



## special research note

### **New Zealand Budget 2010** / 20 May 2010

Budget 2010 strikes a good balance between growth-enhancing tax reform, expenditure restraint and support for infrastructure and the innovation system.

#### **overview**

Budget 2010 is set in a global context of rising concern about the state of public finances in a number of countries, most notably in Europe. Many of those countries are now implementing significant fiscal austerity programmes. Fortunately, we are not in the same boat.

The Government has brought down a Budget that delivers on its objective of significant reductions in personal income taxes and has even managed to throw in a cut in the company tax rate for good measure. Through a mix of new and reprioritised spending, the Government has been able to focus on its priority social areas of health, education and law & order.

Many developed countries would give their eye teeth to be in this fiscal position and be able to deliver a Budget such as this.

In our pre-Budget note, we identified three core areas in which we would be looking for the Budget to make progress:

#### **continued fiscal consolidation.**

The Government is forecasting a faster return to surplus, and a lower and earlier peak in debt levels. This is positive given current heightened concern about many countries challenges to rein in large fiscal deficits and to keep public debt under control.

#### **economic rebalancing and faster economic growth.**

Changes to the tax system are positive and we believe growth enhancing and supportive of the necessary rebalancing in the economy. Lower personal taxes in particular are positive for productivity and for attracting and retaining skilled people. Greater support for the innovation system is also positive. This Budget is also pro-savings which will ultimately lead to a lower cost of capital.

#### **recognition of longer-term fiscal tradeoffs.**

In our view this is the weak point in the Budget. We would have liked to have seen a greater understanding of our long-term fiscal challenges and willingness to make some hard calls.

**Bevan Graham**  
Chief Economist



## key policy initiatives

### lower personal taxes, increase in GST

Significant personal tax cuts are to be made from October 1<sup>st</sup> 2010. The new rates are detailed in the table below:

Income	Current Rates	New Rates
\$0-\$14,000	12.5%	10.5%
\$14,001 - \$48,000	21.0%	17.5%
\$48,001 - \$70,000	33.0%	30.0%
Over \$70,000	38.0%	33.0%

As expected, GST is to be raised to 15%, also from October 1<sup>st</sup> 2010. New Zealand Superannuation, Working for Families and benefit payments will all increase.

The Government also intends cutting the rate of corporate tax to 28% from 30% in 2011. This compares with recent announcement in Australia of a drop in the corporate tax rate to 28% to be phased in by 2014/15.

Other tax changes include:

- Depreciation deductions will no longer be allowed for buildings with an estimated useful life of 50 years or more, such as rental houses and offices. This applies to all such buildings from the 2011/12 income year;
- Businesses will no longer be able to claim 20% accelerated depreciation on new plant and equipment. This applies to assets purchased after today;
- From 1 October 2010 the top tax rate for most portfolio investment entities (PIEs), including KiwiSaver accounts, will be reduced from 30% to 28%, while the other PIE rates drop to align with the new personal tax rates;
- The tax rate for savings vehicles like unit trusts and widely-held superannuation funds will also be reduced from 30% to 28% from the 2011/12 income year; and
- Qualifying companies (QCs) and loss attributing qualifying companies (LACQs) will become flow-through entities for tax purposes, similar to limited partnerships.

These tax changes are significant and, on balance, supportive of higher sustainable growth. The cuts to personal income taxes are productivity enhancing and will assist with the retention and attraction of skilled labour in New Zealand. The reduction in company tax will support our international competitiveness, and lower tax on savings will encourage savings and ultimately lead to lower cost of capital.

In general, these changes will also assist the structural rebalancing we are looking for in the economy. In this regard, lower taxes on income and increased tax on consumption are positive.

### expenditure restraint

The Government has kept to its \$1.1 billion spending cap in 2010. As previously announced, subsequent increases will be kept to 2% per annum. This is somewhat of a luxury for a developed economy, with many countries facing significant fiscal austerity including cuts in spending in the aftermath of the Global Financial Crisis. The Government has also re-prioritised a further \$1.8 billion over the next four years.

As expected, the major winners in terms of new spending are healthcare, education, law and order and support for the innovation system.

## support for the innovation system

Increased spending in the Research Science and Technology was a pre-Budget announcement, but is a key part of the Government's support for the innovation system. The key part of the announcement is a \$234m boost for supporting business Research and Development.

The interesting, and we believe the best, part of this package was the funding made available to encourage links between firms and publicly-funded research organisations. We firmly believe that one of the key constraints for innovation to occur in New Zealand is the poor linkages between the constituent parts. It is pleasing to see a recognition of that challenge and an attempt to rectify it.

