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### **The 2009 Budget: What's Next?**

The National-led government which came into office seven months ago inherited a difficult economic situation.

Not only was the international financial system in crisis, triggering a global recession. More importantly, the New Zealand economy had entered a recession in the first quarter of 2008, largely as a result of the economic mismanagement of the Clark-Cullen years.

The budget documents the appalling economic legacy.

As it notes, between 2000 and 2008, (economy-wide) labour productivity in New Zealand grew by an average of only 1.3 percent per annum, the lowest of any growth cycle going back to the Muldoon years.

Secondly, central government spending grew by nearly 50 percent in the five years to June 2009, crowding out the private sector and putting sustained pressure on monetary policy.

Thirdly, the economy's decline in international competitiveness contributed to current account deficits at near record levels of around 8 to 9 percent of GDP. The resulting build-up of external debt has left New Zealand dangerously exposed to the vagaries of financial markets.

The diagnosis of these problems is set out in the budget, more clearly in the minister of finance's speech than in the executive summary. (These were obviously written in different places – even the style is inconsistent.)

The government now expects the recession to last a full seven quarters, with a weak recovery starting only late this year. Over the government's term of office (2008-2011), GDP per capita is projected to fall by nearly 4 percent. With the Australian economy projected to grow modestly over that

period, the income gap between the two countries looks set to widen further.

The last government and its fellow travellers ignored their critics.

Helen Clark and Michael Cullen duped the country by proclaiming themselves competent and conservative economic managers. In reality they benefited from a sustained period of strong economic growth for which they could take no credit, largely squandered the proceeds, and adopted backward-looking policies that ultimately contributed to the recession.

Given this legacy, how does the budget stack up?

There are several positive features to it. Most importantly, it represents a basic change in economic direction. It emphasises productivity growth and international competitiveness and, particularly in the minister's speech, the need for structural adjustment in the form of a shift of resources from the domestic economy to internationally competing industries.

There were no new major fiscal stimulus plans in the budget. There is little evidence that the packages adopted elsewhere are having a significant impact, and in some cases their longer-term consequences could be horrendous.

Partly because of its adoption of a more conventional economic approach, the government has also succeeded in achieving its aim of averting a credit rating downgrade. The projected debt profile, provided it is achieved, is now less risky. However, sizeable budget deficits are expected to continue for several years – a slow adjustment process.

There were encouraging statements in the budget on regulation (notably on a proposed Regulatory Responsibility Act) and on infrastructure (with the possible exception of broadband).

It also made sense to suspend contributions to the Cullen superannuation fund. Borrowing to buy shares is usually folly. The Cullen Fund was always little more than an accounting exercise and a tax-smoothing scheme with no direct impact on the retirement income problem. A better

approach would be to wind it up, repay debt, and take more effective action to address the demographic problems, such as the well-signalled increase in the superannuation eligibility age to 67 which the Australian government has recently announced.

The government has also taken some steps to rein in spending. Perhaps the most important ones were the early decisions to modify the ill-justified KiwiSaver scheme and the R & D tax credit, and to reduce the allowances for new budget spending in the future. These will need to be backed up by further action to be credible.

Despite the progress made, government spending trends are still alarming. Core Crown expenses are set to rise by as much as \$3 billion this year and to go up from 32 percent of GDP in 2007/08 to 37% in the government's term of office.

Public consumption is forecast to grow every year to 2012 (by around 12 percent in total) while private consumption growth is negative each year (falling by nearly 3.5 percent by 2012). Citizens are being asked to tighten their belts while the government lets its belt out further.

As commentators have been noting, the government broke a firm election policy commitment in deferring planned tax cuts. This looks like a soft option relative to cutting more of the last government's poor quality spending. None of the modest 'line-by-line' review savings represents hard political choices either.

What was perhaps most disappointing about the budget was that it contained few indications of forward thinking to deal with the need for structural adjustment and substantially lift productivity growth.

There should also be more urgent short-term action. The forecast rise in the unemployment rate to 8 or even 10 percent of the labour force, for example, should not be passively accepted. It is an indicator that nothing significant in this regard came out of the Jobs Summit and that more fundamental changes are needed.

Overall, what can be said at this stage is that the budget does not have an economic strategy that is capable of achieving the government's overriding goal of catching up to Australian income levels by 2025.

If we are to do so, the government (and the community at large) have to recognise the need for policy settings much more like those of more successful countries. We can't continue avoiding 'third rail' issues such as the superannuation eligibility age, privatisation of commercial businesses, a freer labour market and welfare reform.

We need to think much more in terms of the smaller role that governments play in small, high-income countries such as Hong Kong and Singapore and less in terms of the high-tax, welfare state models in Europe which the previous government favoured. These countries look even more likely to remain economic laggards in the years ahead.

Can the income gap with Australia be closed by 2025? My answer would be yes, but it is a tall order.

Given the state of public opinion, it is perhaps understandable that the government did not attempt bolder reforms in its first budget. It may think it needs more time to take the public with it and build up a momentum of change. But its aspirations will not look credible at the time of the next election if policy settings and projections have not radically improved by then.

As a first step, the 2025 Commission to advise the government on how to achieve its top priority goal and to monitor progress towards it needs to be set up without delay.

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