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Profit-led inflation in Aotearoa

A joint research note from

NZCTU Te Kauae Kaimahi
FIRST Union
ActionStation

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NZCTU Te Kauae Kaimahi

WORKERS FIRST FIRST UNION

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Foreword

Nā tō rourou, nā taku rourou ka ora ai te iwi

With your food basket and my food basket the people will thrive

Tēnā koutou,

No matter who we are, and where we come from, we all want a chance to live full and healthy lives.

Yet many of us are struggling to afford the basics. Every other day, news articles list out new numbers. Household costs up 16.% since 2021. Food up 9.6% in the last year. The Official Cash Rate has risen dramatically to 5.5%.

But behind every number is a parent making impossible decisions about how to look after their children. A family member racking up debt just to pay for the basics. A neighbour quietly heading to a foodbank for the first time.

For many of us, our food baskets are empty and there are still no real solutions on the table.

This report tells us that the choices of some big businesses have led us to where we are now. We have been hit by a pandemic, followed by a wave of severe weather events such as Cyclone Gabrielle, which have left communities struggling immensely. At the same time, many corporations appear to have seized the opportunity to increase their profit on the back of these struggles. Every few days, we hear another announcement of billions of extra dollars being funnelled from everyday people and into massive, often offshore companies.

And now, we have learnt through this report that the pursuit of profit has contributed over half of domestic inflation during the cost of living crisis.

Over the past year, inflation has been the grand excuse for anyone to wield at their disposal. It provides a convenient cover for business owners to push up prices and freeze wages. It has been sharpened as a weapon for political gain by parties wanting to shrink government and the public sector. It has become unquestionable and accepted as an unavoidable truth.

All of this has effectively obfuscated the role of big business in driving inflation. This has pushed people to internalise their struggles as their own fault, or worse, turn on each other through the pain.

We cannot just sit back and wait while inflation magically resolves itself. Even if we return to pre-pandemic inflation - the transfer of wealth from families to companies has been significant, and lays a worrying foundation for the future.

Now, more than ever, we need solutions to our cost of living crisis that will look after families, strengthen our public services, and prepare us to be resilient in the face of climate change.

This report gives us the opportunity to examine the role of corporate profit in our cost of living crisis, and call on the government to make the right policy changes that will fill up our food baskets so we may all thrive.

I roto i te manaakitanga,

Kassie Hartendorp

Ngāti Raukawa, Ngāti Pareraukawa
Director
ActionStation

Executive Summary

Over the last two years, working people in Aotearoa New Zealand have been on the receiving end of a cost-of-living crisis. They have been ravaged by both the cause – rising costs, particularly around housing, food and transport – and its diagnosed cure, rising interest rates. In the wake of the sharpest hike in the official cash rate (OCR) in history, household living costs are now 16.3 percent higher than at the beginning of 2021.

Much has been made of the drivers of this inflation. While corporate profits have reached dizzying new records, the political consensus in New Zealand rests on the idea that low pandemic-era interest rates led to excessive demand, outstripping the economy's ability to satisfy those demands without increasing prices. Bank economists heap blame on an overheated labour market, prescribing rising unemployment, real wage cuts (and even the threats of a recession) as necessary panaceas. The blunt instrument of monetary tightening – raising the cost of borrowing – remains the sole favoured policy response.

However a contrary view has now emerged, highlighting the contribution of rising profits to rising prices. This view is being propounded by very orthodox economic actors, including the IMF, the OECD, the European Central Bank, and the US Federal Reserve. This approach uses the so-called GDP deflator to decompose the profit, wage and government contributions to inflation, concluding that rising profits have played a key role in price increases.

Terms like profit-led inflation, sellers' inflation and even greedflation have sought to capture this dynamic. A June 2023 report[1] by BusinessNZ challenged the applicability of the profit-led inflation narrative in New Zealand, labelling it an "imported narrative". Using a different methodology, the authors of that report argued that they found "no evidence of widespread increases in profit margins driving up inflation in New Zealand."

This report challenges that assertion, using the same kind of "GDP price deflator" analysis undertaken by the OECD, ECB and the Australia Institute. It concludes that **from mid 2021 to the end of 2022 – when inflation was surging – rising profits contributed more than half of domestic inflationary pressure[2] while wages were responsible for less than a third.** This same trend is also apparent during the pre-pandemic period, with the profit contribution dominating inflationary pressure.

The report then takes a sectoral view on at profitability trends in key groups of prices driving inflation, focusing on food, housing and transport. It uses finer detailed data than the BusinessNZ report, as well as results from key firms to illustrate these findings.

- **Food:** In the early pandemic period, input costs to retail and wholesale trade sectors fall while profit margins rise, as it appears firms pocketed the difference rather than passing on cost savings. As supply chain disruptions push up input costs, firms battle to maintain elevated nominal profits. When commodity prices rise in the wake of the Russian invasion of Ukraine, profits in the food manufacturing sector surged to new highs.
- **Housing and Banking:** The construction and rental, hiring and real estate sectors, experience rising profits as low interest rates push house prices and incentivise residential construction. While profits in these sectors decline as the effect of higher interest rates are priced in, bank profits soar to new heights.
- **Transport:** While profits in the transport, postal and warehousing sector collapsed during the pandemic period, they surged back in the wake of the Russian invasion, reaching new records in 2022.

The purpose of this report is to stimulate discussion on how the NZ Government responds to future bouts of inflation. The findings from this analysis lead us to believe that alternative policy responses are necessary to tackle inflation in the future. We have heard many commentators and analysts demand higher unemployment and wage restraint to control inflation. At no point have we heard similar demands for profit control or margin control.

Fundamentally, we believe that the burden of changes necessary to tackle inflation should fall on those who have ‘won’ during the inflation period. Right now the winners and losers from our existing inflation response don’t appear to live up to that aspiration. That should involve thinking about inflation from both a short-term and a long-term perspective. It will involve thinking differently about the different impacts inflation has on different parts of the population. It will involve thinking about about inflation as a problem to be managed, rather than a number to be forced down.

1. Introduction: the cost-of-living crisis in Aotearoa

In June 2021, the annual growth rate of the consumer price index (CPI) moved out of the 1 to 3 percent policy target range for the first time since 2011. While inflation peaked in the June 2022 quarter, RBNZ took early action – second only to the Norwegian Central Bank in terms of raising rates. To constrain demand, from October 2021 the RBNZ Monetary Policy Committee took every opportunity it could to raise rates, reaching 5.5 percent by May 2023, where it is expected to stay for some time. This is RBNZ's most aggressive OCR hike track on record.

It is generally accepted that it takes 12 to 18 months for the impacts of monetary policy to be felt in the economy, with labour market impacts lagging even further behind. We might therefore be now seeing the impacts of an OCR at 1 percent (as at February 2022) or 2.5 percent (as at July 2022).

Unemployment has now edged up to 3.6 percent at the June 2023 quarter, and underutilisation has jumped to 9.8 percent. Unemployment is slightly ahead of the projection from the RBNZ's May 2023 Monetary Policy Statement (MPS),[3] while the August MPS sees rapid growth in unemployment over the coming quarters: reaching 4.4 percent by the end of the year and peaking at 5.3 percent by the end of 2024. This would suggest unemployment rising to levels not seen since 2016, with 55,000 more unemployed.[4] History suggests that low-income workers with limited job security tend to be the primary casualties.

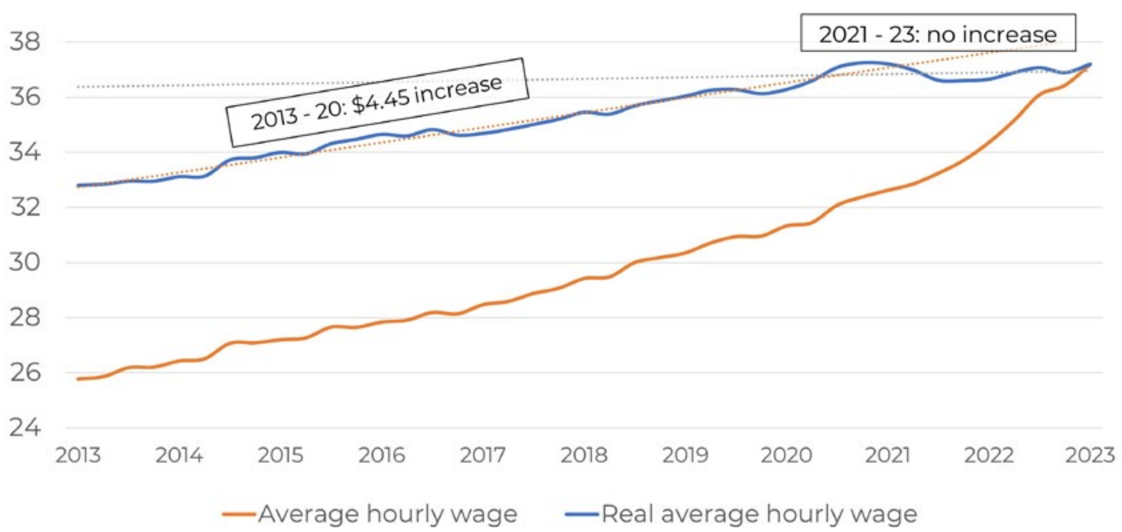
Inflation is felt differently by different households. Household living-costs price indexes (HLPIs) show that those living on fixed and low incomes already experienced inflation at much higher rates that those with higher incomes over the past fifteen years.

Unusually, inflation is hitting higher income groups right now because of higher interest payments.

While wage growth has seemed impressive over the last two years, the benefits of this have been eaten away by inflation. From the beginning of 2013 to the end of 2020, real wages increased by $4.45 an hour, an average increase of 57 cents per year. Real wages did not move from the first quarter of 2021 to the first quarter of 2023.

