

### NZ Budget 2010 Preview

- Budget to focus on reforming tax system to be less distortionary.
- Economic backdrop improved considerably compared to 2009 Budget.
- Nonetheless, continued outlook for fiscal deficits will require fiscally neutral policies.

The Government is scheduled to release the Budget 2010 on May 20<sup>th</sup> (from 2pm). The focus will be on the impact of probable changes to the structure of the tax system. The Government has expressed some appetite for the Tax Working Group's findings and recommendations on tax reform. The motivation behind the reform is to reduce distortions which have been affecting work and investment decisions. Included in these changes, we are expecting the Government will lift GST to 15% (from 12.5% currently) and lower income tax rates across the board, while changing the tax policy around residential investment property.

The Government faces a far more favourable economic backdrop compared to this time last year. The economic outlook improved considerably between May 2009 and December 2009. The December update showed fiscal deficits reducing at a much swifter pace compared to May 2009's Budget. Since December, the outlook has continued to improve, allowing the government more wiggle room with the timing of policy (perhaps delivering some income tax cuts ahead of revenue raising initiatives).

Nonetheless, the continued outlook for fiscal deficits will limit the Government's flexibility within the Budget. Any changes will need to be fiscally neutral. Lost revenue from income tax cuts will need to be offset by increased revenue gathering elsewhere. Additional spending will come at the expense of spending in other areas. Unfortunately, there will be winners and losers on the day. However, the overall thrust of changes are likely to be designed to deliver a tax system which is less distortionary and more conducive to economic growth. Further, as the economy has now lifted out of recession and the RBNZ prepares to lift interest rates, the Government has the opportunity to deliver a budget that will help unwind the level of stimulus, such that interest rates do not need to rise as far as would otherwise be the case.

#### Overview of potential policy changes

*Goal to reform tax system to reduce distortions.*

#### Tax: rationale for changes

*"We want to create a tax system that strengthens the economy, rewards effort, reduces tax avoidance and keeps talented New Zealanders at home. We also want to tilt the economy towards exports and investment, and away from consumption and borrowing" Bill English, Minister of Finance, February 2010.*

The Tax Working Group is clearly of the view that tax reform is required "if New Zealand is to have a fair tax system that minimises the costs of raising taxes, reduces barriers to productivity and growth and positions it well for future challenges". The Government's goal is to remove some of the distortions which are affecting work and investment decisions.

*"...lower personal taxes across the board are a good thing because they reward productivity and effort required to get the economy growing faster" Bill English, April 2010.*

*Weak economic outlook limits options, changes must be fiscally neutral.*

The 2008-09 recession adds to the challenge of reform. The current high Government debt forecasts mean that any tax changes must be "broadly cost neutral" over the next four or five years, i.e. changes cannot reduce government revenue unless there is an offsetting reduction in expenditure.

*"The Budget will be delivered against a backdrop of ongoing restraint, given the Government faces another six years of Budget deficits and net Crown debt will more than treble to a forecast \$65 billion by 2014." Bill English, February 2010.*

#### General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

**Goal: a more level playing field**

*High personal income and corporate tax rates may be harmful to growth.*

The New Zealand tax system has distortions due to differing tax rates for companies, trusts and the top personal income rate. Working for Families tax credits also results in high effective marginal tax rates for some households. International competition for capital and labour also creates a threat to New Zealand's tax base.

*"It's important that our tax system generally remains competitive with other countries - particularly Australia, given our close economic and trade ties with our Trans-Tasman neighbours." Bill English, May 2010.*

There is a desire to level out some of these distortions. High personal income and corporate tax rates are regarded as harmful to growth. However, given that any tax changes need to be fiscally neutral, any reduction to income tax needs to be offset by an increase in tax elsewhere or expenditure cuts.

*New spending initiatives will come at the expense of spending elsewhere.*

Recently the Finance Minister has indicated more spending cuts are on the way. Last year the Government identified \$2 billion of "lower quality spending" which it aimed to redirect into higher priority areas. In this year's Budget, the Government says it "will find another \$1.8 billion of low quality spending between now and 2014 for reprioritising into higher priority initiatives." So spending initiatives will likely be funded out of reprioritisations, and tax cuts will need to be funded by increasing revenue from elsewhere. An increase in consumption tax is likely. Lifting GST (we assume to 15%) has been mooted.

