# HUGOvision

*Assessing the economic and political environment in New Zealand*

BUDGET EXTRA | May 15 2014 | **Confidential to HUGO members**

## Mostly social spending but some value for business too

The budget's principal thrust is in social assistance, particularly "vulnerable children". The main value for business is in the steady fiscal management: rising surpluses and falling debt, which is part of a programme to tighten management of the Crown balance sheet. But there are some other glimmers, including "possible" $480 million of ACC levy cuts in 2015-16 and a "goal" for total science and innovation spending to rise to 0.8% of GDP, which would take it above the OECD average and some tax help (*see p2*).

The budget projects a just-and-no-more return to operating surplus in the 2014-15 fiscal year: $372 million or 0.2% of GDP. A repeat of this fiscal year's revenue shortfall would turn that in to a deficit. But the trajectory is up: to 0.5% of GDP in 2015-16, 0.9% in 2016-17 and 1.3% in 2017-18 and 2.5% in 2019-20. At that point, English argues, net Crown debt, which is set to peak at 26.4% of GDP in 2014-15, should be below 20% of GDP. The amended fiscal strategy published with the budget aims to run net debt thereafter in the 10%-20% range, allowing for variations over the economic cycle, which is in effect a fiscal buffer. This allows resumptions of 2%-of-GDP contributions to the Cullen Fund.

More budget commentary in the regular May 16 Hugovision emailed tomorrow

The improvement is mainly on the spending side. Core Crown spending is projected to drop from 31.0% in 2013-14 to 30.3% in 2014-15 and then head under 30%. (Core Crown revenue is in the 30%-31% range through that time.) That this has been done without public outcry and without giving much traction to opposition parties is attributable in part to public acceptance that some stringency was needed and in part to the "better public services" programme which has made savings that have been channelled into higher spending in targeted areas, initially without total spending rising and then within a $1 billion ceiling, which is to rise to $1.5 billion in 2015-16 and then go up 2% a year.

The impact on the economy of this programme remains negative through to 2017-18 (about 1% of GDP a year), as it has been since 2010-11.

### An investment approach to social spending

The spending pressure to do "more with less" has been supplemented with the gradual introduction of an "investment" approach to some social spending. This calculates future costs of a social outcome and the return on investment in preventative action.

This approach takes a new turn in the budget, with an emphasis on "vulnerable children". This identifies 2000 6-9-year-olds who "have had the worst start in life" and "will cost taxpayers an estimated $750 million in prison costs alone" and a great deal more in welfare, health and other costs.

Specifically, there will be eight more children's teams to protect those "at risk" from abuse and ensure support for them. Otherwise the response is more general: $125 million a year over four years to extend paid parental leave from 14 weeks up to 18 weeks in 2015 and 20 weeks in 2016; a rise in the parental tax credit from $150 a week to $220; free doctor's visits and prescriptions up to age 13 from 6 now; and more money for early childhood centres.

Other social assistance includes $450 million a year over for years for health, $215 million for compulsory education and $50 million for tertiary education and some housing items, including more social housing assistance and removal of import duties on plasterboard, reinforcing steel bars and nails and removal of tariffs on a wide range of building products like roofing, cladding, insulation, paint and electrical and plumbing.

### What pays for this? A "growing economy"

The budget is billed as "managing a growing economy". It projects GDP growth of 3.9% in fiscal 2014-15 (July-June), easing to 2.6%, 2.1% and 2.2% in the following three fiscal years. Beyond that the growth ranges from 2.2% to 2.5%. That should generate job growth of 2.7% in 2014-15, then 1.6%, 1.3% and 1.2%, cutting unem-

*Continued on p2*

*Continued from p1*

ployment to 4.5%, which the Treasury says in the current non-inflationary unemployment rate. It assumes labour productivity growth of 1.4%, 1.5%, 1.1% and 1.1% and a rises in the nominal average hourly rage of 2.8%, 3.1%, 3.5% and 3.5%.

The Treasury projects inflation to climb to 2.6% in fiscal 2015-16 and then to settle at the 2% midpoint of the Reserve Bank's allowable range. Interest on 5-year government bonds is projected to rise from 4.1% to over 5%. The exchange rate is expected to ease from around 79 on the trade-weighted index to around 73 over four years. (Hugo assumes a lower exchange rate track and higher interest rates earlier.)

The Treasury's projections fit an assumption of a softening in 2015-16 in the terms of trade on the back of less buoyant commodity prices. Net external trade is expected to make a negative contribution to GDP growth through the first three of the four-year forecast period, as investment and higher consumption suck in imports. That, the Treasury says, will take the balance of payments deficit back over 6% of GDP in the later years of the four-year projection period. (Hugo thinks this is a bit pessimistic.)

The negative trade balance helps push net country international debt from 65.9% of GDP in 2013-14 up to 76.6% in 2017-18.

## Some risks

The Treasury canvasses some risks.

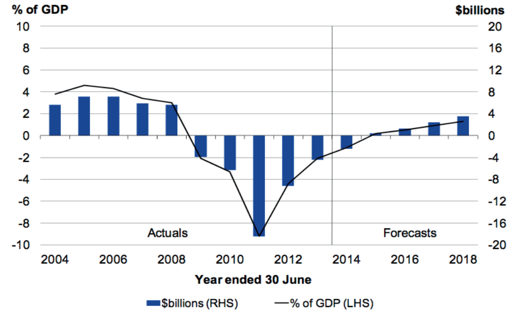
One is to its assumption of **net household saving** of around 2% of disposable income in 2014-15, falling to zero in the latter years of the four-year forecast period. It worries that there is "a risk that, rather than increase their saving households may instead prefer to increase their debt levels to fund the purchase of houses or the consumption of other goods and services and, as a consequence, house price inflation and domestic demand pressures do not ease as anticipated". The Reserve Bank would agree.

Another risk is of an external shock, specifically, that **Chinese growth** "could slow more quickly than in the main forecasts if financial market disruption resulted in significantly tighter credit conditions".

## The politics: probably positive

There is some loosening in this budget but not on the scale of many past election years. On the face of it, that should give opposition parties room to score points with spending promises. Labour, the Greens and New Zealand First will all do that and will counter National charges of fiscal irresponsibility with a promise of some tax rises (for example, on capital gains) to fund increased spending but still

***Figure 3*** – Total Crown operating balance (before gains and losses)




Source: The Treasury

stay roughly on English's surplus track.

But the public mood, while generating very strong positive consumer confidence readings, still seems modest, verging on cautious. Rising mortgage interest rates, both actual and anticipated, are likely to keep them receptive to English's message through to the election.

In short English has probably done enough to keep middle New Zealand cautiously onside – for now.

## Some detailed items

- Loss-making startup companies will be able to cash out all or part of their tax losses from **research and development**. All businesses will be allowed tax deductibility for research and development "black hole" spending. Total returned tax: $58 million.
- $1 billion (from the asset sales programme) is earmarked in 2014-15 for investing in hospitals ($200 million), school buildings ($172 million), Kiwirail's "turnaround" ($198 million), Christchurch housing, irrigation schemes and the Hobsonville housing development. That is in addition to $18.2 million of new capital funding for the Ministry of Social Development "to work with people to find the best housing options for them and to support those who are ready to return to the wider housing market".
- A $375 million interest-free loan to the New Zealand Transport Agency, "as part of $815 million of accelerate Auckland transport projects".
- 6000 more apprenticeships.
- Abolition of cheque duty. (Wow!)
- $132.3 million over four years to Inland Revenue to bolster tax compliance.