Westpac Institutional Bank

New Zealand Government Budget 2016

26 May 2016

Fiscal mirage

- There were few surprises in the 2016 Budget, with a range of modest and sensible-looking policy announcements.
- The Treasury is forecasting very strong economic growth, large surpluses, falling net debt and low bond issuance.
- We are sceptical. From 2018 the economy may be weaker than the Treasury is forecasting due to the wind-down of the Canterbury rebuild and a cooling of the current borrow-and-spend dynamic.
- If so, the Government is likely to face a growing conflict between its long-term fiscal commitments and its desire to deliver tax cuts.

There were few surprises in the 2016 Budget, with its intentions having been well signalled by the Minister of Finance in recent weeks. A stronger set of economic forecasts from the Treasury provided the Government with a greater range of options this year. And while some planned spending in much-needed areas has been brought forward, the Government has largely opted for debt reduction this time.

There was nothing particularly contentious in the policy announcement themselves. The biggest increases in spending were devoted to areas such as health, education and core government services. If anything, some policy areas were more notable in their absence. For instance, there were nothing new in today's Budget on either housing supply or demand, although the Government highlighted that its National Policy Statement on urban development will be released soon (see box).

This was another austere Budget in some respects, with a net reduction in the allowances for new operational and capital spending over the next four years. Admittedly the timing of some of that spending has been brought forward, to address the pressures from a burgeoning population. But much of that near-term increase in spending is effectively running just to stand still: the Treasury's population estimate for June 2017 is around 1.7% higher than it was in last year's Budget, largely due to stronger than expected net migration. With spending allowances being trimmed in the later years, this suggests a meaningful reduction in spending per person.

That aside, it's clear that the improvement in the fiscal outlook has largely come from the economic projections underpinning it, rather than from policy decisions. This is the area where we have the greatest concern. The Treasury is forecasting consistently strong economic growth over the next several years, peaking above 3% next year. In contrast, we expect GDP growth to be slowing by this stage, as the level of earthquake rebuild activity in Canterbury begins to wind down, and the borrow-and-spend dynamic that has supported household spending lately begins to run out of steam.

This point of difference isn't new, and it will be a while before it's resolved decisively. But if our forecasts are right, the Government will find itself with some tougher trade-offs in coming years than this Budget implies. Dealing with the long-term fiscal challenges of an aging population may end up taking a back seat once again, while the economy is going through a soft growth phase. And that's to say nothing of the current Government's long-running desire to deliver income tax cuts, which today's Budget makes no allowance for.

Fiscal projections

A stronger than expected starting point for GDP, and hence for tax revenue, means that the Treasury now expects a modest operating surplus of $668m for the current fiscal year. In contrast, last December's Half-Year Fiscal and Economic update (HYEFU) projected a temporary dip back into deficit. The surplus is expected to remain small next year but to improve markedly in later years, reaching $6.7bn by the year to June 2020. The strong economic growth forecasts have lifted the Crown revenue projections over the coming years, while lower than expected inflation and interest rates have reduced projected social welfare and finance costs.

As signalled by the Minister, the 2016 Budget reduced its operational and capital spending allowances over the next four years as a whole, but brought forward the timing of some of this spending. In particular, the projected capital spend of $6.1bn in the June 2017 year will be the largest in many years, aimed at meeting the needs of a growing population.

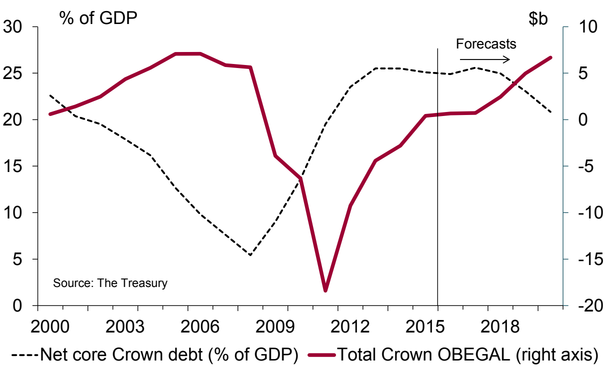
Policy initiatives

The most notable moves on the revenue side came in two areas. First, the Government has renewed its collaboration with the Maori Party to increase tobacco excise duty by 10% each year for the next four years (the last previously scheduled increase was at the start of this year). This will provide an additional $425m of revenue over the next four years, and will also add 0.2 percentage points to the inflation rate each year. It's not clear to what extent the RBNZ may have anticipated such a move, but either way this should give the RBNZ more comfort that inflation will be comfortably back within the 1-3% target band next year.

