Ready to rise?

New Zealand Budget 2014

pwc

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CEO's message

Welcome to our Budget 2014 commentary publication

Another year, another Budget, and this year is a key one with September's general election.

We are pleased to share with you our insights on the Government's Budget 2014 and what it might mean for you and New Zealand.

Prime Minister John Key and Minister of Finance Bill English clearly signalled a Budget with no major surprises, and that is what they delivered today. Budget 2014 continues a steady track of careful fiscal management.

What is really encouraging is how strongly the economy is forecast to grow. The return to surplus fulfils a critical political commitment that Government made, and the forecast for later years of rising surpluses being applied in part to reducing public debt is welcome.

New Zealand is not yet out of the fiscal woods and the Government is keeping a very disciplined approach to the country's finances. But the forecast growth in tax revenues has allowed the Government to make increased expenditure commitments to health, education, social services, infrastructure and better public services. They have also indicated larger capacity to spend (or reduce taxes) from next year.

Making these investments pay off will be key for the coming few years to ensure a strong and prosperous New Zealand.

While the New Zealand economy looks robust in comparison to other OECD economies, there is still a balancing act for the next few years. The housing market, interest rates and exchange rates and the level of private debt mean that many of the pressures we have felt in the last few years remain as risks to growth.

Businesses need to retain a relentless focus on export diversification, productivity growth and innovation. The Government needs to support that by providing fiscal stability and sound regulatory regimes.

The coming years have real promise for New Zealand if we maintain our focus.

I trust our analysis will provide some valuable information to help you assess the direction our economy is heading as well as answer any questions you may have on the Budget. Please let me know if you wish to discuss further.

Bruce R Hassall

Chief Executive Officer and Senior Partner

PwC New Zealand

Summary

Despite carefully managed pre-Budget expectations, Budget 2014 has delivered two surprises: a surplus of $372m in 2015, significantly higher than the wafer thin surplus expected; and when taken over a four year period, higher planned new spending in health, education and welfare than was expected.

The higher surplus, despite extra spending, comes as a result of a forecast of strong economic growth of 3% in 2015 rising to 4% in 2016.

On the back of the strong economy, the Government has announced it will increase new spending in future budgets by around $1.5 billion a year, half a billion dollars a year more than the 2014 budget allowance of $1 billion.

Budget 2014 forecasts rising surpluses over the next four years reaching $3.5 billion in 2018. These surpluses are committed to future capital and infrastructure expenditure.

Net debt peaks at $65 billion and then is held there while the economy grows. As a result, net debt is forecast to have reduced to the Government's target of 20% of GDP by 2020.

A range of areas have benefited from extra Government spending. Children and families have been a real target. As widely predicted, paid parental leave has been extended to 16 and then 18 weeks, and the parental tax credit has been increased to $220 a week. Free GP visits and prescriptions have been extended to children up to 13 and more funding provided for early childhood centres.

Health receives $1.8 billion of extra funding over the next four years in an attempt to feed our insatiable appetite for health services.

Critical to our long-term future as a nation, education receives a range of extra support from $359 million to fund the Prime Minister's 'super principal/teacher' programme, to an extra $199 million more invested in tertiary education. Three new centres of research (CoR) excellence will be established bringing the total to ten.

Encouraging innovation through R&D is a theme that runs through Budget 2014 with measures such as the new CoRs, more contestable science and innovation funding and modest tax relief for R&D companies.

Auckland infrastructure gets another boost with $375 million of additional capital funding for NZTA which will accelerate $815 million of new projects.

Another $1bn of the funds raised from the SOE floats was committed to various capital projects including schools, hospitals and KiwiRail.

The forecast projections show a reduction in the relative size of expenditure on the public service, which will keep the discipline on 'reprioritisation' of expenditure to fund new initiatives.

As expected, there was no softening of the Prime Minister's political commitment to universal national superannuation from the age of 65.

Overall, Budget 2014 tries to strike a balance between returning to sustainable surpluses, allowing some more spending on key areas of need, and providing the fiscal backdrop to support economic growth. We think it largely achieves that.

Yet, after the December 2013 Budget Policy Statement, we saw five important challenges for Budget 2014. So how did it deliver?

