

# New Zealand Budget 2010

## Investment insights

By Jason Wong, Head of Investment Strategy for AMP Capital Investors (New Zealand)

### Key points

- Faced with a deteriorating fiscal position, the Government's policy options for Budget 2010 were always going to be limited. The Government opted for a decent rejig of New Zealand's tax structure as the key policy plank of the Budget – reducing income taxes and the corporate tax rate and raising the consumption tax, for an overall broadly neutral fiscal impact. As far as helping to improve the long term growth prospects of the economy, it was a step in the right direction, albeit a small step. The overall changes to the tax system are cleverly crafted so that most people are better off and it will be hard for critics to argue that the rich enjoy the biggest gains.
- Apart from a higher GST rate, a change to depreciation rules also helps fund the income tax cuts. The change to depreciation rules on property should encourage less investment in that sector as a means of saving. At the margin, this is positive for alternative investment opportunities such as local debt and equity markets and the managed funds industry. The incentive to save is further encouraged by reducing the maximum PIE tax rate to 28%. With a lower corporate tax rate, the valuation of most companies increases, but the value of listed and direct property funds will be clearly hit by the change to depreciation rules.

- Fiscal policy is projected to tighten modestly over coming years, largely via expenditure restraint. That, combined with a cyclical improvement in tax revenues, helps drive the underlying budget deficit from an estimated 4.2% of GDP in the 2011 financial year to 1.3% by the 2014 financial year.
- By international standards, New Zealand's fiscal accounts are in an enviable position, with modest deficits and low debt levels. While many large countries face an extreme period of fiscal austerity ahead, New Zealand's fiscal tightening is much more modest by comparison. A reversion to fiscal responsibility following a few profligate years should keep the ratings agencies satisfied.
- There is no news in the Budget that changes the outlook for monetary policy. A period of tighter fiscal policy reduces some of the work that monetary policy needs to do over the next couple of years but that's old news. While the fiscal impulse is slightly higher over the next year than previously projected, the tax package should encourage positive supply-side effects, an offsetting impact for the modest additional impulse to aggregate demand.

### Overview

- During the global financial crisis we saw a massive blowout in fiscal accounts around the world, as governments tried to prop up ailing financial markets and support economies through the most significant global recession since World War II. With mission accomplished on driving an economic turnaround and the transfer of debt from private accounts to public accounts, it's now payback time.
- With intense scrutiny on government accounts right across the world, "fiscal austerity" is the new buzz phrase. The task of bringing fiscal accounts onto a more sustainable path will be much easier in New Zealand than other countries, given the

### Key Fiscal Indicators

	2009	2010	2011	2012	2013	2014
OBEGAL* (\$ bn)	-3.9	-6.9	-8.6	-5.4	-4.4	-3.0
OBEGAL (% of GDP)	-2.1	-3.7	-4.2	-2.5	-1.9	-1.3
Cash Balance (\$ bn)	-8.6	-9.1	-13.3	-9.7	-7.5	-6.0
Cash Balance (% of GDP)	-4.7	-4.8	-6.5	-4.5	-3.3	-2.5
Core Crown Revenue (% of GDP)	32.2	29.8	29.6	29.9	30.3	30.7
Core Crown Expenses (% of GDP)	34.7	34.2	34.7	33.1	32.9	32.4
Gross Sovereign Debt (% of GDP)	23.5	28.4	32.8	32.3	31.7	32.7
Net Public Debt ** (% of GDP)	9.3	14.1	19.6	23.0	25.3	26.5
Gross Domestic Bond Issuance (\$ bn)	5.8	12.5	12.5	10.5	10.0	6.0

\* OBEGAL is operating balance excluding gains and losses

\*\* net debt excludes assets of the NZ Super Fund

much better fiscal starting point, a milder recession through the crisis and a more robust banking system. That said, as in other countries, a period of fiscal tightening will soon begin.