HLPI data also shows that interest payments have increased by 53 percent since the beginning of the pandemic. Rising interest payments – in particular mortgage rates – are the primary ways we manage inflation, by diverting household income into debt servicing. This channel is particularly effective in the Aotearoa New Zealand context, given the predominance of short-term fixed

Figure 1: Real average hourly earnings (NZ$)



mortgages. By way of comparison, 70% of mortgages[5] in the US are fixed for 30 years, and only a very small proportion have a variable or short-term rate.

The $314 billion of fixed rate mortgage holders have seen their average yields jump from a September 2021 low of 2.72% to 4.88% in June 2023 (216 basis points), while the $36 billion of floating rate mortgages have seen average yields increase from 3.62% to 6.72% (310 basis points) over the same period.[6] These impacts are continuing to increase, with another $128 billion of mortgage debt up for refinancing in the year to 30 June 2024.[7] This is particularly punishing for first home buyers who bought near the top of the market; Westpac economists estimate that an average-priced house in Auckland purchased in May 2021 could be looking at an increase of close to $1600 per month,[8] putting tremendous strain across household budgets.

Additionally, with roughly a quarter ($90 million) of mortgage debt held by residential investors, it is likely that this pressure is incentivising rent hikes, aided by increased demand as inward migration soars.

Food prices – which represent roughly 20 percent of the household budget – have increased by an average of 23 percent since the beginning of the pandemic. Prices rises have been spread broadly across the grocery food, fruit and vegetable, and meat, fish and poultry categories, making it hard for consumers to substitute food groups and avoid price rises. A May 2023 survey of 51 registered food hubs found that since Covid hit there has been a 165 percent increase in the number of people receiving food support, which now extends to more than half a million people.[9]

Surging petrol prices have also hit working families hard. This was felt initially in the wake of the Russian invasion of Ukraine, followed by a temporary alleviation as the Government cut the fuel excise tax, but is again a feature of life for households as excise taxes have been reinstated and international petrol prices are again rising. This is felt more directly by households located in lower socio-economic communities that are often underserved by public transport and also live often far away from their workplaces. Household energy prices have also grown seven percent since the beginning of 2022, at the same time that gentailers have made record profits and delivered enormous dividends to shareholders.[10] With rates of disconnection growing, a movement is now forming, calling for an end to disconnection fees that doubly penalise households that can't afford electricity.[11]

While all of these individual costs are difficult to bear, their combined impacts make for difficult trade-offs in many households. Rising prices make it harder to pay down existing debt, and take on further debt. While higher interest rates reward depositors, that remains unrealistic for low-income communities. The rate of youth employment has risen, as an increasing number of young people opted for work to help support their families rather than pursuing higher education. Older generations that might have otherwise retired remain in work. Rising inflationary pressures often also correlate with rising crime rates.

The above information is far from a comprehensive description of the challenges facing working families in Aotearoa in the cost-of-living crisis, and of course is no replacement for peoples' lived experiences. In the wake of a pandemic that has taken loved ones and affected peoples' lives in immeasurable ways, people are struggling. Seeing and experiencing that at the same time as businesses report record profits is confronting, and has pushed us to look for answers both in international analyses and domestic data. In the following section, we present some of that available material to sketch out the case for profit-led inflation in Aotearoa.

2. Understanding profit-led inflation

2.1 Rising inflation

The global rollout of vaccines in mid-2021 enabled authorities around the world to begin removing social restrictions. Around the same time, we saw inflationary pressures begin to rise across economies.

In New Zealand in the June 2021 quarter tradable CPI surged past non-tradable CPI, jumping from 0.5 percent to 3.3 percent in a quarter and dragging the overall CPI upwards. Initially much of this tradable inflation was attributed to supply chain pressure, as shipping companies, ports and onshore transport operators changed gears from lower volumes of traffic to much higher volumes.

Additional inflationary pressure came in March 2022 when Russia invaded Ukraine, causing the price of fuel, fertiliser and food commodities to skyrocket. By the June 2022 quarter tradable CPI had reached 8.7 percent, its highest level since the data series began in 1999.

Early engagement on inflation focused on the extent to which it was a “cost-push” versus “demand-pull” inflation. The former is when inflation is largely driven by rising supply costs, while the latter ascribes primary responsibility to rising consumer demand. The Government espoused the “cost-push” thesis, noting that NZ’s standard comparator countries were also experiencing rising prices at the same time. This was due to the combined impact of supply chain pressure and the concurrent Russian invasion of Ukraine.

Subsequent research also highlighted the role of rising profits within these cost-push factors. A 108 percent increase in the global container freight index in the five months to April 2022 was dwarfed by an explosion of profits in the industry; global shipping giant Maersk, for example, saw quarterly profits increase by over 26 times over a two-year period, earning US $49 billion over that period.[12]

Oil and gas companies saw their profits surge as a result of the international sanctions that followed Russia’s invasion of Ukraine. The six largest Western oil firms (Shell, BP, TotalEnergies, Chevron, Exxon and Equinor) saw their profits more than double to US$219 billion in 2022, paying out a record $110 billion in dividends and share buybacks.[13] The International Energy Agency suggests that global oil and gas profits more than doubled in 2022, from an average of around US$1.5 trillion in recent years to US$4 trillion.[14]

Similarly, the four largest grain traders – who together dominate 70-90 percent of the global grain trade – enjoyed record profits and rising margins while food prices surged more than 20 percent in 2022.[15] In global shipping, fuel and grain markets, NZ is a price-taker.

While these windfall profits might go some way towards explaining the rise in tradable inflation, they do little to explain the rise in

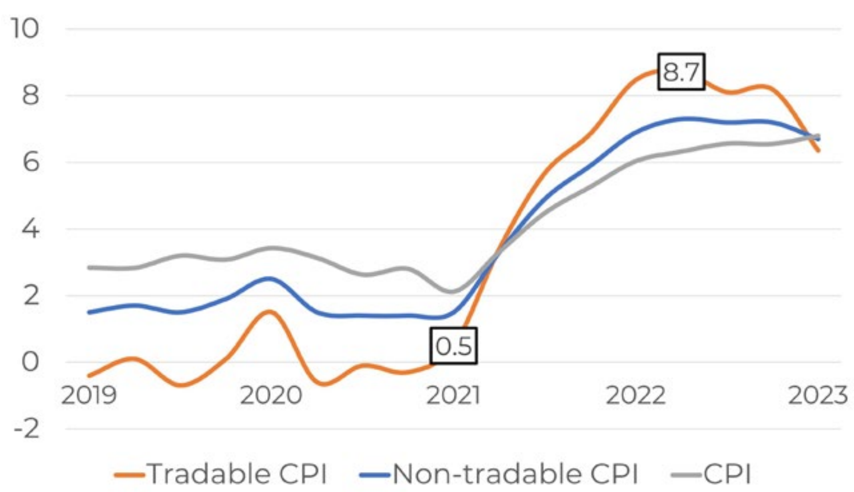


Figure 2: CPI, tradable and non-tradable

non-tradable (domestic) inflation, which is now leading inflation. Monetary policy proponents state that low interest rates (and policies like quantitative easing) during the pandemic were responsible for generating excess aggregate demand.[16] The only credible policy response, therefore, is to lift interest rates to suck demand out of the economy and bring markets back into equilibrium.

At the same time, another school of thought has rapidly developed, spearheaded by German economist Isabella Weber, but now also elucidated by the European Central Bank, the Organisation for Economic Cooperation and Development, the US Federal Reserve, the Australia Institute, and the Economic Policy Institute. While not strictly in conflict with the monetary view, the alternative view looks at the role of pricing behaviour in shaping the inflation outcome. Their analysis suggests that rising profits – whether conceived as nominal profits or profit margins – have played an outsized role in price increases. This view implies that there may be other policy responses alongside (or instead of) rates hikes that can stabilise price rises more effectively. It has been variously named "profit-led inflation", "sellers' inflation" and "greedflation" by proponents and critics.

2.2 International evidence supporting profit-led inflation

In April 2022 the Economic Policy Institute in the United States used "National Income and Product Accounts" data to decompose the wage, profit and government contributions to inflation. For the period 1979 to 2019, they observed that the growth in unit labour costs (i.e. labour costs per unit of production) had accounted for the vast majority (61.8%) of growth in unit prices in the US nonfinancial corporate sector. From Q2 2020 to Q4 2021, however, at 53.9% the major contributor of unit price growth had been corporate profits.[17]

