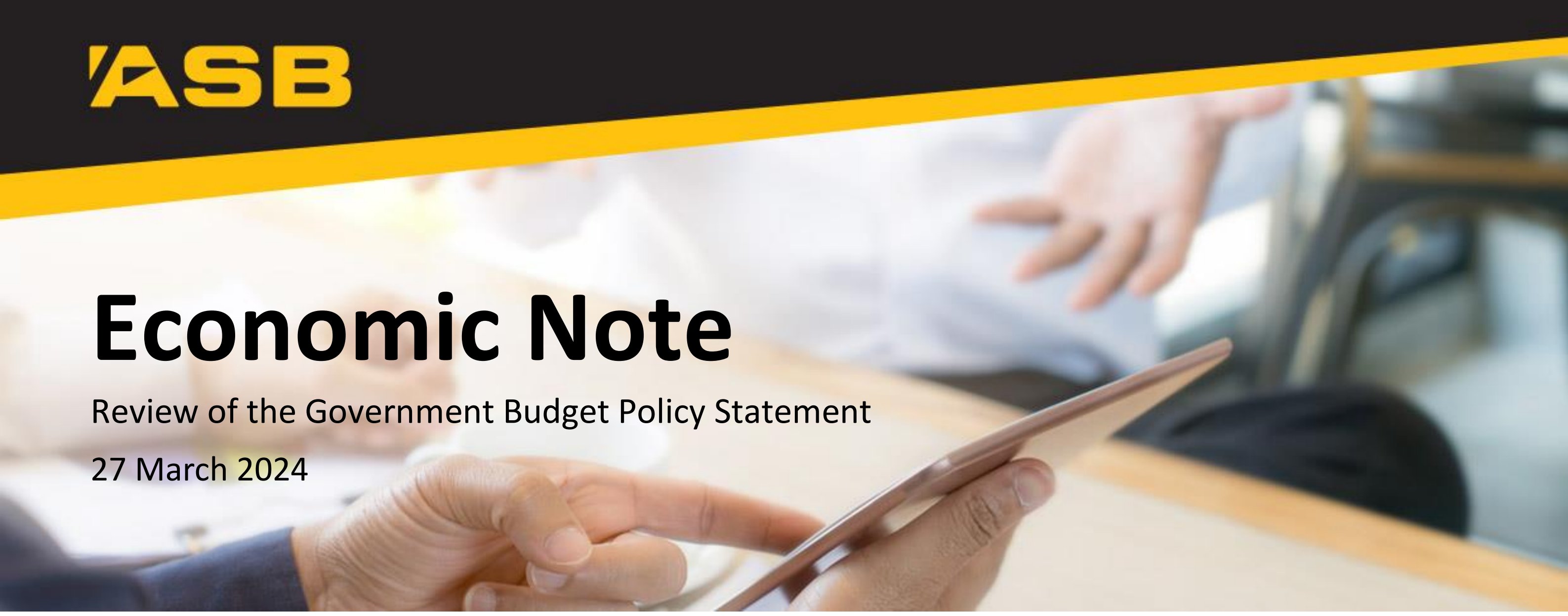

Economic Note

Review of the Government Budget Policy Statement

27 March 2024

An Old Mother Hubbard Budget?

- Delivering tax cuts and trying to get better value out of Crown spending remain key priorities for the Government.
- The economic challenges to the fiscal position are well understood, with the risks to the downside.
- The Government has acknowledged that an operating surplus isn't likely until 2028.

The Budget Policy Statement indicates the Government is still intent on delivering tax cuts later this year and still aiming to get the operating balance back into surplus within an acceptable timeframe. Doing so will involve trade-offs between how much spending can be curbed and preparedness to borrow greater amounts, against the size of the tax cuts the government has previously committed to delivering.

The challenge is the cupboard is looking pretty bare at the moment. In December's Half Year Economic and Fiscal Update a roughly $7bn OBEGAL deficit was forecast for the year ending this June. The HYEFU forecasts did not have the Operating Balance before Gains and Losses (OBEGAL) getting back into surplus until the June 2027 year, and even then the surplus was a microscopic $100mn. Now the Government is aiming for a surplus in the June 2028 year.

The economic backdrop looks set to be weaker than assumed back in December's Half Year Update. That will impact on future growth in the tax base. The Crown accounts had held up reasonably well through to January, although the tax take was slipping slightly behind forecast. May's Budget will reflect an environment of weaker revenue conditions (putting tax cuts aside) and possibly some added welfare spending if unemployment is expected to be higher than previously thought.

That makes the Government's balancing act a delicate one, at a time when the economy is under pressure. The Budget won't be a repeat of the Mother of All Budgets of 1991, when the incoming government had to cope with the impact of an ailing economy and bail-out the BNZ. It's likely to be more Old Mother Hubbard, where the tax cut cupboard may not contain many large bones – unless they are borrowed.

Laying out the priorities

The focus of the May Budget will be introducing tax cuts, while trimming Crown expenditure and getting better value for money out of that spend. It will also build a "long-term, sustainable pipeline" of infrastructure work, and the upcoming Budget will 'top up' the multi-year capital allowance. The Government's stated objectives in the BPS are to:

- "Build a stronger, more productive economy that lifts real incomes and increases opportunities for New Zealanders.
- Deliver more efficient, effective and responsive public services to all who need and use them – in particular, to restore law and order and improve health outcomes and educational achievement.
- Get the government's books back in order and restore discipline to public spending."

Reining in Crown spending is a big theme of the BPS. The BPS states that even if the economy was operating at full capacity, it would still be running operating deficits – such is the increase in spending in preceding years. Hence, it

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needs to get spending back in line with revenue, while also helping the RBNZ in the near term to get on top of inflation. It is aiming to get core Crown expenditure down to 30% of GDP, from an estimated 33.4% this year.

