New Zealand Government Budget 2018

17 May 2018

A 'patient' Budget

- There were no surprises in today's Budget. The tax take delivered a small windfall which was promptly gobbled up by increased health spending, leaving relatively little for other spending initiatives.
- A higher tax take was matched by increased spending, meaning similar forecast surpluses over the five years compared to the Treasury's last forecast.
- Treasury's growth projections were softer in the near-term, but remain too optimistic in our view.
- The Government retained its focus on fiscal responsibility. We support that, given the demands that the aging population will put on spending in the future.

Today's Budget followed a similar script to the final few Budgets under the previous Government. The economy has proved stronger than expected, and that has delivered more tax revenue than forecast. But the Government has found that delivering the health outcomes people want is more expensive than forecast. So most of the extra money was channelled into health, and there was precious little left over for anything else. Labour kept its coalition partner happy by boosting funding for ministries headed by New Zealand First politicians, and education got most of the remainder.

The Government stuck to its self-imposed Budget Responsibility rules, including the net debt target. We think that was appropriate. New Zealand's economy is in a fairly sweet spot, so now is the time to save for a rainy day. The future might hold a recession or a natural disaster, and we know that the aging population will be hugely expensive. And a good way to avoid white-elephant spending is to draw a line in the sand and then prioritise within that spending limit.

The ramp up in spending in this Budget will have inflationary consequences for the economy. Treasury thought these would be significant, and forecast OCR hikes early next year. We view any inflationary consequence as more minor, and more likely to take effect in later years, so we won't be changing our own OCR forecast.

It was a bland Budget, but that leaves the Government with plenty tucked up its sleeve for the remainder of its term.

So while today's Budget may have been a largely business as usual document, next year's Budget could be a different beast, once the Living Standards Framework is integrated and the working groups on tax, education and social welfare report back with policy ideas.

Key Policy Developments

Health

As expected, health gobbled up the lion's share of the additional operating spending. The sector was well signalled as a key priority for Government. However this headline belies the fact that in reality there is relatively little choice in the matter. Health consistently sucks up a big chunk of any Government's spending – the same was true of the last Government. In 2018 health spending will be almost $17 billion – that's around 16% of the Government's entire operational spending Budget. And inevitably, getting the desired outcomes always ends up being more expensive than first thought. Pressure on the health Budget will only grow in the coming years as the population ages and New Zealanders continue to demand high quality healthcare services.

As signalled, free GP visits were extended to include all children under 14 years old. Community service card holders will also benefit from cheaper visits, with a $20-$30 reduction in the cost of visiting the GDP, and more people will become eligible for community services cards.

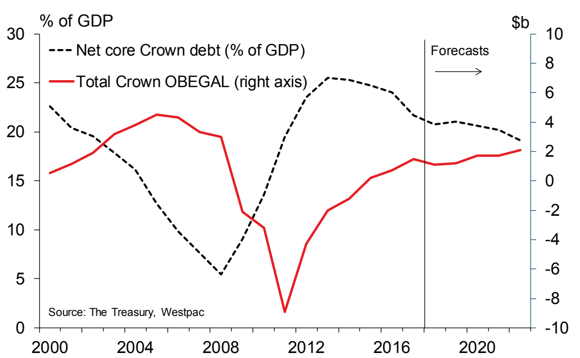
This is likely to have a noticeable, albeit small, impact on our CPI forecasts in the order of 0.1% by the time it is fully introduced. There was also a significant boost to funding of District Health Boards ($2.3 billion). And it was a Budget for all mothers with a lift in funding for community based midwifes. Nurses will no doubt be looking at the 8.9% "catch-up" increase in fees paid to lead maternity carers with an eye on their own forthcoming pay negotiations.

Education

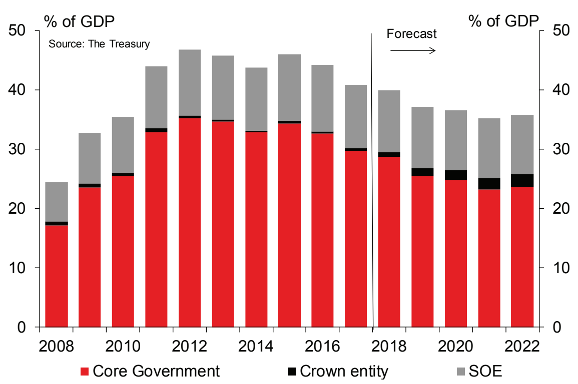
Next in line in today's Budget was the education sector, which received a $1.6bn boost to operational funding. The focus in today's Budget was towards younger children in early childhood education and schools, including a boost to funding of early education centres staffed by fully qualified teachers, a lift in school operating funding and funding for learning support (previously known as special education funding).

