Economic Growth, Taxation and Poverty

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Introduction
In 1993 I went to a UNESCO/CROP conference in Paris organised around the theme: Economic Growth and its Significance for Poverty Reduction. The conference participants were an unusual blend of academic disciplines with historians, sociologists, economists, psychologists and political scientists, with a range of perspectives from Marxist to New Right. They came from countries at all stages of economic development: from western developed nations to the less developed Nigeria and Namibia, the developing countries of Brazil and China, and newly industrialising countries such as Hong Kong, Poland and Mexico.

In the first part of this paper I want to draw upon some of the conclusions which came out of that conference as the conclusions are very pertinent to the theme of this forum. I will then look briefly at international evidence to see whether, at the macroeconomic level, countries which have larger governments, or larger welfare states, have slower economic growth paths, as claimed by many in the New Right. I will then provide some data on poverty in New Zealand, and its trends through time, discussing the interrelationship between economic growth and income distribution and their combined effect on the incidence of poverty.

Economic Development, The Welfare State and Poverty
Despite the wide array of levels of economic development, political structures, differing perspectives on what constitutes poverty and mechanisms for delivering social security, several strong conclusions on the relationship between economic growth and poverty were made from the papers delivered at the CROP conference.

1. Economic growth is essential to reduce the level of mass poverty within society. In a poor, undeveloped economy the majority of the population are going to have insufficient food, low levels of education and poor health outcomes. Only economic growth can lead to an improvement in the standard of living for the majority of the population. This especially applies to the less-developed countries such as Nigeria and Namibia where there are just not sufficient economic resources within the country to redistribute from rich to poor. But it applies equally to the economic development of now rich economies such as New Zealand, Germany and the UK: economic growth was the major force removing Dickensian scenes of poverty and squalor.

2. Within developed countries, and in the process of economic development, economic growth is not sufficient to reduce poverty for groups marginalised from society. What is required is an institutional framework and social structure which will redistribute the benefits of growth to all in society.

Over the last decade, Germany and the USA have had similar rates of economic growth, but the social outcomes have been quite different. In the USA, where market forces dominate, with growth of employment in part-time, marginal and low-paid jobs, there is only a residual and minimalist welfare state. As a result, unemployment rates are low...
(about 4%), but poverty rates are high (14%) as there are few policies to redistribute resources. Germany has a fully developed welfare state, and has altered its welfare state in the post-war period to incorporate the categories of people who did not benefit from economic growth. Wage rates are high and the labour market is inflexible, so that unemployment is around 10%, but the redistributive policies have reduced the poverty rate to around 4%. The Chinese experience provides further insights: whilst general economic growth halved the overall poverty rate, the move to a free market in Southern China has resulted in far greater inequality, and greater poverty for those not receiving the benefits of growth.

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growth, but the social outcomes have been quite different. In the USA, where market forces dominate, with growth of employment in part-time, marginal and low-paid jobs, there is only a residual and minimalist welfare state. As a result, unemployment rates are low (about 4%), but poverty rates are high (14%) as there are few policies to redistribute resources. Germany has a fully developed welfare state, and has altered its welfare state in the post-war period to incorporate the categories of people who did not benefit from economic growth. Wage rates are high and the labour market is inflexible, so that unemployment is around 10%, but the redistributive policies have reduced the poverty rate to around 4%. The Chinese experience provides further insights: whilst general economic growth halved the overall poverty rate, the move to a free market in Southern China has resulted in far greater inequality, and greater poverty for those not receiving the benefits of growth.

5. Globalisation and technological development have meant an increasing division between those in the high-tech core and those in the low-tech periphery. Those caught in the low-tech jobs do not have the skills to move into high-tech areas, have high risks of unemployment and are often socially excluded from mainstream development. The divisions are often spatial, either by suburb or region. In the absence of offsetting education and training, this widening gap between rich and poor may become inter-generational.

6. Economic decline and stagnation mean that the poor will lose, and lose more in proportionate terms, than the rich. Many of those who become unemployed in long periods of recession, or become unemployed as a result of a radical restructuring in society, or live in regions of an economy which are declining, finish up among the marginalised groups in society.

