

TREASURY EXECUTIVE MINUTE

Minute No.

19 January 2011

Deputy Prime Minister and Treasurer

EFFECTS OF REPAIR AND RECONSTRUCTION ON GDP – A CAUTION

Timing: At your convenience.

Recommendation/Issue:

- That you note that repair of houses, buildings or business assets after the floods will not count as an addition to GDP.

Noted

Signature:

...../...../2011

KEY POINTS

- There is a general understanding in the economic community that the repair and replacement of houses, buildings and business assets that have been damaged by the floods will provide a strong boost to GDP during the reconstruction phase.
- This is only partly true because of the way that the ABS treats activity associated with repairs to houses and business assets, which is likely to be a substantial portion of this activity. While *replacement* of houses, buildings and business assets will add to GDP (and add substantially given the size of the disaster), *repair* of those assets will not.
- While the treatment may seem counter-intuitive it is reasonably straightforward. For example:
 - In terms of profits (Gross Operating Surplus in the National Accounts), businesses that repair assets will make greater profits, but the businesses that have their assets repaired will incur the costs of repair and make lower profits. These two effects net out for GDP purposes.
 - Similarly, in terms of the repair of dwellings, some businesses will make more profit fixing them up, but the costs associated with the ownership of dwellings will correspondingly go up, reducing dwelling gross operating surplus. Again the two net out.
 - While it is true that repairs will boost the requirement for labour and increase the total compensation of employees, the extra income will offset the higher expenses borne by the businesses and households that pay for the repairs.
- The effect of this is that we might see, for example, a big boost to construction activity in a quarter, offset by lower activity in business services, transport, or other affected sectors.
- This distinction does not apply to consumption goods. For example, repairs to personal motor vehicles will count as additional GDP.

- Nor does it apply to the replacement of business or personal assets. However, the subtle distinction between repairing and replacing flood damage creates a measurement problem for the ABS, which will probably result in some repair costs leaking into GDP.
- In the case of government expenditure, while the theoretical argument is again that repairs should not add to GDP, in practice this will not be the case. Because the output of the government sector has no market price, its value is determined by the cost of the inputs. So expenditure on repairs will raise the measured value of the government sector's output and add to GDP.
- The overall implication of this particular treatment of repairs in the accounts is that while there is likely to be a considerable amount of GDP generated by the reconstruction effort (capacity issues notwithstanding) the measured effects on GDP are likely to be less than many economic commentators believe.

[This content has been redacted under Section 22]

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