RESEARCH NOTE

# THE DEFICIT DIARIES: SIX YEARS OF RED

SEPTEMBER 2023

BRYCE WILKINSON AND OLIVER HARTWICH

THE NEW ZEALAND INITIATIVE

www.nzinitiative.org.nz

## About the Authors

### Dr Bryce Wilkinson

Dr Bryce Wilkinson is Senior Research Fellow with the New Zealand initiative and Director of Capital Economics Limited, a Wellington-based economic consultancy. He worked in the New Zealand Treasury until 1985 when he joined a share broking firm to undertake capital market research. He set up Capital Economics Limited in 1996. He was a member of the government's 2025 Taskforce in 2010 and 2011. It was charged with assessing productivity growth and other policies capable of closing New Zealand's income gap with Australia by 2025. He has subsequently authored three research papers for the New Zealand Initiative on foreign investment issues and contributed to its 2018 submission on the government's proposed legislative changes.

### Dr Oliver Hartwich

Dr Oliver Hartwich is the Executive Director of The New Zealand Initiative. Before joining the Initiative, he was a Research Fellow at the Centre for Independent Studies in Sydney, the Chief Economist at Policy Exchange in London, and an advisor in the UK House of Lords. Oliver holds a Master's degree in Economics and Business administration and a PhD in Law from Bochum University in Germany.

### About the New Zealand Initiative

The New Zealand Initiative is an independent public policy think tank supported by chief executives of major New Zealand businesses. We believe in evidence-based policy and are committed to developing policies that work for all New Zealanders.

Our mission is to help build a better, stronger New Zealand. We are taking the initiative to promote a prosperous, free and fair society with a competitive, open and dynamic economy. We develop and contribute bold ideas that will have a profound, positive, long-term impact.

## Contents



## Figures

## Introduction

The next Government will face a tough fiscal challenge. The Government is spending more than it receives in taxes. It also spends much more than it used to spend only a few years ago. And it presides over a mountain of debt from years of deficit spending.

Moreover, it has no realistic plan to turn the situation around. The Treasury's projections for a return to fiscal surpluses are not credible because the current government's promises to constrain spending are not credible.

Years of borrowing to fund loose spending have to end with a time of reckoning, a time to pay back, a time to face reality. Debt and deficits must be tackled. The longer the delay the more painful that reckoning will be.

Despite New Zealand's looming fiscal pain, people want the government to do more to ease the cost of living. They do not realise that government deficit spending increases future pain. The real cost of living is already much higher than many likely think.

All this would be easier to face if the excessive past spending had improved critical public services like health, education and law and order. If the public felt satisfied about the state of the country, they would be more prepared for the inevitable fiscal contraction.

Unfortunately, the Government's largesse has failed to deliver results. Outcomes in practically every area of government spending look worse than before.

So, the next Government will have to clean up two messes: the mess in social and economic outcomes and the mess in our public finances.

But before it even gets onto this task, it should do a stock take. It should ask itself how New Zealand got into this mess.

Some might say, "Well, why bother going over the past few years? We had a pandemic to deal with, so let's get on with it now."

Well, if only!

As we will show in this research note, the pandemic explains *some* of the scale of our problem. But its origins predate Covid.

The current Labour-led Government increased spending well *before* Covid started – and kept these spending levels high well *after* Covid had ended.

In so doing, Labour showed us how sceptical we should be about politicians' promises.

Over the past six years, Labour in opposition, then in coalition and finally as single-party Government, presented us with rosy fiscal scenarios. These were forecasts under which spending would be kept in check, surpluses would continue – and, when that hope was gone, would soon return – and public finances would be sound.

We had to learn the hard way what these scenarios were worth. Spoiler alert: not the paper they were written on.

And there is another lesson for us to learn. Despite this mess, at least our unemployment rate looked good. So good, in fact, that the Prime Minister keeps boasting about New Zealand having among the lowest unemployment rates in the world

But, as we will show, even that claim is too rosy. Yes, unemployment is low. However, the number of people on unemployment benefits has multiplied.

New Zealand cannot go on like this. Indeed, polls have shown that a majority of New Zealanders think the country is on the wrong track. They are right. So, what is the right track?

After this year's election, we need a different approach that balances the government's books, starts repaying debt, demands value for money in public spending, and reduces beneficiary numbers. People must be assisted to escape their predicaments rather than assisted to perpetuate them.

But more than that, we need a new policy orientation that grows the New Zealand economy. People at large are clamouring for higher incomes.

Faster productivity growth is the key to sustainably higher incomes. Things like better infrastructure, transport and public services thereby become more affordable. If you want to learn more about these forward-looking, productivity-enhancing reforms, you can find them in the Initiative's recent report *Prescription for Prosperity*.

Meanwhile, this paper focuses on learning from the past six years. Only by diagnosing where we, as a country, have gone wrong will we be able to move towards better policies in the future.

## The origin of the fiscal problem- A lamentably misleading 2017 Fiscal Plan

To understand where things started to go wrong, we need to go back six years – to before the 2017 election, which – quite unexpectedly – propelled Jacinda Ardern to power.