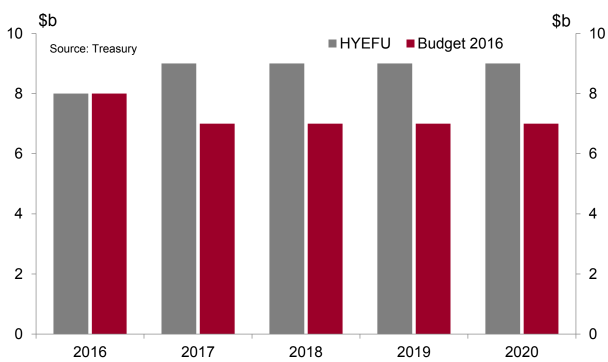
Second, the Budget allows for the phasing out of the 'two-for-one' rule, whereby industries covered by the Emissions Trading Scheme (ETS) have been required to surrender (pay for) one carbon unit for every two tonnes of carbon equivalent emissions they produce, with taxpayers picking up the tab for the other half of these emissions. We recommended scrapping the two-for-one rule in our February 2016 report on the Paris Agreement and the ETS review.[1] The rationale was that the subsidy from taxpayers to industries covered by the two-for-one rule was encouraging an economically inefficient use of resources.

The removal of the subsidy will mean a saving of nearly $360m for taxpayers over four years. The bulk of the cost from this subsidy removal will be borne by purchaser of energy sector products. Taxpayers will benefit from the elimination of the subsidy, but the switch to user-pays will mean that purchasers of energy products (such as petrol) will likely pay more for these products. This shifts the burden of meeting New Zealand's climate change targets in an economically efficient way to those consumers who use the most carbon. We would still argue that the Government has not gone far enough in ensuring that all

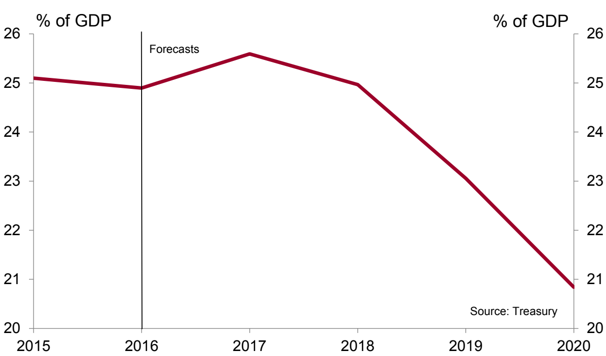
Operating balance (excluding gains and losses)



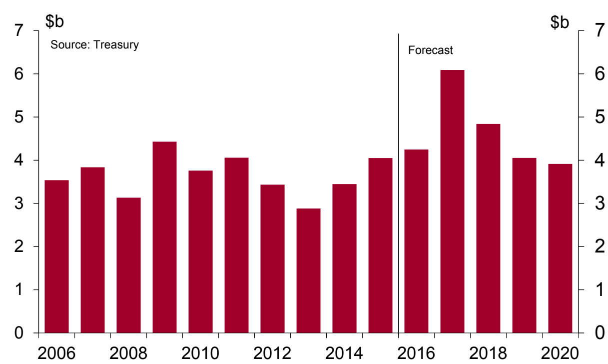
Bond issuance forecasts, Budget vs HYEFU



Net core Crown debt to GDP



Net capital spending (June years)



1 See http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/The-Paris-Agreement-February-2016.pdf

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emitters pay their fair share. In particular, as the producer of nearly half of all greenhouse gases in New Zealand, agriculture remains outside the ETS. Once again, this passes the cost of agricultural emissions onto taxpayers, and skews the New Zealand economy and land use toward agriculture.

