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Commentary

Budget worries

Summary

The Government's Budget will be announced on 24 May. There have been surprisingly few pre-Budget announcements so far. The main one was that there will be a near-zero "operating allowance" for new spending rather than the already very low $800 million the Prime Minister was confident about as recently as February. This is a worrying development.

In a speech last week, Bill English indicated that their priority areas for spending are health, education, science and innovation, law and order, and the welfare changes which push more beneficiaries out to work. There will also be spending on the Government's latest economic programme, the "Business Growth Agenda".

A zero operating allowance means that any "new" spending announcements will have to be paid for from cuts or "efficiencies" elsewhere. The words "new" and "efficiencies" are heavily used by the spin-doctors. "New" spending can include spending on existing services to cater for population growth and aging. "Efficiencies" are often just cuts, but we may not know what the cuts are until months later.

The Government will also be announcing legislative changes including ACT's cap on government spending. Looking back to 2008, if the cap had been in place during the global financial crisis, New Zealand would have had much higher unemployment and economic disruption.

The spending restrictions the government is putting in place will have a depressing effect on the economy. The only significant relief in sight is the boost due to the rebuild of Christchurch – but if it continues to ramp up slowly and occurs over a longer time than currently forecast, not only will Christchurch people suffer, but it may not be enough to keep the economy out of recession. The government's unwavering objective of a surplus in 2014/15 – while its maze of strategies, targets, agendas, priorities and key areas undergo constant change – is looking more and more unwise.

The Government's Budget will be announced on 24 May. There has been surprisingly little so far in the way of the usual pre-Budget announcements, trickling out the tasty bits and preparing us for the bitter pills by talking up the worst so we are relieved when it is just bad.

The main announcement has been that it will be close to a "zero" Budget – which means that there will be a near-zero "operating allowance" for new spending rather than the already very low $800 million the Prime Minister was confident about as recently as 13 February. At that point he said "It could be lower if we really saw a catastrophic meltdown in Europe, but at the moment that seems to have stabilised a little bit in the last week or so". There has been no meltdown since then, let alone a catastrophic one, though high risks certainly remain. Although Treasury forecasts are increasingly pessimistic about both growth in the economy and the ability of the Government to indulge its "Budget surplus in 2014/15" fetish, it is hard to see what has changed so much in two months that they now need to set the allowance at "very close to zero". This is a worrying development I come back to below.

Other announcements made in a speech by Bill English last week included that their priority areas for spending – ranking behind a Budget surplus in 2014/15 – are health, education, science and innovation, law and order, and the welfare changes which push more beneficiaries out to work. We can expect some of the reprioritisation of money to be focussed on the 10 targets which the Prime Minister announced last month.

It seems unlikely there will be any increase in funding for Christchurch over what has already been announced, though timing of it could be brought forward. There are increasingly desperate needs for housing, speeding up the repair of underground services, and getting more momentum behind the rebuilding of the central business district, but the government seems too ready to "leave it to the market" to make big funding changes.

The Government's latest economic programme is the "Business Growth Agenda" whose catch-line is a "competitive and productive New Zealand economy". "Business" is not the same as "the economy" so we will need to watch whether the benefits go only to business, but it has six areas: "Innovation and ideas, Skilled and safe workplaces, Natural resources, Infrastructure, Export markets and Capital markets". There will be announcements on these in the Budget, particularly on Innovation and ideas.

English also spoke about tax changes announced in the 2011 Budget around tax treatment of employee benefits and where assets such as a holiday home or computer get both work and personal use. We are likely to hear further news on these in the 2012 Budget, and perhaps also some more about preventing tax evasion which is getting some tax accountants and businesses increasingly tetchy. Gathering more revenue through these methods could provide the Government with some more spending power.

