24 May 2012

Westpac Institutional Bank

The Key to paying the Bill?

New Zealand Government Budget 2012

- **A conservative Budget, as befits the uncertain economic environment.**
- **The Treasury is still forecasting a return to surplus by 2015, but we suspect more belt-tightening will be required to meet that goal.**
- **The spending and revenue changes amounted to tinkering. We'd like to see a more comprehensive plan for dealing with the fiscal time-bomb of population aging.**

Overview

The 2012 Budget stuck literally to the 'zero Budget' concept, with $4.4bn of new spending over the next four years offset by $3bn of cost savings and $1.4bn of new sources of revenue. Aside from shuffling around of the timing of some spending, forecasts of the Government's balances are similar to last year's Pre-Election Economic and Fiscal Update (PREFU). The Treasury still projects a return to surplus by June 2015 – just. The projected surplus in that year is $197m, or 0.1% of GDP.

The deficit for the current year was revised down to $8.4bn, from $10.8bn in the PREFU. This is mostly due to delayed spending – including over $1bn of earthquake-related spending that is yet to be allocated – which has been shunted into next year's deficit of $7.8bn. Smoothing the deficit a bit implies a slightly softer blow for the economy from government belt tightening, at least over the next couple of years.

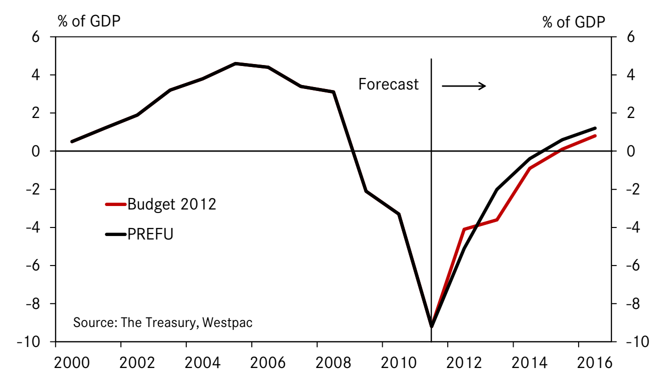
The economic forecasts underpinning the Budget are similar to ours overall, but with a stronger lift in household spending and construction as a result of the Canterbury rebuild. The rebuild, combined with rising inflation, is expected to deliver a much higher GST take, helping to ensure a return to surplus by 2015. Our view is that there are substantial downside risks to the tax revenue forecasts, and with almost no wiggle room on the 2014/15 surplus, there's a high risk that the Government will find itself having to choose between a later return to surplus or more belt-tightening measures before long.

Is this the right time to limit spending?

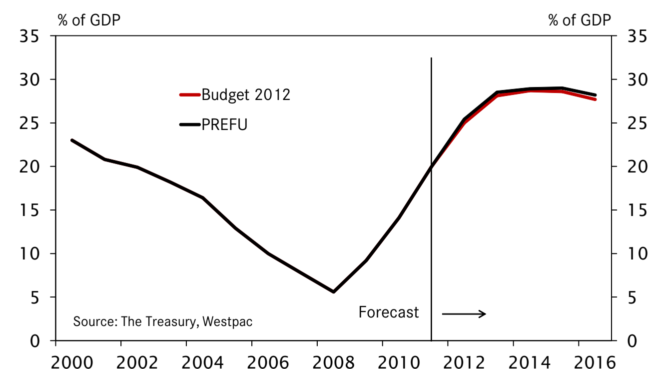
For the last four years, the Government has faced competing demands to get the books in order, keep international lenders onside, soften the impact of a fragile world economy, shift the mix of economic growth, and improve the economy's long-term growth prospects. The conservative approach of today's Budget, and indeed the last four Budgets, has done a reasonable job of addressing the first two of those issues, though it has perhaps come at the cost of a more passive approach towards longer-term issues.

A key aspect of the Government's approach has been to show that there is a plan to get the books in order, by committing to return to an operating surplus in the 2014/15 year, and to keep net debt below 30% of GDP. However, a strong public commitment to those targets has meant less wiggle room to deal with downside surprises to economic growth and tax revenue, and indeed today's Budget stretches that to the limit

Operating balance (excluding gains and losses)



Core Crown net debt



– a 2014/15 surplus of less than 0.1% of GDP is real margin-of-error stuff. What's more, that surplus relies on some strong growth forecasts for household spending and construction, in large part due to the Christchurch rebuild, in order to boost the tax take. We're not convinced that the economy actually has the capacity to meet these forecast growth rates – at least, not without creating a great deal of inflation and prompting the Reserve Bank to lift interest rates.