There were no real showstoppers on the expenditure side. Instead, it was mostly a back-to-basics approach. The bulk of new spending initiatives were directed towards core government business in areas like health, education welfare and justice. That's not surprising given the very strong population growth we've seen of late. And this strong population growth also meant some of the operational spending increases were more front loaded than in the last Budget. Outside these core responsibilities, there was a push to boost spending in science and innovation, while IRD received a sizable wad of cash to upgrade its dated IT systems (which in turn is expected to lead to significant cost savings and increased revenue collection).

The Government's 'social investment' approach to welfare spending of recent years continues, aimed at intervening early in the lives of the most vulnerable New Zealanders. In line with this ongoing approach, a range of support initiatives were included in today's Budget, aimed largely at children and young people.

We've got little to quibble with in terms of these expenditure initiatives, they all broadly look like sensible government policy.

Economic implications

The main way the Budget used the larger projected revenues was to direct it to towards debt reduction. Net core Crown debt is forecast to peak at 25.6% of GDP next year, then fall to 20.8% of GDP by 2020. Planned debt issuance has been reduced by $8 billion over the next four years. The faster reduction in net debt means that the Government is now aiming to restart contributions to the Super Fund in 2021, two years earlier than previously.

As we explain in the *Economic Forecasts* section, we are sceptical of the economic forecasts underlying this reduction in net debt. We expect the economy will be significantly weaker than the Treasury is forecasting for the latter part of the decade, and consequently we doubt that the surpluses will be as large as Treasury is forecasting.

It is also important to note that the Budget made no allowance for tax cuts. This is clearly another source of risk that the surpluses could end up smaller than forecast in the Budget: the Prime Minister recently articulated a preference to cut taxes at some point.

In the near term, this is a more stimulatory for the economy Budget than last year's one, largely due to the boost to capital spending (which was already announced early this year, and was already incorporated in our economic growth forecasts). This capital investment is welcome and necessary, although the timing is less than ideal as it will compete for resources with the Canterbury rebuild. Indeed, the Budget notes that the scale of the increase expected for next year is because some previous spending plans were delayed due to capacity constraints. And even without the benefit of hindsight, some of this spending could have usefully come a couple of years earlier, when monetary policy was most in need of 'mates' to help it keep inflation on target.

Government Bond programme

The stronger fiscal position, and a renewed focus on debt reduction, has led the Government to slash its gross bond issuance programme by a combined $8bn over the four years to 2020. Previously, the gross bond issuance programme was forecast to be $9bn a year for 2016/17 to 2019/20, but this has been reduced to $7bn a year.

The reduction in bond issuance was larger than the market was expecting, although it was in line with the Minister's stated intention to bring down the net debt ratio. The stock of government bonds outstanding is expected to decline from 2018, but from a historically high level, so it shouldn't materially affect the liquidity of the bond market.

Subject to market conditions, a new April 2037 nominal bond will be launched via syndication in the second half of this year. Inflation-indexed bonds will account for $1-2bn of the $7bn bond programme for the next fiscal year.

Housing policy

Today the Minister of Finance indicated that the new National Policy Statement on Urban Development will soon be released, and gave some hints on its likely scope.

The Government remains convinced that the housing affordability challenge is predominantly a supply-side issue. To that end, the new policy will focus on two things. First, it will "direct councils to allow more housing development where necessary". This is the most strongly interventionist language to date and implies that mechanisms will be put in place to force faster release of land where the Government does not believe this is happening fast enough. No doubt Auckland would be first within its sights given the Government's well-publicised concerns about the slow pace of land release there.

Second, the new policy "will direct councils… to measure the impact of their decisions on house prices". Developers have for years decried the ability of councils to make seemingly arbitrary decisions on many facets of each new development, often adding tens of thousands to the cost of each property. In theory, the Resource Management Act already requires councils to conduct an economic analysis of any district plan changes, but most councils do not routinely conduct this analysis on "design guides" or other supplementary policies they impose on new developments.

