

NEW ZEALAND GOVERNMENT 2007 BUDGET

Key points

- Fiscal position remains strong, allowing Government to increase spending and run stronger operating surpluses.
- KiwiSaver and Business Tax Reform package the main centre-piece of *Budget* with a key focus on improving national savings.
- Once again, Dr Cullen has struck a good balance between running prudent fiscal policy and not fanning an excessive domestic economy.
- Despite a stronger focus on saving, the fiscal impulse is more expansionary in the coming year relative to that flagged six months ago.
- The *Budget* on the whole appears to add more pressure on domestic demand and leans against the Reserve Bank's efforts, although a lot will depend on how consumers respond to Kiwisaver.
- Bond tender programme largely unchanged at \$2.5 billion per year over the forecast period.

The Numbers

Treasury Economic Forecasts – 2007 Budget (HYEFU 2006 forecasts in brackets)

March Years	2006/07	2007/08	2008/09	2009/10	2010/11
Real GDP (ann. ave. % chg., production)	1.7 (1.8)	2.6 (2.3)	1.6 (3.2)	2.8 (3.1)	3.1 (3.0)
Nominal GDP (ann. ave. % chg.)	4.4 (3.3)	5.6 (4.3)	3.5 (5.6)	4.2 (5.0)	4.8 (4.9)
Current account deficit (% of GDP)	-8.6 (-9.3)	-7.4 (-8.8)	-7.1 (-6.8)	-6.9 (-6.3)	-6.2 (-6.3)
Unemployment rate (%)	3.8 (4.0)	3.9 (4.8)	4.5 (4.6)	4.4 (4.4)	4.3 (4.3)
CPI (ann. % chg.)	2.6 (2.8)	2.7 (2.7)	2.4 (2.0)	2.4 (2.0)	2.2 (2.0)

Treasury Fiscal Forecasts – 2007 Budget (HYEFU 2006 forecasts in brackets)

June Years	2006/07	2007/08	2008/09	2009/10	2010/11
Operating Balance - \$ million ¹	6,327 (6,260)	6,431 (6,071)	5,569 (5,197)	5,310 (5,826)	5,366 (5,979)
- % GDP	3.8 (3.8)	3.7 (3.6)	3.1 (2.9)	2.8 (3.1)	2.7 (3.0)
Net Core Crown Debt - % GDP	3.1 (3.9)	2.7 (3.5)	3.1 (4.0)	3.3 (4.1)	3.5 (3.8)
Gross Sovereign-Issued Debt (% of GDP)	23.0 (23.3)	23.3 (23.5)	22.5 (21.8)	21.3 (20.5)	21.8 (20.7)
Bond tender - \$ million	2,511 (2,456)	2,520 (2,517)	2,500 (2,476)	2,483 (2,472)	2,515 (2,465)

¹ 2007 Budget figures in new GAAP terms while HYEFU forecasts were based on old GAAP terms.

The economic forecasts underpinning the *Budget* is more cyclical compared to the HYEFU forecasts. The Treasury now sees stronger growth in the year to March 2008 of 2.6 percent, but slowing to 1.6 percent in the year to March 2009 before returning towards trend. Tighter monetary conditions compared to the HYEFU are the main drivers of the economic cycle forecast by the Treasury, and we do not find too much to quibble with. The Treasury sees short-term interest rates staying where they are until mid-next year, and the TWI holding up at around the 69 level until early next year.

