

NZ Budget 2010: Spotlight on tax

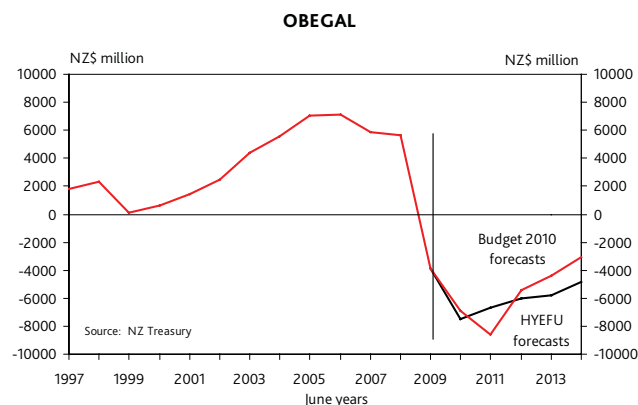
Review

- **Budget 2010 delivers comprehensive reform of New Zealand's tax system, while maintaining a tight rein on spending. Income tax cuts and a rise in GST come into effect on 1 October 2010, with most of the remaining changes effective from 1 April 2011.**
- **Budget deficits remain sizeable in the near term, with the deficit peaking at 4.2% of GDP in FY2011, one year later than forecast in the Half Year Economic and Fiscal Update (HYEFU). However, deficits begin to narrow from FY2012, reaching 1.3% of GDP by the end of the forecast period. A return to surplus is projected for 2016, two years earlier than previously projected.**
- **The Government's borrowing requirement has reduced relative to the HYEFU. Bond issuance of \$39bn is forecast over the next 4 years (\$4bn lower than in the HYEFU), with \$12.5bn of that coming in FY2011. The NZ Debt Management Office is also considering reintroducing inflation-indexed bonds next year and a new bond will most likely be issued within the next six months, with a maturity of March 2019.**
- **On balance, the Budget is mildly more stimulatory in the near term than previously forecast. That supports our view that the RBNZ will begin hiking the OCR from June 2010.**

Comment

Tax reform was widely anticipated to be main attraction of Budget 2010, and we were not disappointed. Across the board income tax cuts and a drop in the company tax rate from 30% to 28%, combined with a higher goods and services tax (GST), a crack-down on loopholes in the tax system, and a tougher stance on taxation around property represent some of the most comprehensive changes to our tax system since the mid 1990s (see Box: Budget 2010 Tax Reforms). While we had expected the Government to announce significant tax changes, they have gone even further than we had anticipated. Today's Budget should leave little doubt that this Government is serious about turning NZ's economic fortunes around.

Indeed, we see the tax reforms as clearly beneficial for potential economic growth. By promoting the fundamental drivers of economic growth (i.e. workforce participation, saving and



investment), the reforms will in time push NZ onto to a higher growth path. Treasury estimates that the tax changes will lift GDP by a further 0.4% in the four years to 2014, and 0.9% over the seven years to 2017. The payoff to economic growth could have been even larger if inroads were made into the size of government. However, the tax package is effectively trying to undo the damage done by poor tax and spending options taken in the past decade. Projections of deficits for years to come mean that the tax package has had to be designed to be broadly revenue-neutral.

From an international perspective, this Budget compares favourably with many other OECD economies. Certainly, the policy direction goes against the grain of that seen in the likes of the US, the UK, Greece and other parts of Europe. Overall, we believe the Government has achieved a good balance between delivering growth enhancing tax reform, while at the same time keeping a tight rein on expenses. In the medium term, that will see our debt levels reduce, making us less vulnerable to international shocks and providing greater choices for fiscal policy in the future.

A stronger economy...