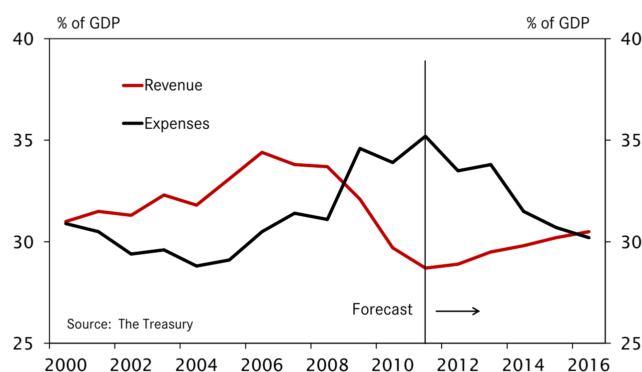
Committing to a return to surplus has also meant steering clear of the temptation to provide some short-term stimulus to the economy, which we think is appropriate in New Zealand's circumstances – slow growth to date does not in itself make a case for more debt-fuelled spending. Bear in mind that the upcoming Canterbury rebuild (to which the Government is contributing $13bn) amounts to a huge stimulus for the economy. Ramping up government spending at the same time as attempting to rebuild Christchurch would drive interest rates higher, possibly increasing the exchange rate and hurting the export sector.

While the near-term impact on the economy has been carefully considered, efforts towards improving the economy's long-term growth prospects have been more limited and mostly passive. The last four Budgets have seen a number of changes around the margins to the incentive to save, the generosity of welfare, and efficiencies in providing public services, which will certainly add up over time. And there are some instances of 'spending money to make money' in this year's Budget, such as providing more support to help people off welfare, and more resources to crack down on tax compliance (past efforts here have paid for themselves several times over).

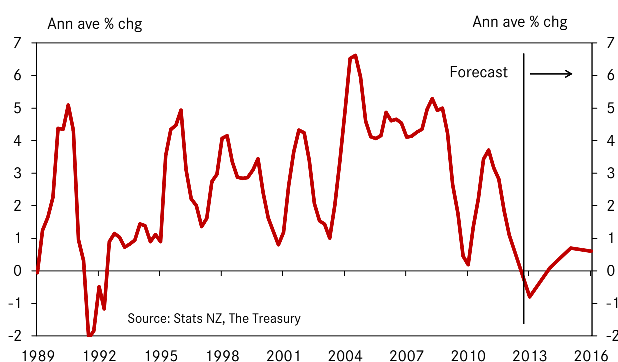
But the desire to appear conservative and sensible in the near term has meant a reluctance to explore more ambitious measures that may have large up-front costs and uncertain payoffs. That means we're left with a system that still has a deeply unrealistic approach to retirement income, a narrowly-based tax system that favours land ownership over financial assets, and no consistent philosophy about the public provision and funding of services.

The proposed changes to the Public Finance Act are a step towards ensuring sustainable fiscal policy in the future, but they risk embedding this passive approach to long-term issues. One of the proposals is to limit growth in core government spending (excluding some items that are largely beyond the government's control) to no more than the rate of inflation and population growth. In a growing economy, that would see government spending make up an ever-decreasing share of GDP. However, as a country gets richer it tends to demand more services. The proposed spending rule imposes an arbitrary cap on the total amount of those services that the government can provide; what really needs to be addressed is which services that the public sector is best-suited to providing.

Core Crown revenue and expenses



Growth in government spending



Policy announcements in a nutshell

The theme of today's Budget was well signalled in advance with many of the spending and savings initiatives detailed in the table below having already made their way into the public arena prior to today's release. Finance Minister Bill English labelled it a "zero" Budget. Yet this doesn't mean that government spending won't increase at all over the next few years. Rather, already allocated spending will continue to climb reflecting factors such as increasing labour costs, a growing superannuation bill and general inflation pressure which push up the nominal cost of running departments. Instead, what the zero budget tag refers to is the fact that there were no new spending initiatives announced today which weren't compensated for by either increased revenue (via tax changes) or savings elsewhere. New spending worth $4.4bn was almost exactly matched by spending cuts and increased revenue expectations elsewhere.