Until a couple of months before that election, Labour did not appear to have a realistic path to the Treasury benches. It was polling in the mid-20s. Then-leader Andrew Little resigned, Ardern took the stage, and the rest is history.

Perhaps because it did not expect or plan for taking power, Labour's spending plans were unrealistic. The party probably did not fully expect to have to deliver on its promises.

In any case, Labour promised to increase core Crown operating spending by a mere $11.7 billion. That rather modest increase was to be spread over the five years to June 2022.

So, the Labour message was clear: Should we get elected, we will be good with money. We will not spend wantonly. We will not get the country heavily into debt. We will run budget surpluses to help fund our capital spending.

Not everyone believed these assurances. In fact, a controversy arose over a so-called 'fiscal hole' in Labour's plans. Not least, Steven Joyce – then Minister of Finance – claimed that Labour's revenues did not cover its spending.

Labour, meanwhile, insisted that its plans had been independently verified and maintained that their numbers were correct.

In a way, Labour was right, and Joyce was wrong. The numbers that Labour presented *did* add up. There was no computational error in adding up projected revenues and subtracting projected expenses.

However, that was not the point and that was where Joyce was right. Because even though the calculations were correct, the assumptions behind them were not realistic.

In putting together its fiscal forecasts, Labour pretended to be tight with money. It left itself practically no room for manoeuvre, including for pay rises for public sector workers.

It certainly did not account for all the other aspirations it promoted during Jacinda Ardern's 2017 election campaign. Ending child poverty, the "nuclear-free moment" of climate policy, the lofty promises for housing and cleaning up the rivers were all treated as costless. Or at least not material enough to require more than that $11.7 billion increase over five years.

So, while there was no arithmetic hole in Labour's 2017 plans, these plans were not forecasts of what Labour was likely to spend. That is why they were highly misleading.

With what we know now, we can only conclude Labour themselves did not believe in or care about their original 2017 spending plans. With a certain nonchalance, they disregarded them as soon as they became the Government.

Prime Minister Chris Hipkins and Minister of Finance Grant Robertson these days like to make it appear as if all our fiscal problems were the result of Covid. As if Covid had made Labour's 2017 best laid plans go awry.

The truth is that Labour's fiscal plan had gone out the window well before Covid arrived. The first few years of Labour's time in office were "normal" years: no Covid, no Ukraine War, no inflation spikes.

And yet, during these two years, the fiscal rot had already set in.

In the first months of Labour being in office, in December 2017, Treasury released its half-year economic and fiscal update (HYEFU, as it is known among economists.) It projected the five-year increase in core Crown spending to be $12.7 billion. That was a billion dollars higher than Labour's Fiscal Plan before the election.

The public hardly noticed. Who cares if it is $11.7 or $12.7 billion? Especially for a five-year period.

However, alarm bells should have started ringing at the time of Labour's first Budget in May 2018. Half a year after taking office, the $11.7 billion had suddenly increased to $18.9 billion.

As it turned out, that was roughly the size ot the fiscal hole Steven Joyce had asserted. Unfortunately for Mr Joyce, he had retired from Parliament just a month earlier, otherwise, he could have pointed this out to the Minister of Finance.

But even that increase in spending projections was not the end of the road. The forecast surpluses kept declining with every Treasury update. By December 2019, about two years after Labour took office, the extra spending had ballooned to $29.7 billion.

By then, it was clear that Labour's fiscal management problems were no mere rounding errors. They were signs of a Government that liked spending a bit too much and did not feel bound by its previous fiscal assurances.

And then Covid hit.

