

# Keeping a tight rein

## Budget 2015 preview, 21 May 2:00pm

- The 2015 Budget is likely to see a return to the theme of fiscal discipline after last year's mini spend-up.
- Softer than expected inflation will mean lower tax revenue and operating surplus projections over the next few years.
- The Government has found a way to deliver tax cuts in a way that reduces rather than adds to inflation pressures.
- The Treasury's economic forecasts are likely to be similar to our own, though we question whether a forecast of rising surpluses in the outer years would be consistent with the wind-down of the Christchurch rebuild.

The National-led Government will present its seventh Budget on Thursday afternoon. Whereas last year's election-year Budget showed a willingness to dip into future surpluses in order to fund new spending, this year's package is likely to return to the long-running theme of fiscal responsibility.

The lack of a surplus this year, and the need to delay some planned spending increases, were already conceded in last December's *Half-Year Fiscal and Economic Update* (HYEFU). Since then, Finance Minister Bill English has indicated that soft inflation will further reduce the Treasury's revenue forecasts over coming years, and that the new spending allowances will be unchanged from the HYEFU. A handful of new initiatives have been announced so far, and no doubt more will be trumpeted on the day, but the overall picture is likely to remain one of limited wiggle room in the fiscal accounts.

### Treasury forecasts

In a recent speech, Mr English indicated that lower than expected nominal GDP, largely due to lower inflation, was likely to shave around \$4.5bn off the Treasury's tax revenue projections over the next four years, compared to last year's Budget. Much of this was already baked into the HYEFU last year, where the revenue forecasts were lowered by more than \$3bn.

	Actual	Treasury's HYEFU Forecasts					Westpac's estimates of main changes				
June Years	2014	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019
OBEGAL \$bn	-2.9	-0.6	0.6	2.6	3.1	4.1	-0.9	0.3	2.6	3.1	4.1
net debt (% GDP)	25.6	26.5	26.5	25.2	24.0	22.5	26.5	26.5	25.5	24.5	23.0
Bond Programme (\$bn)		8.0	7.0	7.0	7.0	7.0	8.0	7.0	7.0	7.0	7.0
March Years											
Real GDP (ann avg % change)	2.5	3.5	3.4	2.8	2.3	2.2	The activity outlook is still firm ...				
CPI (ann % change)	1.5	1.3	2.0	2.1	2.0	2.0	... but inflation has softened since the HYEFU ...				
90day interest rates	3.0	3.7	3.9	4.4	4.8	5.2	... keeping interest rates low for longer.				

We presume there will be some partial offsets on the expenditure side as well – lower inflation means lower indexation costs, and a lower interest rate profile will reduce funding costs. Nevertheless, the end result will be, in Mr English’s words, “a slightly bigger deficit for 2014/15 and a slightly smaller surplus for 2015/16”.

We should point out that the shortfall in revenue says more about the difficult task of tax forecasting than it does about the state of the economy. The main shortfall continues to be on GST receipts, which in the nine months to March were ‘only’ up 5.7% on the same period last year, compared to a forecast of 7.4% growth in the HYEPU. In contrast, individual income tax is on track at +6.5%, while the corporate tax take is well ahead of forecast at +15.3%, though this may be inflated by the irregular timing of tax receipts.

With such a clear signal about the fiscal projections, our interest in this week’s Budget presentation will be more around the economic forecasts underpinning them. The HYEPU assumed that inflation would settle at the 2% midpoint of the Reserve Bank’s target range from March 2016. That date will obviously be pushed out, but it will be interesting to see whether the Treasury has allowed for the risk of a persistent undershoot in inflation.

The HYEPU incorporated some fairly strong near-term GDP growth forecasts, driven by record net immigration and strong housing construction in Auckland, with the pace of growth slowing in the outer years as the quake rebuild in Christchurch passes its peak. While those growth forecasts are not too far from our own, they don’t sit entirely comfortably with a forecast of ever-rising surpluses over that period. We only have to look across the Tasman to see what can happen to the fiscal accounts when the government fails to anticipate the wind-down phase of a massive investment project (the wave of new oil and gas projects in Australia’s case).

## Policy developments

The Finance Minister has said that the operational spending allowances will remain unchanged from the HYEPU, where the allowance was revised down from \$1.5bn to \$1bn for each of the next two years, and up from \$1.5bn to \$2.5bn for the 2017 Budget (yes, it’s an election year). Increases in health and education will typically claim the lion’s share of a \$1bn allowance, which leaves little room for new spending initiatives in the absence of savings elsewhere.

Nevertheless, the Government has already made one significant announcement: a further reduction in ACC levies, focused largely on motor vehicles, worth around \$500m over the next two years. The levy reductions announced in last year’s Budget mean that from July this year, the average ACC vehicle levy will fall from \$300 to \$195, and the latest cut will take it down to \$120 from next July.

Make no mistake, this is a tax cut, delivered in a form that doesn’t put upward pressure on interest rates. Just the opposite, in fact: we estimate that the ACC cuts will reduce CPI inflation by 0.3 percentage points over each of the next two years. In normal times, the RBNZ would have the wiggle room to look through a policy effect of this magnitude. But when inflation has already been below-target for some time, and the RBNZ is concerned that consumers and businesses could fall into a low-inflation mindset, the case for OCR cuts becomes incrementally stronger.

The other significant policy change revealed ahead of the Budget is a tightening of the tax rules around property investment. Under the current rules, property investors incur a tax on capital gains if it can be shown that they bought with the intention of selling for a profit. The new rules mean that capital gains will be taxed on all investment properties sold within two years of purchase (the ‘intentions’ test will still apply after two years). This should have a modest dampening effect on house price inflation, although the impact will depend on the extent to which the property market is currently being driven by short-term property flippers, and whether they are willing to simply hold on for longer in a rising market.

Other pre-Budget spending announcements include \$244m for new schools and classrooms, paid for from the Future Investment Fund (i.e. the proceeds of asset sales); an extra \$98m for elective surgery; an extra \$80m over four years for R&D grants; and \$33m for boosting the number of immigration officers.

One of the most important policy strands of the current Government is better targeting of social spending – using detailed data to identify at-risk groups and provide early interventions, in order to reduce the expected future liabilities from welfare dependency, poor health and crime. This has been developing over the last several years, and there will no doubt be some new initiatives announced in this year’s Budget.

## Bond programme

At face value, lower projected surpluses would imply an increase in the bond issuance programme, but it’s not quite that straightforward. For instance, the Finance Minister has said that the main reason for falling short of a surplus this year is due to accounting rules – relating to ACC and student loan liabilities – which don’t affect the Government’s cash position. Most of the reduction in the projected surpluses was already factored into the HYEPU, with no change to the bond programme at the time. So we don’t expect an increase in the bond programme to be necessary this time.

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