

Budget 2010: Give and take

Budget 2010 Preview (20 May 2.00pm NZT)

- The Government's 2010 Budget will be released on Thursday, May 20.
- Tax reform will be the major focus, the overriding principle being that any immediate changes are revenue neutral and that the 'vast bulk' of New Zealanders are better off. At a minimum we expect across-the-board cuts in income tax rates and an increase in GST from 12.5% to 15%.
- Budget deficits will remain sizeable in the near term, with an operating deficit excluding gains and losses of around \$7bn expected in both FY2010 and FY2011. However, deficits should begin to narrow from FY2012 as a result of a better-than-expected economic outlook. We do not foresee a return to surplus over the forecast horizon.
- The Government's borrowing requirement will remain large over the four years to FY2014 but at an estimated \$35bn, will be smaller than the \$42.5bn forecast in the 2009 Half Year Update.

On Thursday, 20 May, Finance Minister Bill English will release the National Government's second Budget following their election in November 2008. Unlike 2009, this year's Budget will be released in an environment of accelerating economic growth and falling unemployment. That makes for a much more comfortable platform to deliver policy change.

As both the Prime Minister and the Minister of Finance have stressed in recent commentary, Budget 2010 has four main goals:

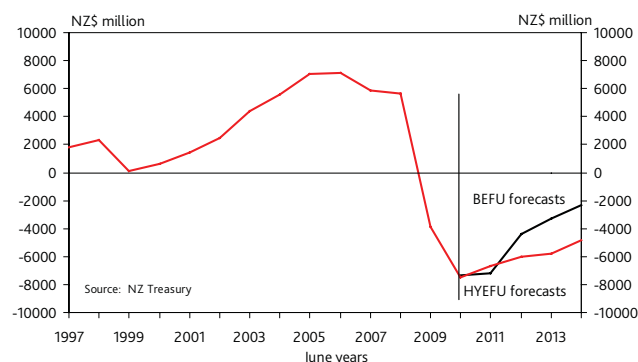
- Lifting the long-term performance of the economy.
- Reform of the tax system.
- Better delivery of public services.
- Maintaining firm control of the Government's finances.

Of these, we have little doubt that tax reform will get most of the attention. Indeed, it seems the Government has assumed as much, taking the unusual step of releasing some key Budget spending announcements early so as to ensure they do not get missed on Budget day.¹ Moreover, with the Government expected to maintain a tight fist on expenses, there is likely to

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OBEGAL



be little to get excited about on the spending front. The upshot is that the significant announcements in this Budget will be tax related.

Tax reform

Following the release of the Tax Working Group's initial recommendations in December last year there has been no shortage of discussion on what the potential tax changes could be. Clearly, there are a myriad of possible tax reform programmes that could be implemented. However, the Government's overriding aim that any immediate changes are revenue neutral and that 'the vast bulk of New Zealanders are better off', provides some clear guidance.

Using Treasury-modelled data we costed a number of possible scenarios that we thought could meet the Government's tax reform criteria. Of those scenarios, we see the most likely changes as:

- a cut in the lower personal income tax rate from 12.5% to 10.5%, with the threshold unchanged at \$14,000;
- a cut in the middle income tax rate from 21% to 19%, with the threshold unchanged at \$48,000;
- a cut in the top income tax rate from 38% to 33%, with income above \$48,000 taxed at 33%.
- an increase in GST from 12.5% to 15%.

¹ Prime Minister John Key announced \$225m of new spending on science and technology while speaking at a Chamber of Commerce function in Wellington on Tuesday, 11 May 2010.

On our calculations, the tax cuts would ensure that the vast majority of workers (including recipients of Working for Families) experience no change in their purchasing power as a result of the rise in GST (see Table 1: Estimated after-tax wage increases by income band). Meanwhile, the immediate 2% increase in payments Prime Minister Key has promised superannuitants and other beneficiaries, on top of the tax cut that they too would receive, would actually see their purchasing power increase.

