

New Zealand Government Budget 2014

15 May 2014

Loosening the purse strings

- The Government has decided to increase future spending allowances, without any change in revenue forecasts.
- The extra spending will add to the current economic upturn – Treasury estimates that it is worth roughly one extra OCR hike.
- The Treasury is now forecasting smaller surpluses in the future, which will erode New Zealand's ability to deal with future downturns and long-run fiscal challenges.
- However, the Government's finances remain very healthy overall. Government is still on track to reduce debt to 20% of GDP by 2020.
- A range of new policy initiatives were announced, many targeted at families with young children. These seemed sensible.

After keeping a very tight rein on spending in recent years, the Government loosened the purse strings in today's Budget – without any matching increase in revenue. This extra Government spending will exacerbate the current economic upswing – the Reserve Bank will be watching carefully. It will also erode the Government's ability to deal with the economic downturn that we anticipate later this decade.

The Government's allowance for new operating spending remains capped at \$1bn in 2014, but increases to \$1.5bn for 2015 and rises by 2% a year after this. That compares to the \$1bn per year allowance incorporated into Treasury forecasts prior to today's Budget. This is a small, but significant, upgrade to Government spending plans.

Meanwhile, the Treasury made little change to its revenue forecasts, despite upgrading its economic forecasts.

The consequence of more spending and the same revenue, of course, is smaller surpluses. The forecast operating balance (less gains and losses) for the 2017/18 year has fallen from \$5.6bn (in December's Half Yearly Fiscal Update) to \$3.5bn, on the back of rising expenses. This does still see the Government books comfortably back in the black over the forecast horizon, and on track to meet its twin fiscal targets of a surplus in 2014/15 and reducing net debt below 20% of GDP by 2020. However, smaller projected surpluses inevitably mean less of a buffer to deal with any unforeseen events. And as we discuss in the Economic Forecasts section, we think Treasury forecasts might be relatively optimistic on the medium term outlook for revenue. In particular they could be underestimating the extent of the slowdown in the New

Zealand economy generated by the trifecta of rising interest rates, a slowing housing market and the eventual wind down of the Canterbury rebuild.

In an ideal world, Government would be restraining its spending during the current upturn, to allow the rest of the economy some breathing space to expand. This Budget does the opposite, increasing spending just as the private sector is also hitting its straps. Treasury analysis suggested the additional \$500m in spending could be worth 15-30 basis points of OCR hikes. This will not go unnoticed by the Reserve Bank, which will now have to incorporate extra Government spending into its forecasts and interest rate deliberations.

Our own forecasts did anticipate an upgrade to the Government's spending plans. However, the Budget went further in that direction than expected. So as far as we are concerned, this amounts to a small surprise leaning slightly in the direction of stronger near-term GDP growth and higher interest rates – but nothing to cause a formal change of forecast.

The other nagging concern we have is that this Budget, not unusually, had a strong focus on the next 5 years. It remained silent on how the Government might help New Zealand meet some of the longer-term challenges it faces such as the growing costs of an aging population. New Zealand is not alone in facing these challenges. But it does seem to be relatively reluctant to put them front and centre of the debate around long-term fiscal management – something other countries have been increasingly forced to do amongst

arguably more challenging economic landscapes. Just this week, Australia made big changes to pension eligibility, mirroring the changes that have been made in many parts of the developed world since the Global Financial Crisis.

Of course, today's budget also firmed up the Government's spending plans for next year. As our "Policy Announcements in a Nutshell" section explains, business as usual ate up most of the increased spending – especially health. Much of the rest was squarely focussed on families with young children, and there were some loosening of the criteria around R&D tax deductions. We can't find fault with this mix of policy choices – they may encourage investment in R&D and participation in the labour force, for example. But so far as the macroeconomy is concerned, they will have a fairly minor effect.

