# Planning for the new New Zealand


pwc

**NZ Budget 2015**

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# CEO's message

***Welcome to our Budget 2015 commentary publication.***

Once more, we are proud to share our insights on the New Zealand Government's Budget 2015. As you will read, and as indicated by Prime Minister John Key and Minister of Finance Bill English, there were no major surprises in this year's Budget. The overall approach simply continues the 'steady as she goes' of the past few years.

At $684 million, the deficit was actually a bit worse than the tone of all the prepositioning ("a few hundred million") but the trend line is what matters, not the specific number.

In 2011, the deficit peaked at $18.4 billion. To put this into context, even the fiscal crisis of the early 1990s that saw "the Mother of all Budgets" only forecast a $3.7 billion deficit. The fact that, in 2015, we are closer to surplus without the cuts to core expenses and capital programme we saw in the 1990s, is a tribute to Mr English's stewardship.

Faced with these financial constraints, the Budget was very much what was expected and had been signalled in advance: more support for those most in need, especially children; support for research and development in public and private sectors; and absorbing cost pressures in health, education, law and order, and defence and security. There's a regional flavour to some of the infrastructure announcements on ultra-fast broadband, roads, and cycleways.

It's good to see the Government more active on housing supply in Auckland, with a fund set up to accelerate the availability of Crown-owned land for housing development.

The change in the Government's finances means that the restraints on public expenditure will continue in the medium term. The steady approach to detailed reform and improvement in quality has served the Government well so far, but the question remains whether it will be enough in the face of longer-term challenges. We remain concerned about the long-term pressures in superannuation and health, and whether the education system is equipping our children for the technology-driven workplace.

I trust our analysis will provide 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

# Budget 2015 at a glance

*$500 million reduction in ACC levies*

*$320 million p.a. for health with $98 million funding for elective surgery*

*Families package worth $240 million a year from 2017*

*$80 million to encourage more private sector R&D*

*$443 million of new operating spending for early childhood, primary and secondary schools*

*450ha and $52 million for new houses in Auckland*

*$29 million for the Inland Revenue to enforce property tax law*

*New Zealand Police has been given $164 million*

*GCSB and NZSIS get another $20 million each over four years*

*New Zealand Defence Force gets $264 million*

*$22 million over the next six years for new forests*

*$33 million to boost the number of immigration offices. New border levy raises $100 million p.a.*

*$32 million of operating expenditure in employment relations services*

# What's in today's Budget?

*"Deficit is worse than initially thought at $684 million when the tone of all the signalling had been 'a few hundred million shy' and the surplus of $176 million next year is back in 'rounding error' territory."*

Richard Forgan

PwC

Click to watch Richard's video

*"This year's Budget documents contain the usual self-congratulations for a growing economy and the effectiveness of recent and future policies. The mandatory Opposition invective followed and more can be expected over coming days and weeks!"*

Professor Norman Gemmell

Victoria University of Wellington

Click to read Norman's comments

## *It's another centre-left branded Budget from a centre-right Government with 'child hardship' a core focus.*

Bill English is a Finance Minister who's proven to be a man focused on the long-term picture. His steady hand has seen him hold his nerve on operating and capital spending when faced with an $18.4 billion deficit in 2011. That, in itself, was spectacular, but in 2015, within a year of coming back to surplus, that same steady hand has seen him present a Budget that looks like he is treading water, waiting for the good economic growth to finally provide him with some fiscal headroom to do a little more than tinker around the edges.

On the economic side, we have good growth and low inflation providing the building blocks of a set of Government books that, despite missing the surplus, are in pretty good shape. Crown debt is under control and future surpluses will allow the Government to start paying back nominal debt.

The delivery of the surplus a year later than planned is not surprising and even as far back as 2011, it was clear Bill English would need both the economy and the revenue flows to go in his favour to meet his goal. That hasn't happened and the Minister of Finance has been faced with a significant turnaround in his forecast fiscal position, losing almost $1.1 billion from his forecast operating balance for 2015/16 year compared to what he was planning on in Budget 2014.

Faced with a deficit close to $700 million for 2015/16 the Minister of Finance has focused well over half of his new spending on meeting wage pressures and demographic growth in the health and education sectors. Similarly, most new departmental spending looks like it is going to address cost pressures rather than any material increases in capability or services.

The major new initiative is the Child Hardship Package with significant rebalancing of Working For Families towards lower income families and $25 increases per week in benefit levels for people with children. Increases in childcare are also provided for, in return for greater work obligations for beneficiaries with children.

The regions are boosted with use of the Future Investment Fund revenues to pay for better roads, better telecommunications connectivity and a large injection for KiwiRail. The regions also get a new Regional Research Institute focusing on regional growth.