Table 1: Estimated after-tax wage by income band

Income band	Tax paid	After tax wage	% increase
\$0	\$0	\$0	
\$5,000	\$525	\$4,475	2.3%
\$10,000	\$1,050	\$8,950	2.3%
\$15,000	\$1,660	\$13,340	2.3%
\$20,000	\$2,610	\$17,390	2.4%
\$25,000	\$3,560	\$21,440	2.4%
\$30,000	\$4,510	\$25,490	2.4%
\$35,000	\$5,460	\$29,540	2.4%
\$40,000	\$6,410	\$33,590	2.4%
\$45,000	\$7,360	\$37,640	2.4%
\$50,000	\$8,590	\$41,410	2.4%
\$55,000	\$10,240	\$44,760	2.2%
\$60,000	\$11,890	\$48,110	2.0%
\$65,000	\$13,540	\$51,460	1.9%
\$70,000	\$15,190	\$54,810	1.8%
\$75,000	\$16,840	\$58,160	2.1%
\$80,000	\$18,490	\$61,510	2.4%
\$85,000	\$20,140	\$64,860	2.7%
\$90,000	\$21,790	\$68,210	3.0%
\$95,000	\$23,440	\$71,560	3.2%
\$100,000	\$25,090	\$74,910	3.4%
\$180,000	\$51,490	\$128,510	5.3%

While we see the company tax rate unchanged at 30%, we would not rule out a cut to 27%. However, such a move would have to be combined with other tax broadening initiatives, with the most likely option being the removal of tax depreciation on buildings and/or removing the 20% depreciation loading on new plant and equipment.

Longer term, the Government has clearly stated that they want to deliver a tax system that is growth-enhancing, fair, and sustainable. Ideally, that involves aligning the corporate, trustee and top personal tax rates. Implementing such a tax package immediately would prove too costly for a Government that is focused on lowering debt. However, we expect the announcements made in the Budget next week will be part of a transition process to such a system, with the Government outlining its intentions for further tax reform over the next few years, fiscal conditions permitting.

Better economy, narrowing deficits

The NZ economy has proved more resilient than the Treasury anticipated when the Half Year Economic and Fiscal Update (HYEFU) was released in December. At the time we felt the growth outlook was conservative, and believed that economic activity was more likely to pan out in line with their Upside scenario. As it turns out, growth now appears to be tracking even stronger than in the Upside scenario. Trading partner growth is more robust than anticipated, our terms of trade have risen sharply as export commodity prices have soared, businesses are employing again and investment plans are back on the agenda. Consumer spending and the housing market remain a source of weakness. However, for the former at least we expect the soft patch to be short lived as the labour market strengthens and consumer confidence remains high.

We expect the Treasury to make substantial upward revisions to their economic forecasts. Real GDP growth of a little over 3.0% is expected in March 2011, following an estimated 0.3% contraction in March 2010. Growth of close to 4% will be forecast in March 2012, before dropping back closer to trend in 2013 and 2014. Such a growth outlook would put Treasury slightly above the current consensus, but weaker than the RBNZ and softer than our top of the market forecast.

More substantial upward revisions will come via the Treasury's nominal GDP growth forecasts. Rising commodity prices and greater demand pressure will see the Treasury lift their terms of trade and inflation forecasts relative to the HYEFU, resulting in much stronger growth in the nominal economy. We expect nominal GDP forecasts could be as high as 7% in 2011 (from 4.8% in the HYEFU) and 6.5% in 2012, providing for a larger tax base and thus bolstering Government revenues.

In terms of expenses, we expect the Government to remain committed to the new operating spending allowance of \$1.1 billion a year (increasing by 2% each year from 2012), with most of that going to the three priority areas of health, education, and science. That means any other 'new' spending announcements will come from savings or the reprioritisation of existing expenses (which the Government estimates is worth around \$3.8bn cumulative to 2014). Forecast lower unemployment will assist in reducing benefit expenses, but overall welfare payments will likely be higher as a result of higher inflation and wage costs.² However, offsetting that should be lower finance costs as a result of lower debt levels.

Sharply higher economic growth together with the Government's commitment to spending restraint underpins our expectation that the Treasury will forecast a narrowing of the operating deficit. The most recent set of Government financial accounts (for the nine months ended March 2010) already show a substantial improvement in the operating balance relative to the HYEFU. The Total Crown operating deficit was some \$2bn smaller than forecast in the HYEFU for the nine month period. However, excluding gains and losses on investment income

² Note that the Treasury's forecasts will have been finalised before the stronger than expected Q1 Household Labour Force data was released.

