New Zealand Government Budget 2017

25 May 2017

Having your cake and eating it too

- The 2017 Budget increases spending in a range of areas, including public and social services, as well as much-needed infrastructure investment.
- The Government has introduced a Family Incomes Package to support those on lower and middle incomes. This includes an adjustment to tax thresholds, an increase in Working for Families, as well as increases in accommodation support.
- Firm economic conditions mean that the Government can make these changes while maintaining its focus on longer-term debt reduction and improving the economy's financial resilience.
- The initiatives announced today are likely to support GDP growth over the coming years. However, we see a risk that economic growth, and therefore surpluses, may not be as healthy as the Government expects over the course of the next five years.

New Zealand's solid economic performance has left the Government in a favourable position. The 2017 Budget was able to provide for more spending, more money in people's pockets, and still project growing surpluses and falling net debt over the coming years. This was a more generous offering than last year's Budget, which actually cut back the future allowances for operating and capital spending even as the country's population – and the subsequent need for housing, infrastructure and public services – surged well ahead of forecasts.

The major policy initiatives in Budget 2017 were announced in advance or were well anticipated. Changes to the income tax thresholds, and increases in Working for Families payments, superannuation payments and the accommodation supplement will leave more money in people's pockets. Meanwhile, the allowances for operating spending have been raised again, with the lion's share going to core services such as health, education and law and order. And the allowance for infrastructure spending has been raised significantly.

There's a very optimistic view of the economy underpinning the fiscal forecasts. The Treasury expects average GDP growth of 3.1% a year over the next five years. That would actually be a faster pace than the previous five years, when the economy was rebounding from the financial crisis. As we've noted before, it would be highly unusual for growth to accelerate at this advanced stage of the cycle.

That may or may not prove to be a serious challenge to the fiscal projections. It's notoriously difficult to draw the link from GDP to tax revenue and spending requirements. Indeed, the story of the last year has been one of much stronger than expected tax revenue despite lower than expected GDP growth. So for now we'll note this as a risk that the next two (non-election year) Budgets could prove to be a bit more austere if growth doesn't live up to the Treasury's lofty expectations.

Fiscal projections

The Government's books are in good shape. Firm economic activity and a focus on cost control has seen the operating balance steadily improving since 2011, with surpluses in each of the past two years. This positive trend has continued into the current fiscal year. In fact, the Treasury has upgraded the projected surplus for FY2017 to $1.6b, compared to a $0.5b surplus in the Half-Year Economic and Fiscal Update (HYEFU) in December.

The surplus is expected to continue growing over the next few years, but at a more gradual pace than previously assumed. The Government is now forecasting an operating surplus of $7.2b in 2021, down from the $8.5b that was forecast in the HYEFU.

A key reason for the more gradual improvement in the operating surplus over the coming years is that Budget 2017 has introduced a Family Incomes Package (described below) that includes adjustments to income tax thresholds. While this is assumed to boost activity and spending (which will support growth in tax revenue), the reduction in income tax pulls down core Crown tax revenues by $6.3b over the forecast period.

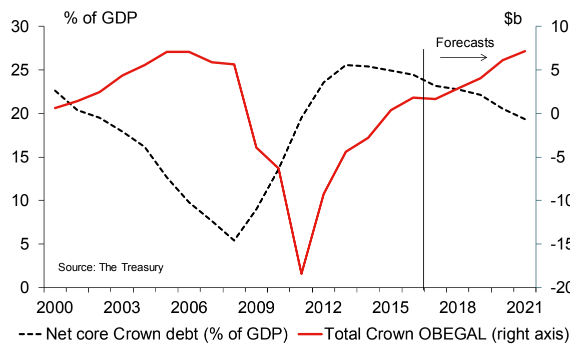
Core Crown expenses are also expected to grow more rapidly than previously assumed. Budget 2017 allows for around $1.8b of new operating spending expenditure in each of the next four years (up from $1.5b as previously forecast). On top of this, allowances for new spending in future years have also been increased. This will see core Crown spending rising to 28.8% of GDP in FY2017, before easing back to 27.5% of GDP in FY2021.

Despite the increase in spending, firm economic conditions mean that the Government continues to forecast a decline in debt levels. As a share of nominal GDP, core Crown debt is still forecast to fall below 20% in FY2021, though by slightly less than previously assumed. As already announced, the Government is aiming to reduce net debt to 10-15% of GDP by 2025.