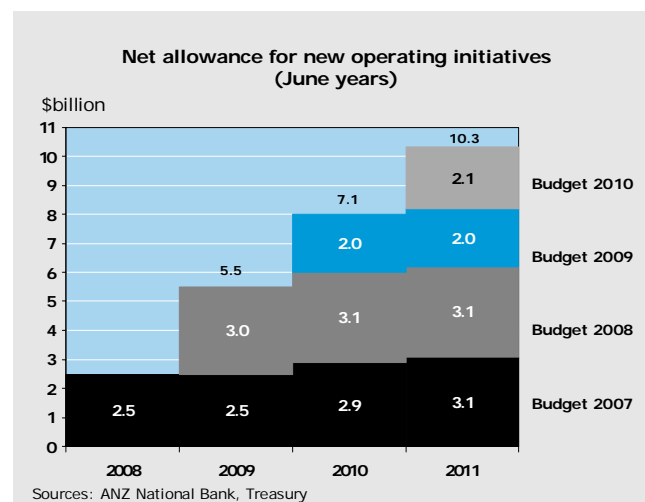
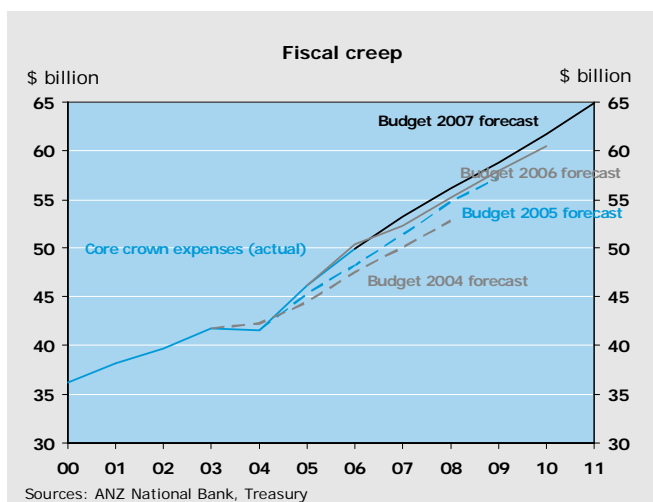
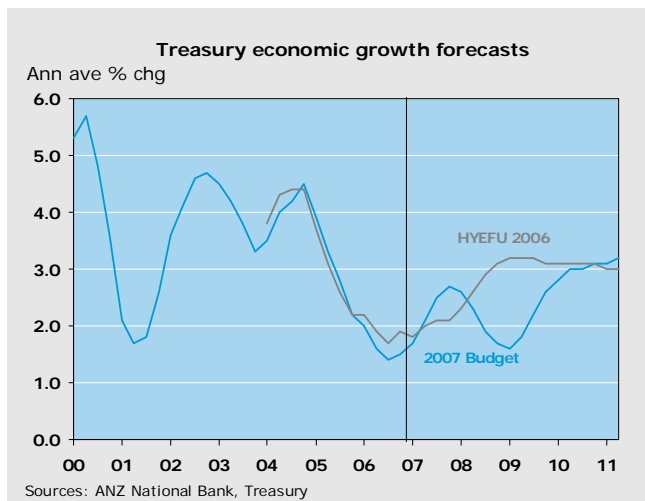
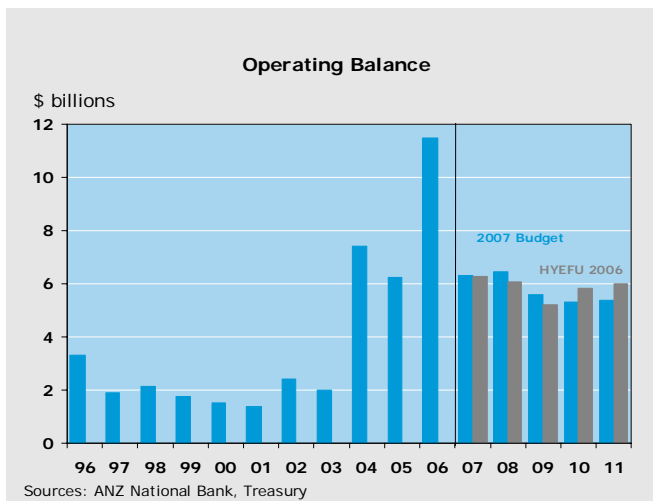
Tax forecasts revised up reflecting higher inflation and a higher effective tax rate on source deductions and company tax. Despite the more cyclical economic forecasts, higher inflation and terms of trade, and some changes to the Treasury's assumptions about the effective tax rate for source deductions and company tax, has delivered more forecast tax revenue. This has given the Government more spending headroom, and allowed them to increase spending (or introduce tax initiatives) while at the same time continuing to run healthy operating surpluses.

The operating allowance for the 2007 Budget has been increased by between \$0.6 billion in 2007/08 and \$1.2 billion by 2010/11. A stronger tax base has given more scope for additional initiatives. Almost all

of this increase is to fund the KiwiSaver tax credit. The operating allowance for future Budgets remain largely unchanged from that signalled in the *HYEFU*. But stronger than expected tax revenues see the fiscal accounts still in strong shape, with an operating surplus of 3.7 percent of GDP expected for 2007/08 and 3.1 percent of GDP in 2008/09.