While the Minister has focused on growing the regions, his focus in Auckland has been on taming the city's growing pains. Today's announcement on increased land supply from Crown land, adds to the tax and loan to value measures aimed at reining in the Auckland housing market. While the measures are a step in the right direction, both the Government and Auckland Council seem a way off getting the right mix. Of most concern is the lack of a focus on providing the infrastructure that will support additional housing development.

For the other major urban centres its business as usual, including Christchurch.

We do have to keep in mind that this is the first Budget of an electoral term, and this is usually when all the tough decisions and unpopular calls are made. Aside from the removal of the KiwiSaver Kickstart and some more user pays for businesses (funding the NZ Business Number) and travellers (with the biosecurity levy), this Budget has very few of these tough decisions. This perhaps reflects the fact this is a third term government who have already had their share of such calls.

What is clear is the Government continues to position itself for Budget (and Election) 2017 with a $2.5 billion provision for new spending, clearly targeted at tax cuts.

## What's not there?

- Superannuation reform or eligibility – not that we expected it to be.
- Stronger performance and reform focus – especially health.
- Tackling other parts of the housing conundrum – building product regulation and non-tariff barriers.
- Extending GST to digital and lowering the thresholds on all imports, although the Government has signalled it's looking at this.

# The winners and losers

***Having no surplus, new Government spending is thin on the ground. Are there big time winners? Or rather, has Budget 2015 created a mixed bag of small changes?***

## Winners

### Families

- Low income and beneficiary families with more money for ***Working For Families*** and on ***benefits***, as well as increases in childcare subsidies
- ***Low inflation*** and good ***economic growth***
- ***Tax cuts*** in 2017
- ***ACC levy*** cuts
- ***Chatham Islanders*** – with $52 million for a new wharf, that's $90,000 per person

### Businesses

- ***ACC levy*** cuts
- ***Low inflation*** and good ***economic growth***

### Public services

- ***KiwiRail*** gets a large capital lifeline of $400 million over two years, but is it on its last chance?
- ***Inland Revenue*** – who once again get money for capability by promising extra tax revenue

## Losers

### Families

- ***Auckland house buyers:*** Minor changes on tax for speculation, and the freeing up of a small amount of land won't meet demand
- Overseas travellers hit by the ***biosecurity levy***
- New employees: Loss of the $1,000 ***KiwiSaver kickstarter***

### Businesses

- Company fee payers who now have to contribute to the cost of the ***NZ Business Number***
- ***Exporters*** with no movement on the dollar

### Public services

- ***Health and Education***: Money for cost pressures and demographics, but not much else
- Fiscal sustainability, with continued inaction on ***superannuation***

***Other smaller initiatives have been announced due to Budget constraints and systematic reprioritisation.***

Winners:

- The Regions – with the creation of Regional Research Institutes and more money for roads, ultra fiber broadband and rural broadband extensions

Losers:

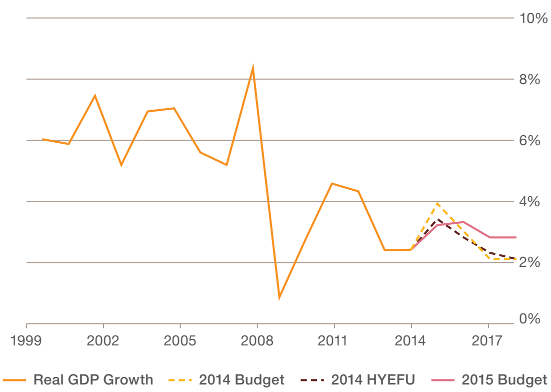
- Users of Government services with more user pays for businesses and travellers

# How did the Budget deliver?

## Fiscal and Economic update

Compared to the December forecasts, we have lower 2015 growth estimates and a rosier picture painted over the medium term for growth in gross domestic product. Short-term GDP growth forecasts have dropped on the back of deteriorating exchange rates for exporters as well dropping dairy prices, compared to when the 2014 Budget was released. Medium-term GDP growth has been increased on the back of a strengthening labour market performance and high net migration figures. Net migration between New Zealand and Australia will be positive for the first time in more than 20 years.

Forecast GDP growth 2015-2018

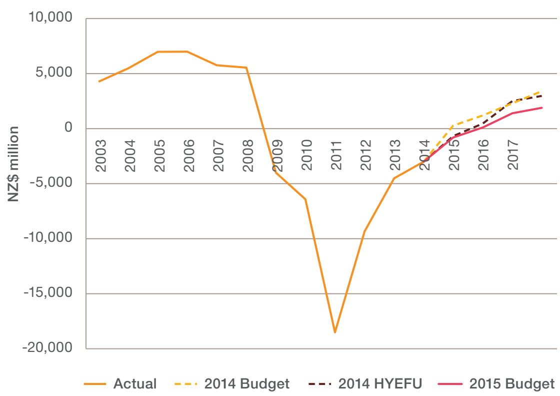



Source: The Treasury, PwC Analysis

## Missing the surplus by a year

The Budget has shown that the return to surplus should occur in 2016, a year later than planned and a $1.1 billion reversal in fortune compared to the surplus the Government was expecting as outlined in the 2014 Budget.