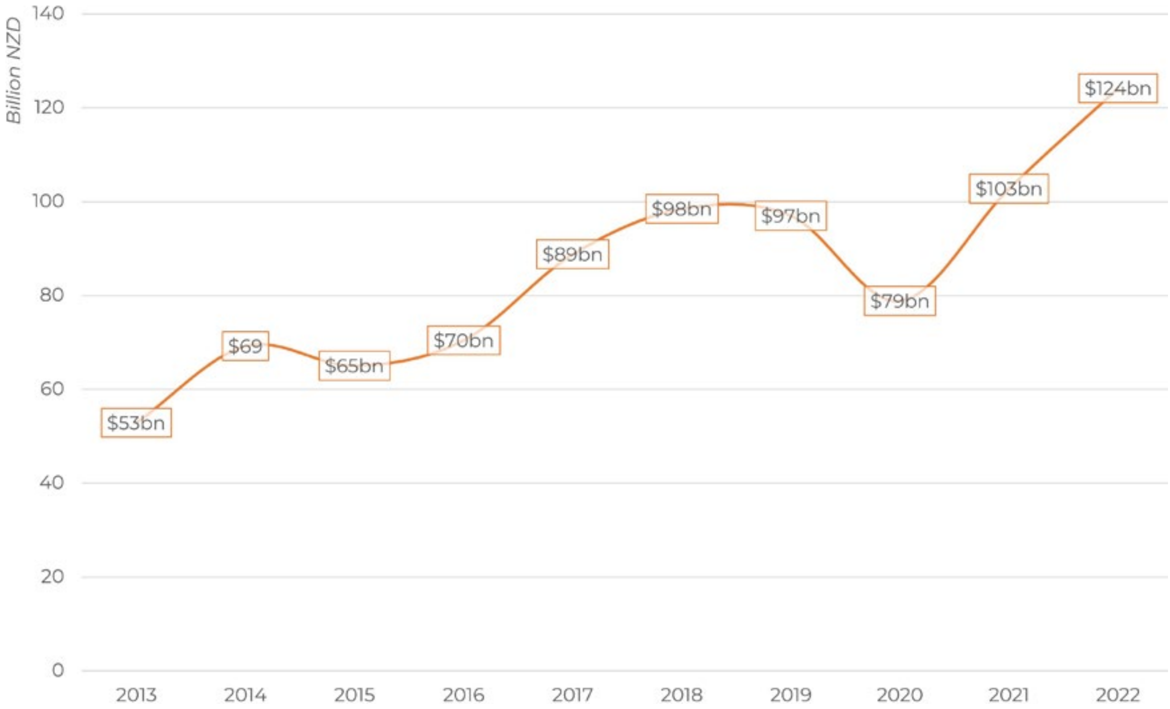
In a May 2022 speech, European Central Bank (ECB) board member Isabel Schnabel reached similar conclusions regarding inflation in the Eurozone, noting that "profits have recently been a key contributor to total domestic inflation, above their historical contribution".[18] In March 2023, ECB economists compared the labour and capital inflation contributions, noting that "the effect of profits on domestic price pressures has been exceptional from a historical perspective. While, on average, from 1999 to 2022 unit profits (i.e. contributed around one-third to the GDP deflator, over 2022 they contributed an average of two-thirds."[19]

The Bank explained that firms have an incentive to "try and minimize their share of the burden by raising their prices in order to preserve their profit margins." Labour will seek to act similarly, however wage-setting tends to be staggered, while firm-level price adjustments can happen relatively quickly.[20] ECB President Christine Lagarde echoed these sentiments in a May 2023 speech, noting that "in some sectors, firms have been able to increase their profit margins on the back of mismatches between supply and demand, and the uncertainty created high and volatile inflation."[21]

Closer to home, a July 2022 analysis by The Australia Institute used Australian GDP deflator data to similar effect. It concluded that wages had made no contribution to Australian inflation in 2019 – 2020 or 2020 – 2021, and accounted for only 0.6 of the 4.1 percent increase in inflation experienced in the three quarters of 2021 – 22 for which data was available, while profits accounted for 2.5 percent.[22] This was followed in February 2023 by another paper suggesting that excluding excess profits from final prices would have roughly halved from the beginning of the pandemic to September 2022.[23]

Two papers by Isabella Weber have helped provide a theoretical basis for understanding the role of profits in inflation. A December 2022 paper looked at how sector-specific price shocks present systemic vulnerabilities for price stability. They argue that in times

Figure 3: Annual Enterprise Survey, All industries



of overlapping emergencies, economic stabilisation needs to go beyond monetary policy, requiring institutions and policies that target systemically significant sectors.[24]

A February 2023 by Weber and Evan Wasner, which coined the term "seller's inflation", looks at firms' pricing behaviour and market power during periods of supply chain bottlenecks and cost shocks. Making creative use of firms' earnings calls, they find that rising prices in systemically significant upstream sectors due to commodity market dynamics or bottlenecks can create windfall profits, and that downstream sectors propagate, or in cases of temporary monopolies due to bottlenecks, amplify price pressures."[25]

In January 2023 the Federal Reserve Bank of Kansas City published a paper suggesting that in the wake of "record corporate profits", that "markup growth was a major contributor to inflation" in 2021, accounting for 3.4 out of the total 5.8 percentage points of inflation experienced that year.[26] In the US context, President Biden has repeatedly chimed in with his belief that corporate profits are driving inflation, recently noting that "one reason we've seen inflation fall by two thirds without losing jobs is we're seeing corporate profits come back to earth."[27] US Federal Reserve Chair Jerome Powell also supports this view, as does former Vice Chair of the Fed Lael Brainard, who is now part of Biden's National Economic Council.[28]

In its first Economic Outlook for 2023, the OECD included a box that looked at the contribution of unit profits to domestic inflationary pressures. They note that the negative correlation between unit profit and unit labour observed over the last two decades (with increases in one being absorbed by the other) has weakened, suggesting that "a period of rising input cost inflation may be conducive to unit profits and unit labour costs rising together, at least in nominal terms."[29]

Finally, in June 2023 the International Monetary Fund published a paper that looks at the role of import prices and domestic profits in euro area inflation. The authors use a novel "consumption deflator decomposition", which gives an even more comprehensive picture of inflation, decomposing the consumer price index into labour, profit, tax and input cost components. Their analysis finds that in the euro area over the period Q1 2022 to Q1 2023, domestic profits accounted for 45 percent of inflationary pressure, outranking input costs (at 40%) and labour (25%), while net taxes were slightly disinflationary.[30]

2.3 Aotearoa New Zealand data and analysis on profit-led inflation

Internationally, the possibility that increased profits might drive inflationary pressures seems to be accepted. However, the increase in profit and the possibility that this increase could have contributed to inflation, have received limited discussion in Aotearoa New Zealand. This section will look at the extent of that discussion, as well as evidence suggesting rising profits by businesses based in Aotearoa New Zealand.

The annual enterprise survey (AES) is one source of data that shows a significant increase in nominal profit, both in the last two years and over a longer-term trend. This is annual data for the year to 30 June (the financial year), however it has a long lead time, being released a year after the latest results. It measures a range of financial indicators on an industry-by-industry basis (as well across all industries), including “surplus before income tax”, which is similar to the profit measure of earnings before interest and tax (EBIT).

AES data shows that surplus before income tax in the 2021 financial year increased $24 billion, and $21.4 billion in the following 2022 financial year - $45.4 billion over two years. In the same two financial years, wages and salaries increased by only $15.8 billion in total. Over the decade to 30 June 2022, surplus before income tax has increased by 134 percent ($71 billion). Over the same period, wages and salaries have increased by only 70 percent ($56 billion).

Treasury’s out-turn tax data is another possible data source that shows a significant increase in profit. This data measures actual company tax collected by Inland Revenue, and it can be used to estimate net profit of all companies in Aotearoa New Zealand. As with the AES data, that shows both a sharp increase in the last two years and a long-run increasing trend.

Like AES data, we can see a sharp decline in net profit before tax in the 2020 financial year, from $56.2 billion to $43.4 billion. This is then followed by a $16.7 billion increase (39 percent) in the 2021 financial year and a $10.2 billion increase (17 percent) in the 2022 financial year.

These are the largest nominal increases in the data (which goes back to 1994), while the 2021 increase is the largest percentage increase. In 2022 net profit before tax as a percentage of GDP hits 19.4 percent, the highest in two decades. Over the last decade, net profit before tax has increased by $34.5 billion or 96 percent, while over the same period GDP increases by only 66 percent.

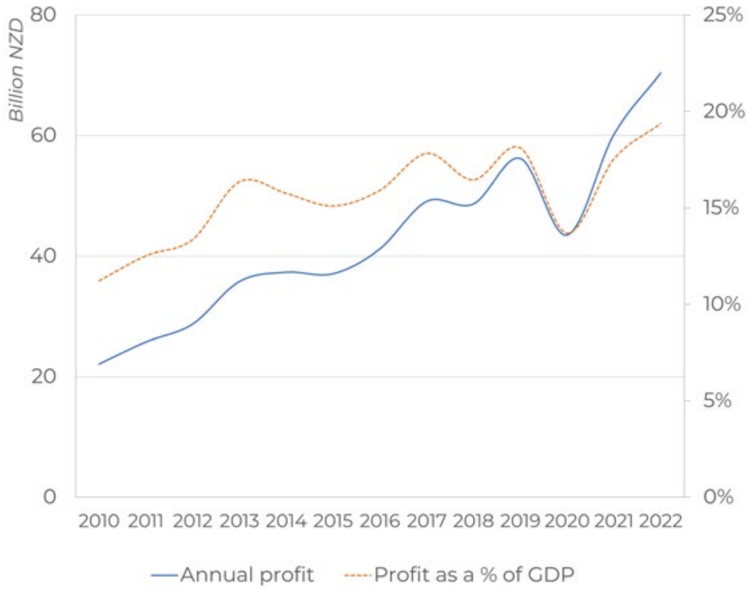


Figure 4: Estimated NZ company profits

While this data is helpful in that it shows profits are rising, it doesn't necessarily indicate a address the question of whether rising profits have contributed to inflation. Comments by both the Reserve Bank Governor Adrian Orr suggested that deficient data remained a problem, while chief economist Paul Conway suggested that "[a]t the aggregate [economy-wide] level we don't see any evidence of an increase in profits feeding into inflation", however this "doesn't rule out the possibility that there are markets in Aotearoa New Zealand that do suffer from a lack of competition and where profits may be above normal levels."[31]

A recent podcast on RNZ's The Detail focused on "greedflation", and featured financial journalist Gareth Vaughan outlining the case for a profit contribution to inflation, while University of Waikato Economic Michael Cameron arguing against.[32] It is the view of the authors of this report that the 'greedflation' framing is unhelpful in determining the question of whether profits are a contributing factor to inflation. Firms didn't just decide to be greedy during the pandemic, company boards and directors have an ongoing fiduciary obligation to maximise returns for shareholders.