The spin around new spending

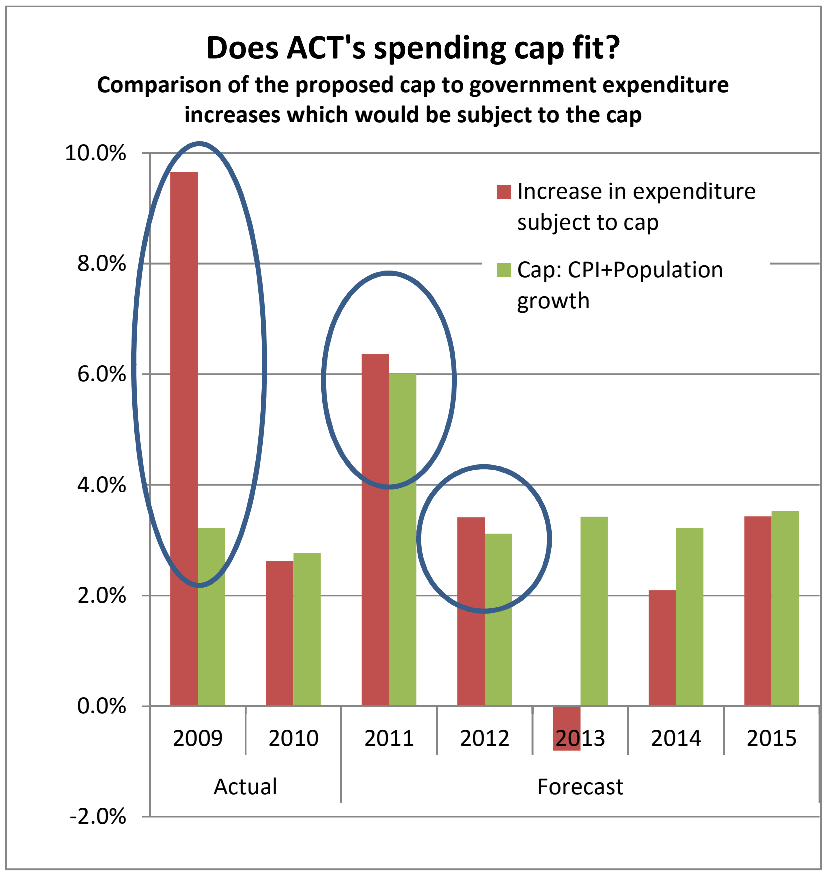
In general though, a zero operating allowance means that any "new" spending announcements will have to be paid for from cuts or efficiencies elsewhere. There are two words here that are heavily used by the spin doctors which we need to be wary of: "new" and "efficiencies".

"New" is now defined to include demographic increases such as in school student numbers or an increasing and aging population using health services. That will gobble up well over $200 million in Health alone. While an increase in spending, it is hardly a "new" service. Of course all cuts are labelled "efficiencies" – if they can be spotted – but many, like reductions in services that District Health Boards are forced to make, won't be publicly announced in the Budget, may not be publicly announced by the agency which has been told to do more with less, and may not surface until months later when someone finds a service no longer exists or is now being charged for. So for example in Health, English says the government will be demanding "more operations and continuing to reduce waiting lists". It is likely some less headline-friendly services which possibly reduce the number of people needing the operations in the first place – such as community or health education programmes – will quietly disappear to pay for them. It will be difficult to tell whether these are "efficiencies" or just plain cuts.

Dangerous policy – cap on government expenditure

English also announced the Budget would detail the implementation of the government spending cap agreed between National and ACT in their confidence and supply agreement. This limits increases in spending to the sum of the rates of population growth and inflation (actually the parties' agreement limited it to "no faster than the annual increase in the rate of population growth *multiplied by* the rate of inflation" – which, absurdly, is little different from zero). Some exceptions are provided for spending on natural disasters, finance costs, the unemployment benefit and asset impairments. But even with these exceptions, it is foolish and dangerous policy.

For a fuller discussion, see the commentary in Economic Bulletin 119 or Gordon Campbell, but the single biggest danger of this type of policy (and there are many dangers) is that it prevents the increased spending which is vital in times of economic downturn. Spending increases throughout the world in response to the global financial crisis greatly reduced its impact on people and the real (non-financial) economy. Simply allowing an exception for unemployment benefits is far from enough. The government here brought forward and ramped up spending on infrastructure, housing insulation, employment programmes and much more, and recession in addition brings greater pressure on other welfare benefits, schools, and tertiary education.



The attached graph shows an estimate[1] of what would have been the effect of the cap if it had been in place during the height of the global crisis, and looking ahead to the Government's spending plans. Years (ended June) where increases in the expenditure which is subject to the cap exceed the cap are circled.