We were pleased to see the focus turning to childhood education, although the quantum was disappointingly small. Spending money on early childhood education has huge bang for buck. Compare that to the $2.6bn the Government spent on free tertiary education and bigger student allowances at the HYEFU, but will do much less for society. It won't make much difference to the number of people attending tertiary study, and it tends to be money going to the people in society who are doing relatively well.

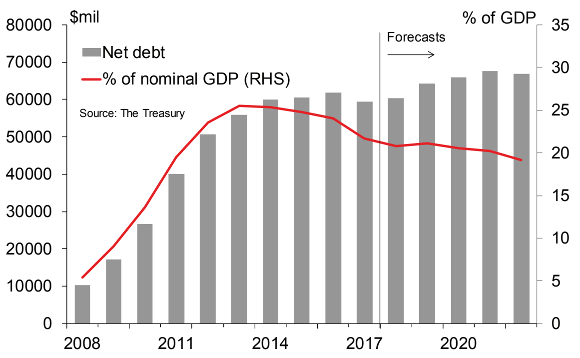
Operating balance (excluding gains and losses)



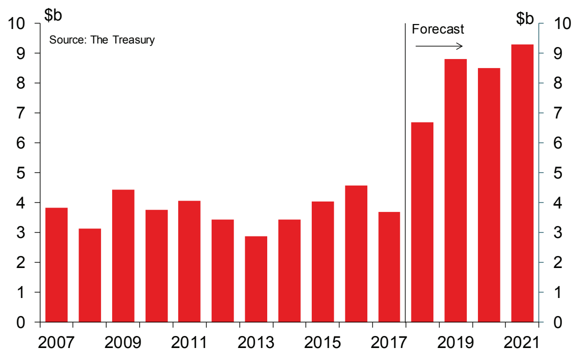
Total Crown debt - borrowing by segment



Net core Crown debt to GDP



Net capital spending (June years)



Housing

There were changes to Treasury's assessment of how the Government's flagship Kiwibuild programme will roll out. Treasury now thinks the impact of Kiwibuild on residential investment will occur later than it had previously forecast. While the programme still aims to build 100,000 homes over 10 years, most of the impact of the programme now occurs outside the Treasury's five year forecasting horizon. This change brings Treasury closer to our own views on the outlook for residential investment. And while we still think that Kiwibuild will crowd out some private sector investment, indications are that despite strong pent up demand, private sector home building is facing some headwinds in the near-term. That could leave a more scope for the Kiwibuild programme to fill these cracks.

Public sector spending

Looking across Government, the biggest winners from today's appear to be the Ministry for Foreign Affairs and Trade which received additional funding for more diplomats and aid, and the Ministry for Defence which received a lift to its operating budget. Like the Provincial Growth Fund, these ministries are headed by New Zealand First Ministers. Clearly, Labour is paying a high price for securing New Zealand First as a coalition partner.

Payoffs for the Green Party's support didn't feature quite as prominently. However, we noted the intention to establish an independent fiscal institution with interest. An independent institution to estimate the cost of parties' promises in the lead-up to an election would be a welcome addition to the New Zealand policy landscape.

A focus on households not firms

There wasn't much in the Budget for businesses. The most significant was an R&D tax credit that had previously been signalled. However, with the incentive limited to firms who spend more than $100,000 per year on R&D, the benefit is likely to accrue primarily to a few large firms rather than a larger number of small to medium sized businesses. We think the impact on investment from this change is likely to be small.

The financials

The 2018 Budget featured both higher revenue and higher spending relative to last December's Half-Year Fiscal and Economic Update (HYEFU), which largely balance out over the forecast period.

The tax take has again surprised to the upside, with core Crown revenue for this fiscal year on track to be $1.3bn higher than assumed in the HYEFU. The Treasury has assumed that this surprise will more or less persist into future years. While there are risks in assuming that a revenue windfall will be permanent, it seems reasonable in this case. Much of the surprise stems from the fact that, after last year's big upward revisions to GDP, the economy is larger than the Treasury believed when it prepared the HYEFU forecasts. With the latest forecasts, the tax take as a share of GDP is more in line with what they were previously expecting.