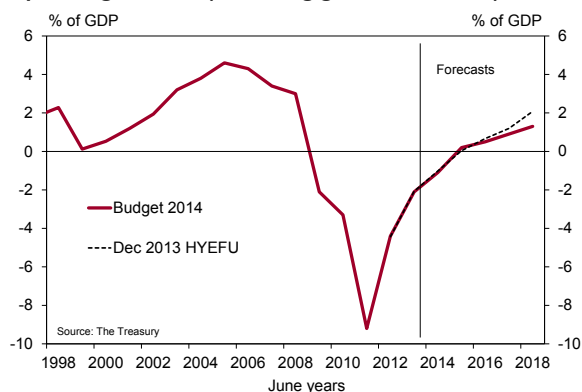
Government Bond Programme

The additional spending means an increased cash requirement compared to the December Half-Year Update. Total issuance over the forecast period has been increased by \$3bn to \$37bn, with an additional \$1bn in each of the 2015, 2017 and 2018 years.

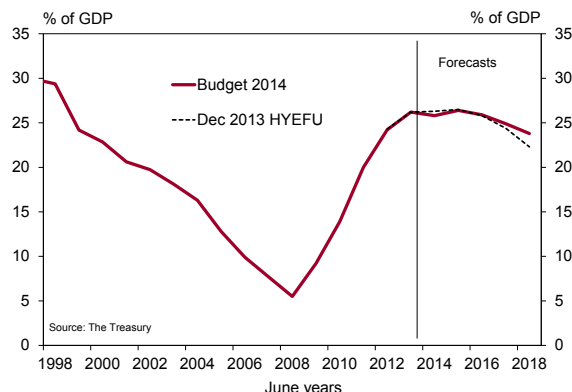
Subject to market conditions, a new 15 April 2027 nominal bond, followed by a new inflation-indexed bond are expected to be launched, via syndication, in the first half of 2014/15. The maturity date of the inflation-indexed bond is yet to be determined. Inflation-indexed bond issuance will be up to \$3bn of the \$8bn 2014/15 domestic bond programme.

Treasury forecasts, Budget 2014

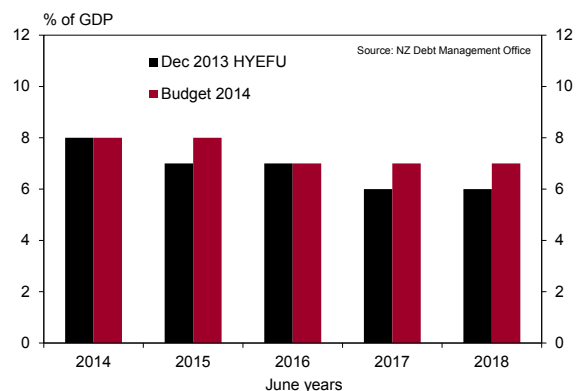
Operating balance (excluding gains and losses)



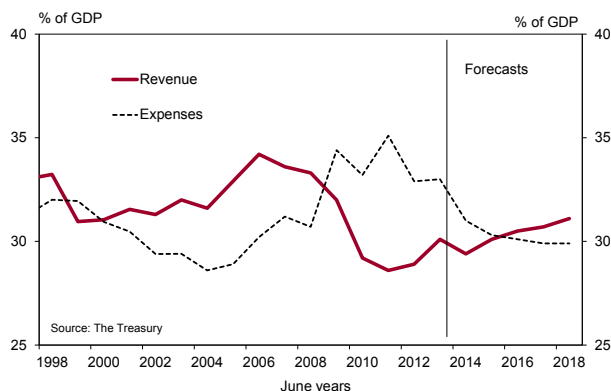
Core Crown net debt



Bond issuance



Core Crown revenue and expenses



Policy announcements in a nutshell

The broad themes of the policy announcements are:

1. Business as usual continues to account for a large share of the rise in spending, especially in healthcare. An aging population means that this will become increasingly true over time, under current policy settings.
2. The most high-profile policy announcements were focused on young children and their parents. In all fairness, these are not just crowd-pleasers; giving children a better start in life can pay big dividends in the long term. All of the policies are well-targeted at specific areas of need. And adverse unintended consequences are limited.
3. The Government continues to push a range of growth-enhancing initiatives, such as increased funding for science and more favourable tax treatment for R&D. In the past

we've been a little sceptical that these would amount to much more than tinkering. But given the evidence of improved productivity in recent years, and the economy's demonstrated capacity to grow without rising inflation, it may be that these little changes are adding up to a lot.

