Westpac

Institutional Bank

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# Treading water

## Preview of Budget 2016, 26 May 2:00pm

- The 2016 Budget is expected to be relatively low-key, with the focus shifting back towards keeping debt in check.
- The Finance Minister has announced an aim to bring the net debt to GDP ratio down faster, and to that effect has signalled some cutbacks to the new spending allowances.
- Achieving this goal would also require strong economic growth and rising surpluses. We're sceptical that this will eventuate, as the impetus from the Canterbury rebuild fades in the latter part of this decade.
- Housing affordability remains a political hot potato. We expect more details on the Government's plans to encourage housing supply.

The National-led Government will present its eighth Budget next Thursday afternoon. As befitting a mid-term Budget, this is shaping up to be a relatively low-key one, with no real pressure for a change of course in either direction. Unlike in many rich countries, the operating balance has been brought back into surplus – barely for now, but projected to increase over time. And the economy is continuing to grow at a modest pace.

### Treasury forecasts

To Finance Minister Bill English, this seems to be an opportunity to put the Government's finances in a more robust position in time for the inevitable rainy day. In his pre-Budget speech, English said that he is aiming to bring net Crown debt down to 20% of GDP by 2020, from around 26% currently. Given that last December's Half-Year Fiscal Update projected a net debt ratio of 24% by that date, this would require a $12bn reduction in the net debt projections – a fairly demanding task.

To that end, English has signalled some changes to the spending plans for the next few Budgets. While some spending will be brought forward into the coming year to meet the needs of a rapidly growing population, the government is planning to reduce the combined operational and capital spending allowances by around $1.2bn over the next five years.

| | Actual | Treasury's HYEFU Forecasts | | | | | Westpac's estimates of main changes | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **June years** | **2015** | **2016** | **2017** | **2018** | **2019** | **2020** | **2016** | **2017** | **2018** | **2019** | **2020** |
| OBEGAL $bn | 0.4 | -0.4 | 0.4 | 1.0 | 3.5 | 4.9 | 0.1 | 0.5 | 1.5 | 4.0 | 5.5 |
| Net debt (% of GDP) | 25.2 | 26.9 | 27.7 | 27.1 | 25.6 | 24.0 | 26.3 | 27.0 | 26.0 | 24.0 | 21.5 |
| Bond programme ($bn) | | 8.0 | 9.0 | 9.0 | 9.0 | 9.0 | 8.0 | 9.0 | 8.0 | 7.0 | 7.0 |
| **March years** | | | | | | | | | | | |
| Real GDP (ann avg % change) | 3.0 | 2.1 | 2.4 | 3.6 | 3.0 | 2.2 | Stronger activity growth in the near term... | | | | |
| CPI (ann % change) | 0.3 | 1.4 | 2.1 | 1.9 | 2.1 | 2.2 | ...while inflation is expected to remain low for longer... | | | | |
| 90-day interest rates | 3.6 | 2.6 | 2.6 | 3.4 | 4.2 | 4.5 | ...and interest rates have fallen further. | | | | |

That on its own would only make a small dent in the net debt projections. The rest would have to be achieved through strong revenue growth and higher surpluses, which suggests that the Government still has a very optimistic view on the economy underpinning its fiscal forecasts. In the December update, the Treasury was forecasting real GDP growth to reach a peak of 3.6% by June 2018, and their view on that evidently hasn't changed.

We have a less positive view on economic growth over the full five-year forecast period. In the near term, real growth has been stronger than the Treasury's forecasts, more than offsetting the fact that inflation has fallen well short. Consequently, the level of nominal GDP, and hence the tax take, is running ahead of forecasts for the current fiscal year. But that stronger starting point will be eroded over time. We're expecting the pace of growth to slow to just 1.4% by 2019, as the level of quake-related building work winds down. So we are sceptical that the large surpluses that the Treasury is projecting towards the end of this decade will eventuate.

It should also be noted that the Government is no longer allowing for future tax cuts in its spending allowances. However, the Prime Minister has expressed a desire to include tax cuts in future Budgets. So even if the Treasury's economic forecasts were on track, it's quite possible that future surpluses (and hence the pace of debt reduction) will be eroded by future policy decisions anyway.

## Policy developments

Previously, the allowances for new operating spending were set at $1bn for this year's Budget and $2.5bn for next year. Some of that spending will now be brought forward into this year's Budget, while another portion of next year's allowance will be diverted towards debt repayment instead.

The policy initiatives that have been announced to date haven't been particularly large, the most expensive being a $303m plan to modernise the fire services and $187m for streamlining tax for small businesses. Given the increase in the spending allowance for this year's Budget, this suggests there's plenty of scope for more initiatives to be announced on the day.

Housing is the area where the Government is most under fire at the moment. Consequently, we think the Government could well announce some further measures which attempt to address concerns around housing affordability, although exactly what form these measures could take is unclear. Housing-related announcements in last year's Budget included funds for social housing, freeing up Crown land in Auckland and a new 'bright line' test to tax capital gains from residential property.

Our inkling is that the focus this year is likely to be on the supply side. The Government has become increasingly vocal about the need for the Auckland Council to free up more land for new building. But it seems difficult to do much more than sabre-rattling on this front prior to the deadline for the Auckland Unitary plan being approved in August.

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