

New Zealand Government Budget 2021.

20 May 2021



New Zealand Budget 2021 – Delayed gratification.

- Budget 2021 featured a modest lift in spending, on the back of an improved economic picture.
- The Government’s Wellbeing priorities came to the fore again, led by a substantial increase in main benefit rates.
- The Budget’s ambitions were underpinned by tax revenue forecasts that we feel are surprisingly conservative, relative to the economic outlook.
- We expect that tax revenue will continue to exceed the Treasury’s forecasts over the next couple of years.
- This will provide scope for more substantial spending plans and faster debt reduction in future fiscal updates.

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Budget 2021 economic forecasts

	2020 (a)	2021	2022	2023	2024	2025
	Actual	F/cast	F/cast	F/cast	F/cast	F/cast
Economic (June years, %)						
Real GDP growth	-1.7	2.9	3.2	4.4	3.3	2.9
Unemployment rate	4.0	5.2	5.0	4.4	4.2	4.2
CPI inflation	1.5	2.4	1.7	1.8	2.0	2.1
Current account balance	-1.8	-2.7	-3.4	-3.5	-3.3	-3.1
Fiscal						
(June years, % of GDP)						
Total Crown OBEGAL	-7.3	-4.5	-5.3	-2.6	-1.4	-0.6
Net core Crown debt	26.3	34.0	43.8	48.0	46.9	43.6
(June years, \$ billion)						
Core Crown revenue	91.9	97.9	99.8	108.9	114.9	121.3
Core Crown expenses	108.8	110.7	114.7	115.4	117.8	121.1
Bond programme	-	45	30	25	25	25

As signalled by Finance Minister Grant Robertson, the 2021 Budget struck a balance between more spending, more investment, and a lower borrowing requirement, enabled by an improved economic outlook. But the extent of this Budget’s ambitions were more modest than we expected – not borne out of prudence, but of some surprisingly subdued financial assumptions.

This Budget was largely a return to the Government’s pre-Covid agenda, again bearing the title of “Wellbeing Budget”. The flagship policy initiative was a substantial increase in weekly main benefit rates, something that has been on the cards since the Welfare Expert Advisory Group reported back



in May 2019. This would undoubtedly have featured in last year's Budget if the response to Covid-19 hadn't taken priority.

As we expected, the allowances for both operating and capital spending were increased for this Budget. Even with that lift in spending, the operating deficit is projected to narrow towards zero over the next five years. The Government's borrowing requirement has been reduced, and net debt as a percentage of GDP is expected to peak at a lower level compared to the Half-Year Update last December.

The overall lift in spending was about in line with what we assumed, and as such there are no major implications for our forecasts. That said, the nature of the additional spending is on the stimulatory side – increasing benefit rates means more cash in hand for people who will be willing to spend it.

What surprised us was that there was only a modest improvement in the financial projections. That's not because of a difference in views on the economy – having been the most downbeat forecaster of the lot last year, the Treasury has acknowledged the economy's recent performance, and its activity forecasts for the next couple of years are close to our own.

Rather, the Treasury has again taken a surprisingly conservative view on how this will translate into the tax take and other forms of Government revenue. The Treasury assumes that revenue relative to GDP will continue to fall in the coming years. With the economy moving into a post-Covid upswing, we think it's more plausible that this ratio will rise, reflecting both company tax (which is highly cyclical) and bracket creep (as incomes rise and people move into higher income tax brackets).

The result is that, presented with only a modest increase in projected revenue, the Finance Minister has responded with a modest lift in spending. We expect that over the coming months, the tax take will continue to surprise on the upside. That will provide room for both larger spending plans and faster debt reduction in future fiscal updates. But for now, we're left with a Budget that feels less ambitious than it could have been.

There were also some policy items that were notable in their absence. In March the Government announced some significant policy changes aimed at dampening investor demand on the housing market, but the promised follow-up on housing supply measures has yet to emerge. And two months later, no decision has been made on the tax treatment of investors who buy new builds – something that investors will need clarity on before they're willing to dive in.