4. Once again, no effort to address some of the structural challenges for fiscal policy. The current Government has already proved itself to be a steady hand in terms of fiscal management over the next few years. But we'd like to see something on the rise in age-related spending over the long term, or the challenge of increasing national savings, or the wildly differing tax treatment for investment across asset classes.

Policy	Cost/Savings over 4 years to June 2018	Comment
Spending Measures		
	\$m	
Health	1,799	Largely to meet cost pressures and population growth. Increases for disability support, elective surgery, home-based support, aged care, cancer treatment and rheumatic fever.
Education	858	Includes \$359m for the Investing in Educational Success programme announced in January, aimed at incentivising high-quality teaching and leadership.
Business Growth Agenda	540	Increased tax deductibility for R&D spending, more contestable funding for innovation
Defence	540	Major upgrades to frigates and maritime helicopters.
Families Package	510	The flagship policy of this year's Budget. Includes extending paid parental leave from 14 to 18 weeks, increasing the parental tax credit, extending free GP visits and prescriptions from under-6s to under-13s, and additional funding for early childhood education centres. Note that around half of this amount is already counted under health and education.
Social Development	285	A further \$100m to help people move from welfare into work, a policy announced last year.
Earthquake Recovery	64	\$50m more funding for the Canterbury Earthquake Recovery Authority.
Other initiatives	629	An extra \$132m for the IRD to chase up tax returns, more funding for social housing, a \$75m contingency for Canterbury housing, and lots of small policies that add up.
Contingencies	690	The catch-all for new spending as needs arise.
Total New Spending	5,652	
Other Major Initiatives		
ACC levies	480	The next round of cuts to ACC levies, as part of a \$3bn total reduction announced last year - effectively a tax cut in disguise. The form of these cuts will be determined after public consultation.
Building materials	22	Suspending anti-dumping duties on a range of building products. A modest loss of govt revenue, but significant savings for the building industry, expected to reduce the average cost of building a house by \$3,500.
Savings		
Reallocation	1,025	Reprioritisation within and transfers between departments.
New revenue	565	Returns from increased IRD enforcement and additional tobacco duty from lowering the duty-free limit.
Total Savings	1,590	
Capital Spending		
Future Investment Fund	1,039	The next allocation of spending from the proceeds of state asset sales. Includes \$200m for health, a further \$198m to make KiwiRail viable, and \$172m for new and upgraded school buildings.
Transport	375	An interest-free loan to the NZ Transport Agency, to accelerate \$815m of Auckland transport projects.

Economic Forecasts: The Treasury and Westpac

The Treasury's economic and fiscal projections for the next few years seem reasonable to us. However, the Treasury may not be allowing for enough of an economic downturn later in the decade as the Canterbury rebuild winds down and the housing market cools. In turn, that means its revenue forecasts for 2018 and beyond may be on the optimistic side.

As expected, the Treasury has upgraded its forecasts since December's HYEPU, largely in response to the big lift in net migration we've seen since then. The Treasury now expects annual net migration to peak at 38,000 later this year. That's translated directly into faster economic growth - GDP growth is expected to peak at 4% in the year to March 2015, slowing to around 3% in the following year and 2% after that.

Inflation is expected to stay below 2% until the second half of next year (in part due to the ongoing strength of the exchange rate), but then to accelerate to around 2.5% over the following two years. With that in mind, the RBNZ is expected to continue raising the OCR at a fairly rapid clip, to around 4% by March 2015 and a peak of about 5% by early 2018.