A mechanism requiring councils to measure the impact of the planning decisions they make on house prices would not in itself lower the cost of housing. However, it would put dollar values on the additional cost imposed by council decisions, increasing adding a level of accountability that may lead to more consistent and measured decision-making.

Policy announcements in a nutshell

Policy	Value over 4 years to June 2020	Comment
Spending Measures	**$m**	
Health	2,218	To meet needs of growing population. More money for Pharmac, disability support services, elective surgery, and primary health care for under 13s (a policy announced in Budget 2014).
Core Government Services	1,138	The bulk of this is to fund an upgrade of IRD's administration system.
Justice Sector	837	Also receives an additional $56m in 2015/16. $299m for Police, largely to fund wage increases, $208m for addressing family violence and catering to victims of crime, $356 to reduce reoffending.
Innovative New Zealand	761	Three pronged approach including $411m investment in science and innovation, $257 for targeted tertiary education and apprenticeship programmes and $94m to support regional economies.
Education	641	$397m for early childhood education, $43m to target students most at risk of under-achieving, $42 for students with high and special needs.
Other Business Growth Agenda	561	A variety of initiatives including business tax package $185m (aimed at reforming the ways SMEs pay tax), $70m toward the elimination of bovine TB, $24.5m freshwater improvement fund, and $20m to establish a computer emergency response team.
Social Development	546	Increased support for CYF ($145m), $200m for system-wide reforms of support for vulnerable children and young people.
Defence and Intelligence	482	$301m for NZ Defence Force, $179 for NZ intelligence community and $20m to create a new National Computer Emergence Response Team to combat cyber-attacks and cyber-crime.
Social Housing	258	The bulk of this provides for additional income-related rent subsidy funding.
Maori Development	100	A range of support measures including $40m for Whanau Ora.
Other	915	Includes spending for future contingencies.
Total new spending	**8,457**	
Saving Measures		
Removal of the One for Two transitional Measure in the ETS	356	Emitters no longer able to surrender one carbon unit for every two tonnes of carbon equivalent emissions they produce.
Savings from the IRD's Business transformation (administrative savings and increased revenue)	564	Following significant spend on upgrading IT.
Increase to Tobacco excise tax	425	10% in excise tax every year for the next 4 years.
GST on cross boarder services and intangibles	150	E.g. collection of GST on digital music purchased from offshore.
Other	422	
Total savings measures	**1,917**	
Capital Spending		
Education	727	Christchurch schools rebuild, public private partnership schools and new schools.
Other Business Growth Agenda	453	Additional investment in Kiwi Rail ($190m), $100m to free up Crown land in Auckland for house building and $115m on regional roading package.
Core Government Services	512	IRD system and NZ Fire Services unification.
Other and contingency	911	NZ's stake in Asian Infrastructure Investment Bank
Total capital spending	**2,603**	
Capital savings	**1,215**	Including repayment of Auckland council loans and fire service levy increase.

Economic Forecasts: The Treasury and Westpac

Much of the projected improvement in the fiscal position over the coming years rests on the Treasury's forecasts for firm economic growth. However, we have concerns about the strength of GDP growth through the latter part of the decade. And in turn, this raises doubts about the sustainability of the longer term trajectory for fiscal policy.

Nominal GDP has been substantially stronger than the Treasury expected six months ago when it released its HYEFU forecasts. This has flowed through into higher than expected tax revenue to date. Stronger activity in other parts of the economy has more than offset the weakness in dairy export prices and the sharp drop in world oil prices early this year. The Treasury's forecasts have effectively banked this stronger-than-expected starting point, so that the level of nominal GDP remains higher than in the HYEFU forecasts over the coming years.