The Government will also change the headline definition in how it reports on net government debt, reversing a 2022 change which, among other things, incorporated the assets of the NZ Superannuation Fund in the calculation (dropping the net debt ratio by rough 20% of GDP). The Government argues that the pre-2022 definition provided a better historical context, as well as removing the potential for volatility in the measure from NZSF asset revaluations.

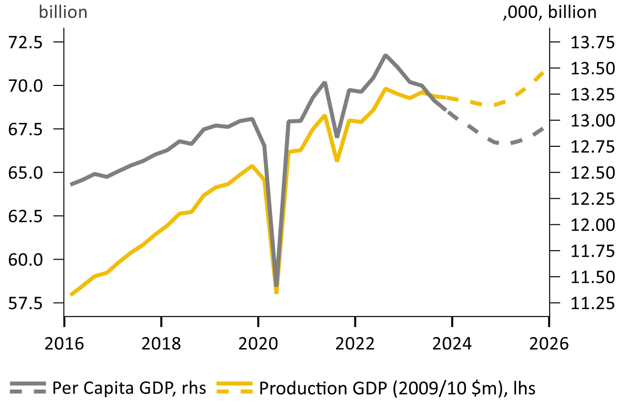
Once debt under the pre-2022 definition is back below 40% of GDP, the Government will aim to keep net debt between 20% and 40% of GDP, giving some flexibility to borrow rather than be too prescriptive and forego "opportunities for productive investment" in narrow pursuit of a debt target.

Taxing fiscal times

The economic environment is less friendly than it looked late last year. GDP in the full June 2024 year was forecast to be 1.5% in the HYEFU, the Treasury's preliminary forecast is now +0.1% (our forecast released this week is -0.5%). For the June 2025 year, the HYEFU forecast was 1.5%, though Treasury now has it rebounding to 2.1%. In contrast, we are forecasting -0.2%. We would love for the Treasury to be right, but that rebound does look heroic. The unemployment rate peak, of 4.9% in June 2025, also looks on the low side. To us, the risk is that the economic environment ultimately puts more pressure on the fiscal position than the Treasury is currently envisaging.

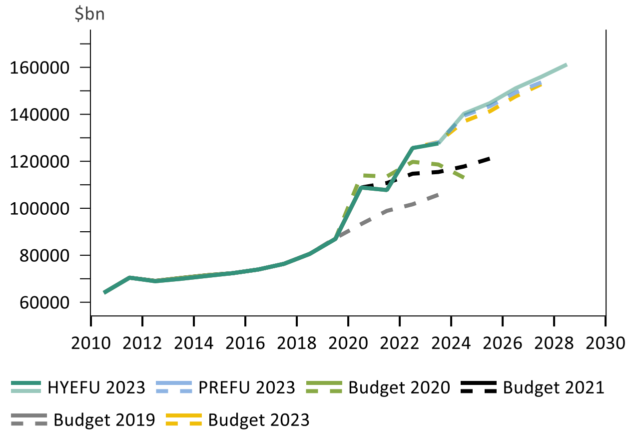
Those forecasts are not necessarily the final ones that will underpin the Budget's fiscal calculation, but they are probably not far off as they need to be finalised soon. They don't take into account the -0.1% decline in Q4 GDP yet, either.

New Zealand GDP, per-capita GDP (quarterly, 2009/10 prices)



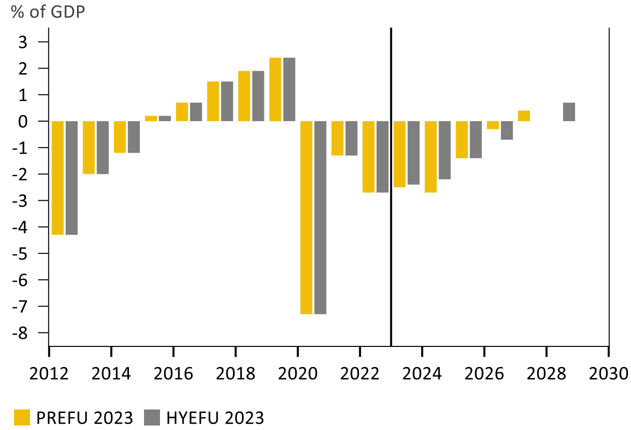
Source: Macrobond, ASB

Core Crown Expenses



Source: Macrobond, ASB

NZ OBEGAL, HYEFU vs PREFU 2023



Source: Macrobond, ASB

Even these preliminary forecasts have nominal GDP a cumulative $42.8 billion lower by June 2028 than in the HYEFU forecasts, implying $13.9bn less tax revenue over that period. These changes alone imply lower OBEGAL balances in the June 2027 and 2028 years of $3bn and $4bn, respectively. Given the OBEGAL forecasts for those years were $140mn and $3.4bn, all other things equal it would be a challenge to run a surplus in 2027 and is not a given in 2028 either.

Compounding the revenue challenge is the alleged underfunding of some existing spending initiatives. The incoming

Government has gone to great pains to point out time-limited funding put in place by the previous Government, such as added Pharmac funding that ends this June. To quote the BPS: "Put together, the cost of pre-commitments and extending time-limited funding exceeds the previous Government's operating allowance."

There is still a lot of number crunching to do between now and when the Budget is released on May 30th. However, there are some clear challenges for the Government in delivering on the tax cuts it has committed to while getting the Crown accounts back into surplus in an acceptable timeframe and meeting other spending priorities. Much will depend on how successful the Government is in finding cost savings amongst existing Crown spending, while still ensuring that needed services are delivered effectively.

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