ECONOMIC BULLETIN

Budget Policy Statement preview.

19 Mar 2024 | **Darren Gibbs**, Senior Economist | +64 9 367 3368 | +64 21 794 292 | darren.gibbs@westpac.co.nz

- **The Government will publish its first Budget Policy Statement (BPS) on 27 March which will set out: its priorities; high-level fiscal goals; the operating spending and capital allowances it will work within in Budget 2024; and an update on the economic outlook.**
- **While the BPS won't contain an updated fiscal outlook, we expect the Government to confirm it will work within operating spending allowances no larger than set out in the Half-Year Economic and Fiscal Update (HYEFU). Baseline spending savings should be no smaller than those detailed in December's "mini-Budget".**
- **We suspect internal Treasury projections presently suggest that a OBEGAL surplus will not occur until 2027/28 – a year later than forecast in the HYEFU. The weaker near-term growth (and thus revenue) outlook will be the key driver. We continue to expect that personal tax cuts will be implemented in some form in Budget 2024.**
- **At present, we think it's reasonable to think that a $7-10bn increase in the four-year government borrowing programme could be announced in Budget 2024. This BPS is likely to announce a top up to the multi-year capital allowance (MYCA) which combined with a weaker OBEGAL outlook implies this greater borrowing need.**
- **We think that the Government will most likely retain its predecessor's long-term goal of achieving an average OBEGAL surplus in the range of 0-2% of GDP and the objective of keeping net debt below 30% of GDP. The Government could choose to differentiate itself from its predecessor by lowering the ceiling slightly given it is unlikely to be binding (net debt currently sits under 21% of GDP).**

The Minister of Finance, Nicola Willis, will publish her first Budget Policy Statement (BPS) on 27 March. The Public Finance Act requires that the BPS sets out the broad strategic priorities that will guide the preparation of Budget 2024 (to be released 30 May). It also requires the Government explain any changes in the short and long-term fiscal objectives and their relationship to the principles of responsible fiscal management. The Minister has indicated that the BPS will set out the operating spending and capital allowances that it will work within in Budget 2024. On this occasion, comments made by the Minister in a speech late last week suggest that the BPS will also indicate an updated – and less positive – assessment of the economic outlook. This new assessment, together with a likely top-up in the Multi-year Capital Allowance (MYCA), will lay the groundwork for projecting a further cyclical deterioration in the public finances and a further increase in the government borrowing programme in Budget 2024.

Budget priorities.

The BPS will confirm that the centrepiece of Budget 2024 will be the Government's plans to deliver personal income tax relief via the upward adjustment of income tax brackets to account for recent inflation. Whether the detail of those tax cuts – exact size and timing – will remain the same as National campaigned on ahead of the election is uncertain. We note that the Minister (and Prime Minister) has declined to be definitive on this point when questioned by the media so we can't rule out the possibility that what is announced in Budget 2024 could differ.

We also expect there to be plenty of talk in the BPS about reducing government spending and achieving better results from public services for the money spent, with the aim of boosting New Zealand's growth potential and reducing the government's contribution to cost of living pressures.

Operating spending and capital spending allowances.

For financial markets, a focal point of the BPS will be the operating and capital spending allowances set by the Government, which will determine the room for new spending in Budget 2024 and help determine the government borrowing requirement.

In the Half-Year Economic and Fiscal Update (HYEFU), operating allowances of $3.5bn and $3.25bn were set for Budget 2024 and Budget 2025 respectively, followed by $3.0bn in each of Budget 2026 and Budget 2027. According to the Treasury, of this forecast total of $12.75bn, about $4bn had already been pre-committed at the time of the HYEFU, leaving a total of $7.9bn of available new spending. The Treasury stated that it believed that this spending should be sufficient to support the level of existing services against the impact of inflation and wage growth. However, it noted that this may not be the case if demand for services were to increase (for example, due to unexpectedly rapid population growth).

We assume that the Government will retain these operating allowances in the BPS, although total baseline spending will be lowered slightly in the Budget to reflect the decisions foreshadowed in the "mini-Budget" released alongside the HYEFU in December. In the HYEFU, the Treasury estimated that the indicative cumulative impact of the Government's mini-Budget – including savings from stopping some of the previous government's programmes and from planned reductions in departmental spending – was to lower core Crown spending by a cumulative $5.2bn over the four years beginning with the 2024/25 year. If the Government wanted to signal even tighter control of spending beyond that already signalled in the mini-Budget – especially in the context of downward pressures on revenue – it could lower these operating allowances a little further.

In the HYEFU, the Treasury forecast net capital spending of $35.6bn over the four-years from June 2024, including about $29bn of investments in non-financial assets (physical assets and equity injections) and an as-yet unallocated $2.9bn of new spending remaining in the MYCA. With the introduction of the first forecast for 2027/28 in the HYEFU, the MYCA would normally have been topped up as part of the BPS. But given the recent formation of the new government, and thus the delayed publication of the BPS, this did not occur in HYEFU 2023.

In recent years, the previous government had allowed for a total four-year MYCA in the range of $8-$11bn. **This suggests that a top-up of the MYCA around $5bn-$8bn might be signalled in the coming BPS** (perhaps in the lower end of that range given the Government's stated intention of seeking other sources of capital to fund investment). **The top up in the MYCA will imply some additional increase in the four-year bond programme compared to that published in the HYEFU** (but by slightly less than the amount of the top up, as some of the top up will be assumed to be allocated beyond the 2027/28 year).

Budget 2024 and the bond programme.

The revised forecast for the bond programme in Budget 2024 will also reflect changes in the outlook for tax revenue due to changes in the Treasury's economic forecasts.