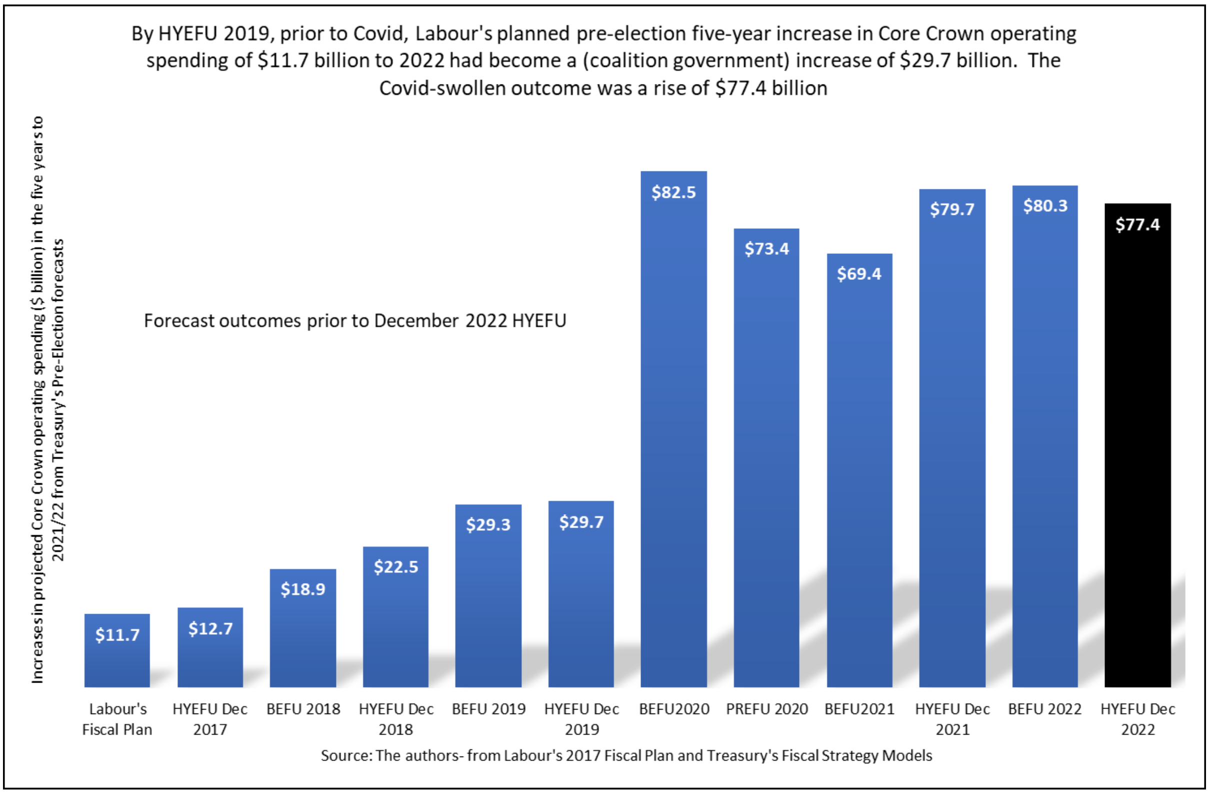


*Figure 1: Labour's overspending to 2022 – the last forecast year in its 2017 Fiscal Plan*

*(The abbreviations in the X-axis of this and subsequent charts have the following meanings: B = Budget, EFU = Economic and Fiscal Update, HY = Half-Year (usually December), PRE = Pre-election. All these are Treasury publications. All its forecasts assume government policies in place when the forecasts were being prepared will remain unchanged.)*

New Zealand went into one of the world's strictest lockdowns when it closed its borders. Those measures decimated key industries like tourism and education and the consequences for the economy were severe.

The Government came to the rescue and embarked on a large array of stimulus and support programmes for the economy. Some measures, like the wage subsidy, The New Zealand Initiative supported because they helped keep firms and employees connected and were effectively compensating businesses for losses due to government-mandated closures.

Even so, three things became clear over the Covid period:

- Not all the extra spending went towards defensible support measures like the wage subsidy. From the various Covid packages, the Government paid for items as diverse as school lunches and cameras on fishing boats.
- Critically, the Government did not wind back its stimulus after it had become clear that Covid was predominantly a supply-side shock, not a demand-side problem.
- There were no signs the Government meant to reduce spending to previous levels after the crisis, let alone repay the debt it had incurred during Covid.

Taken together, Covid thus served as an excuse for higher levels of Government spending – and not just for those Covid years, but forever!