The focus of today's Budget was on health, education, welfare and science and innovation. Science and innovation in particular was a clear beneficiary. While there were no tax changes aimed at incentivising R&D spending by the private sector, there were a number of direct spending initiatives targeted at the sector. Another focus of government policy of late has been reform of the welfare system. While the reforms are intended to eventually lift the number of people joining the workforce, they do come at a significant initial cost. And while there may be considerable uncertainty about the eventual outcomes (and cost savings) generated by the policy, there is considerably less uncertainty about the upfront costs of the initiatives.

Policy	Cost/ Savings next year	Cost/ Savings to June 2016	Comment
SPENDING MEASURES	$m	$m	
Health	$381.8	$1,457.1	More elective operations, upgrade of IT systems, improved services for cancer patients and rheumatic fever prevention. There was also a focus on disability spending including more home and community support services, increased funding for specialist equipment and residential support services.
Education	$125.1	$512.3	Spending on teacher training and recruitment. Support for early childhood education and an increase to school operations grants.
Social Development (including welfare reform)	$82.2	$334.0	Additional spending on early childhood care and childcare assistance for vulnerable people, youth support services, and more staff to support jobseekers and sole parents into work.
Tertiary Education	$25.0	$240.3	More funding for engineering and science degrees, higher rates for private tertiary education providers.
Science and Innovation	$34.4	$169.9	Increased funding for the Performance-Based Research Fund (targeted at research in the tertiary education sector). Funding targeted at providing solutions to questions of national significance e.g. how to reduce greenhouse gas emissions from agriculture. An Advanced Technology Institute is to be created, paid for by partial sales of SOE's.
Housing	$48.6	$127.7	Increased funding to the Social Housing Unit (established last year to facilitate partnerships for the provision of social housing with non-government providers).
Canterbury Earthquake Recovery Authority	$35.6	$114.9	Additional funding to oversee Canterbury rebuild.
Other	$369.4	$1461.3	Includes spending for new contingencies.
TOTAL NEW FUNDING	**$1,102.0**	**$4,417.3**	
SAVINGS			
Increased Revenue	$177.3	$1361.7	Limits on tax deductions available to holiday home and boat owners. Removal of some existing tax credits. Confirmation of the changes to livestock valuation rules. Further increases in tobacco taxes which are set to rise 10% plus inflation each year for the next 4 years.
Tertiary Education	$66.4	$516.6	Increase in minimum repayment rate for student loans. Voluntary repayment bonuses cancelled. Access to student allowances restricted to the first 4 years of study and parental income threshold for eligibility frozen.
Welfare Benefit Savings	$14.3	$135.5	Savings to come from more people joining the workforce in either a part time or full time capacity.
Housing	$20.5	$123.1	Operating savings in Housing New Zealand Corporation, restrictions to housing subsidy schemes.
Other	$478.2	$2,253.9	Cancellation of planned auto-enrolment into Kiwisaver. Prescription fees are to increase from $3 an item to $5 an item from 2013. An increase in student-teacher ratios in years 2-10.
TOTAL NEW FUNDING	**$756.8**	**$4,390.8**	

Economic Forecasts: The Treasury and Westpac

Since last October's PREFU and January's Budget Policy Statement the Treasury has lowered its economic growth forecasts further, reflecting the deterioration in the global outlook and a slower forecast Canterbury rebuild. As such the Treasury's growth forecasts are similar to our latest forecasts, or perhaps slightly more optimistic in 2015 and 2016. Where Westpac and the Treasury differ is on the mix of growth - and that has implications for the likely tax take.

Even with its latest revisions, the Treasury continues to expect residential construction activity to ramp up at a very rapid clip in the next few years, accelerating to a whopping 40% by the 2014 March year. We're not so optimistic about New Zealand's capacity to accommodate such a huge surge in construction activity. We expect the rebuild to be slower, and to provoke more inflation pressure. The Treasury seems to assume that the inflation pressures stemming from its forecast construction boom would necessitate only a modest increase in interest rates: its inflation forecasts are lower than ours in 2015-2016, despite the assumption that the RBNZ will keep interest rates below 5%. Low interest rates in turn keep consumer spending growing faster for longer: the Treasury's forecasts are for consumer spending to grow above 2.5% in 2015 and 2016, whereas we expect it to slow below 2% by 2015.

