Westpac

Institutional Bank

16 December 2014

Delayed gratification

NZ Half-Year Economic and Fiscal Update 2014

- The Treasury projects a later return to surplus, but with larger surpluses now expected in later years.
- Economic activity is running strong, but lower than expected inflation has put a dent in tax revenue.
- We see further downside risks to inflation compared to the Treasury's forecasts; in that environment, producing a surplus even in 2016 could be challenging.
- The Government has responded by delaying some of its spending plans until the 2017 Budget. Some of that 'spending' is likely to take the form of tax cuts.

Key Treasury forecasts

	2014	2015	2016	2017	2018
Total Crown operating balance (OBEGAL), $m (June years)					
HYEFU	-2,993	-572	565	2,602	3,074
Change since PREFU	-398.0	-869.0	-253.0	751.0	110.0
Net debt, % of GDP (June years)					
HYEFU	25.6	26.5	26.5	25.2	24.0
Change since PREFU	-0.3	-0.3	-0.2	-0.6	-1.0
Government bond issuance programme, $bn (June years)					
HYEFU		8.0	7.0	7.0	7.0
Change since PREFU		0.0	0.0	0.0	0.0
GDP growth, ann avg % (March years)					
HYEFU	3.2	3.5	3.4	2.8	2.3
Change since PREFU	-0.1	-0.3	0.4	0.6	0.2

As was widely expected, the Half-Year Economic and Fiscal Update (HYEFU) indicated that the Government's long-held intention of returning to an operating surplus in the current fiscal year will prove too much of a stretch. That goal has served its purpose in years past by helping to put some discipline around the fiscal accounts, but the exact timing of the return to surplus was never particularly important from an economic point of view.

And the HYEFU makes it clear that this is very much a matter of timing. The economy is in a strong position, but low inflation means that this isn't translating into tax revenue as rapidly as expected. Consequently, the Government has delayed, but not reduced, its planned increases in spending over the next few years – inadvertently reducing the procyclicality that often plagues fiscal policy.

Details

Compared to the Pre-Election Fiscal and Economic Update (PREFU) in August, the Treasury has lowered its forecasts of the operating balance before gains and losses (OBEGAL) for the next two years. The surplus of $297m for the June 2015 year has become a $572m deficit, while the surplus for the June 2016 year has been reduced from $818m to $565m.

It's crucial to note that the softer fiscal forecasts are not the product of a weaker than expected economy. While the Treasury has lowered its near-term GDP growth forecasts, it has actually increased them substantially in later years. Higher net immigration and stronger residential construction (the latter presumably driven by Auckland, as the assumptions around the Christchurch rebuild are unchanged) are expected to boost growth, helping to offset the impact of lower dairy export earnings over the next year.

However, persistently lower than expected inflation has meant that tax revenue in dollar terms has tended to undershoot forecasts, and this undershoot is expected to continue for a while longer. Inflation is now expected to gradually rise back to the Reserve Bank's 2% target midpoint and hold there over the next few years, whereas the PREFU assumed that inflation would reach 2.5% by March 2016.

We'd note that this revenue shortfall tells us just as much about the difficult task of tax forecasting as it does about the state of the economy. For instance, the biggest shortfall has been on the GST take: the PREFU projected a whopping 11% increase over the current fiscal year, whereas in the four months to October it was 'only' up 6.6%yr. In contrast, company tax is up 9% so far this year, well ahead of a modest full-year forecast of 2%.

We think the risks around the Treasury's economic forecasts go even further in the direction of what was revealed today – that is, even stronger growth and even lower inflation in the next couple of years. Oil prices have fallen much further than the Treasury assumed when it finalised its forecasts last month. A sustained fall would mean lower inflation, lower wage demands and lower interest rates than forecast, which all point to lower Government revenue. On the other hand, lower interest rates would boost economic activity and house prices. The net effect would probably be negative for government revenue, and if inflation turns out as low as we're expecting over the next year, even on the surplus forecast for 2016 could come into question.