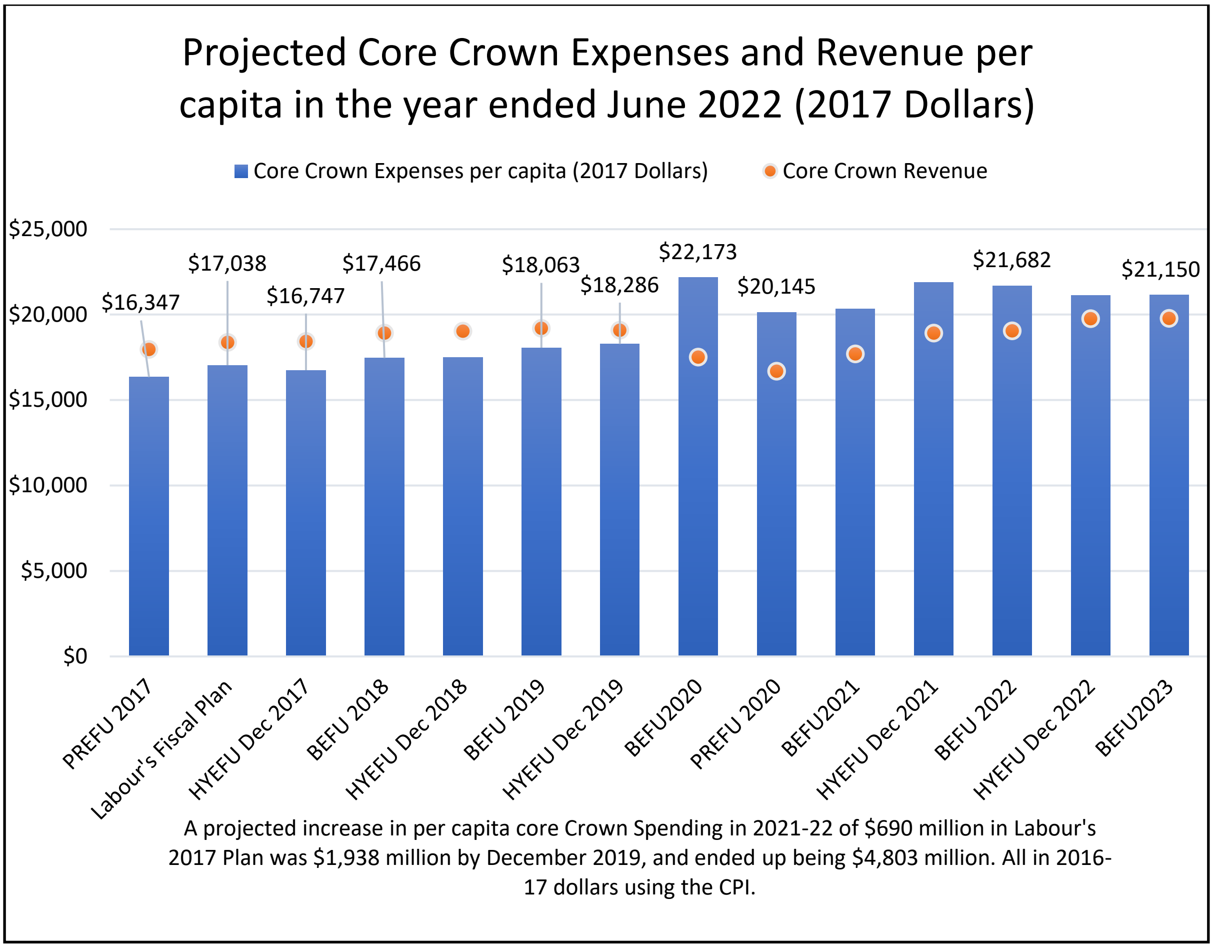


*Figure 2: Labour seized the COVID-19 opportunity to sustain spending ever further above planned spending*

The fiscal consequences of the Government's response to Covid were eye-watering.

When Treasury presented the final figures for the five years ending June 2022, they showed an increase in spending of $77.4 billion since 2017. This increase was more than six times that projected in Labour's fiscal plan before the election.

All of these multi-billion-dollar numbers are hard to comprehend. They become a bit more real once translated into spending per person, so let's do that.

Labour's initial fiscal plan before the 2017 election would have kept government spending per capita in 2022 at $17,038 (in 2017 dollars). When 2022 arrived, per capita spending was $21,150 (again in 2017 dollars, using the actual CPI outcomes rather than the earlier projected inflation rates).

Projections for per capita spending and revenue for 2022 are summarised in Figure 2. It is clear that it took Labour just two years to effectively abandon its planned spending targets. And, once Covid took off, spending took off even more. Forecast surpluses for 2022 became a $10 billion deficit.

Of course, this spike in spending relative to revenue meant that the government now had to borrow heavily, even though, until 2020, tax revenues were coming in more strongly than the government had anticipated.

For the first couple of years of the Ardern Government, it looked as if Labour could spend more than it planned without having to borrow a lot more. The spending explosion in 2020 ended that hope.

That also meant that the budget surplus the government had initially projected for 2022 became a budget deficit. By that time, tax revenues had also started to drop as a result of reduced economic activity under the various Covid lockdowns.

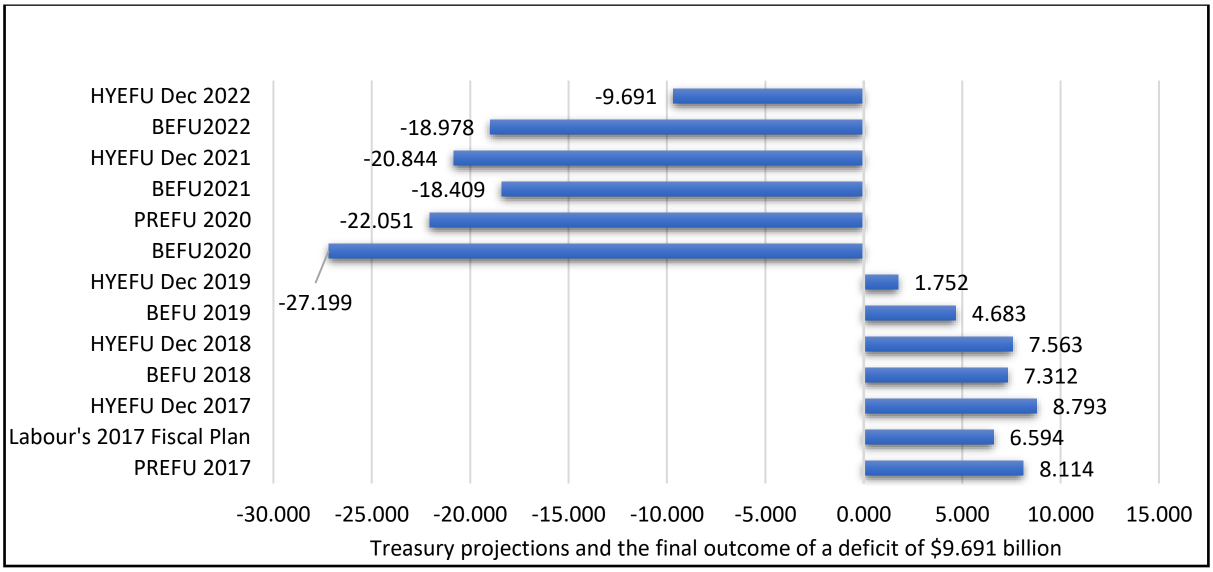


*Figure 3: Evolving projections for OBEGAL for the year ended June 2022*

Figure 3 shows the forecasts for OBEGAL, which is the 'Operating balance before gains and losses'. Put more simply, the OBEGAL shows whether the budget is in surplus or in deficit.

