A Balancing Act
Budget 2018 Preview

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- Finance Minister Grant Robertson delivers the new Government’s first Budget next week.
- The policy direction has already been set by the HYEFU. Budget 2018 will maintain the focus on health, education and public service spending.
- Capital spending is expected to be broadly in line with HYEFU projections. However, the better than expected tax take and reallocated spending mean there is some extra money to play with.
- The Government remains wedded to its Budget Responsibility rules. We expect the Budget to project increasing operating surpluses, with core crown debt to GDP forecast to be less than 20% by 2021/22.

The rubber hits the road for the new Government next week with the release of their first Budget. The path was laid out last year with the release of the Half Year Fiscal Update (HYEFU) just before Christmas. Necessarily, this was something of a rushed affair, with the Treasury noting upfront that it was difficult to fully map out the economic and fiscal impacts of the new policies given the relatively short time since the Government was formed. Most of the detail provided was around the Government’s ‘100-day plan’ commitments, while other policies that were detailed in the coalition agreement were generally assumed to be funded out of the existing spending allowances. But even allowing for this, the HYEFU included an additional $8.4bn of operational spending over the next four years compared to the previous Government’s plan.

Fast-forward six months, and the analysis and processes behind the Budget will have gone through a much more rigorous process. So too will have the negotiation processes both between Ministers and their Departments, and also between the political parties in power: Labour, NZ First and the Greens. Stationed firmly at the pointy end of this process is Finance Minister Grant Robertson, who’s balancing the Government’s reputation for responsible fiscal management against a desire to allow the government to follow through with as many of its pre-election promises as possible.

A strong starting point helps this balancing act. The tax take is running $1.1 billion ahead of forecast in the nine months to March, and the net debt position is 21.4% of GDP versus a forecast of 22.2%. In addition, the Government has managed to reprioritise $700 million of spending over the next 4 years, and they expect tougher enforcement by the IRD to add another $700m to revenue over the next four years.

The Government will see scope for more operating spending while maintaining projected surpluses. Beyond the near term, the Government’s ability to spend will be dictated by the strength of the economy. At the time of the HYEFU, we argued that the Treasury’s GDP growth forecasts looked overly optimistic. Then, growth was forecast to accelerate to 3.6% by 2019, underpinned by firm growth in business investment, ongoing growth in house prices and additional residential construction activity on the back of Kiwibuild initiatives. These are three key sectors where our take on the outlook differs. We expect a lull in business
investment and hiring, modest house price falls in response to new policies targeting the housing market, and subdued growth in total construction activity over the next year or two – despite Kiwibuild starting (since it will mainly crowd out private sector investment in a capacity constrained industry). While the Treasury may not have entirely come around to our way of thinking just yet, there may be some moderation of their forecasts, and the downside risks may get more of a mention.

The 2018 Budget will continue to focus on the Government’s core themes including sustainability, social inclusion, education and healthcare. While it won’t be the fully-fledged Wellbeing Budget that has been slated for 2019, there’s no doubt that there will be some more subtle changes in store as the Government and Treasury begin to head down this path and attempt to broaden the perspective away from just financial implications of policy initiatives.

Spending initiatives announced to date include $100m to tackle homelessness, more than $700m boost to overseas development funding, and $190m extra funding for the Ministry of Foreign Affairs and Trade. There’s also a new R&D tax credit, as well as changes to apply GST to imported goods valued at less than $400.

Despite revenue surprises, the Government still feels constrained, and will probably have to prioritise some of its spending plans. Cheaper GP visits in particular look likely to now be phased in and other policies could meet the same fate.

It remains to be seen what further announcements will be unveiled in the Budget. However, they could include more details around regional spending initiatives, the Green Investment Fund and the flagship Kiwibuild programme.

However, the Finance Minister has made it very clear that these policy initiatives will take place within the bounds of Labour’s Budget Responsibility Rules. The most tangible commitments under these rules are:

- There will be a sustainable operating surplus across the economic cycle,
- The level of core crown debt will fall to 20% of GDP by 2021/22. And,

- The Government will maintain its expenditure to within the recent historical range of spending to GDP ratio.

In a pre-Budget speech, Grant Robertson announced the Government’s capital spending plans over the next 5 years will total $42 billion. That is around $10bn more than the National-led Government was forecasting, but there was no increase over the HYEFU projections. That was surprising given the Government’s rumblings about the state of infrastructure in the health and education sector in particular.

But perhaps the biggest challenge will be lifting investment to the level forecast. The Government is forecasting a near-doubling of capital spending within two years. We seriously doubt they will be able to get that much investment done, given how capacity constrained the construction sector is. Less investment would also mean less debt. Consequently, we have concluded that the Government will easily meet its debt target, but it might be for the wrong reasons.¹

<table>
<thead>
<tr>
<th>June years</th>
<th>Actual</th>
<th>Treasury HYEFU forecasts</th>
<th>Likely direction of changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>OBEGAL $bn</td>
<td>4.1</td>
<td>2.5</td>
<td>Tax take stronger than expected, matched by more spending.</td>
</tr>
<tr>
<td>Net debt (% of GDP)</td>
<td>21.8</td>
<td>21.7</td>
<td>On track to meet 20% of GDP target within five years.</td>
</tr>
<tr>
<td>Bond programme ($bn)</td>
<td>8.0</td>
<td>7.0</td>
<td>No change expected, capex spending unchanged from HYEFU.</td>
</tr>
<tr>
<td>Real GDP (ann avg % change)</td>
<td>2.7</td>
<td>2.9</td>
<td>Forecasts likely to be trimmed due to delays in construction.</td>
</tr>
<tr>
<td>CPI (ann % change)</td>
<td>1.7</td>
<td>2.0</td>
<td>A softer than expected starting point for prices.</td>
</tr>
<tr>
<td>10-year Government bond yield</td>
<td>2.9</td>
<td>3.0</td>
<td>Global long-term rates are heading higher.</td>
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</tbody>
</table>

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