As expected, the Budget presented an improved outlook for the economy. Real GDP is forecast to grow above trend over the next four years, registering growth of 3.2% in March 2011, 3.1% in March 2012, 2.9% in March 2013, and 3.0% in March 2014. Growth is primarily driven by strength in the global economy,

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which boosts demand for our exports, and the lagged effects of the easing in monetary conditions since the middle of 2008. High confidence levels, the Rugby World Cup, and the benefits of the tax package are also seen as key growth drivers over the forecast period. Treasury’s forecast for GDP growth is close to consensus, but weaker than the RBNZ and Westpac’s growth forecasts.

Unemployment is expected to fall substantially over the next few years, with the unemployment rate reaching 4.6% by 2014. Note that these forecasts were finalised before the surprise drop in the unemployment rate, from 7.1% in 2009Q4 to 6.0% in 2010Q1.

Of some surprise, the Treasury forecasts annual inflation to rise to 5.9% in March next year. Of that 2.0% can be attributed to the increase in GST, while 0.5% reflects an increase in the tobacco excise tax. Excluding tax changes, Treasury expects inflation to reach 3.1%. Treasury has assumed that the temporary boost to inflation will not affect inflation expectations – an open point in our opinion. Annual inflation averages 2.4% over the remainder of the forecast period.

Higher real GDP, higher inflation, and forecasts of a stronger terms of trade sees nominal GDP growth rise from 1.7% in the year to March 2010 to 7.0% in March 2011, before averaging 5.4% in the three years to 2014.

...sees the fiscal position improve, eventually

Despite the forecast stronger economy, the pick up in tax revenue is expected to be constrained over the next few years. Subdued business profitability in the early stages of recovery and the accumulation of tax losses will remain key features through FY2010. However, the timing of the tax changes (with many of the tax-broadening measures not being implemented until 1 April 2010, six months after the income tax cuts) mean that there will be a short fall in revenue between 2011-2013 (see Table 3). It is not until 2014, that the tax changes are expected to be broadly revenue neutral.

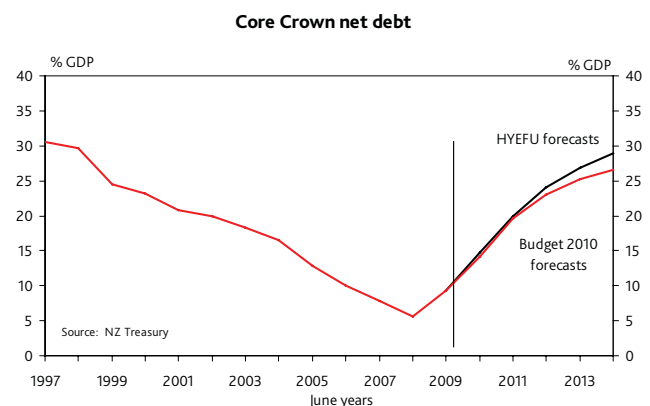
In absolute terms, core crown government expenses are forecast to rise by 19% between June 2010 and June 2014. That is despite the government remaining committed to the \$1.1bn cap on new operational spending from June 2011, growing at 2% per annum thereafter. The higher expenses largely reflect higher inflation-indexed benefit costs and rising finance costs associated with a higher level of debt. However, as a share of GDP, expenses fall from a peak of 34.7% in 2011 to 32.4% in 2014.

The Core Crown operating deficit excluding gains and losses is forecast to be \$6.9bn in the FY2010 year, rising to a peak of \$8.6bn (4.2% of GDP) in 2011. That is worse than projected in the HYEUFU, reflecting the lower tax revenues in the near term and delays in some expenditure that had been previously planned for FY2010, but is now expected to fall in FY2011 (e.g., some transport-related spending and Treaty of Waitangi settlements) Thereafter the deficit is forecast to narrow reaching \$3.0bn (1.3%) by FY2014.

Importantly, the core crown operating balance is expected to be back in surplus in FY2016 (equivalent to 0.6% of GDP), two years earlier than projected in the HYEUFU. By keeping future spending in check, the Government has allowed the majority of the improvement in the economic outlook to flow through to the bottom line. As such, NZ’s fiscal position compares very favourably with other OECD economies.