Before the 2017 election, Treasury predicted that there would be an $8.1 billion surplus in 2022. That was in PREFU 2017, the Pre-Election Fiscal and Economic Update.

Labour's own Fiscal Plan had reduced that projected forecast just a bit, to $6.6 billion. Importantly, that was still a surplus – and Labour politicians stressed that then. They clearly did not want the public to fear that Labour would not balance the books.

Strong tax revenues initially made that surplus look achievable, even despite Labour's early spending spree. Until Treasury's Half-Year update in December 2018, the forecast surplus for 2022 remained around the $7 billion mark.

But as Labour's spending intensified, there was hardly a projected surplus left before Covid – just $1.8 billion in the December 2019 forecast for 2022.

Then Covid struck, and the projected deficits fell deeply into the red. For the first couple of years of Covid, Treasury's projections were even more pessimistic than the eventual outcome. Still, when 2022 finally arrived, the deficit was almost $10 billion.

## New Zealand's current fiscal situation

The experience of the five years from 2017 to 2022 shows two things. First, you should not always trust a party's spending promises. Second, high debt can combine with events to cause further havoc down the track.

With that in mind, let us now look at Treasury's Pre-Election Economic and Fiscal Update (PREFU) 2023.

PREFU 2023 shows fiscal deficits persisting until the year ending June 2026. It does so by taking the Minister of Finance's statements on the Government's planned policies at face value. In fact, it has to do that by law.

Conveniently, PREFU predicts a small surplus for 2026. But just how realistic is that projected surplus?

The assessment depends on the credibility of the assumptions – and the credibility of the person who asserts those assumptions.

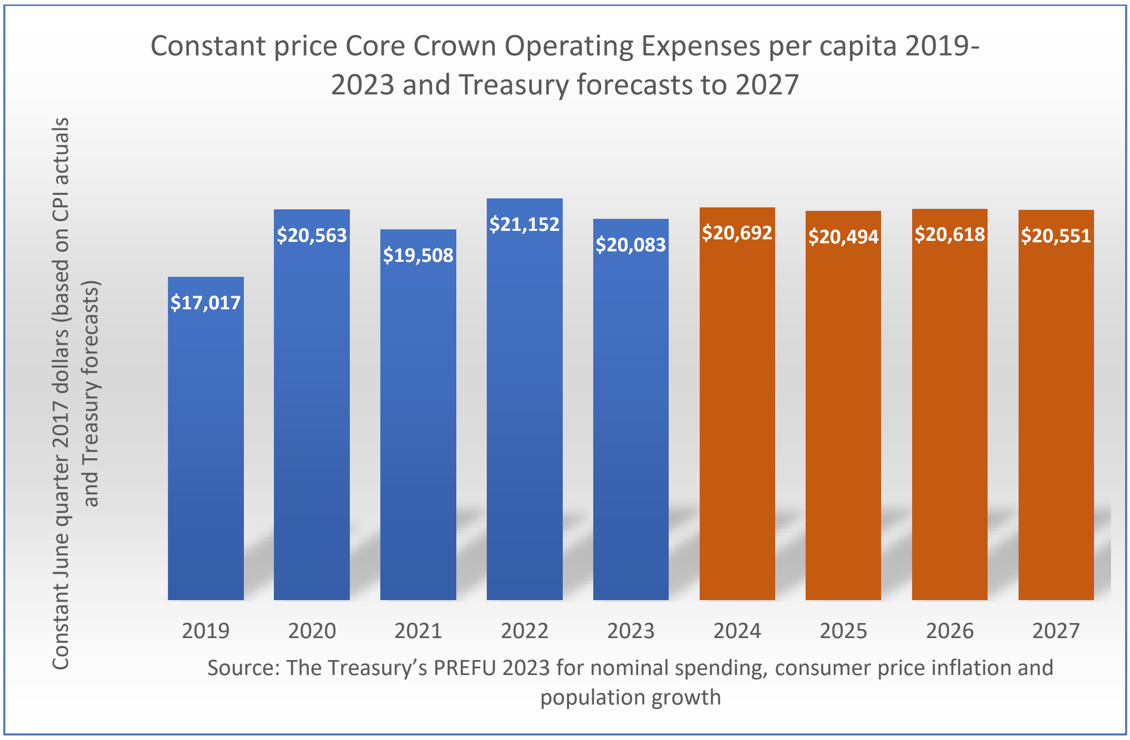


*Figure 4: Locking in the spending response to Covid-19*

As we have seen, Labour's 2017 fiscal plan proposed that cumulative fiscal surpluses in the five years to 2022 would sum to $24.7 billion. But we now also know the actual outcome: a cumulative deficit of $24.3 billion.

Between $24.7 billion in surpluses and $24.3 billion in deficits lies a $49 billion gap. That means that net Crown debt was $49 billion higher in this respect in June 2022 than forecast in late 2017.