There is nothing here to substantially disagree with. That said, there are a few aspects of the Treasury's forecasts we would question, particularly in the later years. On the one hand, the Treasury is more sceptical than we are that the recent upturn in New Zealand's terms of trade will be sustained. (Indeed,

its main downside risk scenario features a steep correction in the terms of trade.) On the other hand, we would regard the Treasury's forecasts for the domestic downturn later this decade as rather benign.

In particular, the Treasury assumes that the impact on the housing market of rising interest rates will be modest, with house prices forecast to rise 7.3% in the year to March 2015, 4.3% in the following year, and then settle around 2.5% annual growth. In other words, the Treasury is saying that house prices will continue rising faster than inflation throughout the forecast! The Treasury also forecasts a very gentle let-down in the pace of growth as the Canterbury rebuild passes its peak and spending starts to fall. By contrast, we expect a period of falling house prices, coinciding with a bigger post-rebuild slowdown in migration and GDP growth.

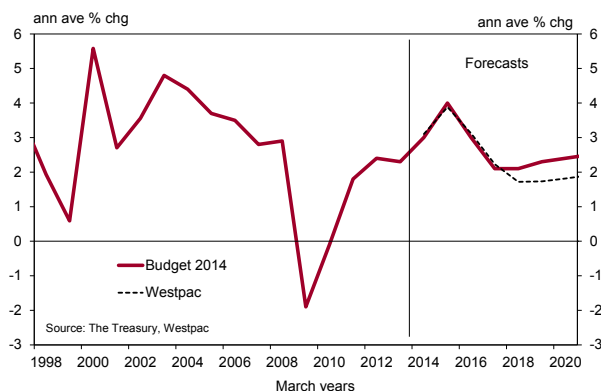
We'd also note that the Treasury's long-term fiscal forecasts are predicated on what we'd see as optimistic rates of productivity growth (then again, the Treasury is also assuming 2% long-run inflation - we think the risks are that it will be higher than that). Overall it adds up to rising surpluses as far the eye can see. That's a standard assumption, but one that's worth noting in a year when the Government has chosen to leave itself a substantially smaller buffer for coping with the inevitable future downturns.

Economic Forecasts: The Treasury and Westpac

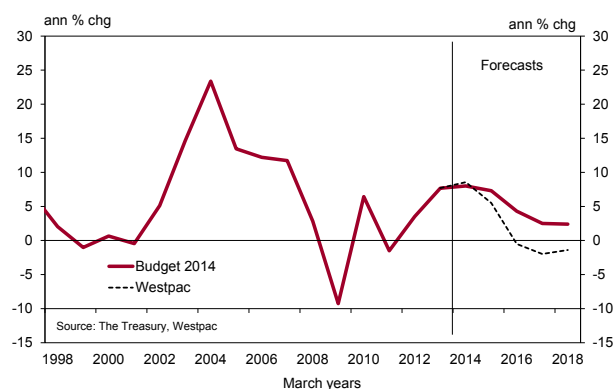
	Actual	Treasury					Westpac				
March years	2013	2014	2015	2016	2017	2018	2014	2015	2016	2017	2018
Real GDP growth*	2.3	3	4	3	2.1	2.1	3.1	3.9	3.1	2.2	1.7
Annual CPI inflation	0.9	1.5	1.8	2.5	2.3	2	1.5	1.8	2.6	2.7	2.0
Unemployment rate**	6.2	5.9	5.4	5.1	4.8	4.4	6.0	5.3	4.9	5.1	5.2
Nominal GDP growth*	2.2	6.7	5.7	4.3	4.5	3.7	7.0	6.1	5.7	4.8	3.7
90-day interest rate***	2.7	3	4.3	4.8	4.9	5.3	3.0	4.0	4.9	5.4	5.1
TWI exchange rate***	75.9	78.7	78.6	78.4	76.9	73.2	78.7	78.9	76.8	73.6	69.2

*Annual average % change, **March quarter, seasonally adjusted, ***March quarter

GDP growth



House price inflation



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