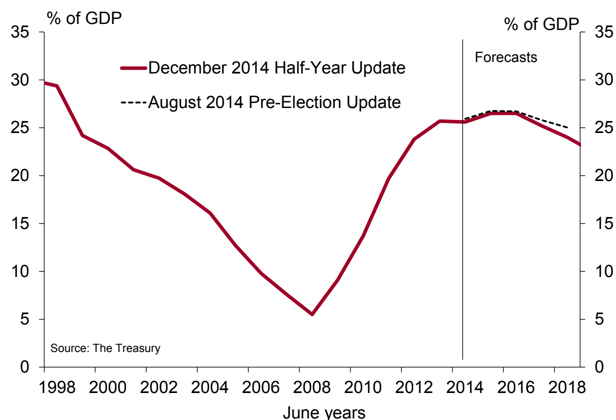
However, the Treasury's stronger outlook for economic activity means that from the June 2017 year onwards, the operating surplus is expected to be even larger than previously forecast.

The upshot is less revenue now, more revenue expected later, and the Government has adjusted its spending plans accordingly. Previously the Government had allowed for $1.5bn of new operational spending in each of the next two Budgets. That has been reduced to an additional $1bn each year, which will likely be swallowed up the usual growth in health and education expenditure.

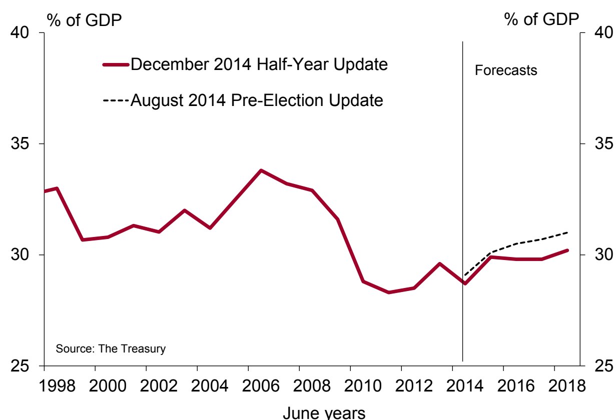
However, the allowance for Budget 2017 has been increased from around $1.5bn to $2.5bn. Assuming another $1bn for health and education, that leaves $1.5bn for new spending plans. The Government has previously indicated that at least some of this new 'spending' is likely to take the form of tax cuts, which could take any number of forms. (See the box on the next page.)

At the May Budget we were a little critical of the Government's intentions to boost spending over the next few years, just as the Canterbury rebuild would be applying its maximum stimulus to the economy. The new spending profile in the HYEFU sees the biggest increase in spending delayed until the 2017/18 fiscal year, by which point we expect economic growth to be slowing markedly as the Canterbury rebuild passes its peak and higher interest rates stall the housing market. So we regard the new proposed timing for fiscal stimulus as more appropriate, even if not by design.

Core Crown net debt forecast



Core Crown revenue forecast



Faced with lower revenue projections, the Government chose to take the hit through lower spending and reduced surpluses in the short term, rather than increasing debt. The bond programme remains unchanged for the next four years, and net debt is expected to peak in the current fiscal year at 26.5% of GDP, falling towards 20% by 2020.

The market response was to mark interest rates on Government bonds down by around two basis points. That makes sense for two reasons: curtailed Government spending means a slightly weaker economic outlook in the short run, and the lack of any extra debt will restrict the supply of Government bonds on the market. There was no discernible reaction in the foreign exchange market.

Dominick Stephens
Chief Economist

Michael Gordon
Senior Economist

Felix Delbrück
Senior Economist

Options for tax cuts in 2017

If the Government did cut taxation by $1.5bn per annum in the 2017 Budget, it would have a range of options. New Zealand's current tax rates and thresholds are:

Key tax rates and thresholds	
Tax on income - up to $14k	10.5%
- up to $48k	17.5%
- up to $70k	30.0%
- above $70k	33.0%
GST	15.0%
Company tax	28.0%

We are not willing to speculate on how the Government might change the tax rates and thresholds, nor are we willing to advocate one policy or another. Out of interest we have estimated that any **one** of the following options, if implemented today, would cost around $1.5bn:

- Reduce the lowest income tax rate from 10.5% to 6%.
- Reduce the 17.5% income tax rate to 14.5%.
- Reduce the 30% income tax rate to 20%.
- Have a top tax rate of 28% kicking in at $48k, thus removing the fourth tax bracket altogether.
- Exempt the first $4500 of income from tax.
- Increase the threshold at which the 17.5% income tax rate kicks in from $14k to $24k.
- Increase the threshold at which the 30% income tax rate kicks in from $48k to $61k.
- Cut GST to 13.5%.
- Cut the company tax rate from 28% to 23.6%.

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

For email address changes contact:
WNZResearch@westpac.co.nz

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