This means that New Zealand's taxpayers must somehow, sometime, pay that $49 billion back.

Economists sometimes call deficits to fund current spending 'deferred taxation'. That means that whatever is borrowed must at some stage be paid back or serviced to the same effect. Either way, future taxes must be higher, and spending lower, in some combination.

The crucial thing is that deficits equal future taxes. Today's deficits are tomorrow's taxes.

How high will these extra taxes have to be?

To answer this question, let us put the $49 billion in perspective. In 2022, the Crown taxed New Zealanders a total of $108.5 billion. In other words, to pay back $49 billion would require New

Zealanders to pay an extra five months of taxes at the current annual rate, or to increase the annual rate by 41.7%.

That indicates the degree to which the Government has hidden from New Zealanders the real cost of living. We have not escaped it, we have deferred it.

New Zealand's overall public debt situation is worrying. In 2017, Treasury expected net Core Crown debt to be $56.2 billion in June 2022. In fact, it turned out to be $128.9 billion - $72.7 billion higher.

The increase of $72.7 billion in debt was driven by both capital expenditure (such as infrastructure) and current expenditure (such as paying for more public servants – and, for a while, the response to Covid).

Unfortunately, we are now informed by Treasury's PREFU 2023 that much of this higher spending will stay with us over the coming years.

Keep in mind that what is projected for the coming years is meant for 'normal' years. There is no longer any need for expensive measures like the Covid wage subsidy. The borders are open and migration is running at or above pre-Covid levels. Treasury cannot forecast the timing of the next adverse extreme event. A prudent debt position provides the buffer – if we can restore one.

And yet, PREFU 2023 forecasts that spending for 2024 to 2027 will be just as high as it was in the crisis year 2020, when Covid began and gave us months of lockdown (Figure 4).

## The expansion of welfare

The deterioration of New Zealand's public finances will not be the only problem for the next Minister of Finance. There is a related and troubling increase in the number of people on Jobseeker Support.

Figure 5 shows that the number of people on a Jobseeker benefit was fairly steady from 2014 to 2018, hovering around 120,000. But then something remarkable happened. Though the unemployment rate fell slightly over this period, the number of people on Jobseeker Support was rising. By December 2019 it was 24,000 *higher* than in December 2017– *before* the onset of Covid.

Once Covid started, beneficiary numbers rose sharply, peaking at over 213,000 in January 2021. That is not surprising because many people temporarily lost their jobs during the lockdowns. What is surprising, however, is the persistently high Job Seeker numbers in the wake of Covid.

In fact, this is doubly surprising because it flies in the face of a further fall in the official unemployment rate. While unemployment is now near record lows, and while many businesses are desperately trying to fill job vacancies, Figure 6 shows that the number of people on Jobseeker Support is more than 50,000 higher than it was on average in the years from 2014 to 2017.

A result is that Treasury expects spending and Job Seeker levels to remain inexplicably high. (PREFU 2023 predicts recipient numbers through to 2027 will not fall below 189,000.) Why is this an accepted outcome for current policies?