The Government would have had to slash expenditure at the height of the crisis in 2008-09, leading to much higher unemployment, cuts in services and a deeper recession. The increase in spending from 2008 to 2009 was partly put in place by the outgoing Labour-led government, partly automatic increases

[1] Expenditure data and CPI forecasts come from the annual Financial Statements of the Government of New Zealand and the Pre-Election Economic and Fiscal Update. Population increases are from Statistics New Zealand with forecasts the average of a five year period. Impairments are not available in the public forecasts, so are estimated as the average of 2008-2011.

in expenditure on unemployment and other benefits, and partly actions taken by the incoming National-led government. In the years ended June 2011 and 2012, the Government would have had to cut back its already tight spending by another 0.3 to 0.4 percent of GDP – on top of the deep cuts it would have had to make in 2008-09. On the other hand, its tight spending plans for 2013-15 are well within the cap.

The only saving graces of this policy are the huge loopholes in it and the lack of conviction with which National is implementing it: under the proposal, all a government has to do if it exceeds the limit is to "explain why and outline how it intends to keep spending increases within the limit in future". Nonetheless, it is pressure on governments to behaviour badly.

Other changes to the Public Finance Act will also be detailed in the Budget. They are aimed at controlling spending when times are good. They will require Governments to spell out in more detail their plans for revenue, expenditure and assets, forecast their economic impact, and "report on successes and failures of past fiscal policy". The implications of this will depend on how mandatory its requirements are made.

Spending restrictions a drag on the economy

Finally – and perhaps most importantly – we need to think about the effect of all these government spending restrictions on the wider economy. There is good reason to think that the already tight government spending is a drag on the economy. That is probably part of the reason for Treasury having to reduce its economic growth forecasts. Tax revenue follows suit as both workers and firms pay less tax than expected because their incomes are not growing as forecast. Of course the international economic situation and the high New Zealand dollar are other reasons. They are affecting exports, especially of manufactured goods, to many of our main markets other than China and Australia. However commodity agricultural exports are booming – but the booming income to farmers is not filtering into the economy as quickly as usual because of high debt levels among farmers. There are some signs that is changing.

The Government had been counting on the Christchurch reconstruction to pull the economy out of its stagnation. That is being constantly delayed and though, again, there is now increasing activity, it is far from reaching the huge construction project anticipated. We now have to consider the possibility that it will be much slower to take off, reach a lower peak, but last much longer than anticipated. That would be hugely frustrating for the people of Christchurch, with many suffering from having to live in damaged homes with inadequate or non-existent services and uncertain outlooks, and would leave the Government without any strategy to get the country out of the doldrums. Even if a construction boom does get underway, there are questions how much of a stimulus it will provide to the rest of the country: how much of the raw materials will be bought locally? How many of the workers will be from New Zealand? What happens to the parts of the economy other than construction-related sectors?

The situation is illustrated by Bill English's embarrassing position at having to repeatedly explain why the Government's target of a Budget surplus in 2014/15 keeps slipping away. In his speech last week, he confessed that Treasury was now forecasting a $1 billion deterioration in forecasts for the Budget deficit in 2014/15 (the operating balance before gains and losses) compared to the Budget Policy Statement in February. That means that this forecast has deteriorated from a surplus of $1,297 in the 2011 Budget to a $370 million surplus in February to a deficit of $640 million last week – an almost $2 billion turn-around. That is getting beyond his previous excuse of it being within the margins of forecast error.

The dangers lurking in the restricted government expenditure are shown in a "fiscal impulse" estimate that Treasury calculates. It estimates (and it is only an approximation) the effect of changes in the government's revenue and expenditure on the size of the economy (GDP). The estimate in the Pre-election Economic and Fiscal Update (PREFU) was that in the year ended June 2012, government activity would add a net stimulus of just 0.6 percent of GDP – but in the year to June 2013 it would be tightening (contracting) the economy by 1.8 percent and by 2.1 percent the following year. Tightening would continue in the years 2015 (approximately 0.5 percent) and 2016 (0.8 percent). In three of the five years 2012-2016, EQC payments would make things even worse by about another 0.5 percent.