Debt build up slower

Reflecting the narrowing in the operating deficits, cash deficits are also expected to narrow, which has seen an improvement in the overall debt position relative to that anticipated in the HYEUFU. Net Core Crown debt is now expected to rise from 9.3% of GDP in 2009 to 26.5% in 2014 (29% in the HYEUFU). Net debt is projected to peak at 27.4% of GDP in 2015. The Government’s long-term fiscal objective is for net debt to be brought back to a level no higher than 20% of GDP by the early 2020s. On these projections, the 20% target will be achieved in FY2022.



Bond programme lower

The Government Bond programme has been front-loaded to accommodate the new profile of the deficit. While, more bonds will be issued in the year-to-June 2011 (\$12.5bn from the \$10.5bn forecast in HYEUFU), fewer will be issued in later years, compared to the previous forecast. Over the four years to 2014, the total bond programme has been reduced by \$4bn.

DMO is considering reintroducing inflation-indexed bonds next year, which will form part of the \$12.5bn programme for that year. A new bond will also most likely be issued within the next six months, with a maturity of March 2019.

Tax changes and the housing market

Today’s changes are a clear negative for house price growth. In New Zealand, property ownership works like an income tax shelter for both owner-occupiers and for landlords. If the rate of income tax falls, then the tax-shelter value of property ownership wanes, and the capital value of property will fall. We estimate that changing the top marginal rate of income tax to 33% would, in time, reduce the value of housing by around 10% relative to what it would have been under a 38% tax rate. This is not the same as forecasting that prices will fall by 10%. More likely, prices will stay flat for longer than they otherwise would have.

Some property segments, and some individual owners, could be hit particularly hard by the tax changes. The change to depreciation rules will adversely impact cash flow for a few property investors. Lower-end property prices will be hit hardest by the reduction in income tax, because that is the segment in which investors are most active and it is the segment that will experience the least improvement in after-tax income. We expect a reversal of the price compression that occurred after the marginal rate of income tax was hiked last decade.

Market reaction and implications

The NZD/USD rose from 0.6810 to as high as 0.6875, though with Europe's woes weighing on global markets it has since fallen back to 0.6750. Perhaps the better indicator of how the market took the news is the NZD/AUD rate, which has risen from 0.8070 to 0.8110. The two-year swap rate rose by 6 basis points to 4.42%, as the Budget was read as supporting the RBNZ's intentions to begin raising rates at the next review in June.

Indeed, we consider the Budget as stimulatory in the short run as the initial cost of the tax cuts is greater than the revenue benefit of GST. In Treasury's assessment, this stimulus will cause 0.3% percent extra inflation. However, the removal of depreciation on buildings and other contractionary measures coming into force from 1 April 2011 will see fiscal policy broadly neutral thereafter. This amounts to a short term boost to the economy in the six month period from 1 October 2010, which all else equal is consistent with our view that the RBNZ will begin hiking the OCR from June this year.

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Budget 2010 Tax Reforms

Immediate change:

- Removing the 20 per cent accelerated depreciation loading for new plant and equipment purchased after Budget day.

1 October 2010 changes include:

- Across the board personal tax cuts worth \$14.3 billion over four years.

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%

- Increasing the rate of GST from 12.5 per cent to 15 per cent.
- Tax cuts on NZ Super and a 2.02 per cent increase in payments to recipients of NZ Super, main working-age benefits and Working for Families – reflecting Statistics New Zealand's calculation of the effect on prices of the rise in GST – worth \$2.2 billion over four years.
- A cut in the top tax rate for most PIEs from 30 per cent to 28 per cent.