## infrastructure

The Government has confirmed a significant investment in infrastructure with the Budget allocating another \$1.45b of the five-year \$7.5b infrastructure funding plan. This includes allocations for broadband, rail, prisons and schools.

In addition to the Budget initiatives, the Government is investing \$10.7b over the next 10 years in New Zealand's State Highway network and \$3.3b through Transpower in the next five years to upgrade the national grid.

Sound economic and social infrastructure are important parts of a modern economy.

## Long-term fiscal trade-offs

From our perspective, this was the Budget's weak point. In many countries, the deterioration in fiscal conditions in the aftermath of the Global Financial Crisis has brought forward the need to deal with some longer-term challenges, including rising healthcare costs and the costs of state funded pensions.

We are, however, fortunate that our fiscal situation is not as bad as in some countries and there is no immediate need to address them. But then we believe the issue is not so much whether we can afford things like current superannuation entitlements, but whether we want that more than other things we could have. These opportunity costs include further tax reductions, greater spending in other priority areas, or indeed a return to the Government's long-term net debt target of 20% of GDP faster than the 2022 projected today.

## fiscal numbers

### overview

Budget 2010 reinforces New Zealand's relative fiscal health when compared to other developed countries. This better position largely reflects the hard fiscal work that was done in the 1990s to get New Zealand's fiscal house in order. That has enabled us to withstand the fiscal headwinds better than most. A feature of this (and the recent Australian) budget is that we will get through the aftermath of the GFC by capping new spending. Others around the world are putting in place significant cuts to spending to find a pathway back to fiscal sustainability.

The fiscal outlook is better than that projected in the Half-Year Economic and Fiscal Update (HYEFU). Operating balances move back into surplus earlier than previously forecast and debt peaks earlier and at a lower level. This is a good picture and should please the rating agencies.

Longer term we need to get back to the strong position we were in before the GFC so that we are in a position to weather the next global (or indeed local) crisis, whatever or whenever that may be.

### revenue

- Tax revenue is forecast to rebound as the economy recovers, albeit with a lag due to recent weakness in tax revenue.
- Core Crown revenue is forecast to rise from 29.8% of GDP in 2009/10 to 30.7% of GDP in 2013/14.

### expenditure

- Expenditure rises each year in absolute terms, but reduces as a percentage of GDP over the forecast horizon.
- This reflects growth in the economy and the Government's cap on new spending (\$1.1b in Budget 2010, rising by 2% per annum thereafter).
- Core Crown expenses initially rise from 34.2% of GDP to 34.7% of GDP in 2010/11, but then decline to 32.4% of GDP by 2013/14.

### operating balance

- The operating deficit (OBEGAL) is forecast to rise from 3.7% of GDP in the current year to 4.2% of GDP in 2010/11.
- Deficits then reduce to 1.3% of GDP by 2013/14, largely reflecting rising tax revenue.
- Operating balances are forecast to move into surplus in 2015/16, three years earlier than expected in Budget 2009.

Fiscal Numbers						
June Years, %of GDP	2009	2010(e)	2011(f)	2012(f)	2013(f)	2014(f)
Core Crown Expenditure	34.7	34.2	34.7	33.1	32.9	32.4
Core Crown Revenue	32.2	29.8	29.6	29.9	30.3	30.7
Operating Balance (OBEGAL)	-2.1	-3.7	-4.2	-2.5	-1.9	-1.3
Net Debt	9.3	14.1	19.6	23.0	25.3	26.5
Gross Debt	23.5	28.4	32.8	32.3	31.7	32.7
Net Worth	54.0	50.9	43.9	39.8	37.0	34.8

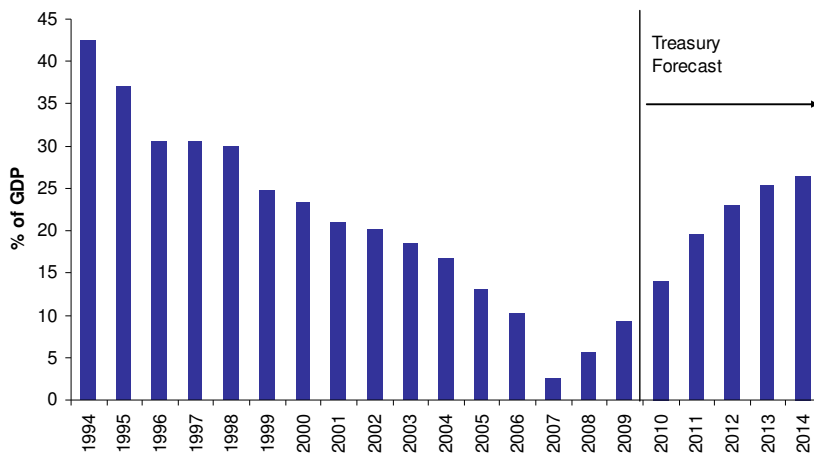
## debt

- Net core crown debt rises from 9.3% of GDP to 26.5% of GDP by 2014 and peaks at 27.4% in 2015.
- The Government’s long-term fiscal objective is for net debt to be below 20% of GDP. Long-term projections anticipate this occurring in 2022.
- Gross debt rises from 23.5% in 2009 of GDP to 32.7% of GDP at the end of the forecast horizon.