That was before the election and before the Government announced it was canning any operating allowance, which will cause further tightening in the economy. Treasury's optimistic GDP growth forecasts for 2013-15 (2.8, 3.8 and 3.1 percent respectively) rested heavily on the Christchurch rebuild adding 1¼ percentage points to annual growth in 2012 and each of those years.

The government's unwavering objective of a surplus in 2014/15 – while its maze of strategies, targets, agendas, priorities and key areas undergo constant change – is looking more and more unwise. If it gets there by pushing the economy into recession, it will risk giving the patient a worse disease than the one it was trying to treat. Even in the much more dire government debt situation that many countries in Europe face, a number of economists are saying that the first priority is to get growth back into the economy (see for example Summers or Krugman).

In any case the Government is treating the wrong disease. In his speech, Bill English emphasised both New Zealand's high net foreign debt (which is almost all private debt), as well as government debt – and then proceeded to confuse the two, as did his media release on the speech. The reality is, as the IMF recently acknowledged in its review of New Zealand's economy, that New Zealand's government debt is moderate by world standards. International debt and other liabilities (overseas ownership of companies) are our real vulnerability. Yet government only became a net international debtor a few months ago, in December 2011. Reducing its debt will make very little difference to the international position. The focus should be on assisting exporters, reducing our reliance on overseas funding of bank lending and overseas investment, managing the exchange rate to a realistic level, raising employment and incomes and encouraging saving rather than pushing recklessly for a surplus that may well cause more damage than it cures.

Bill Rosenberg

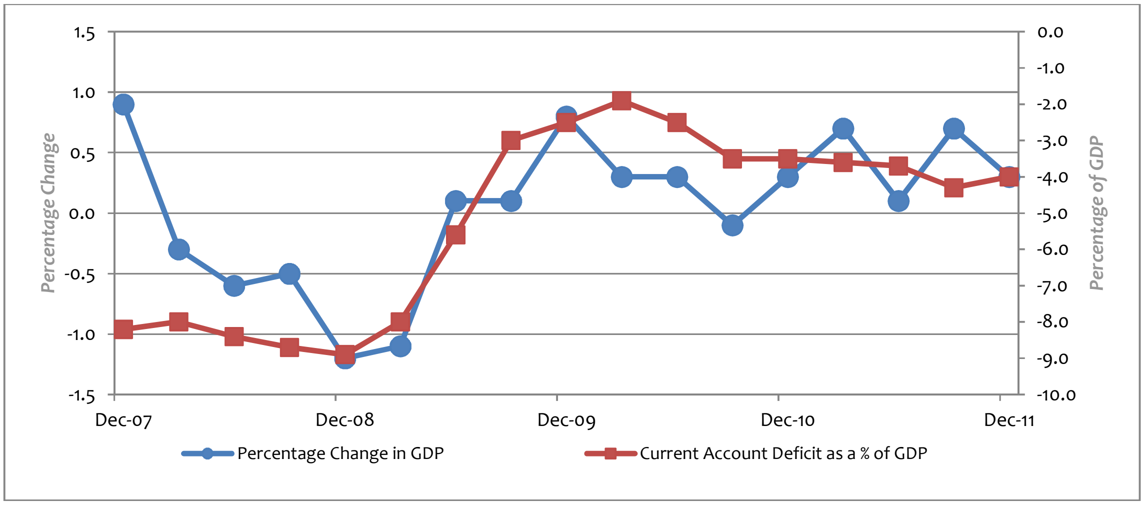
Forecast

- This NZIER consensus forecast was published on 19 March 2012.

Annual Percentage Change (March Year)	**2011-12**	**2012-13**	**2013-14**
GDP	1.8	2.7	3.2
CPI	1.8	2.1	2.5
Private Sector Wages	3.1	3.0	3.4
Employment	0.8	1.8	2.1
Unemployment	6.3	5.9	5.2

A ★ indicates information that has been updated since the last bulletin.