Tax initiatives

As anticipated tax is not front and centre in Budget 2014, but it does include several tax initiatives. The changes are aimed at building a more productive and competitive economy as well as providing more support to lower and middle income families.

The most significant of the tax changes is the announcement of two initiatives in relation to research and development expenditure. The first initiative is confirmation of a previously announced policy which will allow R&D intensive start up companies to cash out all or some of their tax losses rather than carrying them forward until they become profit making. The second initiative is to further address black hole R&D expenditure by allowing all capitalised expenditure on depreciable intangible property to be deducted over time and by allowing a one off deduction for capitalised expenditure on intangible property that is written off for accounting purposes. The Government estimates these initiatives will return over $58 million to eligible companies over the next four years.

In the social assistance arena, changes are targeted at low and middle income families with new born babies. Under the announcements eligible families receiving the parental tax credit (ie those not on a benefit and not eligible for paid parental leave) will receive an increased tax credit (up to a maximum $220 per week) for a longer period of time (out to 10 weeks from the current 8 weeks). There will also be changes to the abatement criteria to better target those families in need.

In a further effort to address compliance cost issues, the Budget announced that cheque duty will be abolished from 1 July 2014. From its lofty heights in 1991/92 when it raised $17 million in revenue, cheque duty now raises just $4 million due to changes in the way we transact. However, it is still a significant cost for some businesses and its abolition will be welcomed.

Finally, in a continuing trend, the Budget announced further reductions in ACC levies, including a likely $130 per year reduction for private cars from 1 July 2015.

The winners and losers

Winners

The winners are many from this Budget. Some highlights for us:

Losers

It's hard to find losers in this Budget, and that perhaps shows the true reversal of New Zealand fortunes compared to the last five years. But, digging deep:

Families

$500m *of additional support over four years.*

Working parents *with increases in paid parental leave and tax credits.*

Education*, from early childhood, to schools through to tertiary level, more than a $1bn of new spending in total.*

Removal of all tariffs and duties on building products for people building homes.

Smokers*, have had duty free tobacco allowance slashed by 75%, contributing perhaps $50m of extra excise duties.*

No real prospect of ***tax cuts****, and even if they are considered they will be restricted to the extra spending cap of $1.5bn a year imposed for future budgets.*

Generations Y and Z*, who will confront the superannuation and aging tsunami sometime in the future, while not being able to buy their own home.*

Businesses

8,000 *new work-readiness places being funded for unemployed.*

Innovation and export businesses *get some additional support including some targeted tax relief for R&D companies.*

Public services

Public health wins with $1.8bn*, of new expenditure committed over the next four years, although this only just grows faster than the economy.*

Christchurch *gets modest additional rebuild support.*

West Coast *will get a new $67m hospital in Greymouth funded from the sale of the Government's power companies.*

Over half a billion dollars committed to strengthening the ***Defence Force****.*

Police *have had it their budget held at 2013 levels (a relative reduction in an economic sense) despite success in reducing crime.*

Continue to be challenged to do more with less.

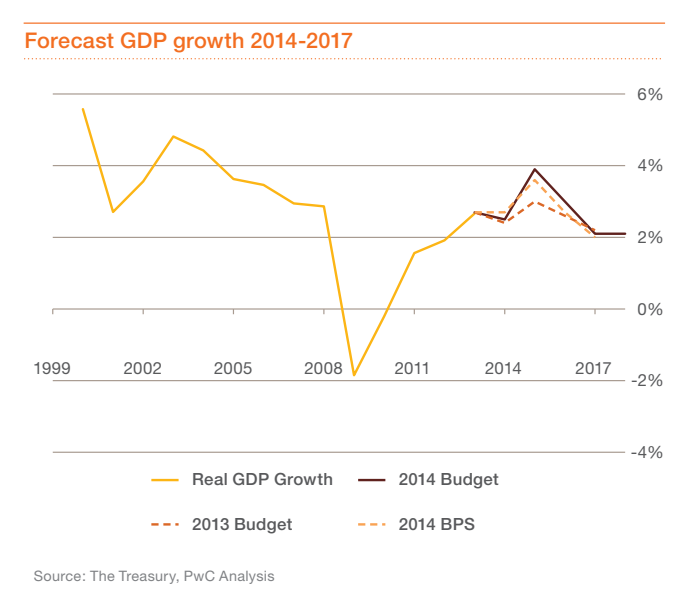
How did the Budget deliver?