On 14 June 2023 BusinessNZ released a report written by SensePartners titled, "Greedflation in New Zealand? An imported narrative".[33] That report finds "...no evidence of widespread increases in profit margins driving up inflation in New Zealand". Unlike the studies highlighted in the previous section, that study uses level 1 NZSIOC data[34] rather than a deflator analysis of the national accounts, and it is therefore unclear what – if any – measure of inflation is applicable. As a result it draws very different conclusions to those studies, attributing the bulk of inflationary pressure (71%) to rising input prices, splitting the difference roughly equally between labour and capital, and attributing no impact whatsoever to Government subsidies and/or taxes.

There are known problems with this analysis. Firstly, the NZSIOC does not include the financial and insurance services sector, which alone make up 27 percent of "surplus before income tax" reported in the AES in 2022. As a result the AES suggests significantly higher economy-wide profits than the NZSIOC data. Secondly the use of only level one data risks losing some of the detail which would be available through the use of more-detailed level two NZSOIC data. For example, at level one the retail trade, accommodation and food service sector data are presented together, while at level two retail trade is separated out from accommodation and food services. This is relevant in the context of the pandemic, when demand for the former sector grew, but the demand for the latter fell.

Sense Partners do suggest that in the wake of the pandemic the wholesale and retail trade sectors experienced higher than pre-covid margins, however many other sectors appear to experience either steady or declining margins. This is presented without a sense of the scale of the sector: wholesale and retail are the largest sectors measured in the NZSIOC ($149 billion and $100 million respectively in the year to December 2022), and the ones where workers feel the impacts of inflation most directly. It is highly likely that rising profits in these sectors would eventually feed back into wage pressure in other sectors.

Finally, the study has an explicit focus on profit margins (as percentages of total sector income), rather than looking at nominal increases, measured in dollars. This is particularly relevant in the later part of pandemic period because international factors (supply chain pressure and commodity price hikes) meant that many industries experienced significant increases in input costs.

The difference between nominal profit and profit margins is important in the context of rapidly rising input costs, like those experienced during the later pandemic period. The BusinessNZ report suggests that margins would have to be rising to be inflationary. A recent ECB Economic Bulletin addresses this issue, noting that "in a situation characterised by surging input costs, unchanged gross profit margins in corporate accounts can also be consistent with increased inflationary pressures from profits."[35] The OECD concurs with this analysis, noting that an increase in input costs means that "an increase in unit profits (profit per unit of value added) does not necessarily entail higher profit margins."[36]

Weber and Wasner describe how this phenomenon plays out between firms:

> *To protect profit margins firms must increase prices by more than costs. If firms do manage to increase prices to protect margins, the next firm in the chain will do the same but now starts from a cost increase that incorporates both the initial upstream cost hike and higher markup for the second firm in the chain. If all firms behave like this, there is a cumulative effect that increase the nominal value of profits while profit margins stay constant.*[37]

Such an instance might best be illustrated with an example. Imagine a bag of flour costs a dollar at a supermarket; it costs the supermarket 80 cents to purchase it, 10 cents goes to paying the supermarket staff and the supermarket takes 10 per cent profit. Now imagine the wholesale cost doubles in a year, while wages remain the same. The supermarket owner decides to simply maintain their existing profit margin levels.

The supermarket owner is happy because her nominal profit has nearly doubled, while her profit margin has remained the same.

Example: buying a bag of flour

	Inputs	Labour	Profit	Price
Year 1	$0.80	$0.10	$0.09	$0.99
Year 2	$1.60	$0.10	$0.17	$1.97

2.4 An emerging role for profit in the inflation narrative

It is becoming increasingly clear that the uniformity of thought around the drivers of inflation is breaking down. While the traditional view suggests inflation is always a monetary phenomenon, this is about as helpful as saying that gravity is always responsible for people falling off buildings. On one level it is true, but it certainly helps to absolve those who regularly push people off buildings. Firm-level and industry-level pricing behaviour, as well as the degree of market competition, must be considered relevant factors to what drives increases prices.

The next section describes the methodology for our analysis of the situation in Aotearoa New Zealand, using national accounts and the implicit price deflator.

3. Methodology and analysis

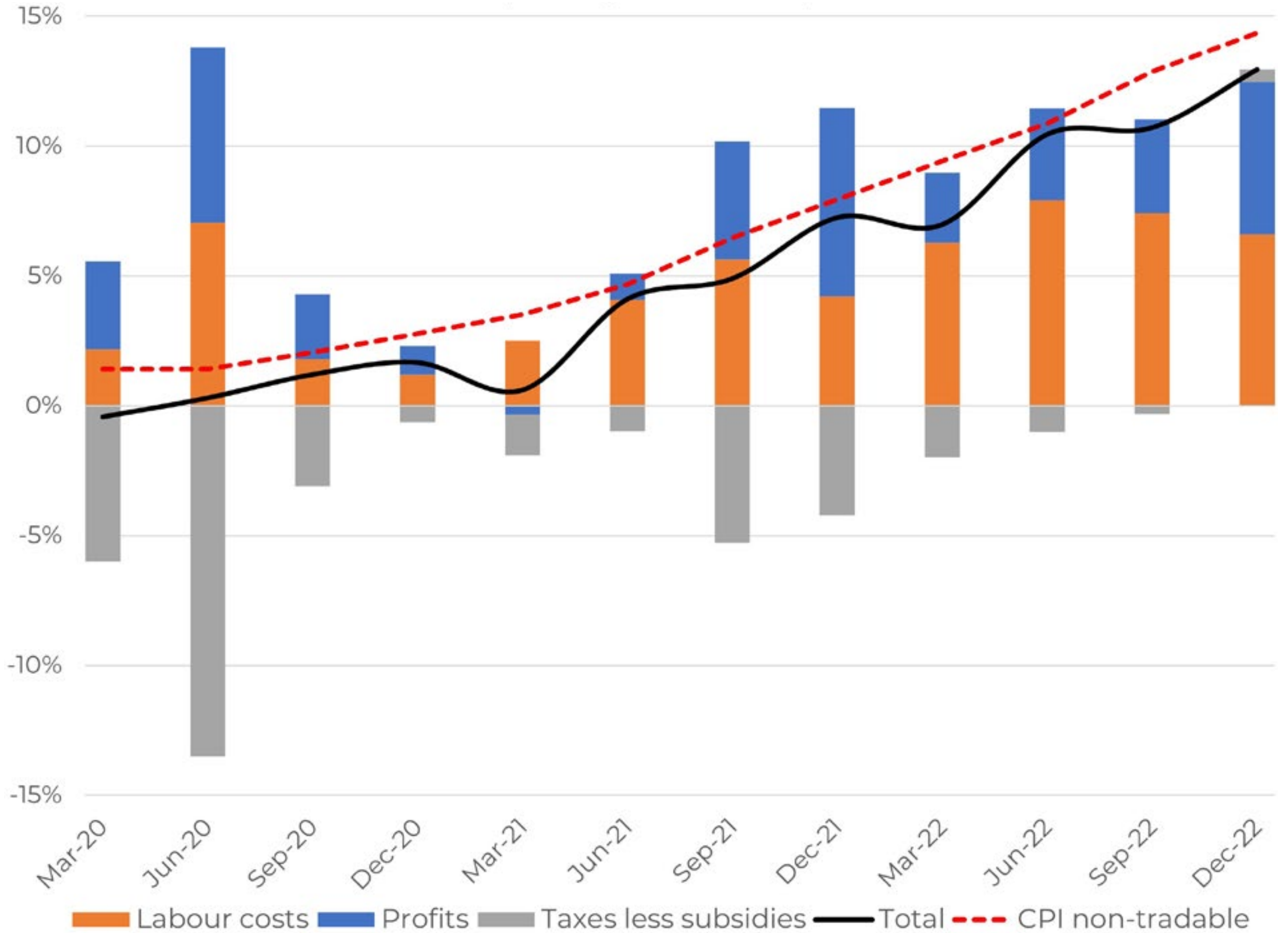
In Section 3.1 we apply the methodology as used by the ECB, OECD and others. Our primary data source is the NZ national accounts data, which have been decomposed through the use of an implicit price deflator.[38] This resulting data has been split into pre-pandemic and pandemic periods, according to changes in movements in the price deflator, and the origin of these respective contributions.

In Section 3.2 we then review the findings from this analysis alongside level two NZSIOC sectoral data to establish some broad conclusions about how we can see rising profits – either as rising nominal profits or rising profit margins – manifesting on the price of food, housing and transport, which together accounted for three-quarters of inflationary pressure during the cost-of-living crisis.

3.1 GDP deflator analysis

This section undertakes a GDP deflator analysis of the national accounts data.[39] A GDP deflator – also known as an implicit price deflator – is a price index for all domestically-produced goods and services in the economy. Unlike the Capitalise Consumer Price Index, which is based on a representative basket of goods and services purchased (consumed) by households, the GDP price deflator is based on all goods and services produced (or purchased) in the economy, including those purchased by firms and government as inputs to their own production and activities. It is a useful tool for decomposing inflationary pressure because it is so broad,and shows pricing trends that are likely to impact the CPI. The GDP deflator excludes imported input costs, and therefore follows a different trajectory to CPI inflation.