Offsetting this strong growth in domestic demand, the Treasury expects exports to grow at a very subdued pace over the next few years. At first glance that seems a little puzzling, given that the Treasury's forecasts for global growth are less pessimistic than ours. While the Treasury expects recession in Europe, it continues to expect growth above 8% in China this year, and overall trading partner growth to remain close to historical averages. By contrast, Westpac expects slower growth in China and a sharper fall in commodity prices (we view the latter as temporary - both the Treasury and Westpac are optimistic on the long-run outlook for export commodity prices).

The logic behind the Treasury's forecasts is that that the construction boom over the coming years will come at the expense of exporters and import-competing producers, through its impact on the exchange rate: a high NZ dollar is expected to boost spending on imports, and keep export growth low, despite a relatively benign global outlook. Presumably the high exchange rate is expected to help keep inflation low as well. By contrast, Westpac expects rising construction to come at the expense of other parts of the domestic economy, particularly household spending, as interest rates rise.

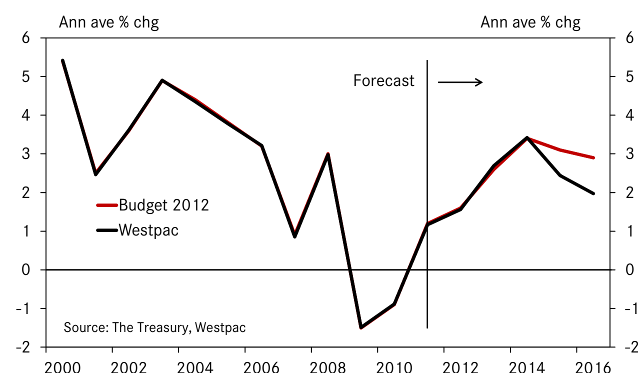
Unlike the October PREFU, the Budget document contains an upside as well as a downside scenario. The upside scenario features an even faster Canterbury rebuild, stronger household spending and stronger migration, while the downside scenario features weaker world growth and a sharper fall in commodity prices. The Treasury notes that the negative impact on its books from a weaker world would be a lot more severe than the boost from the upside scenario. If the upside scenario came to pass, the Government would not change its behaviour. But if the downside scenario eventuated, more belt-tightening would be required. This is yet one more illustration of our central point – the risks lie in the direction of more austerity in coming years, not less.

Economic forecasts: The Treasury and Westpac

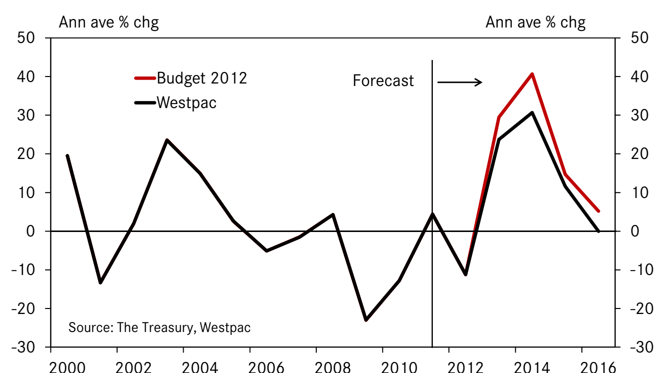
	Actual	Treasury					Westpac				
March years	2011	2012	2013	2014	2015	2016	2012	2013	2014	2015	2016
Real GDP growth*	**1.2**	**1.6**	**2.6**	**3.4**	**3.1**	**2.9**	**1.6**	**2.7**	**3.4**	**2.4**	**2.0**
Annual CPI inflation	**4.5**	**1.6**	**2.6**	**2.5**	**2.4**	**2.4**	**1.6**	**2.2**	**2.5**	**2.5**	**2.6**
Unemployment rate**	**6.6**	**6.3**	**5.7**	**5.2**	**5**	**4.7**	**6.7**	**5.9**	**5.0**	**5.0**	**5.0**
Nominal GDP growth*	5.9	4.2	4.1	6.5	5.4	4.9	4.2	4.7	6.0	4.7	4.2
90-day interest rate***	3	2.7	2.9	3.6	4.1	4.4	2.7	3.0	4.0	5.3	6.2
TWI exchange rate***	67.2	72.5	72	70.8	67.5	63	72.5	73.4	72.6	71.2	69.7

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

GDP Growth



Residential construction growth



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