Economic overview

Growth - Treasury revises position upwards but not by much

Treasury has revised its economic growth forecasts upwards, peaking at 3.9% in 2015 but dropping marginally below the 2013 Budget forecast to 2% in 2017. Overall, average growth is marginally stronger over the forecast period than Treasury was predicting in December.

Overall, Treasury has reflected on the upward trends in commodity prices, business confidence, hiring and plant investment as well as the Canterbury rebuild. What is interesting is that the growth profile the Treasury is picking for 14/15 and 15/16 is almost a mirror image of what Treasury picked in Budget 2011 for 13/14 and 14/15. The comparison serves to show just how much the quantum and the timing of the Canterbury rebuild has on our GDP figures. Further delays in the rebuild will see a flattening of the growth prospects and may put the 14/15 surplus at risk.



Interest rates, the dollar and unemployment – mostly more of the same except for a big shift in employment growth

Interest rates are forecast to steadily build over the forecast period, with Treasury echoing Reserve Bank and market sentiment that we can continue to see increases in the Official Cash Rate for the rest of the year, with the possibility of a pause towards the end of the year.

Treasury has previously noted that the Loan to Value Ratio policy has had a 30 basis points dampening effect on their forecast of the level of that interest rate increase.

Treasury is forecasting the exchange rate to remain elevated in the near term, affecting export prices and inbound tourism, but also making imported goods cheaper

Reductions in unemployment, supported by the economic recovery and the Christchurch rebuild will continue to be a factor in the Reserve Bank's interest rate decisions. Treasury anticipates a significant reduction in unemployment from 6.2% in 2013 down to 4.4% in 2018. Significantly, employment growth is forecast to be more aggressive than the reduction in the unemployment rate. This growth takes into account the movement of people back into the growing labour market, who were not classed as unemployed. Employment growth is forecast to increase tenfold from 0.3% in 2013 to 3% in 2015, before moving back to 1.2% annual growth in 2018.

What does this mean?

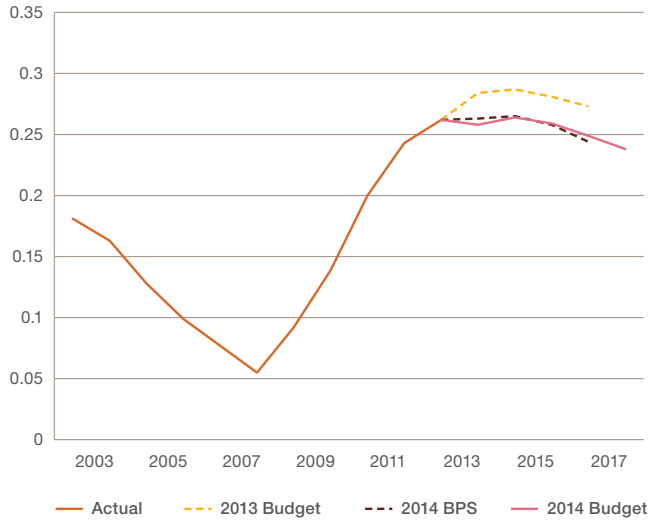
The Government books

A return to surplus – less of a wafer, more of low-fat rice cake

The wafer thin surplus has turned into something substantially more. Budget 2014 sees an upward revision of the forecast 14/15 surplus from $86 million forecast in December 2013, to $376 million. This increase is underpinned by higher economic growth forecasts, as well as additional revenue from changes to IRD capability at tobacco excise.

The operating surplus drops off relative to the December update. This is largely because of the increase in the future spending provisions factored into the Budget. These increased spending provisions are the first indication of a potential 'change-up' in the government's fiscal strategy as they look to woo voters in the 2014 election and, if successful, position themselves for a rare 4th term in 2017.