Key Budget initiatives.

The Government outlined Budget 2021 spending and investment initiatives broadly in line with our expectations. Budget 2021 includes an operating allowance of \$3.8 billion or around \$1 billion more than initially announced back in the Budget Policy Statement in February. This increase was equal to what we had factored into our forecasts prior to today's announcement.

The key spending highlight was a boost to welfare spending. Weekly benefit rates will lift by between \$32 and \$55 per adult. Student living support will also increase by \$25 per week. Benefits will lift on 1 July 2021 and again on 1 April 2022. In making these changes the Government has adopted a key recommendation of the Welfare Expert Advisory Group, with the aim of lifting up to 33,000 children out of poverty. This is expected to cost \$3.3bn over the next four years.

This spending boost targeted the Child Wellbeing pillar of the Government's Wellbeing Objectives. More broadly, Budget 2021 spending initiatives also addressed the other Wellbeing Objectives as outlined in the table below.

The Government's capital expenditure plans were also as big as we expected them to be. The multi-year capital allowance has been increased from \$8 billion to \$12 billion. Key initiatives announced in Budget 2021 include \$810 million for KiwiRail, \$761 million of capital for Education, including for schools, and \$700 million for District Health Boards. All up, the Government has now included \$57.3 billion worth infrastructure investment plans into this Budget.

2021 Budget initiatives

Wellbeing Objective	Description	Key Budget 2021 Initiatives
Child Wellbeing	Reducing child poverty and improving child wellbeing.	<ul style="list-style-type: none"> As per above plus increases to childcare assistance income thresholds and 3,300 extra places for Out of School Care and Recreation Service.
Just Transition	Supporting the transition to a climate-resilient, sustainable and low-emissions economy while building back from Covid.	<ul style="list-style-type: none"> \$300m of additional capital for the New Zealand Green Investment Finance Ltd. \$810m capital and \$535m operating spending for KiwiRail.
Future of Work	Enabling all New Zealanders and businesses to benefit from new technologies and lift productivity and wages through innovation, and support into employment those most affected by Covid.	<ul style="list-style-type: none"> Lifting student living support rates by \$25 per week. Training Incentive Allowance revived to support up to 16,000 beneficiaries into jobs.
Māori and Pacific	Lifting Māori and Pacific incomes, skills and opportunities, and combatting the impacts of Covid.	<ul style="list-style-type: none"> \$380m for delivery of about 1,000 new homes and repairs to 700 homes.
Physical and Mental Wellbeing	Supporting improved health outcomes for all New Zealanders and keeping Covid out of our communities.	<ul style="list-style-type: none"> \$486m for the transition to Health NZ and health reforms. An extra \$200m for Pharmac.

The Government still also has some funding set aside as a Covid contingency (the Covid Response and Recovery Fund, or CRRF) in case there are further outbreaks or flare-ups of the virus. Budget 2021 allocated \$3.7 billion of the fund, leaving \$5.1 billion of unallocated funding for future Covid outbreaks.

Financial projections.

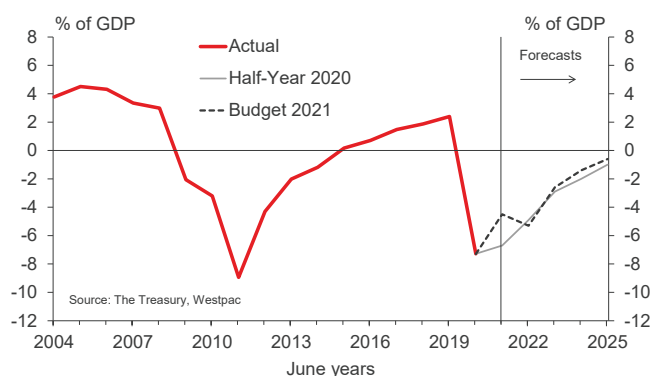
Compared to the Half-Year Update in December, the Budget featured stronger tax revenues, higher spending, and a lower peak for net core Crown debt to GDP. However, the projected operating deficits were larger than we expected, as the increase in tax revenues wasn't enough to offset the larger spending the Government announced.