- The focus for Budget 2010 was to project a modest tightening in fiscal policy, largely through expenditure restraint, but at the same time reforming the tax system to help improve the economy's longer term growth prospects by tilting the economy away from debt and consumption and toward savings, investment and exports. This is music to the ears for fund managers.
- Timing issues with implementation mean that fiscal policy is slightly easier than previously projected for the 2011 financial year but overall the tax package was designed to be broadly fiscally neutral on the fiscal accounts and broadly neutral in terms of its impact on the income distribution.
- It was a well-crafted tax package, with the spin that it is mainly high income earners who are landlords and for many the cut to the high income tax rate will be more than offset by a higher tax liability from the removal of depreciation on buildings and the reduction in the ability of loss attributing qualifying companies (LAQCs) to avoid tax.
- A unique feature of the 2010 Budget was a focus on re-prioritising existing expenditure (circa \$1.8 billion over four years) rather than focusing on new spending initiatives. Indeed, new spending initiatives were limited to the self-imposed \$1.1 billion per annum, barely enough to cover inflation and population growth. That effective spending cap is likely to be an enduring theme. In the Budget speech, the Finance Minister commented that it will require at least a further decade of disciplined fiscal management to deal with the effects of the global financial crisis and the huge lift in government spending during the boom years leading up to that crisis.

### Changes to the tax system the key policy plank

Tax reform was the centerpiece of the Budget. The policy measures can be summarised as follows:

#### From 1 October 2010:

- Across the board personal tax cuts worth around \$4 billion per annum, including a cut to the top rate from 38% to 33%, the second top rate from 33% to 30%, and the lower rates move from 21% to 17.5% and from 12.5% to 10.5% respectively. No changes were made to income thresholds.
- Increasing the rate of GST from 12.5% to 15%.
- A cut in the top tax rate for most portfolio investment entities (PIEs) from 30% to 28%.

#### From 1 April 2011:

- A cut in the company tax rate from 30% to 28%.
- A cut in the tax rate faced by unit trusts, life insurance policy holders and some other savings vehicles from 30% to 28%.
- Ending landlords and businesses' ability to claim depreciation on buildings with an estimated useful life of 50 years or more.
- Tightening the rules for loss attributing qualifying companies so shareholders cannot deduct losses at their marginal tax rate and pay tax on profits at the lower company rate.
- Changes to the thin capitalisation tax rules to limit the scope for foreign multinationals to reduce their New Zealand tax liability. The "thin cap" will be reduced from 75% to 60%.

#### Immediate change:

- Removing the 20% accelerated depreciation loading for new plant and equipment purchased from 21 May 2010.

The impact of these tax changes are:

All household income groups will receive on average around a 0.5% to 1.0% increase in their real disposable income. The clear losers will be residential property investors who are claiming significant tax deductions to reduce their overall taxable income.

The Government has opted to leave the trust rate at 33%, which closes a tax loophole of high income earners transferring assets to a trust. But the gap between the top rate and the company rate will be 5% so the net impact might be some closing down their trusts and setting up a company structure.

The reduction in the corporate tax rate and PIE rate to 28% was a positive surprise in the Budget. This maintains the overall incentive for savings through PIEs for those on the new top tax rate of 33% on income above \$70,000. At the lower end of the income scale, PIE income of up to \$48,000 could be taxed at just 10.5%. For those earning between \$14,000-\$48,000, the marginal tax rate on PIE income is just 17.5% up to a total income level of \$70,000. This tax break on PIEs is a boon to the funds management industry but the challenge will be to get the message across to savers.

The reduction in the corporate tax rate helps most companies, but offsetting the impact of this is the change to depreciation rules. Businesses that currently enjoy the favourable accelerated depreciation rate and/or have significant capital expenditure in buildings will clearly see an increase in their tax liability.