Net Core Crown Debt, percent of GDP

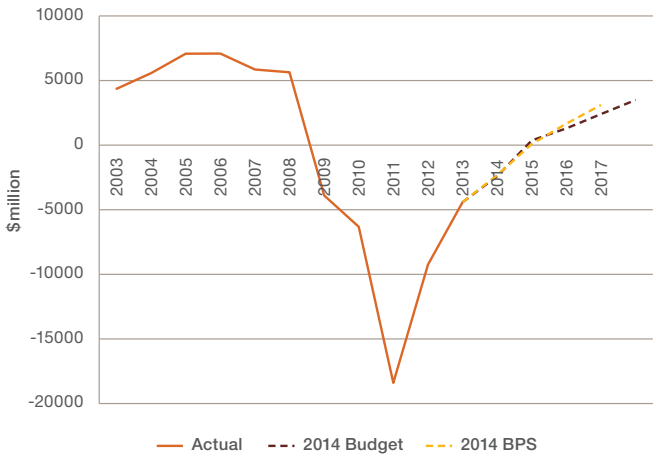


Source: The Treasury, PwC Analysis

The debt track

The net debt position is similar to the HYEFU forecast in December, and materially better than that forecast at Budget 2013, peaking at 26.5% of GDP, down from a forecast 28.7% at Budget 2013 time. Thereafter we see solid reductions in debt over the forecast period. A major signal in the Budget was the government's intent to flat-line nominal debt while the economy grows around it. Again, this long term position points to a change in fiscal strategy, potentially signalling increases in capital spending over the next few years.

Total Crown Operating Balance



Source: The Treasury, PwC Analysis

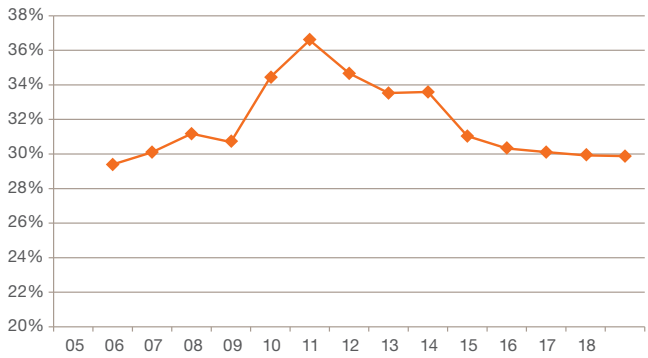
Government spending

Significant reductions in real spending

Bill English continues to drive down the size of government relative to the size of the economy. There is a clear implication that the Minister feels that keeping Core Crown spending at about 30% of GDP feels about right

What is significant here is that the Government has reduced spending on core government services from 2.8% of GDP at the high-water mark of 2009 to 1.7% of GDP by 2018. The reductions in Health, Education and Law and Order have been less dramatic as they have been supported by nominal increases in spending, but it is clear the drive to deliver greater value for money across the entire public sector will remain a focus as long as Bill English is Finance Minister.

Crown Expenses as a % of GDP



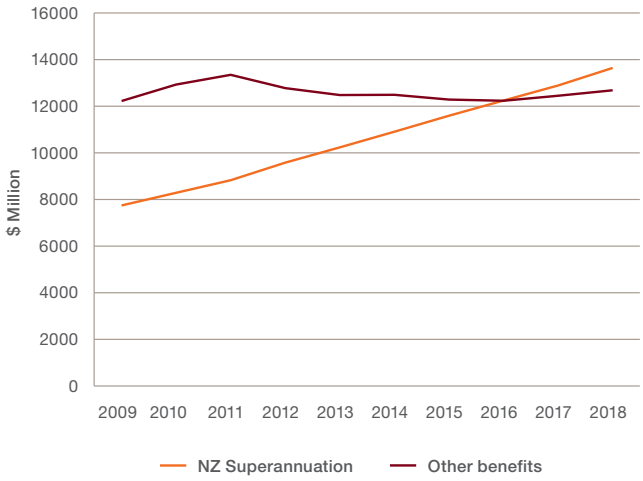
Source: The Treasury, PwC Analysis

Continued concern around superannuation

As in previous Budgets, we remain concerned with the fiscal implications of the superannuation spend. While other welfare spending is flat to reducing, reflecting the improvement in the economy, superannuation growth is linear, and we can expect this growth to accelerate as more baby boomers retire.

The Australians have addressed this fiscal timebomb in their Budget, but the New Zealand Government remains steadfast in its refusal to look at retirement age or eligibility.