The Budget included an extra \$19bn of core Crown spending over the next five years, with largest increases over the June 2022 and June 2023 years. Spending in the current fiscal year was lower, driven by savings from the CRRF.

Forecast tax revenue was \$21.1 billion higher over the five-year forecast period. Most of this was driven by an increase in GST, which is a result of stronger consumption and residential construction. Along with the stronger economy, corporate tax is also assumed to be higher, though still below pre-Covid levels as the level of nominal GDP is still assumed to not have fully recovered.

The operating balance (OBEGAL) is actually projected to move further into deficit in the June 2022 year, due to a particularly low assumed tax take for that year. In the following years the balance is expected to improve, though not returning to surplus by the end of the forecast period in 2025.

Operating balance (OBEGAL) as a % of GDP

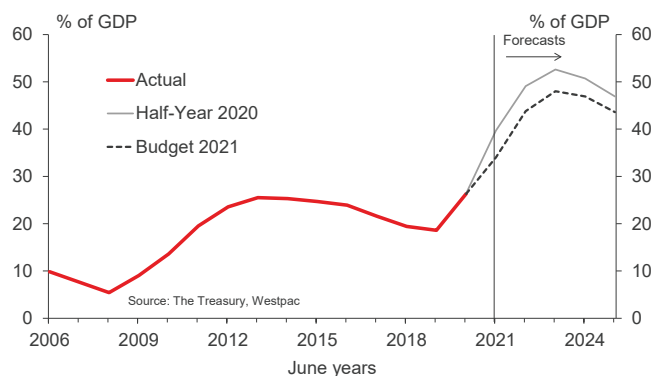


Net capital spending is expected to total \$65.2 bn over the forecast period, compared to \$56.6bn in the December update. Around \$3.5bn of this is due to a higher assumed uptake of the Reserve Bank's Funding for Lending Programme (FLP) for banks.

As a result of the marginal improvement in the operating balance forecasts, plus the additional capital spending, the Government's borrowing requirement was higher than we expected. Net core Crown debt as a percentage of GDP

is expected to peak in 2023 at about 48% and then starts to decline. However, both the peak and the subsequent improvement are overstated by the Reserve Bank's FLP, which is treated as a net liability over the time in which it operates.

Net core Crown debt as a % of GDP



Comparing the economic forecasts.

The Treasury's forecasts for economic activity over the next few years are very similar to our own. With the worst of the Covid downturn (hopefully) in the rear-view mirror and vaccine rollout underway, economic activity is set to continue firming. Continued increases in Government spending and ongoing low interest rates will help to support this. However, there are some notable points of difference on key parts of the economy.

The first area of note is the Government's forecast for house price growth. Prior to the Budget, the Government announced a suite of new housing market policies that will be enacted over the coming months and will reduce the financial incentives for residential property investors. The most significant of these policies is the removal of interest deductibility for residential investment properties. Like us, the Treasury expects these measures will be a significant drag on prices. In fact, the Budget noted that house prices in June 2025 are now expected to be around 16% lower than they would be otherwise. Even so, the Treasury still expects modest price growth over the coming years.

In contrast, given the extent of policy changes that have been announced, we think house prices could be even weaker. In fact, our updated forecasts assume modest falls over 2022 and 2023 as mortgage rates eventually push higher. This is particularly important given the key role the housing market plays in shaping spending more generally in the economy. There are a few details of the new housing policies yet to be finalised – most notably, how new builds will be treated – and that could have an important impact on how prices evolve. The Treasury's working assumption was that interest deductibility will remain in place for new builds for an unspecified period of time, and this will be a key area to watch.