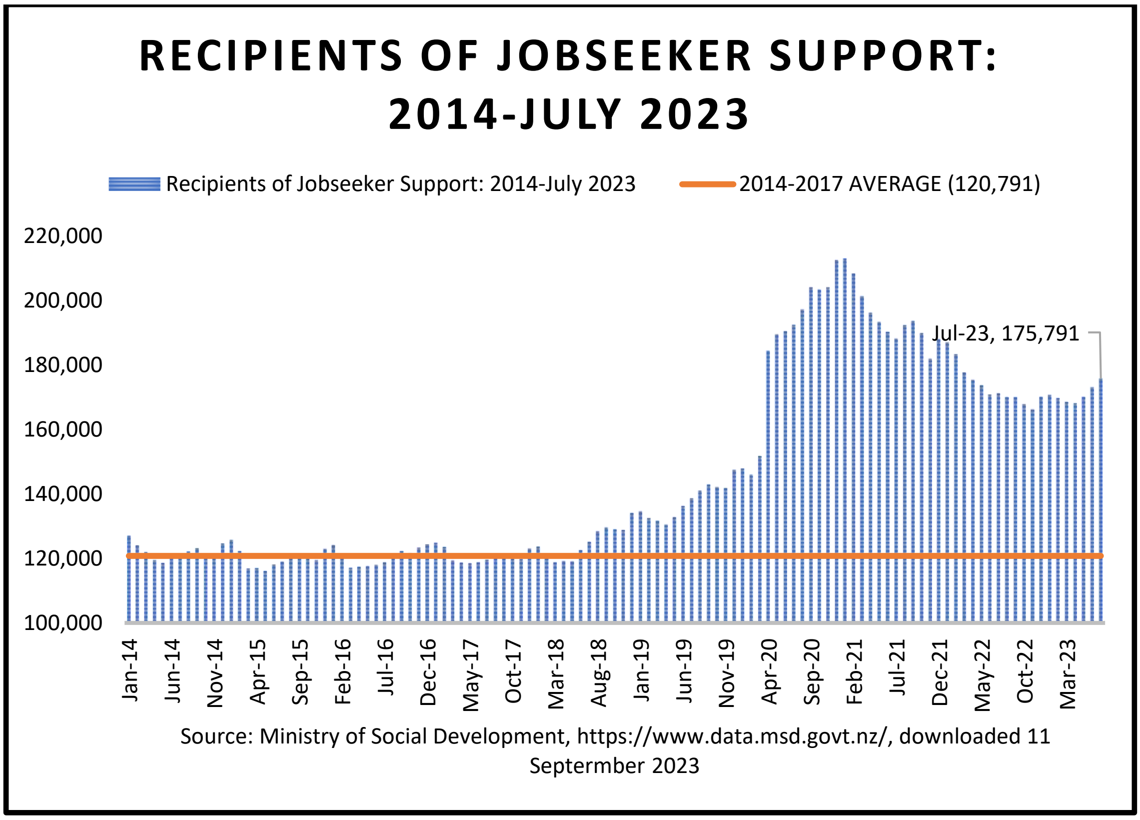


*Figure 5: Jobseeker Support Recipients monthly 2014-2023*

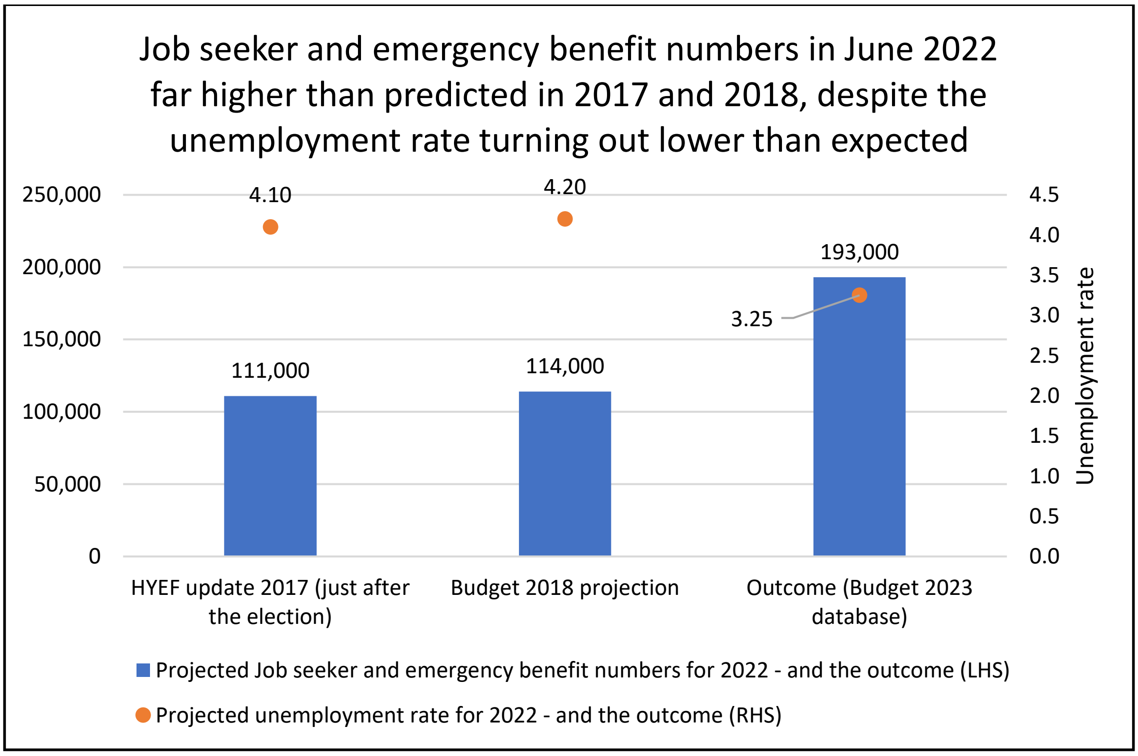


*Figure 6: Unemployment rate and Job seeker recipients in 2022 - actual versus predicted*

## No room for complacency

As we have explained, the trends in New Zealand's public finances are worrying. The simultaneous increases in public debt and government spending levels over such a relatively short time period are remarkable.

Still, some commentators and institutions are downplaying the dangers of New Zealand's fiscal position.

The International Monetary Fund (IMF) is a good example. It recently assessed the health of New Zealand's public finances and concluded that other countries carried much higher debt burdens than New Zealand.

The IMF is correct, of course, but that misses the point.

The other countries that IMF refers to are in unhealthy fiscal positions. The US, for example, now has public debt close to around 100% of its GDP. The last time debt was that high was during World War II.

So, when the IMF says that other countries are doing worse than New Zealand, it is like a doctor telling a severely ill patient that there is nothing to worry about because other people have even worse diseases.

A more prudent IMF report would remind the New Zealand Government that there are some international vulnerabilities that would make lower debt prudent. New Zealand is vulnerable to natural disasters, imposing large financial risks relative to the size of our economy.

Beyond that, after decades of interest rates trending lower, they are now on the increase. The times of financing government debt at near-zero interest rates are over.

So, neither the knowledge that other countries are even more indebted than us nor the recent memory of a more favourable refinancing environment make us feel safer today. There is no room for complacency, and New Zealand's debt and spending issues will need to be addressed.