The Government estimates that the change to depreciation on buildings will raise almost \$700 million per annum. Building owners will still be able to claim deductions for repairs and maintenance, to maintain the condition and value of their properties. They will also still be able to claim depreciation deductions for "fit outs" not considered part of the building. The Government intends to review the treatment of commercial "fit out" and, if necessary, amend the rules prior to 1 April 2011 to address any uncertainty in this area. Property owners will be incentivised to class as much as the capital expenditure as fit out, so expect some quite prescriptive rules from Inland Revenue here. Furthermore, building owners will be able to apply to Inland Revenue for a provisional depreciation rate if they consider a class of buildings has an estimated life of less than 50 years. This is clearly a grey area and we await further announcements from Inland Revenue in this regard.

It is a complex exercise to calculate the impact of the tax changes on listed or direct property fund valuations as we don't know what the impact on rentals might be. Some property businesses might be able to claw back some of the negative impact on after-tax profit via higher rentals. Furthermore, to the extent that the new tax policy might restrict additional supply, this could be positive for the value of existing buildings. In addition, the reduction in the PIE tax rate will improve net returns for many investors and this also provides some offset to the negative impact from the change to depreciation rules. Overall, looking at an average commercial property fund, the removal of depreciation adds about 6% to its marginal tax rate. This could increase if the Government clamps down on the definition of a fit out (changing assumptions about the "life" of particular assets), while the 2% reduction in the PIE tax rate provides a modest offset for investors.

### Key economic and fiscal trends

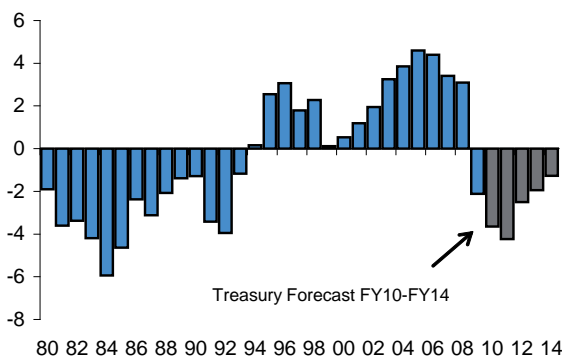
The Treasury's economic forecasts are not controversial with GDP projected to average close to 3% over the next four years. If anything, one could argue that its GDP forecasts are fairly unimaginative with remarkable stability in growth projected.

The only real eye-opener in the economic projections is the forecast rise in the CPI to a peak of 5.9% in the year to March 2011, driven higher by the increase in GST, the rise in tobacco excise tax, the introduction of the Emissions Trading Scheme and the rise in ACC levies for motorists.

The RBNZ, of course, will be looking through this spike in headline inflation but it is hard not to believe that there will be at least some modest impact on inflation expectations, which makes their job harder.

The graph on the next page highlights the damage done to the operating balance over the last few years via a combination of fiscal easing (higher spending and tax cuts) and the impact of the economic recession – a healthy budget surplus quickly transformed into a large deficit. With the fiscal ropes tightened again and economic recovery underway, the path projected is one of ever diminishing operating deficits – from a peak underlying budget deficit estimated to be 4.2% of GDP in the 2011 financial year to 1.3% by the 2014 financial year. The Government now expects to return to surplus in the 2016 financial year.

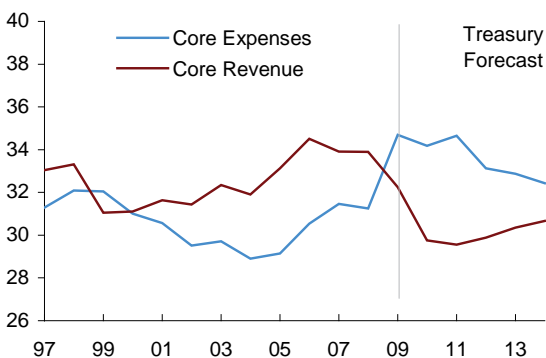
### Operating Balance (ex gains and losses), % of GDP



Source: The Treasury

A look at core expenditure and revenue trends illustrate the key drivers of the operating balance. Spending was on a strong upward trend from the 2005 financial year to the 2009 financial year but with self-imposed spending limits placed (new operating spending allowances of just \$1.1 billion per annum), the ratio of core expenses to GDP tracks lower over the forecast period. Revenue as a percentage of GDP dips with another tax cuts package, but then drifts higher from the 2011 financial year.

