More of everything

Preview of Budget 2017, 25 May 2:00pm

24 May 2017

- The 2017 Budget can afford to be more generous than last year's effort. Net debt is on track with the Government's long-term target, and the tax take is running stronger than expected.
- Strong population growth means that extra spending is also a necessity. The Government has already announced some major increases in capital spending over the last year.
- The economic forecasts underpinning the fiscal accounts are likely to be similar to our own, with solid growth in the near term, slowing by the end of the decade as building activity tops out and population growth slows.

The 2017 Budget is likely to be more generous than the previous offering, and not just because it's an election year. The focus of last year's Budget was on debt control, and to that end there was actually a reduction in the allowances for new operational and capital spending over the next four years, though with some spending brought forward to address population pressures.

Keeping public sector debt in check is still an important consideration. The Government recently redefined its target for net debt, aiming to reduce it to 10-15% of GDP by 2025. However, the Treasury's longer-term projections last year indicated that the Government was already comfortably on track to meet that target. And the improvement in the fiscal accounts since then suggests that the Government has some scope to increase spending without altering its borrowing requirements.

In last December's fiscal update, the Treasury forecast a narrow operating surplus of $473m for the year to June 2017, after an allowance for costs of about $1bn associated with the Kaikoura earthquake. Since then, the monthly fiscal updates have shown both stronger revenue and lower costs than expected, putting the current fiscal year on track for a surplus of closer to $2bn (notwithstanding any additional quake-related costs).

The forecasts of future surpluses are also likely to get an upgrade, though perhaps not to the same degree. Population growth alone argues for greater spending on social services. Net migration has continued to exceed forecasts, and while the recent tightening of residency requirements may stem the inflow to some extent, the greatest surprise – at least for us – has been in areas that are beyond the control of migration policy. The trends in the movements of New Zealanders – fewer leaving, and more returning from overseas – have shown no signs of turning, and in our recently released *Economic Overview* we have actually increased our net migration forecasts for the next few years.

This year's Budget may also see a move towards putting more money directly into the pockets of New Zealanders. The Government has long been signalling a desire to reduce personal income taxes, and Finance Minister Joyce has hinted that any change is more likely to be in the income thresholds than in the tax rates themselves.

Economic and fiscal forecasts

	Actual	Treasury HYEFU forecasts					Westpac forecasts				
June years	2016	2017	2018	2019	2020	2021	2017	2018	2019	2020	2021
OBEGAL $bn	1.8	0.5	3.3	5.4	6.8	8.5	2.0	4.2	6.2	7.5	9.0
Net debt (% of GDP)	24.6	24.3	23.8	22.2	20.3	18.3	23.7	23.2	21.7	19.9	18.0
Bond programme ($bn)	8.0	8.0	7.0	7.0	6.0	6.0	8.0	7.0	7.0	6.0	6.0
Real GDP (ann avg % change)	2.8	3.6	3.5	2.9	2.4	2.3	2.9	3.1	3.1	2.3	1.9
CPI (ann % change)	0.4	1.5	2.0	2.1	2.0	2.1	1.9	1.5	2.2	2.2	2.2
90-day interest rates	2.4	1.9	1.9	2.3	3.2	3.9	2.0	2.0	2.5	2.5	2.9

As a guide, we estimate that updating the income thresholds for inflation since 2010 (the last time that income taxes were reduced) would give the average household an extra $14 per week in after-tax income – enough to meet the Government's desire for a 'meaningful' change. This would reduce tax revenue by almost $2bn in the first year. An alternative would be a commitment to adjust the thresholds for inflation each year in the future. This would push the bulk of the cost into the outer years of the forecasts, where the operating surpluses were already expected to be quite large.

There has also been some speculation about an increase in Working for Families payments. Again, this could be done by indexing the abatement threshold to inflation (this adjustment was removed in the 2010 Budget).

Potentially the more interesting stuff – at least in terms of what has already been signalled – lies outside the operating balance. The Government has announced a capital spending allowance of $11bn for the next four years, a $2bn increase compared to the December fiscal update and a $7.4bn increase compared to last year's Budget. Housing is likely to account for a sizeable chunk of this spending, including the Government's recently announced plan to build 34,000 new homes on Crown land over the next ten years.

At least some of this ramp-up in capital spending is in response to higher than expected population growth. But the greater part of it appears to be a long overdue catch-up on investment in the nation's infrastructure, which was put off in the lean years after the Global Financial Crisis. Auckland is a case in point: it was always expected to be the fastest-growing region, and its population growth over the last ten years hasn't greatly exceeded forecasts.

The offsetting factors of larger operating surpluses, but higher capital spending, mean that the impact on the Government's borrowing requirement is unclear. Indeed, we wouldn't be surprised if bond issuance over the next four years is left more or less unchanged, to support the liquidity of the government bond market.

The economic forecasts that underpin the fiscal accounts are likely to be similar in tone to those in the December Half-Year Update. Lower than expected growth over the second half of 2016 will mean a softer starting point for the forecasts of real GDP growth over the near term. However, nominal GDP is likely to be upgraded, thanks to the strong rebound in export prices over the last year. Higher nominal GDP also helps to lower the net debt to GDP ratio.

Cumulative inflation over the next few years is shaping up to be similar to the December projections, albeit a bit higher this year and a bit lower in 2018. Whether the Treasury shares the Reserve Bank's (and our) caution about the timing and extent of OCR hikes will be a point of interest. But long-term interest rates matter more for the fiscal position, and these are more subject to international trends than domestic ones.

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