because interest rates will simply insure that the economy has sufficient savings to allow it to grow at its optimum level. What they mean by this is that if there is a shortage of savings, and interest rates go up, this should encourage more people to save because they

get a high interest rate and discourage people from borrowing. So the pure theory is that if there is a dramatic shortage of savings, interest rates will increase, savings will increase as a result and consumption will go down, and then the economy will have healed itself.

The Gods Must Be Crazy

Why then for more than eight years have we had high real interest rates and the economy has not moved back on to a positive real growth path in line with the rest of the world? Why have high real interest rates not been able to increase savings? Have the economic Gods changed the rules?

Poverty Trap

The answer to why the economy has taken more than six years to recover and still appears to be unable to correct itself is that the Government is caught in a number of very real poverty traps. In order to illustrate each of these poverty traps the economic system has had to be simplified. In the real economy there are many other forces operating. Two poverty traps are:

- the pressure for funds trap; and
- abdicating decisions to the market trap.

Pressure for Funds Trap

Economic systems like any other system, such as ecological systems, frequently enter self perpetuating cycles. The trigger starting the trap is an increase in taxes (Figure 4). Tax rate increases decrease personal and/or corporate savings (retained earnings)². This means less funds are supplied to capital markets. This increases interest rates, which decreases growth. Decreased growth decreases incomes and profits further. This means *less tax* is collected, and tax rates have to be increased (or new taxes created) to fund the same expenditure. The trap comes full circle and we are into a downward spiral of further declining savings and growth. The conditions under which this spiral can escalate out of control or diminish depends on many factors which will not be discussed in this paper.

Recently more economists and officials have come to understand the existence of the above poverty trap in respect of Guaranteed Retirement Income (GRI).

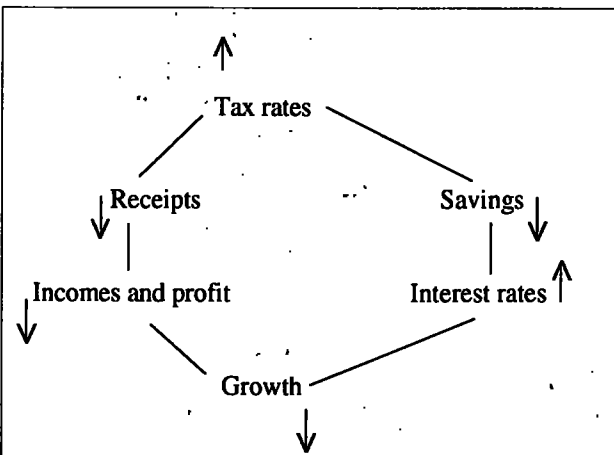


Figure 4: Pressure for funds trap.

Guaranteed Retirement Income

To fund GRI the government has certainly been forced to increase taxes and this has set in cycle the above poverty trap. However, to lay all the blame at the foot of GRI is probably very far from a complete answer. To begin with the Social Welfare budget (GRI is a major component of this budget) has only increased from 10 % of GDP in 1979 to 12 % of GDP in 1990. A 2 % increase is hardly a large increase over 12 years and certainly not an increase which could hold the economy in a six year recession. (Economic Strategy 1990 - Government Publications, p. 68) Economies are amazingly resilient and over a 12 year period could have found other means of generating the necessary savings.

A closer look at the raw savings data shows that although savings did begin to fall prior to 1984, it is only since 1984 that large declines in savings have occurred. What other processes have been occurring from 1984 until today?

Abdicating Decisions To The Market Trap

Over the last few years an alarming trend is emerging whereby the Government is abdicating decisions to the market. This cycle started when interest rate increases pushed up the cost of Government debt. This made the Government increasingly aware of the time value of money. They then hit on the ingenious method of shifting future tax payments closer to the present. This enabled the Government to reap a one off rise in taxes. Unfortunately however, this can only be done once for each tax. For example, in the year withholding taxes were imposed, the Government received the tax on the previous year's interest income and the current withholding tax on interest. The following year however, there was of course no double hit as only the current years withholding taxes were received.