**Reduce tax revenue loss and remove property distortions**

*Removing distortions around investment property tax.*

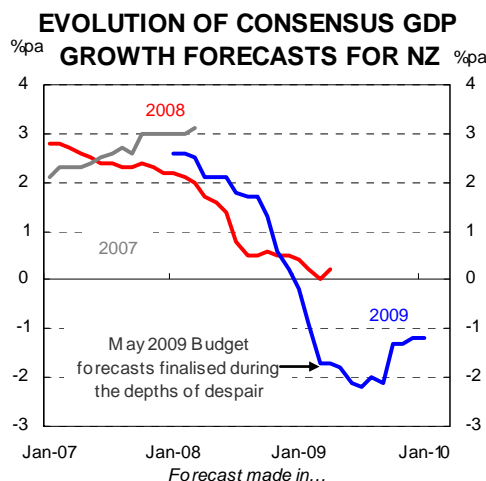
The Tax Working Group identified a "major hole in the tax base concerning the taxation of capital, which is manifest in high investment and low returns in the property market". The options available to the Government range from changing the rules which relate to depreciation, through to ring fencing losses on investment properties against other income sources. Changing depreciation rules would help increase government revenue, and discourage unproductive investment and debt accumulation in rental housing. Tax changes will aim to address the situation where highly uneven tax rates apply between taxpayers with similar incomes, due to property investors' use of property related losses to reduce tax liabilities.

**Overview of changes to Government finances**

*Tax revenue more sensitive to downturn than allowed for.*

**Impact of recession stronger than expected**

During the recession, tax revenue fell more than expected. Revenue was more sensitive to the economic downturn than allowed for. As a result the 2009 fiscal deficit was larger than the Budget 2009 anticipated. However, this weaker starting position (for the updated fiscal outlook in December's Half Year Economic and Fiscal Update) was offset by a substantial improvement in the economic outlook, which led forecast deficits to narrow more swiftly than expected in the last Budget. Recall at the time of last year's Budget (May 2009), the state of the global economy remained highly uncertain.



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Leading into Budget 2009, economic Consensus forecasts were at their most pessimistic as it was too early to gauge how effective policy measures would be in stabilising world activity. As it turned out, the global economy (in particular the Asia-Pacific, including NZ) fared considerably better than expected. The current economic outlook is considerably different than the one presented by Treasury 12 months ago.

**Government finances to date**

*Current fiscal deficit running smaller than forecast.*

The most recent monthly budget statement shows the core fiscal deficit for the year to June 2010 is likely to be slightly smaller than expected in December. Driving this result was a mixture of offsetting one-offs and excluding these the fiscal deficit would be tracking closer to expectations.

Largely driving the smaller deficit has been lower than expected expenses due to the deferral of payment of some large expenses. Overall tax revenues are running behind December's forecasts due to weak business profitability. However, GST revenue provided some offset through stronger than expected retail sales and consumer confidence.

*Strong equity market performance also help's fiscal position.*

In addition, including the performance of state owned enterprise and crown entities and gains from investment portfolios (such as ACC and NZS Funds) helps to further improve the fiscal position. The strong performance of global equity markets over recent months has led to stronger asset values, and points to a possible smaller net debt position overall.

*Economic outlook continues to improve.*

### **Economic outlook has improved**

Relative to December's assessment the economic outlook has slightly improved, helping the Government reduce deficits at a swifter pace. However, much of the expected improvement in revenue has come out of a stronger inflation outlook rather than real economic growth. As inflation also increases government expenditure, improvement of the operating balance is mitigated. Nonetheless, there is a net underlying improvement in the fiscal environment which provides a good starting point. However, the devil will be in the detail: the balance of various tax changes and the timing each is implemented are critical.

*Export incomes likely to be revised up, offset by weaker consumer spending.*

Aside from concerns emanating from Europe's sovereign debt woes, the recovery in trading partner growth looks to be on track. Improved global demand has led to higher commodity prices, which is likely to boost the outlook for export income.

Looking at the rest of the composition of growth, very weak retail sales data suggest consumption is likely to be below December forecasts in the near-term. Meanwhile, residential investment is also likely to be lower given the continued low level of dwelling consent issuance.

