12 May 2011

Westpac Institutional Bank

Budget 2011: Zero hour

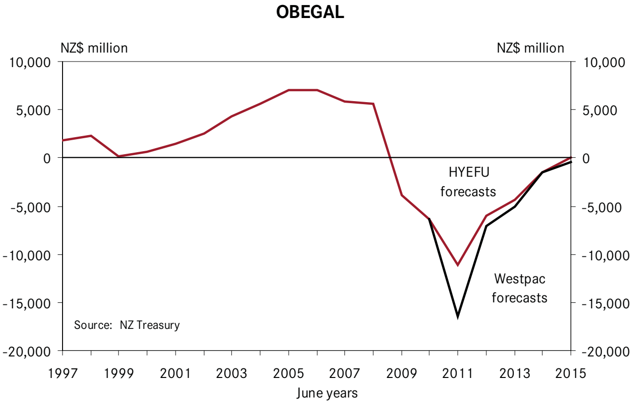
Budget 2011 Preview (19 May, 2.00pm NZT)

- **The Government's 2011 Budget will be released on Thursday 19 May.**
- **Unlike last year's tax reform-minded Budget, the focus this year will be back to cost control.**
- **A weaker than expected starting point for the economy, and the massive expense associated with the recovery and rebuild of Christchurch after two major earthquakes, will see the operating balance blow out to a record $16bn this year.**
- **The most significant policy change will be a zero net increase in operational spending allowances for next year. New spending plans will have to be funded through cuts elsewhere.**
- **The earthquake-related hit to the accounts will be heavily front-loaded, and will only slightly delay the projected return to surplus.**
- **The Government's borrowing requirement and net debt ratio will be higher than projected in the 2010 Half Year Update, but should be sufficiently conservative to satisfy the credit rating agencies.**

Next Thursday, Finance Minister Bill English will release the National Government's third Budget. Unlike last year, where an improving economy gave the Government a platform for a major reworking of the tax system, this year circumstances dictate a sharp focus on cost control, more along the lines of what we saw in the 2009 Budget.

In terms of the changes that have already been flagged, the most significant is expected to be a 'zero budget' for the next fiscal year ending June 2012. That is, there will be no net increase in the operational spending allowance; any new spending plans will have to be offset by cuts elsewhere. That compares to a $1.1bn allowance for new spending in each of the last two Budgets, and around $2bn per year in the previous government's last term.

Achieving a zero net increase is even more difficult than it may sound – operating costs naturally rise from year to year, due to wage increases and general inflation. A freeze on spending in nominal terms translates to outright cuts in real terms. This is one reason why we assume that the freeze will only be applied to the next year (the Government hasn't been clear on this matter). It's worth remembering that even a one-off pause in the rate of growth will help to reduce deficit projections in later years as well.



Source: NZ Treasury

It appears that the frugality of this year's Budget will be sold on two grounds: making some of the late-era Labour Government initiatives more affordable over the economic cycle, and finding money to pay for the recovery of Christchurch after two devastating earthquakes. These are both valid, but they gloss over the more compelling reason for getting the fiscal books in order. In the longer term, the government's spending commitments will grow immensely as the population gets older and lives longer. To tackle these issues, the nation's accounts will need to come from a stronger starting point than where they currently stand.

Policy changes

Changes to some of the previous Government's flagship programmes, to make them more affordable over the course of the business cycle, have received the most attention:

Working For Families: The Government has said that intends to gradually reduce WFF transfers over the next decade, in particular for those families at the higher end of the eligible income range, while reassuring that most families will see the level of their WFF payments rise during the transition period.

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Budget Economic and Fiscal Update – May 2011

	Actual	Westpac Budget estimates					Treasury's HYEFU forecasts				
	2010	2011	2012	2013	2014	2015	2011	2012	2013	2014	2015
Real GDP – ann ave % chg	2.0	5.2	7.0	5.2	4.9	4.5	6.8	5.4	5.6	5.3	4.6
CPI – ann % chg	4.0	3.0	2.5	2.5	2.4	2.3	2.6	2.4	2.6	2.3	2.3
Unemployment – %	6.6	6.6	6.2	5.0	4.5	4.2	6.4	5.6	5.1	4.6	4.6
OBEGAL $bn	–6.3	–16.5	–7.1	–5.1	–1.6	–0.4	–11.1	–6.0	–4.4	–1.5	0.0
Net debt – % GDP	14.1	22.9	27.0	30.1	31.4	32.1	20.8	24.2	26.5	27.8	28.5
Bond programme $bn	12.5	20.0	13.5	13.0	9.5	10.0	13.5	13.5	13.0	9.5	10.0

That combination suggests some reduction in the inflation-indexing of payments, which might be done through gradually lowering the income level at which abatements set in (the level was already frozen in last year's Budget, a major cost saving that largely went unnoticed). Increasing the abatement rate itself is less desirable, as the effective marginal tax rates faced by some families are already dispiritingly high.

Kiwisaver: Nearly half of the $8bn in Kiwisaver accounts has come from government contributions, representing a transfer within the economy rather than an increase in national savings. The Government has said that it will look to maintain total contributions, but to shift the balance more towards individuals and employers. That could involve reducing the Members Tax Credit of up to $20 per week (or perhaps limiting eligibility), and increasing the minimum contribution rate of 2%.

Student loans: Loans will remain interest-free but there will be further steps to tighten eligibility (such as for over-55s and those training for pilot licences). The Government is also looking at ways to increase loan recovery rates, particularly for those working overseas who are responsible for more than half of overdue repayments.