Because the "double-hit" is only one off, the only way of perpetuating the advantage is to keep doing it to different taxes (Figure 5). An imaginative Treasury can think of all sorts of ways of making taxes more immediate. They can:

- increase the immediacy of personal taxes;
- impose withholding taxes;
- favour royalty regimes which yield income sooner rather than later; and

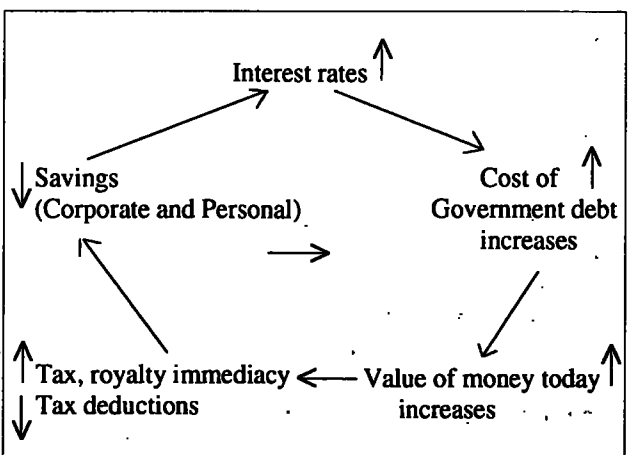


Figure 5: Abdicating decisions to the market trap.

² An increase in taxes could also be paid for to a limited degree by decreasing consumption. A decrease in consumption triggers off another cycle which also decreases growth.

- lengthen depreciation periods and delay exploration discovery write-offs periods (e.g. petroleum taxation changes, 1990).

These measures decrease corporate and personal savings and this in turn maintains pressure on interest rates and completes the vicious circle.

A major difference between this poverty trap and the previous one is that firstly, the motivation for increasing the immediacy of taxes appears to be the increase in interest rates. Secondly, the increase in the immediacy of taxes will tend to hit savings, rather than consumption.

We thus have the position that the Government, itself the major cause of the initial increase in real interest rates, is continuing to feed into a vicious downward cycle which progressively decreases growth.

A quick review of past Budget Speeches has revealed no less than 8 taxation changes that can be shown to be feeding into this poverty trap.

(i) In 1984 the intention to tax life insurance companies was announced and in 1988 both Superannuation and Life Insurance Companies were taxed. This was replaced with the promise that pension payments from superannuation companies would be tax free. The discounted present day benefit of the tax saving in 20 to 30 years time is very small in comparison to the alternative of paying no tax now.

Thus the Government by this single measure, significantly changed the nation's preference away from saving and in favour of consumption today. The Government gave a clear message to the New Zealand population that saving for retirement was less important than the Government's need to tax and spend.

(ii) In 1990 the last incentive to save, the \$200 tax exemption for interest on savings, was withdrawn.

(iii) A further group of taxes have had the effect of decreasing the working capital of the nation. The working capital of the nation is just like the working capital of any company, as it is the pool of funds required to finance the ongoing running of the nation. The working capital of a nation is often forgotten about but is a very important part of the savings base of a nation. If Government tax the working capital of the nation this will have an immediate adverse impact on the amount of capital/savings that can be supplied to capital market and interest rates will increase. Some of these measures are:

(iv) In 1986 the accrual regime was introduced. This meant that income was deemed to be earned not when it was received but rather when it was earned. This significantly increased and brought forward the tax on the working capital of the nation.

(v) Since 1987 foreign income which is brought back to New Zealand is double taxed in shareholder's hands. If this income is kept offshore it is not double taxed. This encourages New Zealand savings which are offshore to remain offshore, thus depriving domestic capital markets of scarce savings.

(vi) Since 1988 if a provisional taxpayer underestimated his income for the year he/she has been penalised. Previously this unpaid tax reserve had formed part of the nation's working capital.

(vii) Withholding tax on interest was introduced in 1989. This again brought forward and increased the Government's cut into the nation's working capital.

(viii) In October 1990 changes to the depreciation and exploration deduction rules governing petroleum production

significantly increased the immediacy of the Government's tax take. It appears that the real reason for the tax changes was the increased cost of deferring tax receipts. This is suggested by:

- over the life of a project the Government will not raise additional funds from the changes—the only change is that taxes are collected very much sooner; and

- in the past the Government used the level playing field argument to justify the taxation increases. It was argued that petroleum should be treated in a similar way to other industries. The weakness of this argument has become apparent because if it were the case offsetting changes would have been made to Royalties. This has not occurred.

Secondly, the petroleum industry's research and development, (i.e. exploration) should have been treated on the same basis as other industries.

In hind sight it is now apparent that the petroleum taxation changes were nothing more than a revenue raising exercise and were just another element of the larger poverty trap into which the Government was locked.