Going forward, the Treasury forecasts real GDP growth to average 2.8% over the next five years, peaking at 3.3% growth in 2017 (similar in essence to the HYEFU). Inflation is expected to remain low in the near term, but to return to the 2% target midpoint by the end of 2017 as the impact of the oil price plunge drops out. Dairy export prices have fallen by more than expected, but are forecast to gradually recover over the next couple of years.

Our concern – and this is not a new one – is that we are not convinced that the Treasury's strong growth forecasts in the later years will eventuate. While the Treasury continues to forecast growth of around 2.8% between 2018 and 2020, we expect that it will actually fall to a low of 1.4% in 2019.

The Treasury's forecasts assume continued strength in residential construction over the coming years, as increasing activity in other regions (especially Auckland) offsets the eventual wind-down of reconstruction spending in Canterbury. However, given the sheer magnitude of residential reconstruction work, we expect that its eventual wind-down will have a much more marked dampening impact on economic activity over the coming years.

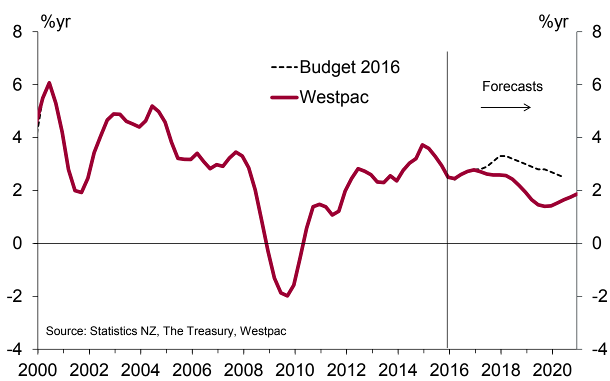
The Treasury also assumes a very modest easing in consumption spending in the latter part of the decade. This is an area where we see considerable risk. Household debt has already risen to elevated levels (a development that the Treasury acknowledges). This has been spurred on by low interest rates and related strength in the housing market, which have given rise to a borrow-and-spend dynamic in the economy. However, increases in debt cannot boost growth indefinitely. Debt eventually needs to be repaid, and borrowing more today means committing more future income to repaying that debt. In addition, higher debt levels mean that households are more vulnerable to unfavourable changes in economic conditions. That's a particular concern given the other factors that will dampen growth over the coming years.

Economic Forecasts: The Treasury and Westpac

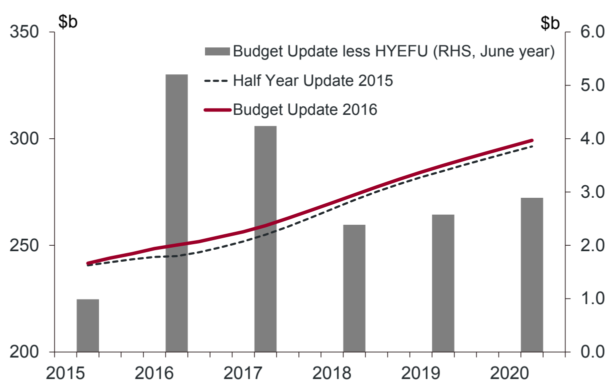
	Actual	Treasury					Westpac				
March years	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2016**	**2017**	**2018**	**2019**	**2020**
Real GDP growth*	3.3	2.6	2.9	3.2	2.8	2.5	2.6	2.5	2.4	1.4	1.6
Annual CPI inflation	0.4	0.1	1.5	2.0	1.9	2.1	0.5	1.0	2.2	2.0	1.2
Unemployment rate**	5.9	5.6	5.6	5.1	4.6	4.6	5.6	5.2	5.2	6.1	5.7
Nominal GDP growth*	2.8	3.5	3.6	5.6	5.1	4.1	3.2	3.5	4.7	3.3	2.9
90-day interest rate***	3.5	2.2	2.2	2.6	3.7	4.2	2.1	2.1	2.1	1.6	1.6
TWI exchange rate***	76.2	72.5	70.5	70.2	70.3	69.5	71.1	68.2	65.5	63.1	62.9

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

Real GDP growth (annual average)



Nominal GDP level



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