Figure 5: New Zealand: contributions to increase in unit costs since 2020Q1
(% change since 2020Q1)



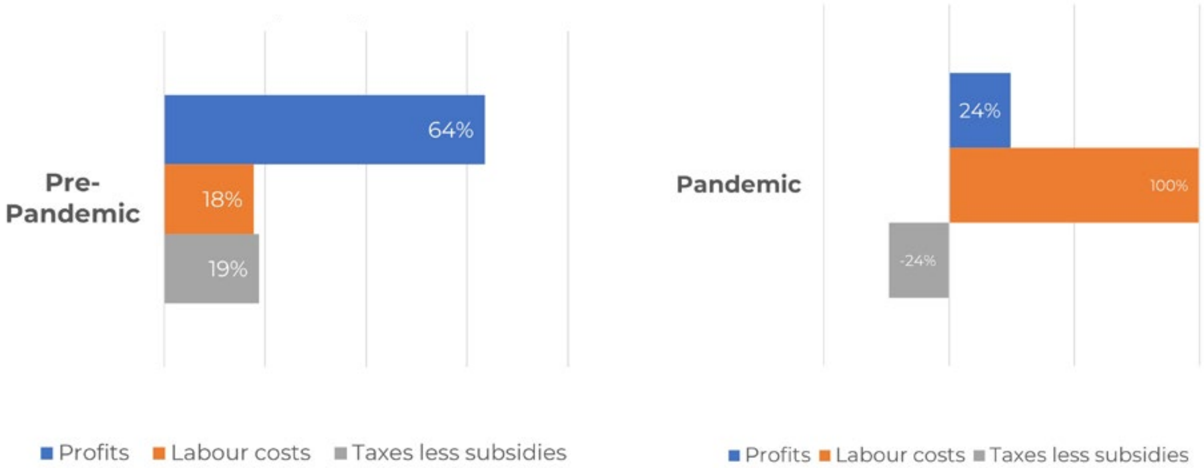


Figure 6: Contributions to GDP deflator
Based on quarterly values

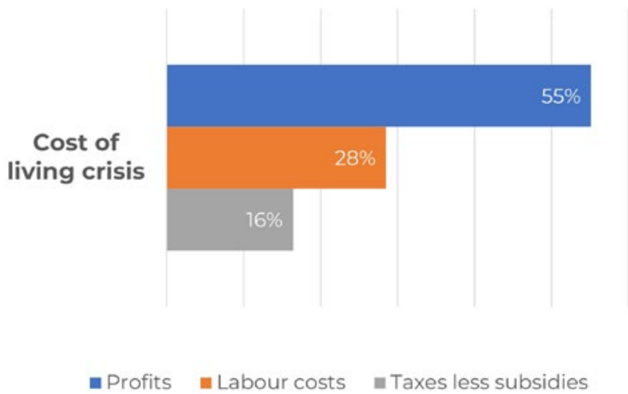
The data has been organised as contributions from labour (compensation of employees), capital (gross operating surplus of corporations, other gross operating surplus and mixed income) and government (taxes[40] less subsidies). Each bar running along the horizontal axis represents a quarter; bars on the top indicate inflationary pressure, while bars on the bottom are deflationary. Where positive and negative bars are equal there is no inflationary pressure, however where they are not equal there is either inflationary or disinflationary pressure. The balance of inflationary and disinflationary pressure is represented by the black line, the GDP deflator, which show cumulative increases since the beginning of 2020. For reference, the red dotted line shows non-tradable CPI inflation, which follow similar (but not identical) trajectories.

To recap: in the period leading up to the pandemic, low quarterly CPI inflation kept annual CPI within the 1-3 percent window required by the Reserve Bank Act. In the early pandemic period of the pandemic, quarterly inflation seems to drop even lower. In the latter part of the pandemic, quarterly inflation rises higher, with apparent contributions from both capital (profit) and labour (wages and salaries).

The above chart shows aggregated quarterly data across the pre-pandemic (Q2 2016 to Q4 2019) period. The GDP deflator shows cumulative growth of 10.4 percent across this period. Across this period, growth in unit profits accounts for 64% of the increase in the GDP deflator, while the contribution from labour costs is only 18 percent. The contribution from taxes less subsidies (see footnote 37) is 19 percent, greater than the labour contribution. In other words, during the pre-pandemic period, it appears that profit growth accounted for significantly greater inflationary pressure than wage growth. Average annual non-tradable CPI inflation over this period was 2.6 percent, while the annual GDP deflator averaged 3 percent.

This dynamic flips during the main pandemic period, (from the beginning of 2020 to mid-2021). Pressure on the GDP deflator from profits falls significantly, accounting for only 24% during this period, balanced by an equivalent negative in contribution from taxes less subsidies. This is consistent with the decline in profits observed in the 2020 financial year as a result of rolling social

Figure 6a: Contributions to GDP deflator
Based on quarterly values



restrictions (e.g. lockdowns) and the increasing frequency of working from home.

As a result, labour costs effectively account for all of the contribution to the GDP deflator over this period. Again, this is consistent with the fact that the Crown was providing the Wage Subsidy Scheme during this period. Essentially the subsidy may have purchased "more labour" than the economy required during this period of time. Some of that cheaper labour may have turned into profits as effective wage prices fell with subsidy. Average annual non-tradable CPI inflation over this period was still only 2.9 percent, while the annual GDP deflator averaged 2.3 percent.

As we move from the main pandemic period into the cost of living crisis, the dynamic flips again as inflation rises and the contribution of profits to the GDP becomes dominant. Over the period from mid 2021 to the end of 2022, profit growth contributes more than half – 55 percent – of pressure on the GDP deflator. Labour costs, on the other hand, contributed less than a third – 28 percent – of pressure, while taxes less subsidies only 16 percent.

This period is consistent with a much greater increase in inflation, with both annual non-tradable CPI and the annual GDP deflator averaging 5.9 percent over this period.

There appears to be a clear differentiation of periods – rising profits dominate rising cost pressure in the pre-pandemic period, labour costs dominate during the main pandemic period, then profits again lead during the cost-of-living crisis period. This seems consistent with the fact that firms have much more freedom to adjust prices (and accordingly unit profits) at multiple points through the year, whereas changes in labour costs are often constrained to set periods of collective bargaining, minimum wage hikes, or when an employer decides to otherwise review wage rates.

It will be interesting to see the impact of rising interest rates on both wage and profit pressure on the GDP deflator as the 2023 data becomes available. Regardless, the predominance of profit pressure during both the pre-pandemic and cost of living crisis periods suggests that rising profits tend to precede rising wage demands, as workers try to keep pace with the rising cost of living.

3.2 A sectoral analysis

While inflationary pressures have been spread relatively broadly across the economy, three expenditure groups have consistently accounted for three quarters of total price changes: food, housing and transport.

The following section looks at profitability trends in the sectors of the economy that have played a major role in driving those price changes. This looks at the interplay between changing input costs on the one hand, and changing profit levels on the other. To do this, we have used level 2 NZSIOC data which gives quarterly measures of sales (i.e. total income), purchases and operating cost, salaries and wages and operating surplus (i.e. profit). Because the banking sector is not included in the NZSIOC data, we have substituted RBNZ bank income and profit data for this purpose. Quarterly figures have been averaged across four quarters to smooth out fluctuations. This analysis is additionally complemented by financial results from leading firms in their respective industries.

Section 3.2.1 looks at how changing profitability trends of the wholesale trade, retail trade and food manufacturing sectors have influenced **food prices**. Section 3.2.2 looks at how changing trends in the construction, real estate, rental and hiring and banking sectors have influenced the **cost of housing**. Section 3.2.3 looks at **transport** costs, with respect to the retail trade and transport, postal and warehousing sector.

It should be noted that this is a preliminary attempt to understand how the GDP Deflator data can be reconciled with the detailed

Figure 7: Wholesale trade and retail trade cost components as % of sales

sectoral data in the NZSIOC and other sources like company reports. As mentioned earlier, the NZSIOC data does not have a built-in inflation measure so this is an attempt to interpret that data in light of the findings of the GDP deflator.

3.2.1 Food prices

Food prices are surely the most visible area of price inflation, as most households visit the supermarket multiple times a week and purchase a wide range of items. In the modern globalised economy, food prices are of course influenced by a wide range of factors, including commodity input costs like fuel and fertiliser, weather conditions, wage rates and changing trends in profitability across the supply chain.

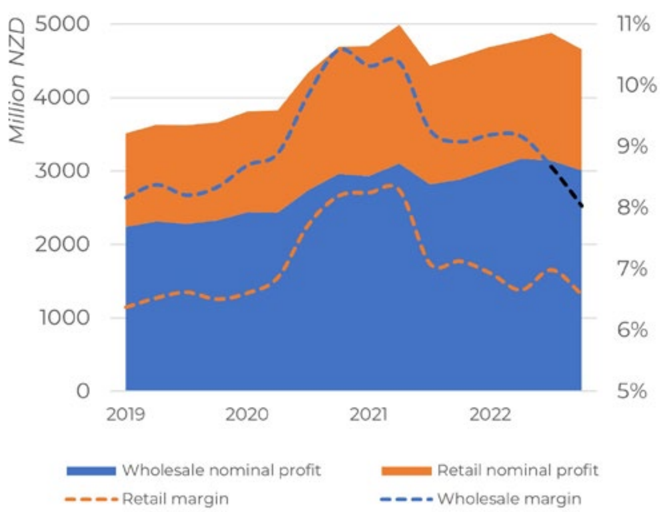
Declining input costs during the pandemic period for the retail and wholesale trade sectors lead to a surge in both nominal profit and profit margins. As we entered the cost-of-living crisis period, supply chain disruptions pushed up the cost of input costs, with sales following suit. While this squeezed profit margins back towards the top of the pre-pandemic range, nominal profit remained at elevated levels. The Russian invasion of Ukraine pushed input prices further, resulting in a surge in nominal profit in the food manufacturing sector, as margins pushed towards the top of their range. The combined impact of changes in both input costs and profitability in the sector translates into a consistent increase in food prices.

The **wholesale trade** and **retail trade** sectors are the largest sectors of economy measured in the NZSIOC data (by sales); in 2022 they accounted for $149 billion and $100 billion respectively, more than a third of total of sales measured in that dataset. The scale of these sectors is such that even small changes in the margins can correlate to significant gains or losses for firms. In Aotearoa New Zealand many of the lead firms in key retail markets – including retail grocery, department stores and retail hardware – are vertically integrated across both the wholesale and retail sectors.

