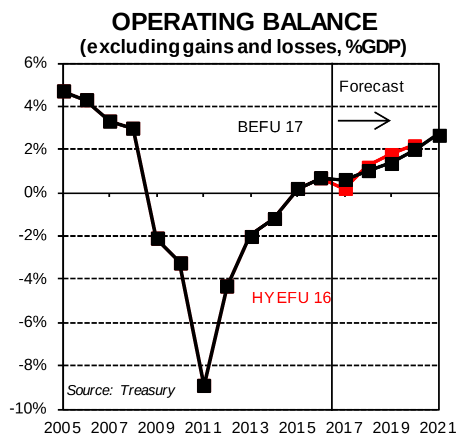
Budget 2017 – a family focus

- **As expected, Budget 2017 shows the Government's books are very healthy.**
- **Also as expected, the Government has chosen to lift the income tax thresholds.**
- **However, there remains a streak of conservatism, particularly in the focus on long-term debt reduction.**

Summary
As the pre-Budget hints suggested, the **focus of policy initiatives was very much on assisting low-income earners and low-income families.**

Standing back the **picture is very healthy**. The nominal growth outlook has improved since 2016, boosted by the return of some long-absent inflation. And the **Government has outlined how it intends to share some of these gains** with Kiwis and, in particular, families.

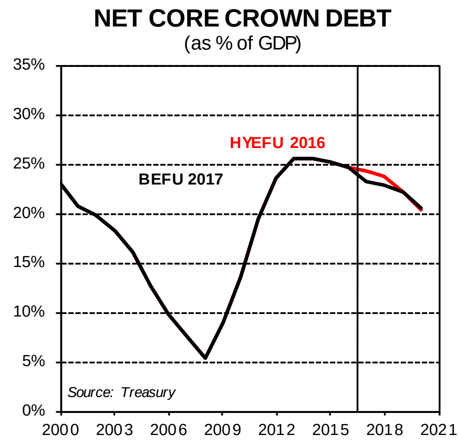
However, **could they do more**? **We think so**, particularly as there is scope to debate how far net debt needs to fall over the long term. Will they do more? Possibly. After all there are still four months until the election and these healthy books mean that **the Government will still have options up its sleeve during the election campaign.**



Operating surpluses
As expected the Government, to a degree, **has had its fiscal cake and eaten it too.** The Government has been able to increase spending modestly via the Family Incomes Package, while keeping its healthy forecast surpluses intact.

Indeed, the **OBEGAL (Operating balance excluding gains and losses) forecast track looks very similar to previous outlooks**. Namely, OBEGAL is forecast to be 0.6% of GDP in 2016/17, and then lifts steadily to 2.7% of GDP by 2020/21.

Within the new OBEGAL, the operating allowance has lifted slightly. New operating spending as part of Budget 2017 averages $1.8bn annually over the next four years compared to $1.5bn previously forecast. This lift has also largely flowed through to future Budgets, with the allowance for Budget 2018 lifted to $1.7bn.



Net debt
The fiscal picture is also remarkably similar in terms of net debt. For example, the Budget shows net debt falling to 19.3% of GDP in 2020/21. This figure is only marginally higher from the 18.8% estimated at the Half-Year Update back in December.

FISCAL PROJECTIONS					
Period Ending (June year)	**2017**	**2018**	**2019**	**2020**	**2021**
Core Revenue ($bn)	**80.8**	**83.8**	**87.5**	**92.5**	**96.8**
(HYEFU 2016)	*80.5*	*84.2*	*88.4*	*92.6*	*97.1*
Core Expenses ($bn)	**77.5**	**80.5**	**83.5**	**86.2**	**89.2**
(HYEFU 2016)	*78.3*	*80.1*	*82.4*	*85.2*	*87.8*
OBEGAL ($bn)	**1.6**	**2.9**	**4.1**	**6.1**	**7.2**
(HYEFU 2016)	*0.5*	*3.3*	*5.4*	*6.8*	*8.5*
OBEGAL (% GDP)	**0.6**	**1.0**	**1.4**	**2.0**	**2.7**
(HYEFU 2016)	*0.2*	*1.2*	*1.8*	*2.2*	*2.7*
Net core crown debt (%GDP)	**23.2**	**22.8**	**22.1**	**20.6**	**19.3**
(HYEFU 2016)	*24.3*	*23.8*	*22.2*	*20.3*	*18.8*