(ix) It is probably no coincidence that a review of all royalties was announced in 1988. This was at the height of what could be referred to as the poverty trap period—when numerous measures were introduced as a result of the increased value that the Government placed upon a dollar today rather than in the future. It is also probably no coincidence that the first few reports that came out tended to favour types of royalties which returned revenue sooner rather than later. Hence the dismissal of rent resource royalty which of all the types of royalty, returns revenue to the Government, the latest.

(x) The above measures have now become a permanent part of the tax system and as such create a permanent disincentive for the nation as a whole to accumulate domestic savings.

As if the disincentive to save were not bad enough, there are tax incentives to borrow. Excessive borrowing places strain on the small pool of savings and interest rates again are pushed up. The tax incentive to borrow arises because:

- interest from borrowing is tax deductible; but
- interest from savings is not.

The rational person/company will therefore not save—even though savings are clearly good for the country's long term future. The rational person would borrow and buy an asset such as a house or shares. The interest on the borrowing can be offset against the income earned from the asset. Thus by borrowing, a person can minimise tax payments. Saving on the other hand maximises tax payments. In this way the tax system at present not only provides no incentive to save, but it positively discourages savings.

Breaking the Poverty Trap

Over the last 7 years Government policy can be seen to have:

- aggravated and prolonged the recession;
- adopted policies which have increasingly increased the disincentive to accumulate domestic savings³; and
- abdicated making crucial decisions to the market.

To break the poverty trap public policy must stop abdicating crucial decisions to the market. A market is NOT a decision

³The present Government might claim that their recent cutting of the dole and welfare payments provided an incentive to save for a rainy day. This however relies on punishment for not saving rather than reward for saving. The Behavioural Sciences however have proved that punishment tends to be a weak motivator in comparison to reward.

maker it is a clearing mechanism for good and bad decisions. It is an abuse to abdicate decisions to a market. The result is a poverty trap. For example, if you want growth then you make a decision that a minimum level of savings is necessary to attain that growth. You don't sit back and let taxation and other policies be driven by the market.

Petroleum Policy

If New Zealand wants to maintain a certain level of domestic production, again you don't sit back and let this policy be driven by the market. Recently there has been a disturbing trend of comments that suggest that petroleum policy should be left entirely up to the invisible hand of the market. Once again it should be remembered that the market is not a decision maker but merely a clearing mechanism for good and bad decisions.

Because the petroleum industry is a very long term industry, decisions made today will be cleared by the market in 10-15 years time and only then will it be known whether they were good or bad decisions.

Figure 6 shows that post Maui B development New Zealand will experience an ever increasing import gap. Having to pay for the importation of an ever increasing quantity of petroleum products will be an enormous drain on national savings. Also, New Zealand's share of exploration/appraisal wells drilled in the Far East is decreasing (Figure 7). The danger is that this will come at a time when New

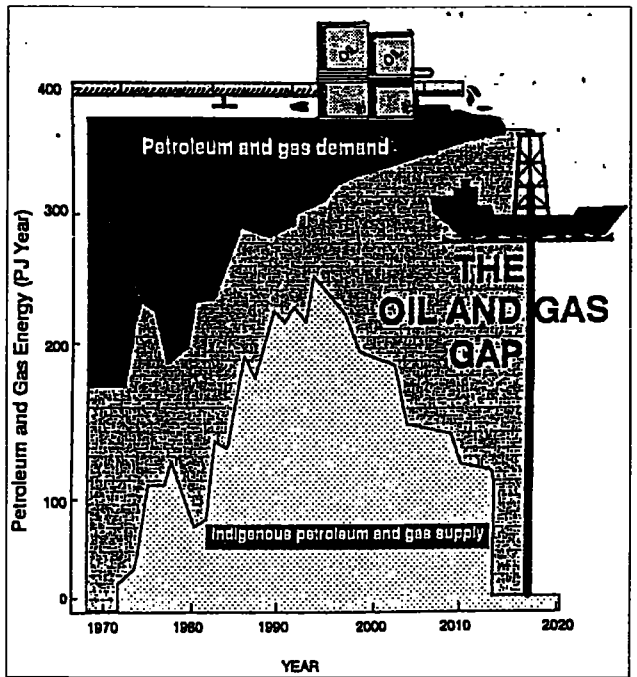


Figure 6: Petroleum and gas demand, and indigenous supply in New Zealand between 1974 and 2016.