With economic growth, the poor may gain, but the extent of the gain depends upon the political will to redistribute resources. The trickle-down effect of economic growth was not seen as sufficient: income distributional policies were also needed. These would have to operate both through the labour market (minimum wages, high-productivity, permanent jobs in primary labour markets) and social policy with adequate benefit levels, preventing hardship and deprivation, as well as training and job skills programmes to facilitate re-entry into the primary labour market.

The Size of Government and Economic Growth

The oil crises of the 1970s signalled the end of the post-war boom. To offset the slow-down in economic growth, many western countries used Keynesian policies to stimulate the economy, increasing government expenditures, especially those on the welfare state. The claim was made that these government expenditures were crowding out private spending, shifting resources from productive investment into unproductive income transfers. Moreover, it was argued that both higher tax levels and the increased use of transfer payments had adverse incentive effects on work effort, savings and investment, locking the economy into a path of low economic growth. In other words, the slow-down in economic growth was directly caused by larger government.

The required solutions were seen as a shift in economic policy away from Keynesian economics to monetarism, a change to a minimalist role for government in the economy, setting up a level playing-field for the influence of government on resource allocation, and shifting attention to economic incentives in tax/transfer policies rather than poverty relief and

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income redistribution. These ‘new right’ policies seemed to have their most ardent disciples in New Zealand. The policies do not seem to have increased economic growth. But they have changed the welfare state from being one which redistributed resources in a cost-effective manner to the poor, allowing beneficiaries to ‘belong and participate in society’, to a libertarian welfare state with ‘a minimal safety net’ and a poor record of poverty reduction.

But were these changes necessary? Did the growth in government cause the economic slow-down? International comparisons between size of government and rate of economic growth have failed to reveal any statistical relationship between the two variables. When attention is restricted to all social spending (education, health, cash transfers), there is a slight, but not statistically significant, negative relationship between social spending and growth, but this relationship disappears when only social security expenditure is considered. Sweden, Norway, Denmark are all large government countries; Australia, Japan and the USA are small government countries - the economic performance between these two groups is hard to distinguish.

At a micro level, it is argued that high benefit replacement rates (i.e. where benefit levels are high relative to earnings) will encourage people to become unemployed and increase the duration of that unemployment. Despite the fact that our unemployment system is different to most other countries, empirical studies in New Zealand give similar results to those in the international literature. There seems to be a small relationship between the replacement rate and unemployment. But the fact that the effect is small indicates that most people ‘leave’ jobs for other reasons such as redundancy. Once unemployed, people tend to stay a little bit longer on the register if the replacement rate is higher - but this is often seen as positive. The longer search means they get jobs that they want, rather than marginal jobs, and thus are less likely to slide back into unemployment.

For sole parents, international comparisons show no relationship between employment rates and replacement rates. The replacement rate for sole parents in New Zealand is about the average for OECD countries, but our employment rate is the lowest (20%), and we have the greatest difference between employment rates for sole parents and cohabiting parents. Sweden has a very high replacement rate, and over 80% of sole parents employed; France has a replacement rate similar to that of New Zealand but an employment rate similar to Sweden’s. What seems to be important is not the replacement rate, but the social and cultural attitudes to employment versus child-rearing (New Zealand policy seems confused between these two objectives), cost and availability of child care (our child care costs are very high) and the degree of assistance (job search, training schemes) and cajoling (case management, strict entitlement rules) of sole parents into the labour market.

In other words, benefit levels and incentive effects are not the important issue in encouraging employment (and thus economic growth). There are superior economic and social instruments for that. The benefit level can thus be set at level sufficient to avoid poverty. Setting a benefit level at a rate where beneficiaries can ‘belong to and participate in the wider community’ will minimise the consequential downstream effects that poverty has on families.