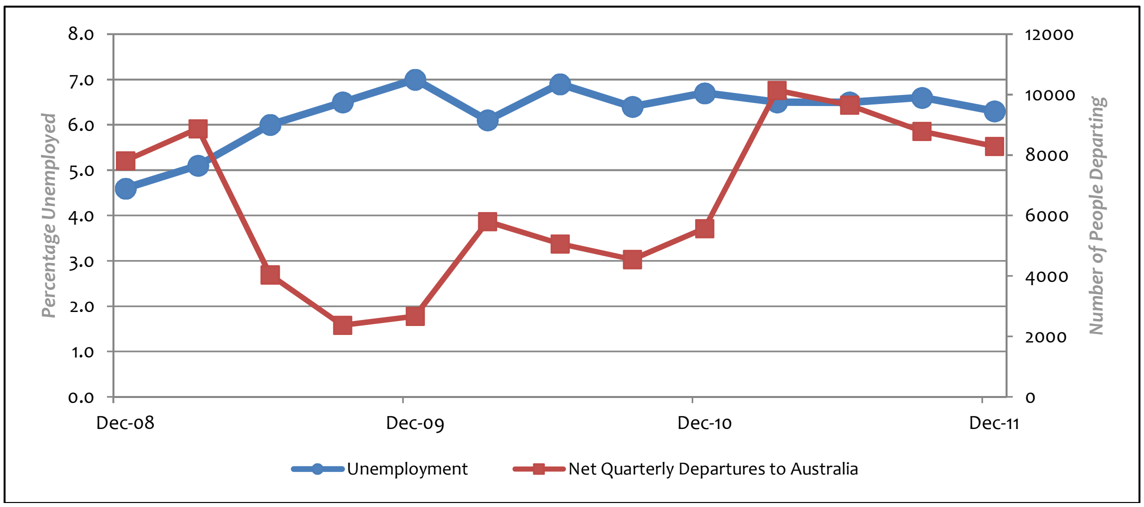
Economy



- Gross Domestic Product was up 0.3 percent in the December 2011 quarter, and GDP growth for the year to December 2011 was 1.4 percent. The largest contributor was finance, insurance, and business services which rose 1.3 percent in the quarter, with agriculture (up 3.5 percent) and retail, accommodation and restaurants (up 2.2 percent) also strong. However there were significant falls in manufacturing (down 2.5 percent), electricity, gas and water (down 2.4 percent) and government administration and defence (down 2.3 percent). Agriculture and retail, accommodation, and restaurants were both up 7.6 percent from the December quarter in 2010, while construction was down 8.0 percent for the year.
- New Zealand recorded a Current Account deficit of $2.8bn for the December 2011 quarter ($2.0bn seasonally adjusted) and a deficit for the year to December of $8.3bn (4.0 percent of GDP). This compares with a current account deficit of $6.8bn (3.5 percent of GDP) for the year ended December 2010. The annual deficit is mainly due to profits and interest going to overseas investors ($10.4bn deficit) plus a deficit in services trade ($1.0bn) partially offset by a positive balance on goods trade ($3.6bn), all of which worsened during the quarter.
- The country's Net International Liabilities were $147.0bn at the end of December 2011 – 71.9 percent of GDP compared with $146.2bn or 72.0 percent of GDP in September and $146.5bn in December 2010. Reinsurance claims owed but not yet paid for the Canterbury earthquakes totalled $12.7bn at the end of December 2011. Without them, international liabilities would be $159.7bn. In December, the Government for the first time since December 2005 became a contributor to the net international liabilities with net overseas liabilities of $3.5bn despite $4.5bn of unpaid reinsurance claims which are counted as an asset.
- ★ For the month of March 2012, Overseas Merchandise Trade recorded a seasonally adjusted $358m deficit – 9.6 percent of the value of exports for the quarter. Exports fell by 8.79 percent or $400 million in the month. The largest fall was for milk powder, butter, and cheese, which were down $179 million. Imports rose by $48 million (1.2 percent). For the year to March 2012, New Zealand recorded a trade surplus of $207 million (0.4 percent of exports).
- ★ The Performance of Manufacturing Index for March 2012 fell to 54.5[1], off its steep rise to 57.7 in February. The employment sub-index rose a little however, to 52.3 from 51.4 in February.