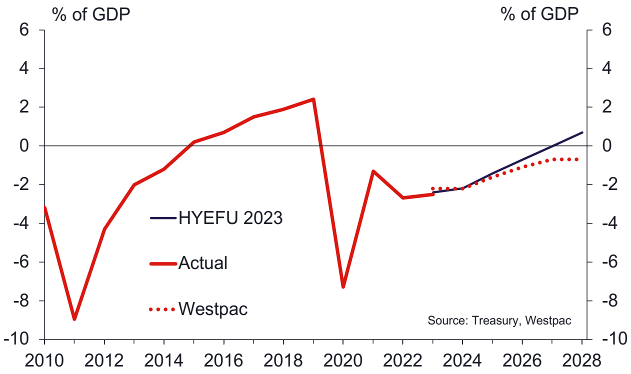
Recent tax data already suggests some risk that tax revenue in the current year will fall short of the HYEFU projections, with collections through January now tracking $0.8b below the Treasury's expectation (mainly due to a shortfall of corporate and small business tax – a reflection of the profit squeeze in the economy).

A weaker baseline for tax revenue would add to upward pressure on the bond programme, unless offset by more optimistic forecasts later in the forecast period. However, comments made by the Minister in a speech late last week suggest that the BPS will set out an updated – and less positive – assessment of the economic outlook.

In the HYEFU, the Treasury forecast that real GDP would grow 1.5% in both the year to June 2024 and June 2025, before strengthening to about 3% in subsequent years (all figures in annual average terms). Recent forecasts published by the RBNZ in its February Monetary Policy Statement suggest that growth in the year to June 2024 is more likely to be close to zero. **The RBNZ's forecast aligns with that which we published last month in our Economic Overview**, while our forecasts also imply that growth will fall short of the Treasury's forecast in the subsequent year too.

Despite the baseline spending savings detailed in the "mini-Budget", given a weaker near-term growth (and thus revenue) outlook and our expectation that personal tax cuts will be implemented in some form in Budget 2024, **we suspect internal Treasury projections likely suggest that a OBEGAL surplus may not occur until 2027/28 – a year later than forecast in the HYEFU**. Westpac's own forecasts in the recent *Economic Overview* implied that the OBEGAL would remain in deficit even in 2027/28 as we have doubts that any government can deliver such sustained expenditure restraint.

Operating balance (OBEGAL) - % of GDP – 2028 is the new 2027



The bottom line is that without significant further spending cuts, at present it seems likely the Government will unveil a further $7-10bn upgrade in its borrowing requirement over the next four years in Budget 2024. An upgrade at the lower end of that range might be possible if the MYCA top-up is at the lower end of expectations. We will see two more months of tax collections ahead of the 30 May Budget and will be watching this data closely for any signs of further deterioration.

Longer term fiscal goals/rules.

The previous government set two long-term fiscal goals or rules in 2022:

- The operating balance before gains and losses (OBEGAL) should average between 0-2% across the long-run.
- Net debt should remain below a 30% of GDP ceiling.

In its briefing to the incoming Minister of Finance, the Treasury indicated that it considered that the broad design and calibration of the existing fiscal rules from 2022 remain appropriate, but it noted that it could provide advice on options to strengthen the rules to better support fiscal sustainability. The Treasury also opined that in the absence of any unexpected events or significant negative economic shocks, there was an "on balance" case for the Government committing to a return to surplus in 2026/27 "at the latest". The Treasury argued that this would see government debt remain at prudent levels into the future and maintain the strength of the Crown balance sheet. The Treasury also argued that tighter fiscal policy would also lean against demand imbalances such as New Zealand's elevated current account deficit and high inflation, supporting macroeconomic stability.

We agree with the Treasury's assessment that it is desirable, on multiple grounds, that the OBEGAL balance be returned to surplus as soon as possible (although we note that small deficits can still be compatible with a gradual decline in the debt ratio). Whether that occurs through more extensive cuts to spending or through new revenue raising opportunities is a matter for the Government to decide. That said, in the current circumstances, there seems merit in considering the delay of the tax cuts planned by the Government until such time as the OBEGAL balance is closer to surplus and inflation is under better control.

As far as long-term objectives are concerned, we think that the Government will most likely retain its predecessor's goal of achieving an average OBEGAL surplus in the range of 0-2% of GDP. However, given that the economic outlook that will underpin Budget 2024 will be weaker than that in the HYEFU, the Government will likely signal – at least implicitly – that a return to surplus might not occur until 2027/28 (a year later than forecast in the HYEFU).

While we think that the Government should at least balance the operating budget over the cycle, given New Zealand's relatively low level of public debt, there is no fiscal obstacle to a government borrowing more to fund well thought out investment that boosts New Zealand's physical, human or natural capital (though there may be implications for monetary policy settings dependent on the stage of the economic cycle). That said, the government also needs to retain headroom to respond to the likes of natural disasters as they come along. The current net debt ceiling of 30% of GDP provides scope for additional investment to occur. And of course, as the Government has signalled, there are other avenues that can usefully contribute funding e.g., public-private partnerships, domestic investment funds (such as the NZ Super Fund, ACC and Iwi investment) and revenues raised from value capture.

We think it is most likely that the Government will choose to retain a similar rule for net debt as its predecessor, although tightening that ceiling slightly (say to 25% of GDP) is also possible if the Government wishes to differentiate itself from its predecessor and signal greater long-term restraint (especially in the context of delay in returning to an OBEGAL surplus). It is also possible that the Government might reformulate this rule to specify a different measure of debt (for example, net debt excluding the assets of the NZ Super Fund). However, we note that the new debt measure was recommended by the Treasury as being the best measure of New Zealand's fiscal sustainability (and is broadly comparable with measures calculated in Australia and by the IMF).

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