1 April 2011 (or the 2011/12 income year) changes include:

- A cut in the company tax rate from 30 per cent to 28 per cent.
- A cut in the tax rate faced by unit trusts, life insurance policyholders and some other savings vehicles from 30 per cent to 28 per cent.
- Ending landlords' and businesses' ability to claim depreciation on buildings with an estimated useful life of 50 years or more.
- Tightening the rules for loss attributing qualifying companies (LAQCs) and qualifying companies (QCs) so shareholders cannot deduct losses at their marginal tax rate and pay tax on profits at the lower company rate.
- Changes to the thin capitalisation tax rules to limit the scope for foreign multinationals to reduce their New Zealand tax liability.
- Tightening the definition of income for Working for Families eligibility. The new rules will exclude investment and rental losses and end the automatic CPI indexation of the abatement threshold to stop higher-income recipients getting bigger increases than those on lower incomes.
- Increasing IRD audit and compliance activity to improve the integrity of the tax system.

Table 1: Economic Outlook

March years	Actual 2009	Budget					Treasury's HYEFU forecasts				
		2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
GDP (Prodn, Real)	-1.4	-0.3	3.2	3.1	2.9	3.0	-0.4	2.4	3.2	3.0	2.8
Nominal GDP \$bn	1.7	1.7	7.0	6.3	4.8	5.1	1.7	4.8	5.2	4.9	4.9
Unemployment rate	5.0	7.1	6.2	5.5	5.1	4.6	7.0	6.9	6.0	5.3	4.8
CPI inflation	3.0	2.2	5.9	2.4	2.4	2.4	2.5	2.3	2.2	2.3	2.0
TWI*	53.7	65.3	65.2	63.5	58.5	54.0	66.5	63.5	58.1	55.1	53.2
90-day bank bill rate*	2.7	2.7	4.3	5.2	5.4	5.7	2.9	3.9	4.9	5.4	5.8

* Average for March quarter

Table 2: Fiscal Outlook

June years	Actual 2009	Budget					Treasury's HYEFU forecasts				
		2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
OBEGAL \$bn	-3.89	-6.93	-8.63	-5.41	-4.39	-3.04	-7.46	-6.68	-6.00	-5.78	-4.87
%GDP	-2.1	-3.7	-4.2	-2.5	-1.9	-1.3	-4.0	-3.4	-2.9	-2.7	-2.2
GSID % GDP	23.5	28.4	32.8	32.3	31.7	32.7	29.1	33.2	33.9	34.3	36.0
Net Crown Debt % GDP	9.3	14.1	19.6	23.0	25.3	26.5	14.8	20.0	24.1	26.9	29.0
Bond Programme \$bn	5.8	12.5	12.5	10.5	10.0	6.0	10.5	10.5	12.5	12.5	7.5

Table 3: Fiscal impacts of tax changes in Budget 2010 \$million (rounded to nearest \$5m)

	Increase (decrease) in operating balance				
	2010/11	2011/12	2012/13	2013/14	4-yr total
Personal tax rate cuts	-2,455	-3,685	-3,935	-4,255	-14,330
Compensation for GST rate increase	-420	-585	-610	-620	-2,235
Company tax cut to 28%	-20	-340	-450	-305	-1,115
PIEs & savings vehicles capped at 28%	-15	-40	-55	-60	-170
Administration associated with tax package	-10	-	-	-	-10
<i>Sub-total of negative impacts on operating balance</i>	-2,920	-4,650	-5,050	-5,240	-17,860
GST rate increase ¹	2,040	2,840	2,985	3,160	11,025
Non-compensatory Working for Families changes	5	40	75	65	185
Depreciation measures	140	935	1,000	1,045	3,120
LAQC changes	-	70	65	55	190
Thin capitalisation 60% threshold	-	200	200	200	600
GST base changes	15	60	60	60	195
Tobacco excise rate increases	135	180	210	190	715
Increased audit and compliance activity (net revenue)	120	210	210	205	745
<i>Sub-total of positive impacts on operating balance</i>	2,455	4,535	4,805	4,980	16,775
Sub-total of estimated static impact	-465	-115	-245	-260	-1,085
Adjustment for macroeconomic effects	5	25	205	435	670
Total impact on operating balance	-460	-90	-40	175	-415

¹ Includes the additional tax revenue generated from spending associated with the static net income gain for households resulting from the tax package