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The 2010 Budget: Rough Water Ahead

Preparations for the 2010 budget will be underway in government circles. The 2010 Budget Policy Statement, which sets out the broad parameters, is due in December.

The task won't be an easy one. Core Crown expenses have mushroomed from 29.2% of GDP in the year to June 2004 to a forecast 37.3% in the year to June 2010.

On the wider OECD measure, which includes local government, total government spending is running at 46.4% of GDP, higher than the OECD average.

The government succeeded in protecting New Zealand's credit rating in the 2009 budget largely by putting tight parameters around future spending.

Thus no increases are foreshadowed in health and education through to 2013 aside from a general provision for new spending, which is much smaller than in recent years. Meanwhile social security and welfare spending is projected to grow by over $2 billion by 2013.

Even more worrying, debt serving costs are rising fast with the sizeable budget deficits the government inherited – by nearly a further $2 billion by 2013.

This outlook has several implications.

First, with the weight of government spending on the economy, which crowds out productive private spending and harms growth through the deadweight costs of taxation, it will be hard for the government to achieve fast growth.

The Taskforce advising the government on a programme to bridge the income gap with Australia by 2025 will clearly have to address this issue.

Second, the trend in recent years confirms the weakness of the Fiscal Responsibility Act (now part of the Public Finance Act) in constraining government spending.

In its 2009 report on New Zealand, the OECD recommended that a direct statutory cap on spending should be introduced. It referred to research suggesting that spending rules outperform deficit rules in virtually every aspect of budget policy.

Such rules could take the form of an overall limit (Hong Kong's Basic Law, for example, provides that government spending should not exceed 20% of GDP) or a limit on spending growth (to, say, population growth plus inflation unless higher increases were approved by taxpayers in a referendum). The government is to introduce a bill incorporating such a limit (sometimes called a Taxpayer Rights Bill) next year for parliament's consideration.

Third, many questions can be raised about the quality of recent spending increases.

In the public hospital sector, for example, Business Roundtable research found that hospital efficiency and productivity fell in recent years despite large increases in spending.

An interesting survey by Simon Kemp of the University of Canterbury published in the latest *New Zealand Economic Papers* found that the median participant perceived little or no change in the quality of any government service in recent years, regardless of how much additional funding it actually received.

This is consistent with International Monetary Fund research suggesting that countries have achieved few social gains from pushing government spending above around 30% of GDP.

There is wide scope for cutting wasteful government spending, but meaningful cuts will require examination of programmes and agencies.

The government should also consider divesting its commercial businesses, primarily to make them more efficient but also to reduce debt servicing costs.

A further issue is the tension between government spending and monetary policy.

Government spending increases push up costs and prices in the domestic sector of the economy and raise the real exchange rate faced by exporters.

Recent IMF research confirms that the most effective tool available to policymakers to contribute to a lower real exchange rate is likely to be public expenditure restraint.

It also finds that a policy of resistance to nominal exchange rate appreciation – advocated by some in New Zealand – has not generally been successful in preventing real appreciation.

Around the world, government budgets have been battered by the financial crisis and the recession that followed it.

The United States and Britain are staring at double-digit budget deficits.

In Britain, both main political parties are promising spending cuts after next year's election. Tax increases are generally seen as threatening already fragile recoveries.

With our economy picking up, there is no longer any argument that fiscal stimulus is needed. Such action seems to have had little effect in many countries, and wasteful spending should be cut in any event. Tax increases are not desirable in New Zealand either.

The challenge facing the government should not be under-estimated. Modest cuts to adult education in this year's budget caused a public outcry.

Special interest groups are always affected by spending cuts, as are public sector jobs.

In Britain it seems that the voting public is ahead of politicians in understanding the need for austerity.

What will the New Zealand reaction be? Time will tell, but one thing we know is that soft options will put the country's credit rating and the government's aspirations for improving living standards at serious risk.

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