The capital spending allowance has been increased to \$1.6 billion over four years, from the \$0.9 billion flagged in the *HYEFU*. This increase is to fund transport infrastructure spending with the bulk of the increase going into the electrification of Auckland's rail network, the upgrade and maintenance of Wellington's network, and improvements to the national network.

The bond tender program was left largely unchanged with around \$2.5 billion expected to be issued for each year in the forecast period.



Key Budget themes

The *Budget* is aimed at advancing initiatives on three themes:

- **Economic transformation.** The KiwiSaver and Business Tax Reform packages are the key flagship initiatives in the *Budget*. \$500 million over 4 years in capital spending is also included for the electrification of Auckland's rail network, the upgrade and maintenance of Wellington's network, and improvements to the national network. Regions will be given the ability to raise funds through a regional fiscal fuel tax for specific transport capital projects. Other initiatives include funding to promote the 2007 Export Year and improve tertiary education.
- **Families – young and old.** As usual, health is the big winner here, along with more funding for the police and justice sector, and for initiatives for schooling, early childhood education and youth interventions. The adjustment of the New Zealand Superannuation rate to no less than 66 percent of the net average ordinary-time weekly wage is also a key part of this theme.
- **National identity.** This theme covers a whole raft of initiatives ranging from increasing New Zealand's Official Development Assistance, to increased funding for Maori and Treaty-related initiatives.

Tax credit for KiwiSaver and the Business Tax Reform package are the *Budget's* key flagship policies. There is not a lot of surprises from the Business Tax Reform package. The company tax rate will be cut to 30 percent from 33 percent on 1 April 2008. Tax credits for R&D and a tax exemption for active income of New Zealand controlled foreign companies will be introduced.

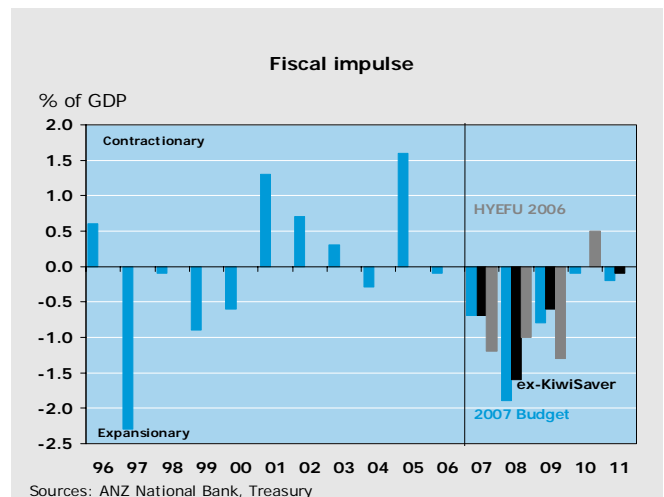
Tax credits and matching contribution from employers is to be introduced for KiwiSaver, in what is the only "deep dark secret" that this *Budget* provided. The Government will provide tax credits of up to \$40 a week (half to the employee paid into the KiwiSaver account, and half for employer contributions) for those contributing to KiwiSaver. Matching employer contributions will be compulsory from 1 April 2008, starting at 1 percent of employee's gross salary and rising to 4 percent by 1 April 2011. A take-up of 50 percent for KiwiSaver by 2016/17 is expected. The tax threshold adjustment that was due to come into effect from next year has been shelved to partly fund the KiwiSaver tax credits.

Assessment

Rosy fiscal numbers give more room for spending. It was always going to be the case that, presented with such a strong fiscal position, the Government could not just pocket the higher forecast tax revenue. Any additional revenue was always going to be spent and the only question was on what. Dr Cullen is well aware of the macroeconomic pressures facing the economy, and the limited headroom that the Reserve Bank has. The Bank has given repeated warnings about the effect of fiscal policy on domestic demand. Dr Cullen's decision to channel the extra spending (\$0.6 billion in 2007/08 rising to \$1.2 billion in 2010/11) mainly into the KiwiSaver tax credit is designed to reduce his "embarrassment of riches", give the KiwiSaver a kickstart, and limit any pressure on monetary policy. Even with the increased spending, the Government is still expected to run operating surpluses of around 2¾ and 3 percent of GDP over the forecast period.