Budget Economic and Fiscal Update – May 2010

	Actual	Westpac Budget estimates					Treasury's HYEFU forecasts				
	2009	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
Real GDP – ann ave % chg	-0.9	-0.3	3.2	3.9	3.0	2.8	-0.4	2.4	3.2	3.0	2.8
CPI – ann % chg	3.0	2.0	4.5	2.6	2.7	2.3	2.5	2.3	2.2	2.3	2.0
Unemployment – %	5.0	7.0	6.3	5.3	4.7	4.5	7.0	6.9	6.0	5.3	4.8
OBEGAL \$bn	-3.89	-7.40	-7.20	-4.40	-3.30	-2.30	-7.46	-6.68	-6.00	-5.78	-4.87
Net debt – % GDP	9.5	14.4	19.3	22.2	23.9	25.0	14.8	20.0	24.1	26.9	29.0
Bond programme \$bn	5.80	12.50	10.50	10.00	10.00	4.50	10.50	10.50	12.50	12.50	7.50

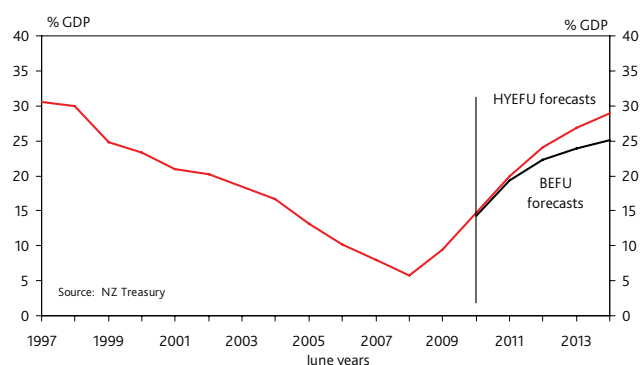
and contingent liabilities (the OBEGAL), the variance was much smaller at \$500mn. And, looking at the detail reveals that much of the improvement has come from delayed expenses (some of which will now come through in the 2011 fiscal year), rather than a pick up in revenues. In fact, underlying revenues are running around \$930mn below forecast, driven largely by lower source deductions and corporate tax. We expect the cyclical pick up in revenue to lag behind the rest of the economy through the remainder of the 2010 fiscal year and well into 2011 as companies continue to bring previous losses to account. That suggests that the OBEGAL will come in close to expectations in 2010 (we expect a deficit of \$7.3bn), with little improvement in 2011 (a deficit of \$7.0bn is anticipated).

From 2012, we expect the deficit to begin to narrow as stronger revenue growth feeds through to the bottom line. Even so, we do not foresee a return to surplus before the end of the forecast period, with the OBEGAL still showing a deficit of \$2.3bn in 2014. However, we expect the medium term projections to reveal a return to surplus two years ahead of that in the HYEFU (i.e., in 2015).

Debt burden to reduce

On these forecasts cash deficits, while remaining sizeable, will also reduce over the next four years. That will see a more gradual increase in net debt over the forecast period than factored into the HYEFU, with net debt expected to reach around 25% of GDP by 2014. That compares with a forecast of 29% in the HYEFU. While that is well above the forecast peak in net debt in Australia (at 6.1% in 2012), it compares very favourably with the debt profiles of other developed economies, with the US & UK approaching 100% of GDP.

Core Crown net debt



Bond programme

The NZ Debt Management Office (NZDMO) has already announced a \$2.0bn increase in the bond programme for the current fiscal year from \$10.5bn to \$12.5bn, with the intention being to pre-fund some of the future borrowing requirement as demand conditions permit. As such, we do not anticipate any further changes to this year's bond programme in the Budget.

Prefunding of future programmes and our prediction of smaller cash deficits relative to the HYEFU forecasts, will see a smaller overall funding task during the 2011-2014 period. Our forecasts assume a total borrowing requirement of \$35bn over the four years to 2014, down from \$42.5bn in the HYEFU.

The sale of financial assets held by the NZDMO will also assist the Government in meeting the cash shortfall over the 2011-2014 period. The HYEFU forecast financial assets to fall from \$22.1bn in 2010 to \$10.5bn in 2014. We expect a similar profile in the Budget. However, if the Treasury forecast a larger (smaller) rundown of assets, then the overall funding task will be lower (higher) than we expect.

Market implications

The immediate focus for markets will be on the size of the fiscal stimulus and the borrowing requirement going forward. While we expect the Government to continue to provide significant support to the economy over the next couple years, their commitment to fiscal discipline will likely see a smaller stimulus than estimated back in December (around 2.7% of GDP over 2010 and 2011). That is particularly important for the RBNZ. If the stimulus from the Government is smaller than they anticipated, that ultimately means they have a little less work to do.

From a medium term perspective, a Budget delivered on our expectations above should be greeted positively by the markets, in that the NZ Government will be seen to be providing a tight rein over spending while at the same time cutting taxes and reducing debt. That will be in stark contrast to many of our OECD counterparts, and will see investors continue to look to NZ as a favourable place to invest.

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