Forecast changes in welfare spending



Source: The Treasury, PwC Analysis

Important challenges

Challenge 1: Striking a balance between affordability, demand and supply for housing

The past year has seen unprecedented changes in our residential housing market including the Auckland Housing Accord, the implementation of the Reserve Bank's LVR policy, the Christchurch rebuild and changes to consenting, building regulation and insurance.

Housing Minister Hon. Nick Smith has already signalled further changes in the sector, particularly in terms of building materials.

Long term, these individual changes should improve housing affordability. However, in the immediate future they may be seen as lots of policy levers being pulled at once to see which one works, without a clear vision of how they work together. That coherent vision is needed in 2014.

Challenge 2: Getting a sustainable, high-value public service

In our Budget 2013 coverage, we highlighted the fact that despite a significant number of structural changes in the public service since 2008, there has been only a minor change in headcount, and the recent news that the public service will soon be hitting the employee cap would have surprised many.

The return to surplus and the improved fiscal position provide the Government with the opportunity to make step changes in the way the public service delivers for New Zealanders.

Challenge 3: Driving growth in the regions

The Government has already made a number of significant strides in regional economic development, particularly with regard to infrastructure. The Roads of National Significance, UltraFast Broadband roll-out and the Crown Irrigation Equity Fund will all provide a long-term stimulus.

Looking ahead the Government has an opportunity to leverage taxpayer investments by breaking down barriers for private investment in the regions. While reforms to the resource management regime have improved the legal process for the approval of major investments, there are still huge time and financial costs associated with the development of proposals, as evidenced by recent developments like mining on the Denniston Plateau and King Salmon.

One of the key reasons why it takes so long is neither the Crown, nor councils use an established economic evaluation methodology to evaluate the impact of projects. Such an approach is used as a matter of course in transport projects and the efficiencies in commonly agreed values enable focus, benefiting both proponents and opponents of development.

Challenge 4: Globally competitive cities

Cities and the services sector are probably our largest latent economic opportunity. We've traditionally seen our cities as servants to our domestic economy, but in the last decade, our cities have been progressively contributing more to our foreign exchange earnings. Our cities drive earnings in the tourism and international education sectors, and provide support to the film industry.

More recently, technology and professional services firms such as Xero have been driving growth.

2014 will be an important year for competitiveness of New Zealand's cities with the Ultra-Fast Broadband roll-out, the Christchurch rebuild and the Roads of National Significance programme all underway. 2014 will also see the Productivity Commission make progress on its Services Review, and should see further progress on urban infrastructure such as the City Rail Link in Auckland and the Wellington Airport runway extension. However, we are missing a coherent view on the importance of cities to our international competitiveness and what we need to do to improve this.

Challenge 5: Managing demographic change in a fiscally responsible manner

In our commentary on Budget 2012, we noted New Zealand's ageing population was beginning to hit the Government's forecasts and that the current business as usual approach to providing for future generations was not going to be sufficient.

On current projections, spending on New Zealand Superannuation will move from 4% of GDP in 2011 to 8% of GDP in 2060, and health spending will go from 6.9% of GDP to 11% of GDP over the same period. Put simply, the next six years are pivotal to achieve fiscal sustainability as demographic changes begin to bite.

Agribusiness: for a more prosperous New Zealand

Turning our attention to agribusiness and primary industries, the 2014 Government Budget has reaffirmed the Government's commitment to the policies described in its Business Growth Agenda (BGA), the Ministry of Primary Industries' (MPI's) 2030 Strategy, and the Export Double goal.

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The goal requires a NZ$32 billion increase in the total real value of New Zealand's primary exports and average real export growth of 5.5% p.a.

- **Primary Growth Partnership (PGP)**
  What? It aims to boost the productivity and profitability of our primary sector through investment between Government and industry.

  Why? It enables New Zealand to stay at the forefront of primary sector innovation.

  Where is it at? 18 PGP programmes announced. $708 million in funding committed from both industry and Government. Potential benefit to the wider economy estimated at NZ$7 billion per year from 2025.