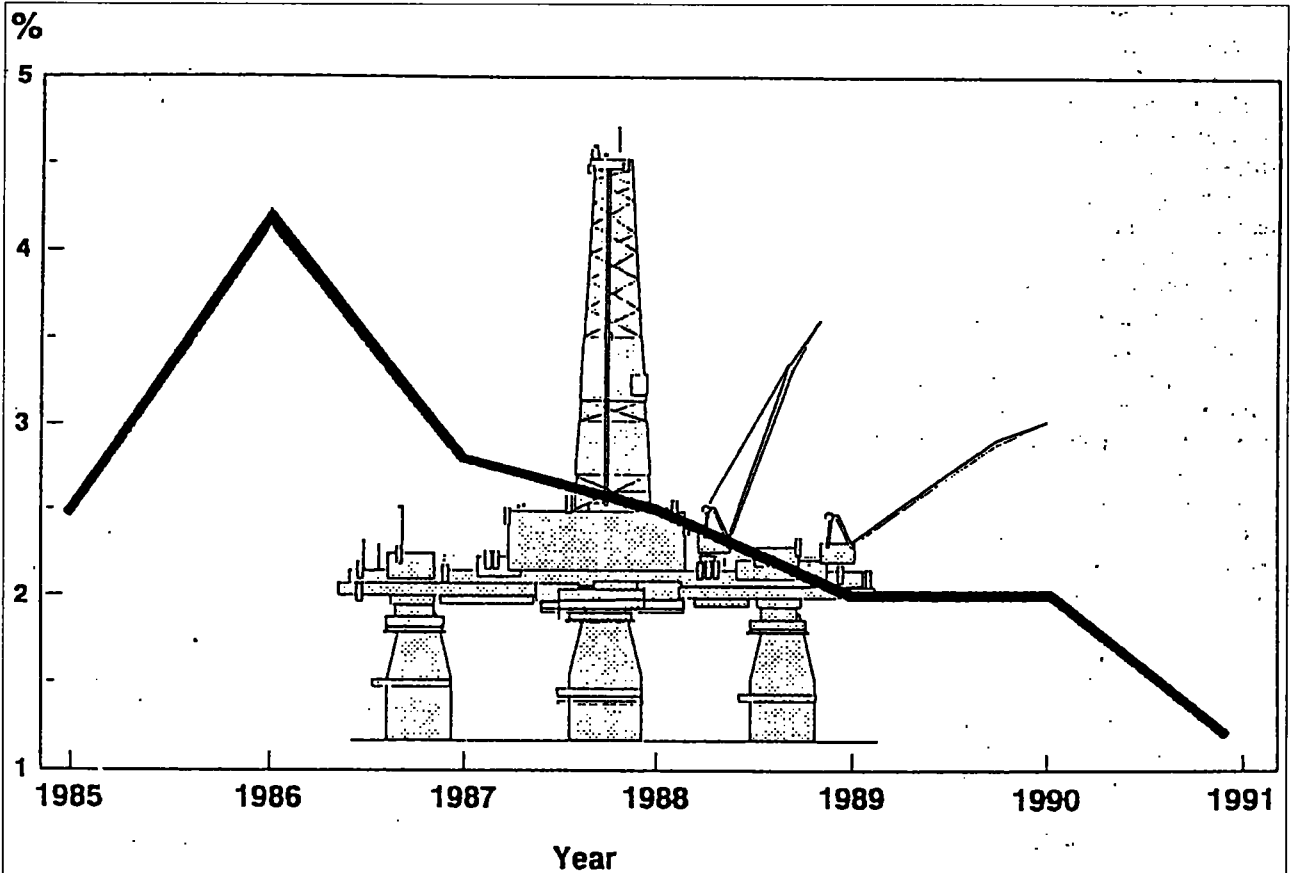
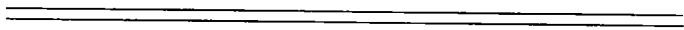


Figure 7: New Zealand's share of exploration/appraisal wells in the Far East from 1985 to 1991.

Zealand is just starting to recover from the recent prolonged dis-saving induced recession. Policy decisions made now however can avert this.

In conclusion, I would like to express the hope that in the coming year, while the various Ministries complete their task of reviewing the petroleum taxation system and the royalty regime, they will:

- take note of the poverty traps that we have fallen into in the past;
- distance themselves from the short term pressure of the market; and
- will develop a proactive petroleum development policy that will drive us through to the 21st century.



Author

RODNEY DEPPE is Project Manager for the Todd Corporation, where he specialises in advising the group on energy related investments. He has been an international financial consultant for more than 10 years.