The additional revenue provides the leeway for a substantial increase in the operational spending allowances in coming years. The HYEFU allowed for an additional $1.8bn per year of new net spending in future Budgets; this has been increased to $2.4bn per year. The effect of this increase really starts to accumulate in the later years of the forecasts, with spending growth accelerating again in 2021.

The net impact is that the accumulated surpluses over five years are about $300m less than in the HYEFU. However, the profile of the forecast has changed, with larger surpluses in the near term and smaller surpluses in later years.

There was no change to the capital spending forecasts, though there was a modest increase in the spending allowance for future Budgets. The forecasts already include a hefty $34bn of net capital spending over five years (excluding Super Fund contributions), compared to $18.7bn over the previous five years. As we've noted, the government will need to overcome some significant capacity constraints in the construction sector just to deliver on the existing forecasts, before they consider adding more to the pile.

With only slightly smaller accumulated surpluses, and no new capital spending, there was little change in the forecast for net core Crown debt after five years. One of the government's self-imposed Budget Responsibility Rules – and perhaps the only truly binding one – is to bring net debt below 20% of GDP within five years of taking office. The latest projections see it drop to 19.1% of GDP by 2022, leaving the government with some wiggle room.

That wiggle room in the core crown net debt projections might prove useful, given some of the identified risks to the fiscal projections. Of course, an assessment of the fiscal risks is included in every Budget, and it doesn't usually get a lot of attention. But there are a few that stand out to us this time.

The government has not made a specific allowance for pay settlements for teachers and nurses – that would give away their hand at the negotiating table – but they will clearly be under pressure to deliver a sizeable increase. The Budget suggests that these could be accommodated within the current spending allowances for these portfolios.

In contrast, the cost of dealing with the Mycoplasma bovis outbreak is uncertain given the fluid situation – neither the extent of the problem, nor the best response, has been determined yet. But the cost is likely to be large, and to require additional funding.

Splitting the Bill

While the forecast of the core crown debt to GDP ratio are expected to fall safely under 20% of GDP by 2022, there is a trick. The debt held by crown entities (technically not counted as core crown debt, but it is a grey area) is expected to increase from 0.5% currently, to 2.2% by 2022.

Partly this increase is related to existing Public Private Partnerships. But Housing New Zealand also intends to undertake additional borrowing to fund 600 new homes over the next four years, and Crown Infrastructure Partners will borrow to roll out ultra-fast broadband around the country. The Green Investment fund similarly hopes to use $100m of Government money as well as borrowing to stimulate $1billion of new investments in low carbon industries by 2020.

Borrowing through these entities allows the Government to keep net core crown debt down, as promised. But the trade-off is that these entities will probably end up paying a higher interest rate than if the investment had been funded by Government. This size of any additional risk premium will presumably vary depending on how certain the market is that the Government will pick up the pieces should something go wrong. And this in turn will depend on how closely the investment is linked to core crown activities. It's difficult to see the Government walking away from a half built state housing development, but the risks around Green Investment fund projects could be much broader.

Equally, borrowing indirectly won't fool investors who lend money to NZ or ratings agencies who will also keep an eye on total borrowings as well as those strictly defined as core crown debt. The more borrowing these entities do, the more likely it is to appear on the radar. But we're probably not at that point yet.

Budget 2018 economics forecasts

	2017 (a)	2018	2019	2020	2021	2022
	Actual	F/cast	F/cast	F/cast	F/cast	F/cast
Economic (June years, %)						
Real GDP growth	3.3	2.8	3.3	3.4	2.7	2.5
Unemployment rate	5.0	4.5	4.4	4.1	4.1	4.2
CPI inflation	1.7	1.4	1.5	1.8	1.9	2.0
Current account balance	-2.7	-2.6	-3.1	-3	-3	-3.1
Fiscal						
(June years, % of GDP)						
Total Crown OBEGAL	1.5	1.1	1.2	1.7	1.7	2.1
Net core Crown debt	21.7	20.8	21.1	20.6	20.2	19.1
(June years, $ billion)						
Core Crown revenue	75.6	79.5	83.9	89.00	93.9	99
Core Crown expenses	76.3	81.7	86.7	90.1	94.7	98.1
Bond programme	-	7	8	8	8	7

Economic Forecasts: The Treasury and Westpac

The Treasury's forecasts still look too optimistic to us. Although the Treasury has accounted for the recent cooling in growth, their forecasts still assume a reasonably strong outlook over the next five years, with GDP assumed to average close to 3% per annum. The pick-up in growth that the Treasury assumed in the HYEFU is still in the forecast, but has been pushed out.