**Poverty in New Zealand**

Since 1984, New Zealand has been through a period of substantial economic and social reform. Much of the microeconomic reform between 1984 and 1990 was necessary to improve economic
efficiency. However, the poor sequencing of that reform, poor choice of macroeconomic policy parameters, the lack of positive policy to offset the worst effects of economic reform (for example, labour market retraining schemes were needed for those made redundant during the corporatisation process) and the failure to recognise a demographic blip with increased numbers of 17-20 year-olds coming onto the labour market when labour demand reduced meant that the reforms produced no economic growth and increased numbers unemployed. Policy concentrated on efficiency rather than equity, except for the introduction of the targeted Family Support Tax Credit. Debate on causes and consequences of poverty started during this period, largely due to the increased numbers of households receiving benefits combined with increasing duration of benefit receipt.

From 1990, social policy reform has been on the agenda. The 1991 benefit cuts (averaging 11% + 4% non-CPI adjustment) and tightening of entitlement rules brought immediate claims from voluntary agencies and community groups of hardship among beneficiary groups: people going without food, sale and non-replacement of assets in order to pay the market rents for state housing, a tenfold increase in food parcel usage and the appearance of poverty-related diseases. The Government had claimed that the benefit cuts were necessary in order to produce fiscal savings, with the reduction in size of government expenditure and its deficit permitting economic growth, and to give beneficiaries an incentive to move into the labour market. The result was an immediate economic recession and even fewer jobs for beneficiaries to move into. When economic recovery occurred in 1993, the majority of job growth was part-time, at relatively low wages and on a short-term basis. A large proportion of these jobs were taken by non-beneficiaries, resulting in a division into work-rich and work-poor households. The latter continue to have their jobs skills atrophy, feel marginalised from the work force and often live in rural regions which general economic growth passes by. Cheap housing allows people to survive in these communities, but with current economic policies there is little prospect for employment.

Hopefully, this discussion sounds a plausible explanation of what has happened over the last 15 years. But the relationship between economic growth and poverty needs statistical evidence to support it. The early community-based studies, which provided a real feeling of the problems beneficiaries were having following the benefit cuts, were criticised by the government and its officials for the lack of statistical validity. The New Zealand Poverty Measurement Project was established to provide that statistical validity, looking at changes in the incidence and severity of poverty between 1984 and 1998.

The project team (Paul Frater, business economist, Charles Waldegrave, social policy analyst, and Bob Stephens, university economist) used focus groups, predominantly from low-income and beneficiary households, located in Wellington, Auckland and small rural North Island towns, to establish a poverty measure. The focus groups drew upon their collective experience as to what constitutes a minimum adequate standard of living - this would allow three meals a day and replacement of assets, but not holidays or restaurant meals, and would not require food parcels or applications for special needs grants or special benefits. The focus groups were reasonably consistent in their estimation of what constitutes a minimum adequate standard of living, with the major variant being housing costs. The average focus group result was used to establish a poverty line adjusted for different household sizes and compositions.
The poverty line was then applied to the annual Statistics New Zealand Household Economic Survey to provide information on who were poor and the extent of their poverty. A major problem was the adjustment of the focus group result for non-focus group years: two methods were used - one relating the focus group result to median household disposable income (a relative poverty measure); the other to movements in average consumer prices (an absolute poverty measure). In periods of economic growth, a relative poverty measure means that the standard of living of the poor should rise in line with general standards of living, which means that only changes in income distribution can alter the incidence of poverty. Using an absolute poverty level, economic growth should reduce the incidence of poverty, provided living standards of the poorest rise in line with those of the majority.

As Chart 1 shows, New Zealand has had little or negative economic growth for much of the period of economic and social reform. Unemployment increased until 1992, and fell from 1992 until 1996, before starting to rise again. Moreover, it has been estimated that New Zealand had the largest increase in income inequality among OECD countries. Between 1984 and 1993, the bottom 50% of the population had a fall in their standard of living (measured by changes in equivalent household disposable income) of 14%, and only the top 20% actually improved their economic position as shown in Chart 2. The widening of the income distribution can be attributed to a variety of factors including:

- the increase in unemployment, with a greater proportion of the population dependent upon social security rather than wages
- changes in tax rates for upper income groups while middle and low income people had no effective tax change
- the 1991 cuts to social security benefit levels
- higher salaries for upper income groups, whereas many at the lower income levels failed to maintain their real wage, especially after the Employment Contracts Act 1991
- an increasing proportion of ‘work-rich’ households who appear at the top of the income distribution, while the number of ‘work-poor’ households also increased.