- The Performance of Services Index for March 2012 was 53.9[1], a fall from 55.8 in February. The employment sub-index was almost static: 52.4 compared to 52.3 in February.
- The Retail Trade Survey for December 2011 found retail sales were up 2.2 percent by volume and 2.0 percent by value between the September and December 2011 quarters. Volumes for core retailing, which excludes vehicle-related industries, rose 2.9 percent, the largest seasonally adjusted increase since the series began in 1995. Both the Rugby World Cup and the delayed timing of school holidays were likely influences. Retail sales were up 6.6 percent by volume and 8.0 percent by value compared to the December quarter in 2010.
- On 26 March 2012 the Reserve Bank left the Official Cash Rate unchanged at 2.50 percent. The next review will be announced on 14 June 2012 when the bank will also release a Monetary Policy Statement.
- The REINZ Housing Price Index recorded a 1.9 percent rise in March 2012 after a 0.8 percent fall in house prices for the month of February, and the median house price rose to $370,000 after three months at $355,000. The House Price Index was up 4.2 percent for the year to March.

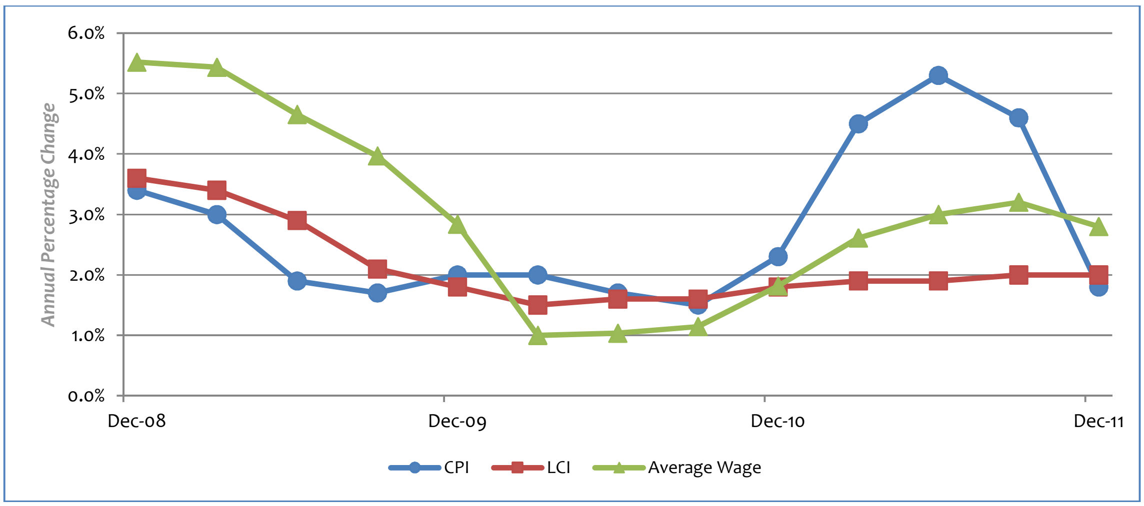
Employment



- According to the Household Labour Force Survey the unemployment rate in the December 2011 quarter was 6.3 percent, down from 6.6 percent in the September quarter. The participation rate was 68.2 percent – down 0.2 percentage points on September. There are 150,000 people unemployed. Māori unemployment was 13.4 percent (up from a revised value of 13.1 percent), Pacific unemployment was 13.8 percent, Asian unemployment was 9.1 percent and European/Pakeha unemployment was 4.7 percent. Youth unemployment (15-19 year olds) was 24.2 percent (up from a revised 23.4 percent).
- At the end of March 2012 there were 53,479 working age people on an Unemployment Benefit, a fall of 2,992, or 5.3 percent, from 56,471 in February. This is the second consecutive month in which there has been a reduction. (Quarterly figures on Unemployment Benefit numbers are available from the MSD website.)
- In March 2012, Job Vacancies Online fell by 0.8 percent for all vacancies and rose 1.1 percent for skilled jobs in seasonally adjusted terms.