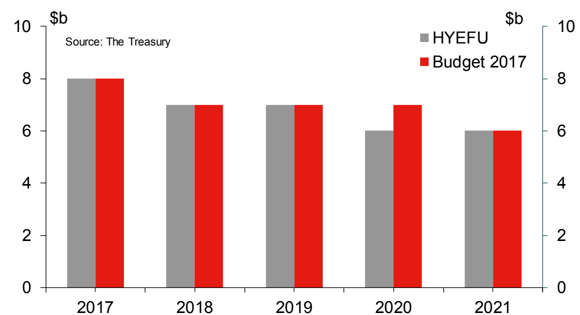
Policy initiatives

The 2017 Budget aims to deliver increased investment in public services and infrastructure, as well as a boost to household incomes (particularly those on lower to middle incomes). Its key initiatives include direct support for family incomes, increased spending on infrastructure and social

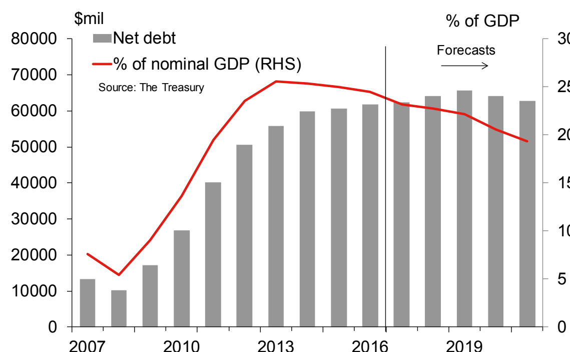
Operating balance (excluding gains and losses)



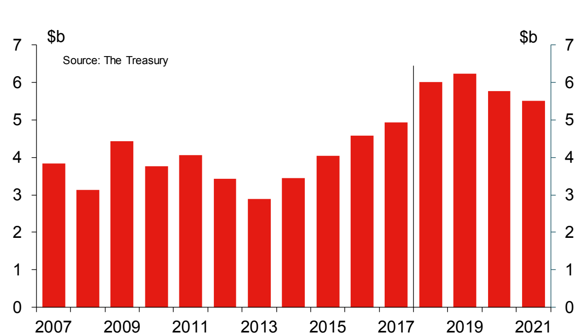
Bond issuance forecasts, Budget vs HYEFU



Net core Crown debt to GDP



Net capital spending (June years)



services, and measures aimed at building the economy's financial resilience.

Family Incomes package

The big policy announcement in Budget 2017 was the introduction of a $2b Family Income Package targeting those on low to middle incomes. This package comes into effect from 1 April 2018. It has four key parts:

1. Income tax thresholds are being increased. The current $14,000 threshold will be increased to $22,000, and the current $48,000 threshold will increase to $52,000. In terms of cash in hand, those earning more than $22,000 will now get an extra $11 per week, rising to $20 per week for those earning more than $52,000.
2. The Independent Tax Earners credit of up to $10 per week is being removed. This was available to those on lower incomes without families. But its removal will be offset by the change in tax thresholds.
3. Working for Families payments for those with children under 16 will be increased to the same level as those with older children. This will affect around 310,000 families.
4. Accommodation supplements will be increased for families and students. These limits have not been updated since 2005, and the change will benefit around 136,000 lower income households.

In addition to the policy changes themselves, there will be flow-on effects for superannuitants due to the link between after-tax wages and NZ Superannuation. The couples rate for superannuitants will increase by $13/week from 1 April.

Other initiatives

In addition to the Family Incomes package, Budget 2017 makes allowances for increased spending in four key areas.

- Public services: $7b including spending on health services, education, law and order, and social services.
- Infrastructure: Around $4b of spending is planned. This includes spending on roading in Kaikoura, rail networks, and schools.
- Business growth agenda: $1b. This includes $373 million as part of the Innovative NZ program, as well as spending to support increased trade, the tourism sector, and the film industry.
- Social investment: $321m – social spending to support those in need including mental health support and support for vulnerable children.

One of the Government's key aims in recent years has been to build the economy's financial resilience to adverse economic events (like the financial crisis in 2008/09) and natural disasters such as earthquakes. The main way it has tried to do that is through a gradual reduction in Government debt, and this is set to continue for the foreseeable future. In addition, the Government today announced that from 1 November this year, EQC premiums for homeowners will increase from 15c to 20c per $100 of cover. These additional funds will be used to replenish the National Disaster Fund. This change will see homeowners' EQC premiums increasing by $69 per year.

Capital spending and infrastructure

One of the Government's key priorities is investing in infrastructure, and they've announced $11b in new capital spending over Budgets 2017 to 2020 on top of existing plans. This includes $4b of new spending in Budget 2017. 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 catchup 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 lion's share of the new infrastructure spending introduced in Budget 2017 of this relates to transport infrastructure (around $1.8b). This includes the reinstatement of State Highway One near Kaikoura, other work on state highways, as well as rail infrastructure in Auckland, Wellington and elsewhere.

Other large areas of spending include prison capacity ($763m), defence ($576m), schools and classrooms ($392m), and health facilities ($150m).

Economic implications

The 2017 Budget is generally more stimulatory than last year's effort. Much of this stimulus was well signalled, and is already incorporated into the forecasts behind our recently-released Economic Overview. The $2b increase in the capital spending allowance was announced earlier this month, and the Government has long been signalling some form of reduction in personal income taxes.

Some of the announced increases in spending, particularly around infrastructure, are simply necessary for the economy's continued functioning. Five years ago, investing in infrastructure may not have seemed a high priority – the Budget was deep in deficit, net migration had turned negative, and Christchurch was reeling from two major earthquakes. But things have changed dramatically since then. Strong net migration has pushed population growth well above forecasts over the last few years, and a significant catch-up spend on infrastructure is now required.