The interrelationship between economic growth effects and income distributional changes means that neither the absolute nor the relative poverty measure fully captures the changes in the incidence of poverty. Chart 1 shows that except for the period of economic recovery between 1992 and 1995, the absolute and relative poverty measures show quite distinct paths. Over the period 1984-92 of low and negative economic growth, rising unemployment and widening income distribution, the absolute poverty measure conveys the appropriate public impression of a poverty rate rising from 4.8% in 1984 to 10.8% in 1993. The relative poverty measure actually shows a decline in poverty over that period - the result of the significant decline in median household disposable income of 14.6%. With economic growth between 1992-1996, both measures show similar trends. However, the absolute poverty measure continues to show falling poverty levels when economic growth declines after 1996 and unemployment levels rise again. But while the relative poverty measure shows the expected increase in poverty, the increase seems a little exaggerated.

These trends in the overall incidence of poverty ignore two issues: first, the severity of that poverty (not discussed here), and second, how the different household groups fare through time. Chart 3, based on a relative poverty measure, indicates the significantly different poverty rates between the various household types. Sole parents have by far the greatest
incidence of poverty, often over 40%, and, even on a relative measure, this incidence increased during the 1980s. The incidence for single adults took a significant fall after 1990 - from 26% to 9% - and it is this fall which drives the overall trend in relative poverty incidence. The single adult group is a composite of young and elderly single people. After the benefit cuts of 1991, which did not apply, in nominal terms, to old-age pensions, National Superannuation was roughly equivalent to the poverty line, so most elderly escaped from 'poverty'. But in 1998, the rise in median disposable income with economic growth and the gradual adjustment downwards of the New Zealand Superannuation level, meant that elderly with no other income were now just below the poverty line, and the poverty incidence for single adults went back up to 22%.

The other feature that is significant, is the high incidence of poverty for households with dependent children. The incidence of poverty rises with number of children, and this is partly explained by the lack of assistance which is given to families with dependent children in New Zealand.

Conclusion

The economic growth of the last two centuries has resulted in the vast majority of New Zealanders living above subsistence level, and not suffering the consequences of abject poverty as occurred during recessions in the 1800s. Economic growth has also meant that there are sufficient resources to alleviate the immediate problem of poverty as well as provide long-term solutions in the form of training, skills development, improvements in health status and adequate employment opportunities. The claim that the provision of these resources by the state has negative consequences for economic growth has not been borne out by international comparisons, nor by microeconomic analysis of incentive effects.

The lack of economic growth since 1984 has had adverse effects on the poor. However, the widening of the income distribution, with cuts in the real standard of living for the bottom half of the income distribution, has been of equal significance for increasing the incidence of poverty. Concentration on economic efficiency has meant that an increasing proportion of the population has been marginalised from society. Despite the rhetoric of the slogan ‘welfare to well-being’, with active assistance being provided to encourage people into the labour force, the reality is one of fiscal constraint on active labour market policies, curtailment of economic and job growth because of obsessive fears of inflationary pressures, a lack of any regional policy or strategy to shift employment to depressed regions and an implicit encouragement of part-time job growth in poorly paid marginal jobs. A two-class society, with work-rich couples doing extremely well and work-poor families falling further behind is the outcome of 15 years of economic policy.

An increasing segment of the population seems to be locked into poverty or near-poverty, irrespective of whether on a benefit or in work. Only a significant change in the direction of economic and social policy will correct this. Economic growth is paramount, but needs to encompass the regions as well as major cities. Social policy should concentrate on poverty relief as well as the longer-term skill training and improvements in health status. **VEC**
CHARTS

Chart 1

Chart 2

March 1996 Prices.
Footnotes

1 Paper delivered to the Capital City Forum, 1 June 1999, Wellington by Robert Stephens, Public Policy Group, School of Business and Public Management, Faculty of Commerce and Administration, VUW.