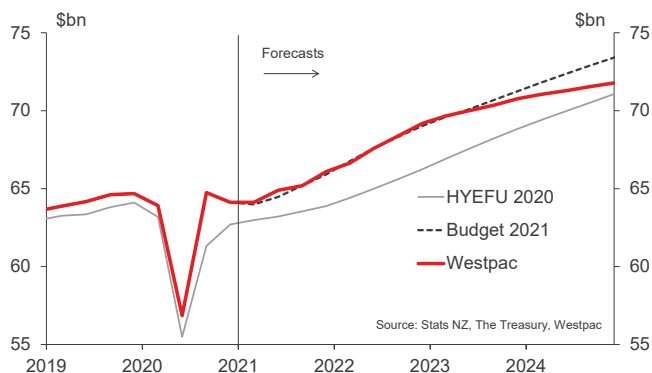
We should note that our house price forecast reflects our views on prices in the secondary market. We recognise that

the tax treatment for new builds could potentially create a two-tier market, where there is no single measure of house prices.

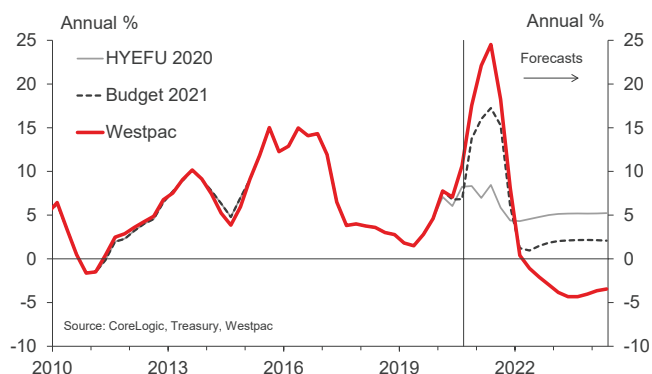
Another notable feature of the Treasury's forecasts is their assumption for net migration. The Budget notes that annual migration is expected to increase to 43,000 in mid-2025. That wouldn't be an unusually high level compared to what we've seen over the past decade. However, earlier this week the Government signalled its intention to reset migration policy over the coming years. That likely foreshadows a much lower level of migration when the borders reopen. The implications of this will be very important for many parts of the economy, signalling slower growth in the economy's demand base, as well as more modest home building activity. Slower population growth also signals a drag on the economy's productive capacity.

The impacts of slower population growth on the Government's books will take time to become apparent, but this does signal downside risk for the Government's projections for economic growth as we head into the middle part of the decade. In fact, the Treasury's estimates for underlying or potential GDP growth over the coming year's look quite optimistic to us given the slowdown in population growth that's on the cards. That signals related pressure on the fiscal position, with growth in tax revenue likely to be similarly restrained.

Real GDP level



House price growth



Economic Forecasts: The Treasury and Westpac

June years	Actual		Treasury (Budget 2021)					Westpac				
	2020	2021	2022	2023	2024	2025	2021	2022	2023	2024	2025	
Real GDP growth	-1.7	2.9	3.2	4.4	3.3	2.9	3.0	3.0	4.4	2.2	1.5	
Annual CPI inflation*	1.5	2.4	1.7	1.8	2.0	2.1	2.5	1.5	1.8	2.2	1.9	
Unemployment rate*	4.0	5.2	5.0	4.4	4.2	4.2	4.7	4.3	4.0	3.8	3.9	
Nominal GDP growth	2.0	5.6	4.6	6.3	5.7	5.5	6.5	5.9	5.2	3.8	3.5	
90-day interest rate**	0.3	0.3	0.3	0.3	0.3	0.9	0.4	0.4	0.4	0.8	1.2	
TWI exchange rate**	69.7	74.5	74.5	74.5	74.7	75.1	75.6	75.7	74.0	72.0	70.2	

*Quarter over same quarter last year, **Quarter average

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