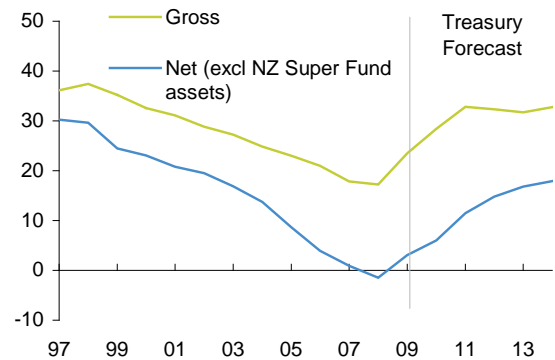
### Core revenue and spending, percent of GDP



Source: The Treasury

Debt as a percentage of GDP remains on a rising trend, before stabilising by the 2014 financial year.

### Sovereign Debt, percent of GDP



Source: The Treasury

With regards to the NZ Super Fund, the government projects that contributions should be able to be restarted in 2018/19.

### A wall of bond supply

To fund the budget deficit and maturing debt the Government stepped up its borrowing programme in the current fiscal year, with \$11 billion of government stock already issued and a full year target of \$12.5 billion.

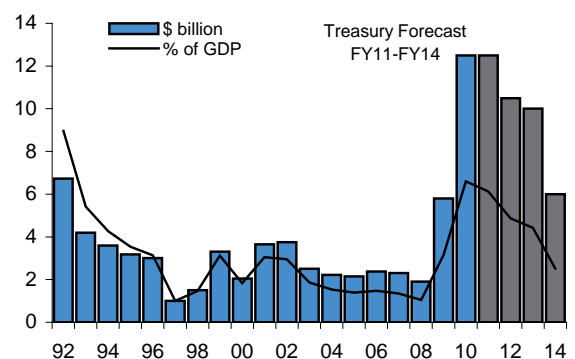
The Government has had little problem in raising money, with demand for government stock relatively high, reflecting increased demand from local banks as they solidify their balance sheets and risk aversion from investors still scarred from the global financial crisis.

For the 2011/12 fiscal year, the Government will issue another \$12.5 billion of domestic bonds, but issuance tracks lower over later years. Total issuance is about \$2 billion lower than previously projected in the December update.

Projected bond supply figures remain well above historical averages, but recent experience suggests that it may not necessarily be a problem. When measured as a percentage of GDP, the possibility of supply indigestion is even less obvious.

If New Zealand's strong relative fiscal position against other countries is maintained (see the next section), then there could well be a steady source of foreign demand.

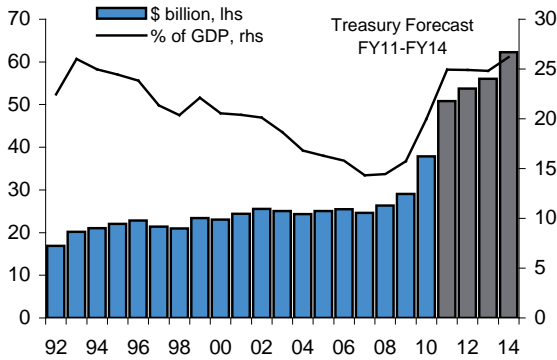
### Government Domestic Bond Issuance



Source: The Treasury

As a result of the significant borrowing programme, government stock on issue is set to remain on its higher trend, as the following chart suggests, from pre-GFC levels of below \$30 billion to circa \$60 billion by the 2014 financial year.