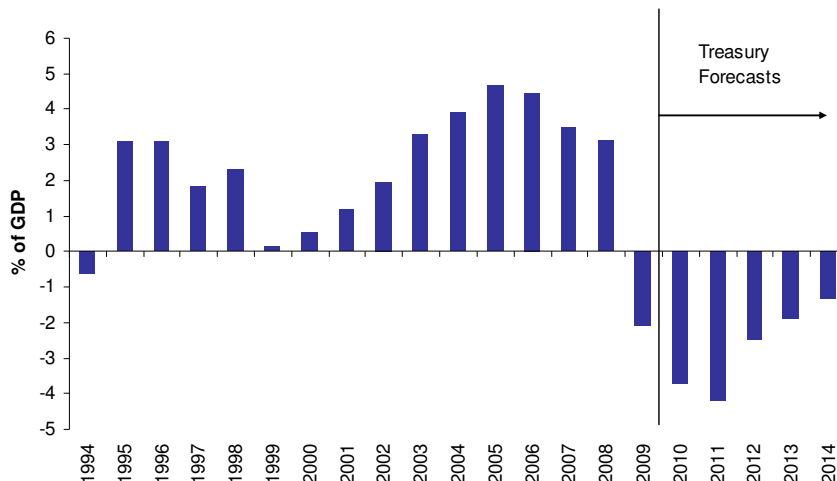
## bond programme

- The New Zealand Debt Management Office intends issuing \$12.5b of bonds in 2010/11.
- Programmes of \$10.5b in 2011/12, \$10 b in 2012/13 and \$6b in 2013/14 are forecast.
- Total issuance is \$2b lower than announced in the HYEUFU.
- The NZDMO is “actively considering” reintroducing inflation-indexed bonds as part of the 2010/11 issuance.

**Net Core Crown Debt**



**Crown Operating Balance (OBEGAL)**



## economic forecasts

The economic forecasts underpinning the Government's fiscal outlook appear reasonable.

Treasury notes the global economic environment is improving, with stronger trading partner growth. Risks remain however.

GDP forecasts show growth of 3.2% in the March 2011 year. This is stronger than the 2.4% forecast in the HYEPU. Growth is then expected to hold at around 3% per annum in the out-years. This is in line with our expectations.

In a now all too familiar scenario, Treasury sees a pattern of subdued consumption, but stronger growth coming from exports as trading partner growth continues to recover. A healthy rise in the terms of trade is also predicted over the forecast horizon.

Inflation is forecast to reach 5.9% in the year to March, reflecting a number of one-off factors including increases in excise, the introduction of the Emissions Trading Scheme and the increase in GST. Thereafter, inflation is forecast to return to around the mid-point of the target range. Treasury notes this incorporates a gradual tightening in monetary conditions which is not inconsistent with that expected by ourselves or the Reserve Bank.

These forecasts were finalised before the release of March quarter household labour force data which showed a sharp drop in unemployment. Nevertheless, Treasury sees a gradual drop in the unemployment rate over the forecast horizon consistent with a modest economic recovery.

Like us, Treasury believes much of the recent improvement in the current account deficit is cyclical. They see the deficit returning to over 7% of GDP over the forecast horizon. Perhaps if savings do rise on the back of this Budget, future forecasts might show a stronger structural improvement in our external position.

Economic Forecasts						
As at March	2009	2010	2011(f)	2012(f)	2013(f)	2014(f)
<b>GDP</b>						
<i>Ann Ave % Ch</i>	-1.4	-0.3	3.2	3.1	2.9	3.0
<b>Unemployment Rate</b>						
<i>March qtr, s.a.</i>	5.0	7.1	6.2	5.5	5.1	4.6
<b>CPI Inflation</b>						
<i>Ann % Ch</i>	3.0	2.2	5.9	2.4	2.4	2.4
<b>Current Account</b>						
<i>March Year, % of GDP</i>	-7.9	-2.6	-4.4	-6.1	-7.0	-7.3
<b>Terms of Trade</b>						
<i>Ann % Ch</i>	-0.7	-6.3	4.9	0.6	1.7	1.0

May 2010

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