Nick Tuffley – Chief Economist – 649 301 5659 – nick.tuffley@asb.co.nz
Nathan Penny – Rural Economist – 649 448 8778 – nathan.penny@asb.co.nz

Notably, **with the Government on track to hit its net debt target of below 20% of GDP that year**, contributions to the New Zealand Superannuation Fund also remain on schedule to then kick in. However, the Finance Minister has signalled his intentions to go further. Prior to the Budget, Minister Joyce indicated that the **Government intends to reduce net debt to between 10% and 15% by 2025.**

But how low is low enough?
We remain unconvinced on the need for this lower debt target. From where we sit, low debt, which **NZ already has**, makes sense to give NZ **resilience against any further global shocks or natural disasters**. But even lower – we are not so sure. NZ continues to climb up the global leader board in the economic and fiscal credibility stakes. And globally, while interest rates have risen a touch over the past year or so, they remain historically low. We also note that the 5-cent rise in the EQC levy will allow the fund to rebuild its disaster reserves to $1.75bn over the next 10 years.

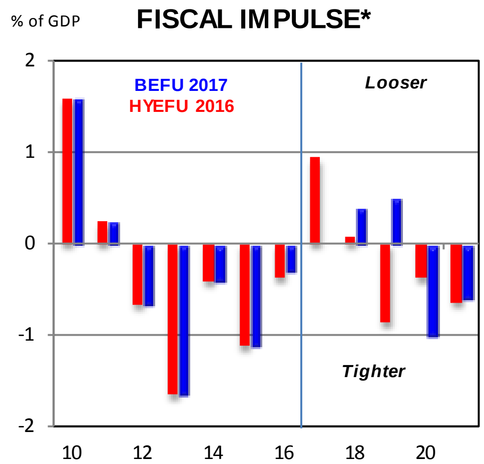
A steady net debt profile around the previous target of 20% would still have the same stabilising and comforting effect, should the Government have to deal with a large earthquake or financial crisis. And the move lower could be more gradual. **NZ no longer has to prove it can be fiscally responsible – it has spent the last 8 years doing that.**

Restoring the finances after the ravages of the Global Financial Crisis and devastating earthquakes has been a necessary priority. That legacy is evidently still a factor behind current fiscal decisions. And, **perhaps, the Finance Minister still has one eye on the election later this year and kept some powder dry.**

There is, though, an alternative approach that was previous a luxury. NZ's population growth has grown rapidly in recent years, putting strain on NZ's physical and social infrastructure. **Increasingly, the potential costs of not being further prepared for the random 'what-ifs' need to be balanced against the here-and-now costs being faced by numerous families.**

There is now the scope for even greater investment (**than announced**) in infrastructure, social services, education, and other areas that will help lift the incomes and quality of life of New Zealanders. And, while doing that, the Government could still choose to run down net debt, albeit at a slower pace, and still retain some room for future fiscal choices.

Moreover, in an environment where inflation pressures are still low overall, **there is room for a more expansionary fiscal stance**. Note that as shown in the chart, the **fiscal impulse – despite increased spending and capital allowances – remains on the contractionary side**. In other words, if fiscal policy was more expansionary, it would make the Reserve Bank be more confident in meeting its medium-term inflation objective.



*plus Crown Entity ex EQC and Southern Response

More nominal growth

Economic Forecasts	2016	2017			2018			2019			2020		
June years (ann avg)	Actual	Budget	ASB	HYEFU	Budget	ASB	HYEFU	Budget	ASB	HYEFU	Budget	ASB	HYEFU
GDP (Production)	2.7	3.1	2.8	3.6	3.5	3.4	3.5	3.8	3.8	2.9	2.9		2.4
Private consumption	3.2	4.6	4.3	4.0	3.9	3.1	3.7	3.7	4.0	3.3	2.2		2.8
Govt consumption	1.9	3.0	3.2	2.6	2.0	2.9	1.5	1.4	2.8	1.0	1.4		1.1
Residential Invest	6.3	6.7	7.6	14.3	0.3	3.3	7.8	8.7	1.1	2.1	8.8		-1.7
Non-residential Invest	2.7	6.4	4.1	-	6.8	6.8	-	5.9	5.7	-	5.7		-
Exports	5.1	-0.6	-0.3	1.4	3.4	2.1	1.9	3.3	2.3	3.0	2.7		2.7
Imports	1.3	6.3	6.5	5.7	3.7	3.7	5.0	4.5	3.7	4.0	4.2		2.8
Inflation (ann % chg)	0.4	1.8	1.8	1.5	1.6	1.6	2.0	2.1	1.8	2.1	2.2		2.0
Unemployment	5.0	5.0	5.0	4.8	5.0	4.7	4.6	4.6	4.6	4.2	4.3		4.3
90-day bank bills*	2.4	2.0	2.0	1.9	2.0	2.0	1.9	2.7	2.5	2.3	3.4		3.2
TWI*	73.6	76.1	73.4	76.5	76.6	74.6	74.9	76.9	73.7	75.0	76.7		74.5