## Government Stock on Issue



Source: The Treasury

While the trend appears somewhat alarming, as mentioned, in a world of leveraging there remains considerable appetite for government bonds by investors. Even with the concerns about sovereign risk on the radar of many investors, bond yields are tracking lower, if anything, and remain well below historical averages.

We believe that “bond supply” is often exaggerated as a factor for interest rates. In our view, looking at bond supply in isolation, without considering bond demand and monetary policy, is misguided in assessing the outlook for interest rates. One only needs to look to the Japanese experience to realise that this is the case.

The following section highlights the high levels of government deficits and debt around the world and the need for a prolonged period of fiscal austerity. With tighter fiscal policy ahead, monetary policy can remain easier than it otherwise would be. This effect on lowering the equilibrium level of short rates is probably a more important factor in assessing the outlook for interest rates than is bond supply.

## International comparison

While we’ve seen a marked deterioration in New Zealand’s fiscal accounts over the last couple of years, they remain a beacon of strength when compared against most other countries. While many of the major economies are facing issues of fiscal sustainability, New Zealand’s fiscal accounts are far from that position, with the deficit and debt levels at much more comfortable levels.

This is highlighted in the following two charts which compare New Zealand’s projected operating balance and net public debt to

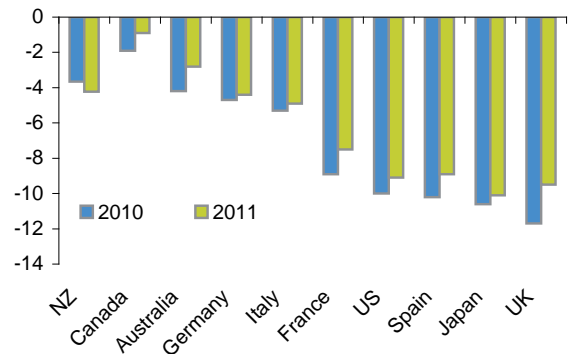
GDP ratios (for the 2010 and 2011 financial years) with those of Australia and other major economies.

New Zealand’s projected operating deficit (excluding gains and losses) of 3.7% of GDP for the 2010 financial year is well below the projected circa 10% plus of GDP rates projected across the US, UK, Spain and Japan. New Zealand’s projected gross public debt of 28.4% of GDP for the 2010 financial year is significantly below the 60% plus rates projected for most of the major countries.

This is important because New Zealand needs to attract foreign investors to service the country’s debt and rating agencies use cross-country comparisons when setting debt ratings.

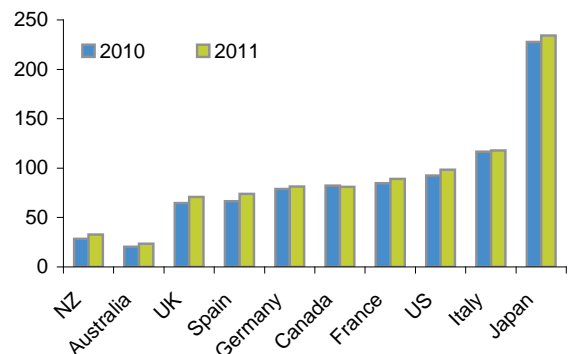
The heat is certainly on other countries to bring down deficit and debt levels and this will be an enduring theme over coming years, creating a lot of market uncertainty during the process. Much tighter fiscal policy is required right around the world to bring accounts onto a more sustainable footing and this is likely to be a key headwind for GDP growth in the developed world. By comparison there is only modest pressure for New Zealand to reduce deficit and debt levels ahead of the deteriorating demographic picture – an enviable position to be in, really.

### Operating Balance, percent of GDP



Source: NZ Treasury, Goldman Sachs, OECD

### Gross Public Debt, percent of GDP



Source: NZ Treasury, Goldman Sachs, OECD

## Investing. It’s what we do.

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