- **Free Trade Agreement negotiations**
  Where are we at in 2014? In April, Prime Minister John Key and China's President Xi Jinping agreed to increase the 2020 New Zealand - China two-way trade goal - to US$30 billion (two-way trade with China is currently valued at US$18.2 billion). It coincides with the launch of a new China-New Zealand Dairy Exchange Centre in Beijing.

  In March, Hon John Key announced the presidents of the European Commission and European Council agreed for the first time to consider a Free Trade Agreement with New over the next 12 months. The EU is New Zealand's third largest trading partner with over US$16 billion in two-way trade of goods and services. Peru has opened its border to registered New Zealand sheep meat and beef exports, while long running negotiations with South Korea are also advancing.

- **Irrigation investments**
  Why? The Government has continued its commitment to Crown investment in regional water storage and off-farm irrigation infrastructure schemes from Government. (Crown Irrigation Investments or Crown Irrigation.

  Where is it at? Crown Irrigation established to manage these investments in July 2013, with irrigation investment funding of NZ$80 million provided in Budget 2013. Budget 2014 invests a further $40 million.

- **Assurances that add value to New Zealand's food products**
  What? To vote Food Safety is another Government's initiative to strengthen Government influence in biosecurity, food safety and primary production systems.

  Why? To ensure that food systems are managed in a way that ensures that growth in primary sector export earnings is conducted in a sustainable way.

  Where are we at? MPI is largely responsible for the certification of food produced according to domestic and overseas market access requirements and monitoring compliance. Government can deliver assurances to consumers, the public, overseas authorities and other stakeholders that food and inputs into the production of food are managed in accordance with New Zealand legislation and, for exports, relevant importing countries' market access requirements.

Critical China

China is now New Zealand's largest trading partner. It is also a vital trading partner to Australia, and hence to New Zealand indirectly as well as directly. Expansion of economic links with China will be vital to the Government's goal of increasing by 10 percentage points the share of GDP in exports (from 30 percent to 40 percent by 2025).

The underlying flows of trade are indeed expanding rapidly, but the relationship between the countries has been hindered by a number of difficulties: the contaminated milk powder false alarm; problems with labelling leading to meat exports being stuck in Chinese customs. This has highlighted the importance not only of the basic structures facilitating trade, but also the need for the Government to engage effectively with the Chinese system in support of further opening markets, and in navigating and resolving problems and issues at the vitally important government to government level.

New Zealand was the first country to negotiate a free trade agreement with China. The direct convertibility now possible between the NZ dollar and the Chinese currency RMB will also boost trade and investment in the long run, as it helps to reduce the cost of conversion and makes it easier for the two countries businesses to deal with each other.

Goal:

$20 billion
two-way trade by 2015

$30 billion
by 2020

Key Government Agencies in our China Relationship:

Foreign Affairs
Primary Industries
Trade & Enterprise
Education

Continuing support for engagement with China, the Budget allocates funding for a large expansion of Government agency staff on the ground in China: NZTE has $69 million to expand New Zealand's presence in China and elsewhere. On top of this, the Government is investing some $40m in a new Embassy in Beijing, a visible and important signal of the Crown's commitment to the relationship.

What's next? China is expected to have a shortage of safe food, particularly dairy products for more than 10 years, particularly after China relieved on the Single Child Policy. Exports of retail-ready infant formula have doubled in recent years and now represent about 4 percent of New Zealand's dairy exports to China, or about $200 million a year. The total dairy trade to China was $5 billion in 2013 and the growth of export to China will continue in the future years. Chinese President Xi Jinping often expresses food safety and agricultural need as the number one issue for China. Meeting this need is an obvious opportunity for New Zealand businesses.

Investment

In line with China's Go Global policy and with more resources and capabilities in New Zealand agencies in China, we can expect direct investments from China will increase in the coming years.

Bilateral investment will strengthen cooperation between the two countries to provide mutual benefits. Foreign direct investment from China to New Zealand increased by 32% to $391 million in 2013. Recently Transpacific Industries had entered into an agreement to sell its New Zealand business to Beijing Capital Group for $950 million. Fu Wah group is going to build a new five star hotel at Auckland waterfront worth $200 million.

More New Zealand businesses, especially the export businesses, would like to invest in China as direct investment within China is the long term vision to secure the export trade opportunities.

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