We expect that both nominal and real GDP growth will undershoot the Treasury's forecasts. This signals some associated downside risks for the Treasury's forecast for tax revenue and projected surpluses.

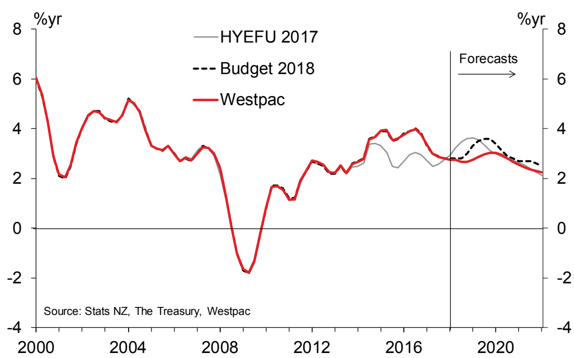
The Government now expects that residential construction will rise more gradually, due in part to capacity constraints, and because the KiwiBuild program is now assumed to take longer to ramp up. However, we expect that building will rise even more gradually. The construction sector is confronting a number of significant headwinds, and not all are related to capacity or increases in costs. Financing is a challenge for many developers, and there is nervousness about the cooling of the housing market.

Similarly, the Treasury's forecasts for investment spending by businesses appears optimistic. Businesses have been reporting increased nervousness about the outlook, and in many cases this is likely to see investment plans being shelved for a time.

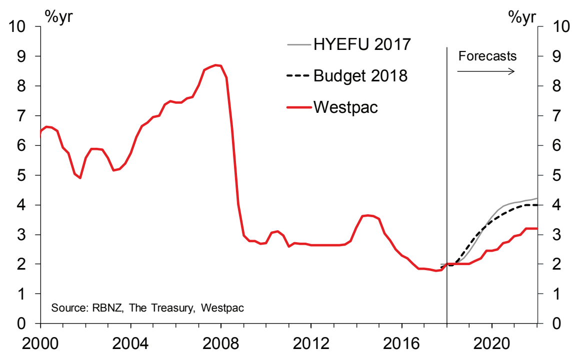
A very notable feature of the Treasury's forecasts is the assumption for the 90-day interest rate. The Treasury's forecasts assume that the 90-day rate will start to rise from December of this year, and that it will continue to climb over the next few years. That is a much faster pace of interest rate increases than we (or the RBNZ) expect. The Treasury also notes that a key reason for the expected interest rate increases is *"the more stimulatory nature of government policy adding to capacity pressures"*. In other words, the Treasury views the Budget as inflationary.

We do expect that Government policy will add to inflation pressures over the coming years. That's due to both the boost to economic activity, as well as the lift in consumer prices stemming from policies such as increased petrol taxes. However, we are still doubtful that inflation will rise to the sorts of levels that would warrant interest rates rising as quickly as the Treasury is assuming. A range of factors is continuing to dampen inflation, including competitive pressures in the retail sector.

Real GDP growth (annual average)



90-day rate



Economic Forecasts: The Treasury and Westpac

	Actual	Treasury					Westpac				
June year	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2018**	**2019**	**2020**	**2021**	**2022**
Real GDP growth	3.3	2.8	3.3	3.4	2.7	2.5	2.7	2.8	3.0	2.5	2.3
Annual CPI inflation*	1.7	1.4	1.5	1.8	1.9	2.0	1.5	1.5	1.5	1.5	1.7
Unemployment rate*	5.0	4.5	4.4	4.1	4.1	4.2	4.4	4.7	4.6	4.3	4.2
Nominal GDP growth	6.4	6.1	4.7	5.0	4.6	4.5	5.3	2.6	4.5	4.2	4.3
90-day interest rate**	2.0	2.0	2.6	3.4	3.9	4.0	2.0	2.0	2.5	3.0	3.2
TWI exchange rate**	76.5	74.9	75.8	75.5	75.4	75.0	74.5	69.6	70.5	71.9	71.6

*Quarter over same quarter last year, **Quarter average.

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