The vast majority of income in both sectors – between 82 and 86 percent – covers the cost of purchases and non-labour expenses. Wholesale wages and salaries are consistently between 6 and 7 percent, while retail wages are between 10 and 11 percent. At the beginning of the pandemic, growth in purchases and non-labour expenses turns negative; in other words, inputs costs decline. Sales follows a similar trajectory, albeit a less dramatic one, however profits begin to grow dramatically.

The adjacent graph demonstrates this by looking at purchases and profits as proportion of total sales. In both the wholesale (blue) and

Figure 8: Wholesale trade and retail trade Averaged quarterly operating surplus



retail (orange) trade sectors, we can effectively see a transfer of income from purchases (the solid lines) to profits (the dotted lines).

One explanation here is that given the volatile pandemic environment and the threat to revenue presented by social restrictions, rather than passing on the benefit of falling prices to consumers, firms pocketed the difference. Over this early pandemic period, quarterly nominal profits for the wholesale sector increased by 27 percent, an increase of $663 million, while quarterly retail profits increased by $520 million (38 percent). By mid 2021, the combined overall quarterly profit of these sectors reaches $5 billion.

From the beginning of 2021, the downward trend in input prices ends, reverses and then accelerates, places downwards pressure on margins. However, with rising input costs pushing up the overall cost of goods, firms battle to sustain their nominal profits. We can see this in the graph below, where both retail and wholesale margins trend downwards but the overall level of nominal profit remains similar, hovering around the $5 billion per quarter for both sectors. This period likely favours larger vertically-integrated firms like supermarkets that are able to hold large inventory of stock that are purchased when prices were relatively lower, then sold when prices were relatively higher.

We can see these trends play out in some sectors of the retail grocery sector. In NZ that sector is dominated by two firms – Woolworths (which operates Countdown and FreshChoice) and Foodstuffs (which operates New World, Pak n Save and Four Square). Woolworths experiences a 30 percent spike in operating profit (to $376 million) in the year to 30 June 2020, which is largely sustained over the next year (operating profit of $360 million in 2021). While gross profit (revenue minus cost of sales) continued to rise in 2022, a decline in operating profit in 2022 results from a $200 million increase in stores expenses and administrative costs. This notwithstanding, the company still delivers a windfall $600 million dividend to its Australian parent company that year.

Countdown does, however, clearly report its results and has a national collective agreement, negotiating a 12% pay increase with FIRST Union members in 2022. Foodstuffs, on the other hand, has a complex corporate structure that allows them to negotiate wages in an ad hoc enterprise manner and effectively conceals total group profits.[41] The Commerce Commission has estimated higher ROACE (Return on Average Capital Employed, another profitability measure) for the Foodstuffs cooperatives than for Woolworths.[42]

Figure 9: Food manufacturing

While supply chain disruptions place initial pressure on input costs, the Russian invasion of Ukraine significantly amplified these pressures. This is clear in the food manufacturing industry. From mid 2021 to the end of 2022, quarterly sales increased by 20 percent, while purchases and non-labour costs increased by only 16 percent. Over the same period, quarterly nominal profit increased by 87 percent, with profit margins rising to their highest level.[43] Pressure from this sector compounded the existing impacts of rising input costs and profits from other sectors, resulting in consistently rising food prices for households. We will discuss bank profits in more detail in the subsequent section in relation to the rising cost of borrowing during the cost-of-living crisis period – which resulted in a significant increase in bank profits.

Rising borrowing costs has also had an impact on food prices, particularly at the farm level. Data from the farm expenses price index shows that rising interest rates accounted for a third of the rise in prices faced by farmers in the year to December 2022.[44]

Of course, the retail and wholesale sectors cover more than just supermarkets, and results from other general retailers like *The Warehouse Group* and *Kmart* show similar but slightly different trends. In these industries profits peak higher and later, which is presumably due to the largely non-perishable nature of inventory, which can be bought when prices are low and sold when they rise.

The Warehouse Group – which also owns The Warehouse Stationery, Noel Leeming and Torpedo 7 – experienced a 150 percent increase in net profit in the year to 31 July 2021, despite revenue rising by only 8 percent. *Kmar*t saw a moderate decline in net profit in the year to 30 June 2020, followed by an 87 percent increase in the next year to $95 million, with revenue rising only 20 percent. Both The Warehouse and Kmart saw profits decline in the 2022 financial year as the cost-of-living crisis changed consumer purchasing patterns, lowering expenditure on household goods and increasing expenditure on food.

3.2.2 Housing

Housing represents the largest single cost for most households in Aotearoa, and low building rates over the last two decades have created a material housing shortage that pushes up both house prices and rents. Housing accounted for roughly 35 percent of CPI inflation in 2021 and 31 percent in 2022, principally the cost of building a house (roughly 60 percent) and rent hikes (roughly 20 percent). Together, the construction and rental, hiring and real estate sectors account for seventeen percent of economic activity measured in the NZSIOC, totaling $128.3 billion in sales in 2022. In addition, with more than 70 percent of lending activity in NZ going to the housing sector, profits generated from the banking sector (not measured in the NZSIOC) remain material to this discussion. While borrowing costs are not included in the consumer price index, they are measured in the household living costs price index. Over the last two years, the rising cost of interest payments has directly accounted for close to 18 percent of the change in household living costs.

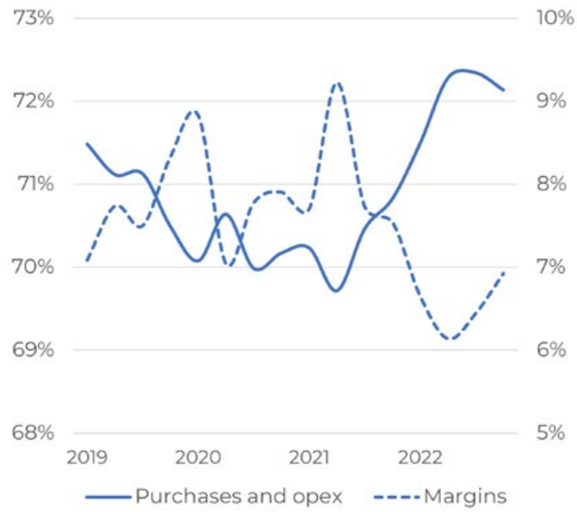
The construction and rental, hiring and real estate sectors together account for seventeen percent of economic activity measured in the NZSIOC, totaling $128.3 billion in sales in 2022. Together these sectors produce and distribute housing and housing services in Aotearoa New Zealand, which accounted for roughly 35 percent of CPI inflation in 2021 and 31 percent in 2022. Debates in NZ continued for much of the 2010s about whether there was a housing crisis, with Governments unwilling to address how tax-free capital gains had distorted investment from the real economy to the speculative economy, however as the pandemic progressed this debate became a distraction.

Both the construction and rental, hiring and real estate workforces employ relatively high proportions of independents contractors. In the construction sector this figure is up around 20 percent of a workforce (of around 300,000), while in the rental, hiring and real estate sector it is closer to a third (of around 60,000), which may impact the distribution of wages and salaries and profits, as contractor income is considered part of operating surplus. The ECB suggests adjusting income shares at the rate at which wages and salaries are distributed to get a clearer idea of operating surplus, which we have done in this analysis.[45]

One of the primary concerns of economic policymakers when the pandemic hit was ensuring that the housing market – which makes up 55% of NZ net wealth – would

Figure 10: Rental, hiring and real estate

Figure 11: Construction



not collapse. Rising prices in the lead-up to the pandemic had already supported high rates of residential construction and rising margins, however the pause in construction activity during the lockdown period lockdown period impacted margins. In April 2020 the Reserve Bank dropped interest rates to 0.25 percent, and kept them there until November 2021, during which time house prices – already considered elevated – increased more than 40 percent across Aotearoa, with many areas experiencing levels much higher. Rising house prices incentivised residential construction, leading to record rates of residential consenting.

Profits in the construction sector fluctuate significantly, however there is a clear upwards trend visible, with the troughs becoming higher over time. The trend in the rental, hiring and real estate sectors is clearer, rising consistently from 2020 onwards. The rise in the cost share of purchases and opex from the beginning of 2021 onwards makes the inflationary effect of this growing profit share more visible.

Most firms in these industries don't report results, however results from some construction firms are illustrative. *Fletcher Building* saw earnings yo-yo from profit to loss in the pre-pandemic period, before record results in both 2021 ($300m in pre-tax profit) and again in 2022 ($432 million in pre-tax profit). Similarly, Australian *CPB Contractors*

Figure 12: Quarterly nominal profit

– whose average operating profit in 2018 and 2019 was less than $20 million achieved – a remarkable turnaround during the cost-of-living crisis. After making a $144 million loss in operating profit in 2020, in 2021 operating profit jumped to $108 million, followed by $178 million in 2022.