*Inflation forecasts to be revised up.*

Inflation in the year to March 2010 has been below Treasury's HYEFU forecast. However, we expect Treasury will have revised up its inflation outlook over 2011 through 2013. A host of administrative inflation is expected to come through over the coming years. In particular, the Government has hinted the Budget will likely include an announcement that GST will be increased (we expect from 12.5% to 15%). Such a move is expected to boost annual CPI to over 5.5% in 2011 ([Potential impact of a GST increase](#)).

Note the Budget forecasts would have been finalised before the release of much stronger than expected March quarter employment data. As such, their unemployment rate forecast will be much higher and employment growth much lower than the actual outturns.

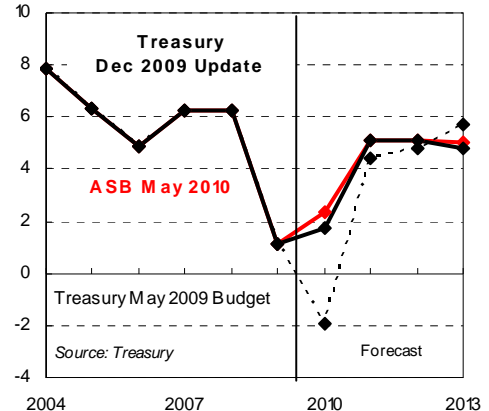
*Main changes to include higher GST, lower income tax and changes to investment property tax rules.*

### **Tax changes may not be fiscally neutral in the near term**

Following the Tax Working Group's recommendations in January, the Government has signaled a willingness to make substantial changes to the tax system at the upcoming Budget. To broaden the tax base we expect GST to increase to 15% from 12.5%, and we expect the Government to change rules regarding depreciation and property. These changes will boost the tax revenue and allow the government to introduce income tax cuts: ideally aligning the top marginal tax rate, lower the other personal tax rates to compensate for higher GST, and – potentially – lower the business tax rate. Using the Tax Working Group estimates (which assume the bottom two tax rates are reduced to 10.5% and 19%) these measures will be fiscally neutral (including additional revenue from stricter enforcement and thin capitalisation rules). However, recent comments by the Finance Minister suggest the Government may not be introducing all measures at the same time. Due to the timing mismatch, these measures may not be fiscally neutral immediately, although should be over the medium term. The upshot is (according to our estimates) the stronger starting point allows the government some wiggle room to be able to make tax cuts slightly ahead of introducing added revenue gathering initiatives.

*Timing of initiatives could be important to fiscal position.*

**NZ NOMINAL GDP FORECASTS**  
(June years, \$billion)



There may also be practical issues that limit the ability to implement some changes as quickly as others.

**Budget Implications: Reserve Bank pressure**

*RBNZ has been looking for more fiscal restraint.*

Ideally (for many reasons) the Government will deliver an outlook which has fiscal deficits improving at a swifter pace than presented at the December update. The Reserve Bank of New Zealand, for one, has been very direct with comments it is looking for more fiscal restraint. If the Government disappoints on that front then monetary policy will carry more of the load of reducing the overall stimulus in place.

*Potential for slightly better fiscal position and net debt outlook*

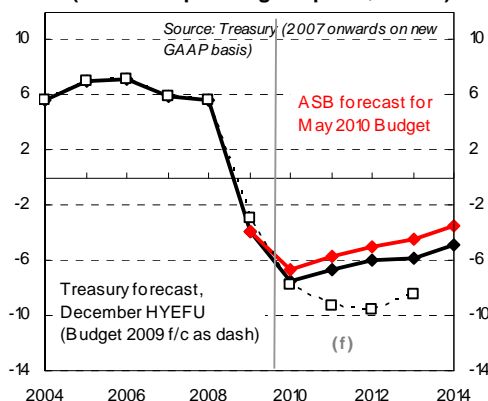
Overall, we expect to see a slightly better fiscal position and net debt outlook. Just allowing for the better economic outlook alone we see scope for the fiscal operating balance to return to surplus by 2015 (a year earlier than previously expected). However, just how neutral the tax package and other initiatives are will be key to how much quicker surpluses return.

*Smaller deficits may reduce bond tender program*

**Bond tender programme, as at December**

Bond tender programme	\$bn			
Period Ending June	10	11	12	13
HYEFU 2009	10.5	12.5	12.5	7.5
Budget 2009	8.5	11.5	15.0	15.0

**NZ KEY FISCAL BALANCES**  
(OBEGAL Operating Surplus \$ billion)



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