The pickup in government spending comes at a useful time, when we expect some private sector sources of growth to be waning (as detailed in the Economic Forecasts section). For that reason, we don't think that this Budget will put significant upward pressure on inflation or interest rates.

Policy announcements in a nutshell

Policy	Value over 4 years to June 2021	Capital	Comment
Spending initiatives	$m		
Business Growth Agenda	1,001	56	$373m for the Innovative NZ program including funding for science and innovation, economic development and training. Also spending on fisheries management systems, biosecurity and climate change work.
Investing in Public	5,444	82	Increased spending on health services ($3.9b), education ($1.1b), and justice (1.2b). There is also increased spending on social development, social housing and services for vulnerable children.
Infrastructure for a Growing Economy	154	3,782	$4b of spending was announced in the 2017 Budget, with significant additional increases planned in future Budgets. Key areas of spending in Budget 2017 include state highways around Kaikoura ($812m), rail infrastructure ($984m), as well as spending on schools/class rooms ($392m), health assets ($150m), prisons ($763m) and defence ($576m).
Māori Development	93	–	Includes support for Whanau Ora ($10m), Māori Language initiatives ($21m), and spending to support tourism activity ($10m).
Other	566	277	Spending in a range of areas including investment by RNZ ($11m), heritages and conservation projects.
Contingencies	412	93	–
Revenue and Savings	–576	–312	Various measures.
Budget 2017 Net Package	7,093	3,977	
Care and Support Workers Pay Equity Settlement	1,541	–	Funding boost for care and support workers.
Total	8,634	3,977	

Budget 2017 family incomes package

$m	2017/18	2018/19	2019/20	2020/21
Tax Reductions	486	1,896	1,895	1,976
Working for Families	97	373	318	310
Accommodation Supplement	87.6	361.6	380.3	399.7
Accommodation Benefit	6.3	19.5	19.5	19.8
Transitional Fund*	1.1	0.5	0.4	0.3
Consequential Impacts (Flow on to superannuitants)	(74.3)	(575.2)	(760.9)	(693.7)
Total	603.6	2,075.3	1,852.3	2,012.0

* This is a payment to those who may be adversely affected by the other policy changes.

Economic Forecasts: The Treasury and Westpac

The Treasury's economic growth forecasts are substantially stronger than in last year's Budget, driven by population growth, investment, consumption and exports. The Treasury expects real GDP growth to average 3.1% over the next five years, peaking at 3.8% in the June 2019 year. The pace of growth slows in the outer years as net migration falls back towards its long-run trend.

Nominal GDP, cumulatively over the next five years, is forecast to be $23.9b higher compared to the December HYEFU, driving a significant increase in the tax revenue forecasts.

Interestingly, the Treasury appears to regard this pace of growth as being close to the economy's potential. The projected output gap remains near zero, and inflation settles close to the Reserve Bank's 2% target midpoint, over the next four years.

In contrast, we expect real GDP growth to average 2.6% over the next five years. We see two key points of difference in the forecasts. The first is residential investment: the Treasury is forecasting nationwide growth of almost 9% in each of the 2019 and 2020 years, at a time when the Christchurch quake rebuild will be winding down. The need to build more homes in the rest of the country, particularly in Auckland, no doubt underpins this forecast. But we are more sceptical about the industry's ability to ramp up activity to those levels.

The other factor is that we think the current slowdown in the housing market will 'stick' this time, as mortgage rates rise further from their lows. In contrast, the Treasury expects house price inflation to re-accelerate to 7.8% over the next year. In our view, a sustained housing slowdown will undercut households' willingness to spend over the next few years.

That said, we're not forecasting a marked slowdown in spending growth, as there are still some positive factors on the horizon such as the tax cuts and a rebound in incomes in the more dairy-intensive regions. But with household consumption making up about 60% of GDP, even a modest difference in growth forecasts has meaningful implications for the wider economy.

Economic Forecasts: The Treasury and Westpac

	Actual	Treasury					Westpac				
March years	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2017**	**2018**	**2019**	**2020**	**2021**
Real GDP growth*	2.4	3.1	3.5	3.8	2.9	2.4	2.8	3.1	3.0	2.0	2.1
Annual CPI inflation	0.4	1.8	1.6	2.1	2.2	2.1	1.9	1.6	2.2	2.2	2.2
Unemployment rate**	5.0	5.0	5.0	4.6	4.3	4.3	5.0	4.8	4.9	5.1	5.3
Nominal GDP growth*	4.2	6.2	4.8	5.4	5.0	4.2	6.1	3.7	4.6	3.9	3.7
90-day interest rate***	2.4	2.0	2.0	2.7	3.4	3.9	2.0	2.0	2.5	2.5	2.9
TWI exchange rate***	73.6	76.1	76.6	76.9	76.7	74.7	75.2	75.8	74.1	72.9	72.4

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

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