Regardless of the merit of these changes, they will not produce the cost savings needed to achieve a 'zero Budget' in the June 2012 fiscal year. The Government has said that it will campaign on these changes in the 26 November election, so they are unlikely to be implemented before next April. The WFF changes will be phased in over the best part of a decade, and the Kiwisaver changes will only be applied once the economy is well down the road to recovery, and workers and employers are better able to afford it.

Instead, next year's savings will come through a combination of spending cuts and reallocation across a range of departments, and a (relative) lack of new spending initiatives. Increases in health and education spending have been prioritised (as always) and it's not yet clear what will be sacrificed to provide for these.

Economic and fiscal forecasts

One of the side effects of the Christchurch earthquake is that it leaves little room for disagreement about the profile of economic growth over the next couple of years. The blow to activity in our second-largest city, combined with the wobbly pace of recovery to date, points to only modest GDP growth in 2011. Treasury has said that it expects 1% real growth this year, though this is on the low side of market forecasts, and recent indicators suggest a bit more momentum than this.

Next year is a different story. As reconstruction activity in Christchurch gets into full swing (and admittedly the timing of this is not certain), GDP will accelerate sharply and is likely to remain at elevated levels for at least a few years. We expect nominal GDP growth to reach over 7% next year, which would be a substantial boon to tax revenues.

The deterioration in the fiscal accounts, relative to December's Half Year Economic and Fiscal Update (HYEFU), will be heavily front-loaded. The Government has indicated that the operating deficit will reach around $16bn for the year to June 2011, compared to the $11.1bn forecast in the HYEFU. Much of that increase reflects the immediate costs of dealing with the earthquake: temporary welfare payments, search and rescue, demolition, repairs to infrastructure, temporary housing, ACC and so on. The Government is incurring these costs now and is not looking for offsetting cost cuts at this point, so they will contribute to the increase in the bond programme this year. The EQC's combined excess of $3bn for the two quakes will contribute to the operating deficit for this year, but not the bond programme.

Over the next few years, the impact of the quake on tax revenue and spending will be offset by a mix of cuts to spending plans (relative to last year's Budget) and an increase in debt. The most recent indications from the Government are that revenue will be slightly less than $3bn below the HYEFU projections, due to the quake impact and a weaker starting point for the economy than was thought in December. Expenses will rise by $5.5bn, with about $3bn going towards the above-mentioned costs and $2.5bn to cover for uncertainty and decisions that have yet to be made, such as around land remediation.

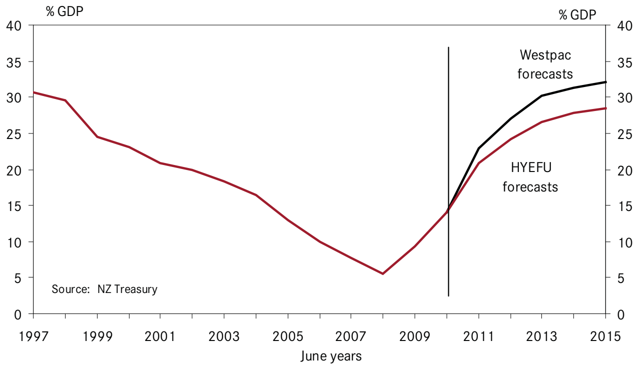
The Government initially hoped that the earthquake would not prevent a return to operating surpluses by the 2014/15 fiscal year, but has since indicated that this is likely to be delayed by a year. This is probably less serious than it sounds, since the HYEFU projected a surplus of just $39m in 2014/15, barely more than a rounding error. Higher interest costs as a result of the extra debt issuance would account for a slower return to surplus.

Bond programme

The Debt Management Office (DMO) has already announced a series of increases for this year's bond tender programme, which is now at $20bn compared to $13.5bn in the HYEFU. Some of the increase reflects pre-funding of future deficits, which is reasonable given that much of the required capital spending in coming years is already identifiable (reconstruction in Christchurch), and that borrowing conditions are quite favourable at the moment.

We have assumed that net government debt will peak at around 32% of GDP by 2015, compared to 28.5% in the HYEFU. The Government has expressed a desire to keep the net debt ratio below 30%, but the higher deficit for this year alone would make that a tough call, without some cuts to the bond programme in later years.

Core Crown net debt



Source: NZ Treasury

Market implications

This year's Budget has something else in common with 2009: it will be closely watched by the credit rating agencies, especially Standard & Poor's which has placed New Zealand's AA+ sovereign rating on a negative outlook. We think the risk of a downgrade in the near future is low; by now the Finance Minister will be well-versed in what it takes to satisfy the rating agencies!

We'd also point out that, by S&P's own standards, the rating shouldn't be determined by the Budget anyway. Firstly, a rating 'outlook' is not meant to imply an immediate decision, but a consideration how things evolve over the next few years. Secondly, S&P's concern is not with Government debt as such; even when the outlook change was announced last November, the fiscal position was described as "a key credit strength for New Zealand". Rather, its concern is with the high level of overseas debt accumulated by the private sector, which could become the government's problem in a crisis. On that note, a move towards greater individual and employer contributions to Kiwisaver will be welcomed.

Aside from the issue of whether the credit rating can be maintained, there is unlikely to be much in this Budget to attract the market's attention – it will certainly be lacking the generous spending plans or high-profile policy initiatives that are usually found in an election-year Budget. We will be looking for more details on: the size and duration of quake-related costs, how long the spending freeze will apply, and any increases in the bond tender programme for coming years.

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