Building materials supply chain sectors similarly enjoyed strong results. The **metal product manufacturing** and **wood product manufacturing** sectors suffered during the pandemic and even during the early part of the cost-of-living crisis, but quarterly profits surged in those sectors in the latter part of 2022. We have already discussed the wholesale and retail trade sector in the context of food prices, however results from the vertically-integrated retail hardware giant Bunnings shows the interplay of some of profitability trends across these supply chains. *Bunnings* experienced a decline in operating profit in the year to 30 June 2020, which was more

Figure 13: Quarterly bank profits

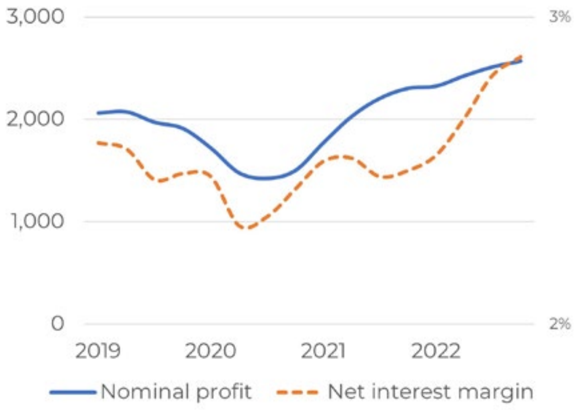
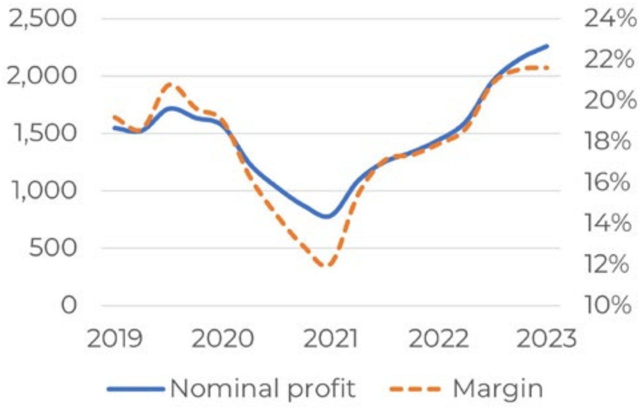


Figure 14: Transport, postal and warehousing



than made up for in the subsequent years. In the 2021 financial year operating profit more than doubled to $93 million (a $47.5 million increase), and in the 2022 financial year operating profit rose another $42.5 million (a 46 percent increase) to $135 million.

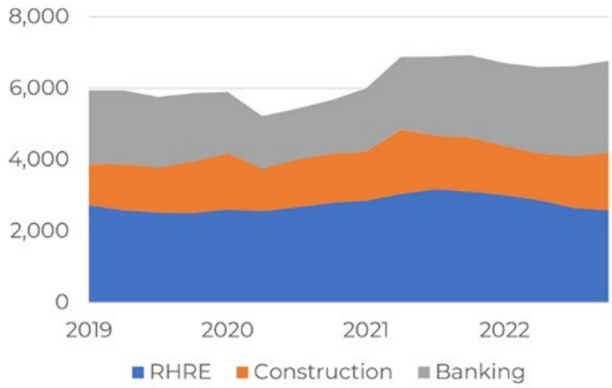
Bank profits represent another crucial part of the housing costs story. In November 2021 the Reserve Bank began hiking interest rates to quell emerging inflationary pressures across the economy. At the same time, there has been an expansion in the spread or Net Interest Margin – the difference between the rates at which they borrow money and the rates at which they lend money – and in doing so expand their profit margins. With banking outside the coverage of the NZSIOC data we have substituted RBNZ data[46] and used the net interest margin as a substitute for profit margins.

NZ banks have often been accused of having relatively high profits, with recent analysis suggesting rising net interest margins.[47] In its May 2023 Financial Stability Report, the Reserve Bank confirmed existing FIRST Union research[48] that the big four Aotearoa New Zealand banks' return on equity is amongst the highest in the developed world, barring only Canada. The Reserve Bank also noted that banks' volatility of earnings "has been relatively low in Aotearoa New Zealand compared to other countries in recent decades. This suggest that risk does not full explain the relatively higher returns of Aotearoa New Zealand banks. The difference in risk-adjusted profitability may reflect a lack of competition."[49]

Before the pandemic, quarterly bank profits were around $2 billion per quarter, with a net interest margin of 2 percent. From the fourth quarter of 2019 to the third quarter of 2020, quarterly bank profits fell 25 percent, from $1.9 billion per quarter to $1.4 billion per quarter, with net interest margins declining to around 1.8 percent in mid-2020. However with low interest rates driving house price growth, quarterly bank profits soon returned to the $2 billion mark by mid-2021 and the net interest margin returned again reached 2 percent.

Interest rate hikes from November 2021 pushing net interest margins further. From the third quarter of 2021 to the fourth quarter of 2022, bank profits consistently equalled a full 60 percent of bank income. From their mid-2020 dip to the end of 2022, quarterly bank profits increased by 80 percent ($1.15 billion), reaching $2.6 billion per quarter by the close of the year.

Figure 15: Construction and rental, hiring and real estate (combined averaged quarterly operating profit)



In the December 2022 quarter the net interest margin reached 2.37 percent, its highest level since 2014.

In 2019, the combined quarterly profit of the construction, rental, hiring and real estate and banking sectors was around $6 billion. Profits dipped in 2020, but by mid 2021 the combined quarterly profits of those sectors had reached $7 billion.

3.2.3 Transport

When Russia invaded Ukraine in March 2022, fuel, fertiliser and food commodity prices spiked. The increase in petrol prices[50] resulted in significant downstream price impacts for the transport industry. This allowed the **transport, postal and warehousing** sector to recover from the impact of the pandemic, which saw the restoration of pre-pandemic margins and new highs in nominal profit.

Pre-pandemic, the transport, postal and warehousing sector had margins[51] of around 20 percent, with nominal profit hovering around $1.5 billion per quarter. Lockdowns and other restrictions during the pandemic hammered the sector, pushing margins down to 12 percent by the beginning of 2021, while nominal profit had nearly halved.

Nominal profit recovered to pre-pandemic levels throughout the remainder of 2021, however the Russian invasion significantly changed the sector's fortunes. Growth in purchases and non-labour expenses pushed up prices, with total sales rising to $11 billion per quarter by the end of 2022, a 30 percent increase from the beginning of the year. Profit growth was even more impressive: in the year to December 2022 operating profit increased by 61 percent, reaching $2.15 per quarter and pushing margins close to 22 percent.

A number of firms in the transport sector show these trends. *Mainfreight* – which earned around $200 million per year in net profit before tax in 2019 and 2020 – saw profits jump to $489 in the year to 31 March 2022 and $587 in the year to 31 March 2023. Similarly *Air New Zealand* – which experienced severe disruption during the pandemic – saw net profit before tax jump from a $810 million loss in the year to 30 June 2022, to a $574 million profit in the year to 30 June 2023.

4. Policy recommendations

The evidence above shows that we have got our thinking about inflation and its impacts wrong. If inflation is being driven at least in part by higher profit levels, then we may benefit from additional tools to address this challenge. We still fight inflation as if the Reserve Bank is trying to convince the markets of its credibility, however today no-one doubts the Bank's seriousness. Nonetheless, we remain unconvinced that the tool that it has been given to tackle inflation is the most effective tool for the job.

What should be in question is how we address the challenges currently in front of us. Inflation is not a new problem. For many New Zealanders, inflation has never felt low. Low-income working people and beneficiaries have faced consistently higher inflation over the past ten years. The costs of the essentials in life — food, fuel, energy, shelter, and health — have risen faster than the cost of other goods. If you can barely put food on the table, the fact that a mobile phone is marginally cheaper is of little comfort.

Recent higher inflation, and the OCR increases that have been used to tackle it, simply makes that quiet misery even worse, especially for those on low incomes, those who have recently entered the housing market, and those locked out of it, all of whom are now finding themselves falling further behind. It's only now, that the consequences of high inflation have started to hit the pockets of the wealthy, that the noise and pressure to act on long-standing problems have begun to take up so much airtime in the public discourse.

Aotearoa New Zealand is capable of developing a better way of dealing with inflation. One that allows the costs, benefits, and opportunities of change to be shared more equitably. One that strengthens the ability of communities, workforces, and industries to determine their own futures. It's imperative that we don't perpetuate a system that simply forces those on the lowest incomes to continue to carry the cost of economic change.

Our current approach is asking 55,000 workers to lose their jobs and take one for the team of 5 million. It asks those with very low incomes to not ask for more, while those generating profits have no limit on their gains. We must move away from this approach. We should care about tackling both the corrosive effects of inflation today, and preventing it from reoccurring in the future. This means investing to lift our productivity, not short-run tax cuts. It means delivering economic wellbeing, not just economic growth. If we fail to address the root causes of inflation demonstrated in this report, it will emerge again and again in the future.

There is nothing just or equitable about our current textbook reactions to economic change and shocks. Many of our go to fixes are frequently band-aid responses to longer-term, more complex problems. Such as a lack of adequate, healthy housing for both purchase and rent. Over the past decade, New Zealanders have been forced to spend more and more of their income on housing, leaving less money for food, transport, power, and raising a family.

Our failure to invest in a more sustainable economy and society has meant that we are at the mercy of the global oil price. Our failure to generate genuine competition in markets has seen the price of critical goods and services spiral, especially at the supermarket and in the construction sector. The evidence presented within this report shows that it is not wages for workers that have risen dramatically during the past few years – but it they who are being asked to show restraint.

Inflation wreaks such havoc because we have failed to plan over decades. We need strong political leadership to make investments in our economy so that we can better endure future changes. In short, if the causes of inflation have changed, then the rules of the game for inflation also need to be changed. To do this will require new laws, new policies, and new investment. A commitment to a more equitable economy means changing how we both perceive and respond to our economic and inflation issues. The evidence in this report shows that continuing to simply lean on monetary policy and the OCR as a means of reducing inflation is a mistake.

This report calls for a new way of thinking about how we tackle inflation. We believe that we should break inflation down into two parts. The first part – short-term inflation – would continue to managed by the Reserve Bank, together with support from the government when extreme challenges occur. In Spain, this approach has worked to reduce inflation remarkably quickly.

The country's government capped energy prices, lowered the cost of public transport, taxed excess profits and put in place limits on how much landlords can raise rents. For example, in 2022, the government has prevented landlords increasing their rental prices by more than 2%, a measure now extended until 2024. It also cut value-added tax on staple food items to zero. This has seen inflation fall from 7.3% in October 2022 to 2.1% in July 2023. There, profits have been shown to be responsible for 90.7% of domestic inflation by the Spanish Economic and Social Council.[52]

We should explore what options would be appropriate in Aotearoa New Zealand given our specific economic context. Given the lack of competition in some sectors of the economy, it may be preferable to use tools such as price controls to avoid some companies taking advantage of temporary bottlenecks. It may also be preferable to have the power to levy windfall taxes that fund income support or greater supply of goods and services at particular times. This would have distributional benefits that are far preferable to the blunt instruments of the Reserve Bank.