## Concluding comment

In this short research note, we have focused on the fiscal performance of the Sixth Labour-led Government. We have pointed out that much of our current predicament comes down to unrealistic plans, lack of commitment to stated intentions, and not enough rigour in fiscal management.

But for most ordinary New Zealanders, the Government's poor financial record will not be of greatest concern. Rather than worrying about PREFUs, OBEGAL, and net Core Crown debt, they will be concerned about the poor *outcomes* of Government spending.

That is because they can see these poor outcomes every day, for example, in the sad state of our hospitals, schools and universities. Sometimes they can even feel them when they are driving over pothole-riddled streets.

Serious problems are now occurring in every major government sector. Crime, immigration, education, hospitals, homelessness, water infrastructure, transport, and welfare dependency are frequently in the news for all the wrong reasons.

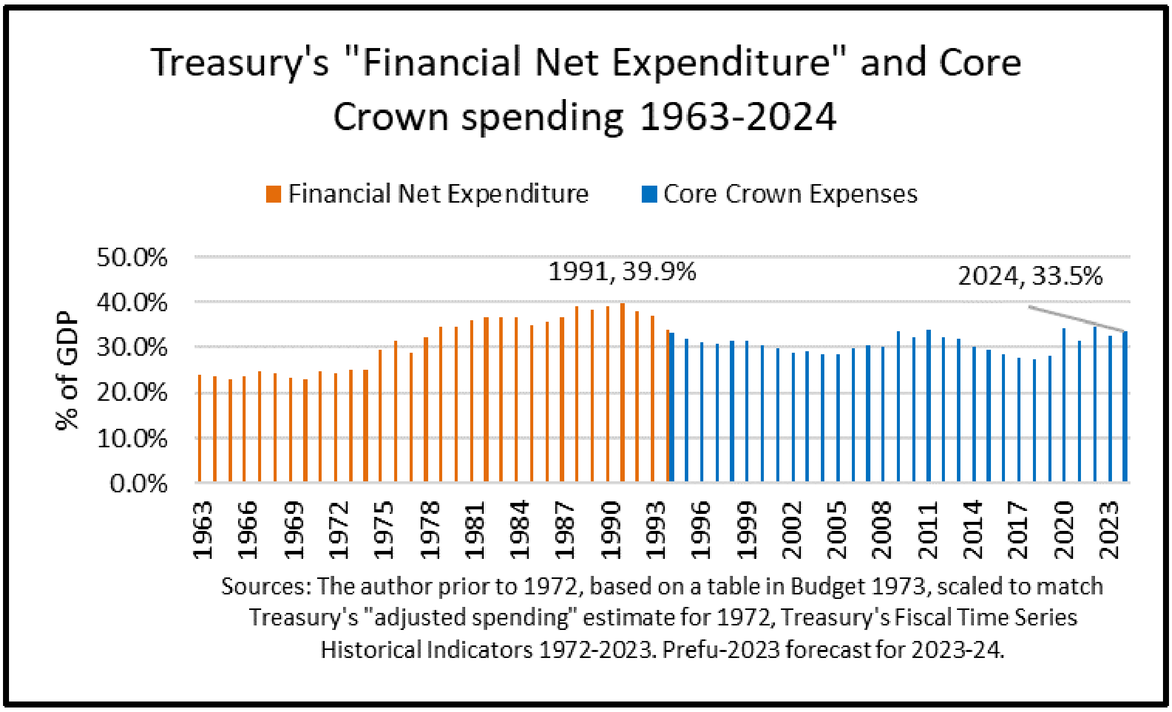


*Figure 7: The scale of core Crown Spending 1963-2024*

It may be hard for New Zealanders to understand that these problems are not caused by a Government that is spending *too little* but by a Government that is spending *too much, poorly.*

Figure 7 shows that, by historical standards, our current spending levels are not low. This fiscal year, Government operating spending is running at 33.5% of GDP. In December 2017, Treasury was forecasting it would be only 27.6 % of GDP.

That difference of 6% of GDP is massive. The outcomes are poor, yet the calls to increase spending ever more are inexhaustible. Sanity requires much greater attention to value-for-money.

What New Zealand needs goes beyond lower debt, tax burdens and spending. New Zealand needs better spending, better outcomes, better value for money, and New Zealand needs better policies more generally. We need policies that allow households and businesses to make better choices.

As mentioned at the outset, The New Zealand Initiative has compiled a list of such policies in our recently published report *Prescriptions for Prosperity: Briefing to the Incoming Government.*[1]

What New Zealanders must first understand is that the coming years will not be a time for big spending commitments or generous electoral giveaways. The coming years, unfortunately, must be focussed on cleaning up the fiscal, social and economic messes left behind by the current Government.

---

[1] See https://www.nzinitiative.org.nz/reports-and-media/reports/prescription-for-prosperity-2023-briefing-to-the-incoming-government/

The New Zealand Initiative is an independent public policy think tank supported by chief executives of major New Zealand businesses. www.nzinitiative.org.nz | +64 4 499 0790 | info@nzinitiative.org.nz



Research Note
ISSN 2816-0347