Economic Bulletin.

11 October 2019

Balancing the books – NZ fiscal accounts for the year to June 2019.

- The Government's accounts for the June 2019 financial year remained in reasonable shape.
- However, they don't give us reason to reassess the scope for an increase in Government spending.
- The surplus was in line with forecasts, after adjusting for some one-off accounting changes.
- Government spending has already ramped up significantly, and will rise further in the coming years.
- Infrastructure spending has picked up, but capacity constraints mean that it continues to fall short of plans.
- Fiscal stimulus has probably helped to support household spending, at a time when a slowing housing market has weighed on household balance sheets.

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The Government's financial statements for the June 2019 year were released this week, showing that the fiscal accounts remain in reasonable shape. The operating surplus rose to a new high for this cycle, and net debt was lower than was projected in the May Budget.

With the economy losing momentum both here and overseas, governments are facing growing calls to boost their spending. And at face value, the fiscal accounts would seem to bolster the claims that the Government can, and should, be doing more. However, a closer look suggests that there's not much fresh ammunition to be gained from these figures.

First, the larger than expected operating surplus was inflated by some one-off accounting changes, which tell us nothing about either the current fiscal stance or the scope for more spending in the future. Without those one-offs, the surplus appears to be small and shrinking, as was forecast in the May Budget.

Second, the fiscal accounts confirm what was signalled in the Budget: this is already a very spendy Government, and it will continue to be so. As we've shown before, the biggest constraint has not been a willingness to spend, but the ability to get the money out the door fast enough.[1]

This is not to argue for or against an increase in the Government's spending plans. Indeed we think it's very likely that they will. As we detailed in our latest quarterly *Economic Overview*, we've already built some extra spending into our forecasts – it's an important part of our view that GDP growth will pick up over 2020 and 2021. But our motivation for this is more around election-year considerations than around managing the economic cycle.

1 See our note "Spending up is hard to do", available at https://www.westpac.co.nz/assets/Business/Economic-Updates/2018/Bulletins-2018/Fiscal-responsibility-May-2018.pdf

OBEGAL, OMG.

The operating balance excluding gains and losses (OBEGAL) rose to a surplus of $7.5bn in the June 2019 year, up from $5.5bn in the previous year. However, this result was inflated by two accounting changes.

The first relates to a change in the method used to value KiwiRail, treating it as a component of the wider transport network rather than as a standalone commercial entity. This is essentially a return to the valuation method used prior to 2012, and it resulted in the reversal of $2.6bn of write-downs that had been booked in the years since then.

The second factor was the switch to the IRD's new IT system, which took effect in April. Tax revenue is recorded on an accrual basis, that is, at the point when it is considered to have been earned. The IRD's new system recognises tax revenue earlier than before, which means that some revenue that was previously expected in the June 2020 fiscal year was brought forward into the June 2019 year. It's not possible to identify how much, but it was plausibly in the range of $1-2 billion.

Adjusting for these one-offs, as we've done in the first chart, suggests that the underlying balance was not far from the $3.5bn surplus that was expected in the May Budget. That's fairly small – about 1.1% of GDP – and is smaller than a year ago. The surplus is projected to narrow further over the next year, with planned spending growing faster than forecast revenue.

Hey big spender (and earner).

Last year's modest surplus reflects the balance of strong growth in both revenue and spending. Total revenue rose to $119.3bn last year, up 8.5% on the previous year. However, the change to the IRD's system means that we can't infer anything from this about the health of the economy. What we do know is that, prior to the change, tax revenue was running about 5% ahead of a year ago – not a bad performance, but it was still about 1% behind forecast, whereas the tax take has tended to beat forecasts in previous years.

Meanwhile, operating spending was up by 7.1% to $111.4bn, the fastest rate of increase in ten years (apart from the spike in earthquake-related spending that was recorded in 2011). Even that understates the case, as it was dragged down by the KiwiRail write-back (effectively a negative expense). Excluding that one-off, spending was up by a whopping 9.6% on the previous year.

Operating spending is expected to grow at a more modest pace over the next few years – at least, according to the 2019 Budget projections. But experience shows that the allowances for future spending tend to be ratcheted up over time, as long as the money is available. And the temptation to deliver a spending 'surprise' is particularly strong in election years.

Capex constrained.

Net debt fell to 19.2% of GDP, compared to 19.9% in the previous year, and the Budget forecast of an uptick to 20.1%. Gross debt issuance was actually a little higher than forecast, but that cash wasn't spent as quickly as expected, leaving the net debt position lower.

The Government's borrowing requirement largely stems from its capital spending plans. Capital spending includes infrastructure spending, where capacity in the construction sector has been a real issue, but it also includes financial transfers to other government entities, which don't face any capacity constraints. The figures we cite here exclude contributions to the Super Fund (which were restarted in 2018) to make them comparable with previous years.