*quarter average

The key economic revision for the Treasury was higher Terms of Trade than expected previously, which led to a higher nominal GDP growth outlook. The boost from higher export commodity prices more than offsets weaker real GDP growth in the near term.

All up, **Treasury expects nominal GDP to be cumulatively $23.9bn higher in the 5 years to June 2021** compared to the HYEFU forecasts. This highlights that a little inflation is a good thing from the point of view of the Government's tax take.

Broadly speaking, Treasury's economic forecasts are reasonably similar to our own. Treasury expects economic growth to accelerate over coming years. From 3.1% growth in the June 2017 year, Treasury forecasts annual growth to pick up to 3.8% growth in the June 2019 year.

However**, while this indicates that the economy is growing strongly overall, per capita growth remains modest.** For example, per capita growth fluctuates between a modest 1.1% and 1.8% over the forecast period.

One area of difference from our own forecasts is Treasury's view of residential investment growth. The Treasury views the **recent slowdown in dwelling consent growth as temporary**, but acknowledged "considerable uncertainty" in this assumption. **In contrast, our views for residential investment growth are more conservative**, reflecting a view that capacity constraints in the construction industry may cap growth despite strong underlying demand.

Slightly larger Bond Programme

The **bond programme is largely unchanged as expected**. Precisely, gross bond issuance over the five years to 2020/21 is cumulatively $1bn higher than forecast at HYEFU 2016, with the extra issuance scheduled for 2019/20.

Despite the Government's intention to further reduce net debt, the **Government has announced that it intends to maintain the levels of bonds on issue at no less than 20% of GDP over time**. In this sense, "*the Government recognises the importance of maintaining a sustainable NZGB market.*"

Bond tender programme $bn					
Period Ending June	**2017**	**2018**	**2019**	**2020**	**2021**
BEFU 2017	**8.0**	**7.0**	**7.0**	**7.0**	**6.0**
HYEFU 2016	*8.0*	*7.0*	*7.0*	*6.0*	*6.0*

Budget 2017 Initiatives

As was widely signalled pre-Budget, the flagship Budget announcement centred on lifting the tax income thresholds and providing income support for low-income families. On the day, the announcements were grouped together as the Family Incomes Package.

All up and once fully implemented, **the Family Income Package changes amounted to a cost of $2bn in annual terms**. As well as the tax changes, increases were made to the Family Tax Credit, Accommodation Supplement and Accommodation Benefit. However, the tax threshold changes accounted for the lion's share of the $2bn cost.

In terms of weekly incomes, **people earning $22,000 or more will receive a tax cut of $11 a week**. The tax cut rises to $20 per week for someone earning $52,000 or more.

Tax Income Threshold Changes:

Current Bracket $	New Bracket $	Rate %
1 - 14,000	1 – 22,000	10.5
14,001 – 48,000	22,001 – 52,000	17.5
48,001 – 70,000	52,001 – 70,000	30
70,001+	70,001+	33

Market reaction

With the **Budget broadly as expected, there was very little reaction in financial markets**. There was only $1bn of additional bond issuance signalled. Swap rates were entirely unmoved over the first 10 minutes of the release. The NZD did lose a few points against most currencies, but the move was well within recent ranges and did not test any major levels.

ASB Economics & Research			Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659	(649) 302 0992
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853	
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778	
Senior Wealth Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915	
Economist	Kim Mundy	kim.mundy@asb.co.nz	(649) 301 5661	
Economist	Daniel Snowden	daniel.snowden@asb.co.nz	(649) 301 5657	
Publication and Data Analyst	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660	

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@ASBMarkets

ASB Economics
ASB North Wharf, 12 Jellicoe Street, Auckland