★ International Travel and Migration figures show 7,460 permanent and long-term arrivals to New Zealand in March 2012 and 7,330 departures in seasonally adjusted terms. The net gain of 130 migrants is only the second such gain since the February 2011 Christchurch earthquake. There was a net loss of 3,383 migrants in the year to March 2012. Net migration to Australia in the year to March was 39,500 departures, the highest-ever net loss of people to Australia. There was an increase of 11,306 permanent and long-term departures from New Zealand nationally for the year to March 2012 compared to the year to March 2011, the increase more than accounted for by Australia.

Wages

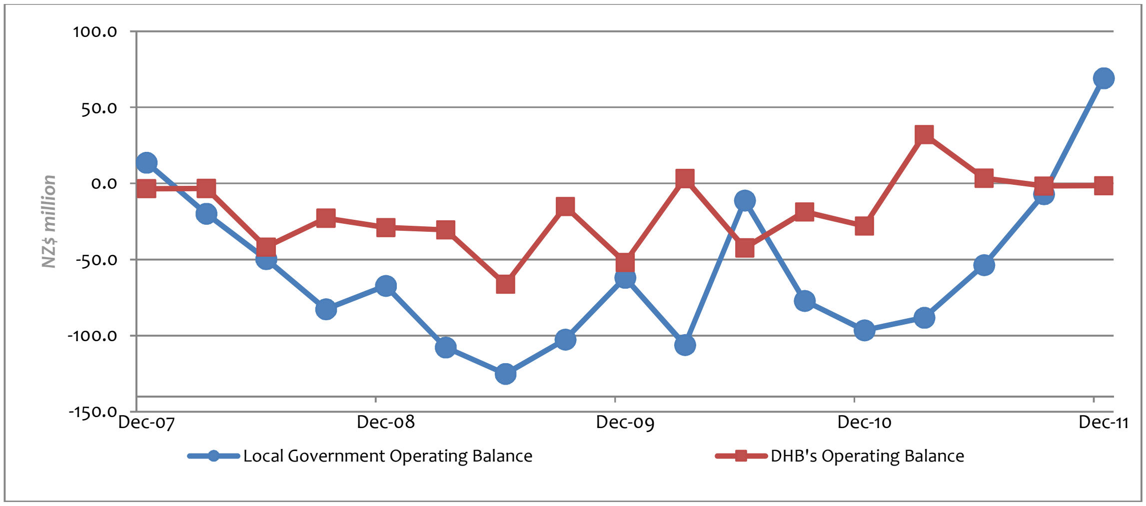


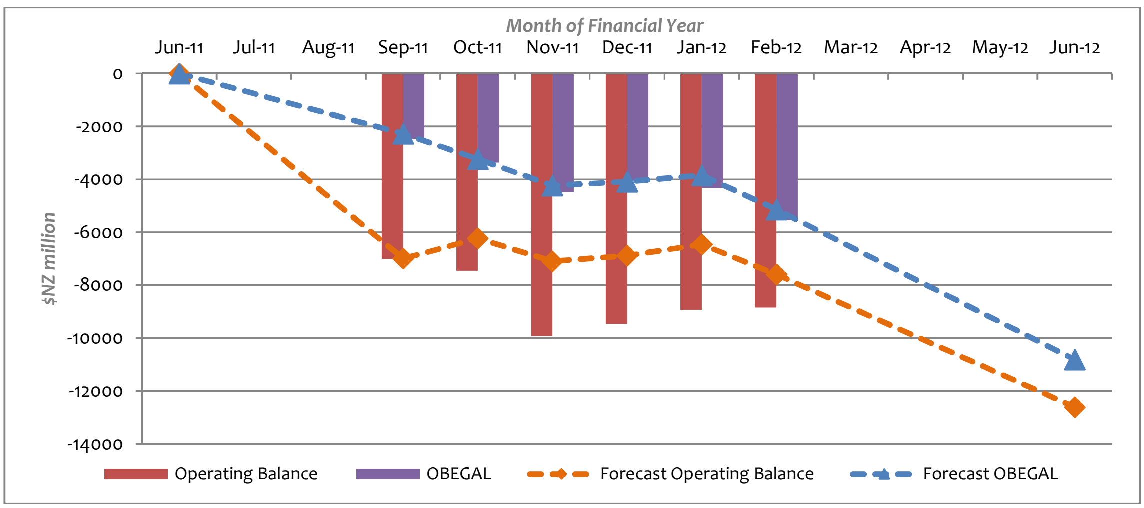
- The Labour Cost Index (Wage and Salary Rates) (LCI) rose 2.0 percent for the year to December 2011 and 0.6 percent for the December quarter for salary and ordinary time rates. It rose 1.8 percent in the public sector and 2.0 percent in the private sector for the year. For the 57 percent of those surveyed who received an increase in their salary or wage rate during the year, the median increase was 3.0 percent.
- The December 2011 Quarterly Employment Survey found the average hourly earnings for ordinary-time work was $26.56, up 0.1 percent on the September quarter and 2.8 percent over the year. The average ordinary-time wage was $24.53 in the private sector (up 0.0 percent in the quarter and 2.8 percent in the year) and $33.82 in the public sector (up 0.9 percent in the quarter and 3.4 percent in the year). Female workers (at $24.60) earned 87.1 percent of what male workers earned (at $28.24) for average ordinary time hourly earnings.