Capital spending rose from $5.4bn last year to $5.7bn this year, a new record high. Despite the capacity constraints, capital spending has clearly taken a step higher in the last couple of years. Yet it was well short of the $7.8bn that was allowed for in the May 2018 Budget.

This has been an issue for the last several Budgets – borrowing projections have been based on a sharp ramp-up in capital spending in the near term, which has failed to live up to forecasts. The shortfall in spending is then pushed out into the projections for subsequent years (in some cases beyond the five-year horizon that is published in the Budget.) The 2019 Budget continued that pattern, with capital spending projected to jump by nearly $2bn over the next year, a boost equivalent to 0.6% of GDP.

There is a solid argument for more spending on infrastructure, to accommodate the country's strong population growth in recent years. But we question the value of adding more spending to the list without first addressing the bottlenecks in the existing pipeline.

Where's the stimulus?

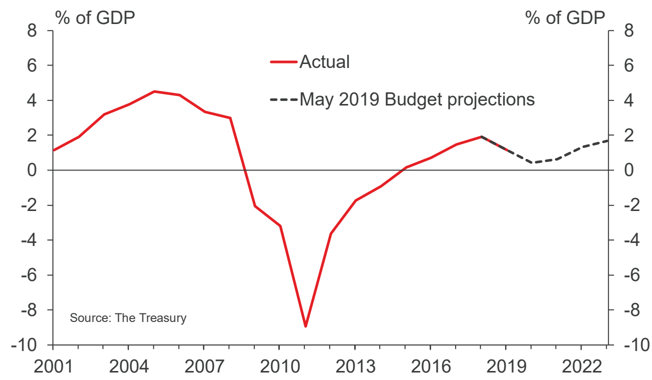
If the Government has ramped up its spending by as much as the fiscal accounts show, it's fair to ask why this doesn't appear to be showing up in the economic data. Real GDP growth slowed to 2.4% over the year to June 2019, compared to 3.2% in the prior year. And within that, the government expenditure component made even less of a contribution to growth, rising by 2.1% compared to 3.0% in the previous year.

We don't have a clear answer for this, but there are some clues. The first is that while government expenditure (which covers areas such as health, education, defence and law and order) grew at a slower pace in real terms, nominal spending growth has accelerated. This implies that much of the ramp-up in government spending is coming through in prices – namely, higher pay rates for public sector workers – rather than in increased services.

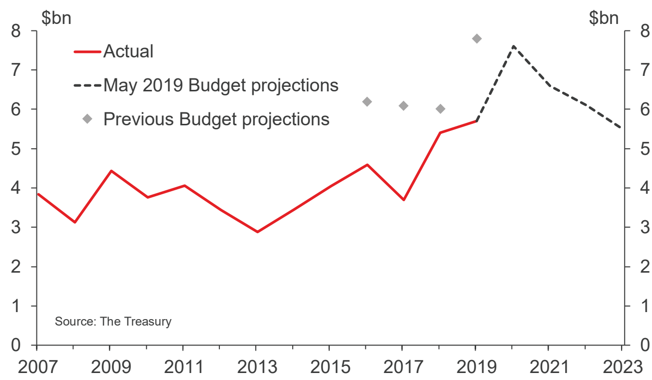
The second clue is that one of the biggest increases in 'spending' under the new Government was an increase in transfers to households via the Families Package. These transfers, plus higher pay rates for public servants, mean that much of the fiscal stimulus will ultimately show up in the household consumption line in GDP, rather than in government. Household spending growth hasn't been

particularly strong in recent years, but it has held up on the face of a slowing housing market, which suggests that it might have been even softer in the absence of government support.

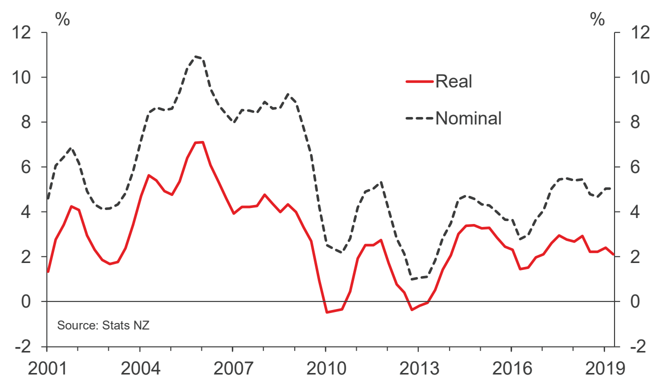
OBEGAL, adjusted for one-offs



Government net capital spending



GDP government expenditure growth



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