The fiscal stance is more stimulatory in 2007/08, even when the KiwiSaver expenditure is excluded.

Complicating the fiscal impulse comparison with the *HYEFU* is the less than expected expansionary impact in 2006/07, mainly due to delays in operating and capital spending and stronger tax revenue. This in turn has boosted the fiscal impulse measure in 2007/08. The contribution of fiscal policy on the economy is less expansionary than first thought in 2006/07, and yet resource and inflation pressures have turned out to be more intense. This suggests that the fiscal impulse in 2007/08 will work against the Reserve Bank by more than first thought, even if the KiwiSaver spending is excluded. More infrastructure spending on the rail network in Auckland, Wellington and the national network is already on top of previous large increases in infrastructure spending, and will add to more pressure in the construction industry.



Introduction of regional fuel taxes could add direct inflationary pressure. The *Budget* paves the way for regions to raise funds through a regional fuel tax for specific transport projects. An increase in the fuel tax will reduce household disposable income but will also add directly to headline inflation. The Reserve Bank may choose to look through the initial effects of any fuel tax increase. But it will cause the Reserve Bank concern if the fuel tax increases were to become entrenched in inflation expectations.

The Business Tax Package will provide some much needed relief for the business sector. The reduction to the corporate tax rate and tax credits for R&D will be slightly offset by the compulsory matching contribution that employers are expected to make. However, on a net basis, businesses will still be better off as part of the matching contribution will be reimbursed by the Government through a tax credit.

No personal tax cuts signalled. The *Budget* was silent on personal tax cuts. The income tax threshold adjustment, which was due to come into effect next year, has been shelved to partly fund the KiwiSaver tax credits. The gap between the company tax rate and the top marginal tax rate will increase to 9 percent, which will encourage more high income earners to consider setting themselves up as companies. Such a large tax differential is highly distortionary, but there seems no willingness to close this gap at present.

Saving up the warchest for next year. The strong fiscal position gives the Government ample scope for a big election year lolly scramble next year. As we noted in our *Budget* preview, there is no need for them to splash out at the moment, and the incentive is to hold on until next year to unveil an election-winning *Budget*. We suspect any changes to income taxes will be part of either next year's *Budget*, or at least as part of pre-election spending promises.

Attempts to reign in housing market. There has been no change to existing policies regarding LAOCs or the tax treatment of investment property. But the IRD has been given \$14.6 million to expand and strengthen its audit activity targeted at property speculators. This is merely ensuring that current tax rules around capital gains tax are more rigorously enforced.

Financial Market Implications

The *Budget* appears to make all the right noises in terms of being fiscally prudent, encouraging saving, investing in infrastructure and skills to improve productivity, while at the same time not putting too much undue pressure on the economy. The Business Tax Package was well signalled in advance and today's *Budget* contained no surprises. All the additional spending in the 2007 *Budget* has been channelled towards KiwiSaver.

Fiscal impulse larger, but composition makes a difference. On the face of it, the fiscal impulse over the next few years will add to domestic demand and inflation pressure, stemming from more capital spending and the KiwiSaver tax credits. At the margin, the composition of the fiscal impulse means it is more favourable than the headline impulse measure suggests. The impact of the KiwiSaver tax credits depends a lot on how consumers indirectly respond to it.

Nonetheless, the Reserve Bank will remain wary. The Reserve Bank faces the real reality that a more material fiscal loosening will occur next year. The fiscal impulse for 2007/08 is now expected at between 1.6 percent and 1.9 percent of GDP, depending on whether you include the KiwiSaver tax credits or not. This is a substantial fiscal stimulus at a time when inflation pressure is still expected to be severe. Further fiscal stimulus in next year's *Budget* will see the fiscal impulse become expansionary to the tune of over 1 percent of GDP over 2008/09 and 2009/10 as well. This is a long period of time when fiscal policy is expansionary and working against monetary policy.

On balance, given the Reserve Bank's repeated concern towards fiscal policy, we take today's *Budget* as slightly adding to the case for a further rate hike, and sooner as opposed to later. While financial conditions have tightened considerably, the Reserve Bank cannot afford to let momentum within the economy continue given the prevalence of inflation pressure. This time around, the consolidation for the economy and housing needs to be definitive. The bias will be to do more than is necessary on the rates front to engineer this.

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