But alone, short-run activities are not enough, we need to tackle long-term inflation as well, and that will require all parts of society to work together, not just the Government. Our current approach is the equivalent of attempting to lose weight via not eating, when what is needed is a balanced diet and exercise.

This report recommends that the government should legislate so that it is responsible for targeting 'core inflation', and stabilising that inflation rate over the next 10 years. Core inflation is the inflation basket of the poorest 20% of households. The poorest 20% is defined by Statistics NZ's household living-cost price index.

The Reserve Bank will be asked to assess whether this is being delivered as part of its 6-monthly Financial Stability Report statements. The Reserve Bank will be required to publish a letter setting out how the Government is delivering on, or failing to deliver on, this target. This will include an assessment of what the consequences of that failure are likely to be.

The legislation will also include targets around rents. The initial aim should be to ensure that the median rent in Aotearoa New Zealand is no more than 30% of the median household income, which could ratchet downwards over time. This will be assessed at the Territorial Local Authority level. The Government will need to demonstrate how it intends to achieve this goal within a 10-year period. Alongside this, the Government will be required to publish how many households live in energy poverty. It will be required to report publicly what actions it is taking to reduce rents and energy poverty and what impact it is having.

The Government will need to demonstrate from a distributional perspective how it is delivering equity in its responses to long-term inflation. The Government will be required to show through Budget documentation that its policies in this area contribute to its overall economic strategy and to child poverty targets.

4.1 Outputs and Goals

Our economic policies should ensure Aotearoa New Zealand's economy is capable of growing in a way that tackles our long-term economic problems, while delivering durable improvements to Aotearoa New Zealander's wellbeing – including tackling inflation. It will invest to provide a country that is the best place to be a child, a worker, and a business.

Our inflation response should assist the creation of new, good, green, and sustainable jobs. Good, green jobs contribute to climate resilience as they have the dual benefit of long-term employment, business, and industry stability. In 2021 Aotearoa New Zealand generated 20% of our electricity via coal and gas — the same as 10 years ago. Alongside this, we have failed to invest in new green electricity generation. The last major investments were through the Ministry of Works.

Green jobs offer a better long--term investment than their fossil fuel counterparts, and should help reduce our inflationary pressures in the long-run. One study[61] has shown that climate-friendly investments create more jobs per dollar invested than their fossil fuel counterparts. They create more high-skilled jobs as many fossil fuel industries are highly automated and capital intensive. Clean energy and sustainable infrastructure jobs hire more workers.

Removing petrol and diesel cars from our vehicle fleet reduces both carbon emissions and our reliance on imported fuels. Mass transit, electric vehicle manufacturing, and related infrastructure create more jobs than servicing internal combustion engines (ICE). It's time to tackle Aotearoa New Zealand's intertwined inflation, equity, and growth challenges together.

We need to address_energy security and climate change by ensuring infrastructure resilience, environmental and health impacts, and price stability. We should end our reliance on imported coal, via a just transition.

We should progressively bring the energy generators back into public ownership, using the profits of the operators to buy the public shareholdings of the firms. Our goals should be for generators to provide stable pricing, and 100% renewable energy generation.

In housing there is much that we can be doing as well. Inflation for the poorest households often requires that they choose between heating and eating. We should be creating much wider access to subsidised insulation and low-energy heat sources. This would be available to homeowners and to landlords. To reduce spending on energy in the long-run, we should be consistently seeking to improve new building standards, increasing both the thermal quality and building durability.

Our problems in housing require an enduring solution to Aotearoa New Zealand's housing crisis, making housing more affordable to build, rent and own. We should be reinvesting in the state's capability to build at scale through a Ministry of Green Works. This would rebuild the state's capacity to plan, build, and train its workforce. To help pay for this, we need to a comprehensive capital gains tax (excluding the family home).

Housing is also likely to require a supply-side solution to reduce the inflationary pressure that exists. That will mean addressing the supply chain blockages in building materials for construction. Encouraging new entrants into the market, and adopting comparable overseas quality control marks. Examining how changing housing certification from Local Authority control to Builder/Supplier certification might enhance construction productivity. Importantly, we should be expanding and regulating off-site manufacturing and improving access to appropriate overseas products. This will lead to increased construction quality and productivity.

In transport we should be kick-starting a just transition to a fully electrified public transport system, together with a more equitable public transport funding mechanism. Aotearoa New Zealand has one of the oldest and dirtiest vehicle fleets in the world. Improving the use and cost of public transport not only reduces cost pressures for lower-income families, it improves the productivity of our cities and our economy.

We should be addressing the long-run cost of living pressures New Zealanders face in core inflation, by encouraging greater investment and competition in key sectors. But we also believe that incentives are not enough. We believe that Aotearoa New Zealand should introduce a windfall tax regime on excessive profits, particularly in times of national crisis. This would be designed to disincentive price hikes, stop price gouging and protect wages. Alongside this we would introduce a levy on the larger banks, to ensure bank profits made in Aotearoa New Zealand stay here and contribute to our economic development, together with additional resources and powers for the Commerce Commission to police markets in Aotearoa New Zealand.

New Zealanders need to see more reward from the value they help create in the workplace and care economy. We can ensure that contractors are covered through Fair Pay Agreements, and expand their coverage so that minimum terms and conditions are prevalent across most of the economy. We can also make the minimum wage the Living Wage, and set the rate in the future via a tripartite process involving business, unions, and the Government.

We have two proposals to help manage the cost of living that would also help those who are just starting in the world of work. This is often a time of low pay and big expenses. We believe that we should reduce the burden of student debt repayments by making the scheme more progressive, as is the case currently in Australia. Currently, the amount student loan borrowers must repay each year is 12% of every dollar earned over the repayment threshold. This means that the effective real income tax rate for earnings above $70,000 is 45%. In comparison, the wealthiest income earners in New Zealand pay only 39%.

We also believe that we should be introducing a new mortgage product, with a low fixed interest rate for 25 years on Crown-built new properties. A new State Advance loan would see mortgage holders benefit from stability of repayments. Debt would be resold as an investment, as is the case in the US right now. It would also create a pipeline of demand for new Crown construction through a Ministry of Green Works.

There are things that the government could do which don't involve activities in the private market, but simply involve the provision of high quality, accessible public services. Work by Max Rashbrooke has shown that lowering the cost barrier for access to national health services, including general practitioners and dental care, would actually generate net economic benefits – to the tune of $4 for $1 invested.[53] Alongside, this we should further expand support and access to effective and culturally appropriate mental health services. This would have the longterm goal of making access to mental health services as simple as accessing your local GP.

One of the key ways in which we could be reducing inflationary pressures and making sure that we are building a better future is through the provision of free high-quality public early childhood education (ECE) progressively over 10 years. This would increase access and participation in the labour market, alongside reducing the gender and ethnic pay gap. It would make one of the most expensive elements of having a young child free. It would provide support for young families who are often doing it tough. Study[54] after study[55] has shown that the programme pays for itself. We should complement this by extending the free/low-cost school meals programme, so that all children receive a hot meal at least once a school day.

4.2 Fiscal approach

Our inflation and economic challenges are compounded by our current fiscal system, which encourages a short-term focus on fiscal stability and an overly conservative position on debt. There is no government debt crisis in Aotearoa New Zealand, but we behave as if there was one permanently around the corner.

The inflationary consequences of our attitudes towards government investment and debt are stark. Historical underinvestment in the economy, and public services, leads to price rises when there are increases in demand. Sustained underinvestment has left us with little flexibility to respond to changing needs, growing populations, or economic shocks.

We entrench increases in demand by failing to build enough public goods and services, and by charging for access to public services like GP appointments. This stores up expenses for everyone, as earlier interventions in health, housing, and education are often cheaper and more effective. We do this, ironically, to protect the public finances. However, this simply results in a larger liability for future generations, who will have to pay to backfill our lack of investments.

To illustrate the point, we know the cost of building Dunedin Hospital over the next decade. But what we don't know is the true cost of not having rebuilt Dunedin Hospital over the many years when it should have been started. The cost in terms of misery, lost employment, lost medical training, and lost economic output is a measure that is not calculated — and so never considered.

It's time for a new approach. To start, we should provide greater clarity is required on the expected demands of our economy and public services. We should be ensuring that the public is informed of the expected costs and liabilities for health, education, and transport over a ten-year time frame. This would be represented by a new 'value for money' approach within the government. This should highlight the cost of noninvestment — the true opportunity cost. It would produce an estimate of the 'liability' the Crown faces for future expenditure to keep services running, set alongside the debt and operating balance consequences of an investment.

That new approach needs to extend to our spending levels. Many of the countries that we compare ourselves to have structurally higher levels of government spending than Aotearoa New Zealand. We should commit ourselves to a long-term goal of increased government expenditure. The goal should be to have 35% of GDP as government expenditure by 2035. This would put billions of new dollars into the government coffers, and ensure the sustainability of high quality public services.

To deliver on this change, we need a more equitable tax system including new taxes on capital, wealth, and further anti-avoidance activities. This in itself would help deliver a more resilient economy, one with lower levels of inflation and reduced calls on public expenditure.

Finally, we should also be increasing the government capital spending allowance, consistent with keeping Net Core Crown Debt sustainable. Sustainability should be based on financing costs, rather than arbitrary debt-to-GDP ratios. We have a $210bn public infrastructure gap in Aotearoa New Zealand, and this is likely to grow if we don't invest to deliver. Smoothing the delivery of this expenditure should assist with inflation management, deliver capacity in the construction and infrastructure sectors, and lead to lower costs in the future.

Nā tō rourou, nā taku rourou ka ora ai te iwi

With your food basket and my food basket the people will thrive

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