★ The Consumer Price Index for the March 2012 quarter rose 0.5 percent, and 1.6 percent for the year to March. For the quarter, the largest contributor to the increase was a 13.5 percent rise in cigarette and tobacco prices as a result of tobacco tax increases, though rents also rose 0.9 percent. Insurance rose 3.0 percent. Food costs rose 0.2 percent and education 3.1 percent, while communication prices fell 0.2 percent, clothing and footwear fell 0.6 percent, and recreation and culture fell 2.4 percent.

★ The [Food Price Index](#) fell by 1.0 percent in the month of March 2012 compared to February 2012, and there was a 0.2 percent increase in food prices between March 2011 and March 2012. Between February and March, Fruit and Vegetable prices fell 4.2 percent, Grocery food fell 0.3 percent, Meat, Poultry and Fish fell 1.8 percent, Non-alcoholic Beverages fell 0.1 percent, and Restaurant Meals and Ready-to-eat food prices fell 0.2 percent.

Public Sector





★ According to Treasury's [Financial Statements of the Government of New Zealand](#) for the eight months ended February 2012, Government revenue was down $1,167m (2.9 percent) on the forecast in the 2011 Pre-Election Economic and Fiscal Update (PREFU). This was mainly due to tax revenue being down $825m (2.3 percent) on forecast including $200m in source deductions (PAYE) reflecting weaker than forecast "labour market and employment and wage growth", $369m in GST due to earthquake-related insurance refunds, and $193m in corporate tax due to weaker than expected profitability. Expenditure was down $1,339m (3.0 percent) on forecast, with the largest contributors being costs associated with child support penalties ($258m) and a reduction in the carbon price under the Emissions Trading Scheme ($375m). The operating balance before gains and losses (OBEGAL) was a deficit of $5.5bn, $395m worse than forecast. The operating deficit was $8.8bn, $1.3bn worse than forecast due to $1.0bn in unforecast actuarial losses in the GSF, $329m higher than forecast actuarial losses on ACC's liability for outstanding claims due to a decrease in the discount rate, and $629m lower than forecast net losses in investments, mainly due to the New Zealand Superannuation fund recording a net gain of $39m rather than the $825m loss forecast. The Government's net debt is 24.0 percent of GDP, 0.2 percentage points better than forecast in the PREFU.

- District Health Boards recorded an operating deficit of $1.4m for the December 2011 quarter compared to a deficit of $1.6m for the September 2011 quarter. Employment costs were $1.25bn, up 2.3 percent for the December 2011 quarter, compared to total expenses of $3.38bn, up 0.7 percent.
- Local Government recorded a 1.8 percent increase in operating income and a 2.0 percent fall in operating expenditure for the December 2011 quarter compared to September, resulting in an operating surplus for the quarter of $69.2m, compared to a deficit of $7m in the September quarter, all in seasonally adjusted terms. Without seasonal adjustment, their surplus for the December 2011 quarter was $11.0m, compared to a $143.7m deficit in the December 2010 quarter.

Notes

1 For the Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) a figure under 50 shows the sector is contracting; above 50 shows that it is growing. Previous month's figures are often revised and may differ from those published in a previous Bulletin.

This bulletin is available online at http://www.union.org.nz/economicbulletin134.
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