Total Crown Operating Balance

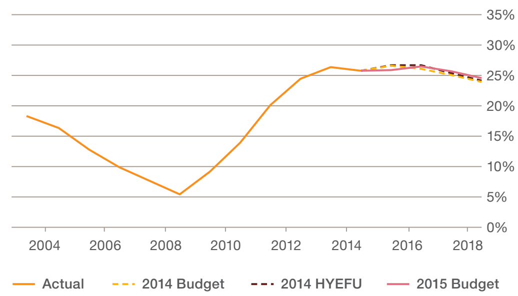



Source: The Treasury, PwC Analysis

## The debt track: maintained at current levels despite the change in surplus

Net debt levels are continuing to fall in line with previous Budgets and fiscal updates. These rates of reduction have remained stable between budgets, as the Government's focus remains squarely on gaining a surplus as soon as possible. What is interesting is that even though the surplus has been pushed back a year, there has been no change in the debt repayment timeline.

Net Core Crown Debt, % of GDP




Source: The Treasury, PwC Analysis

# What are the key challenges?

## Auckland housing

Auckland housing is the toxic hole in the economy. There are a list of measures to address pressures on demand – targeted loan-to-value ratios and the speculators' tax, for example – while the Government also focuses on supply with Special Housing Areas and making Crown land available for accelerated development. However, going from bare land to actually selling houses takes time and in the meantime, a net 50,000 new arrivals p.a. are looking for homes. The missing element is loosening building product regulation without creating a new weathertight crisis. Expect prices to continue to climb.

## Auckland infrastructure

Increased population is also putting far greater pressure on Auckland's transport infrastructure. There is a programme but the linked issues of funding and managing demand – whether through congestion charging or tolling key routes – have not yet been addressed.

## Targeting public money

There's probably a stronger story here than was told in the Budget documents: focusing services on the most challenged and challenging parts of society, which also generate the greatest costs in welfare and law and order. But this will need sustained focus over a long time, requiring much greater join-up across Government. It could end up costing substantially more than the current approach.

## Healthcare

Over the long term, superannuation and healthcare place the greatest demands on the public purse. Tackling long-term health pressures and the structural reform of the healthcare system is going to be hard, whereas superannuation can be changed at the stroke of a pen. But, when reform of superannuation remains off-limits, where is the plan for healthcare?

# What's the Government spending?

*"The fiscal pressures around superannuation remain an unaddressed issue in Budget 2015."*

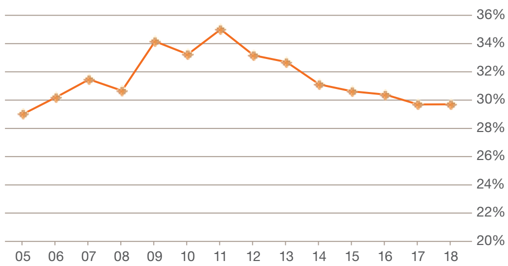
Geof Nightingale
PwC

Click to watch Geof's video

## *Minister of Finance Bill English has continued his focus on ensuring Crown expenses as a proportion of the economy are maintained at prudent levels.*

Since the onset of the Global Financial Crisis, the Crown has reduced the amount of expenditure as a percentage of GDP for four successive years with measures such as Kiwis Count and Better Public Services hinting at possible improvements to the quality of public services.

Crown Expenses as a % of GDP

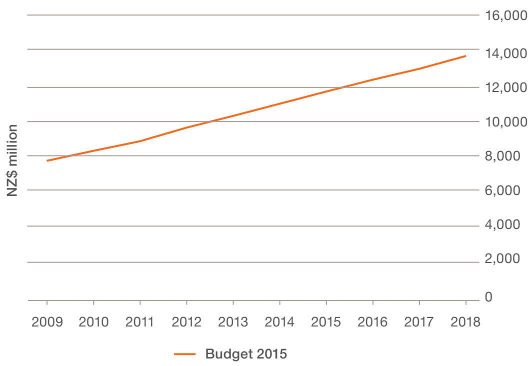



Source: The Treasury, PwC Analysis

## The impact of demographics

The fiscal pressures around superannuation remain an unaddressed issue in Budget 2015. Spending has increased at around $750 million per year (a similar magnitude to the size of this year's deficit) on current rates – and that's before the baby boomers begin to retire.

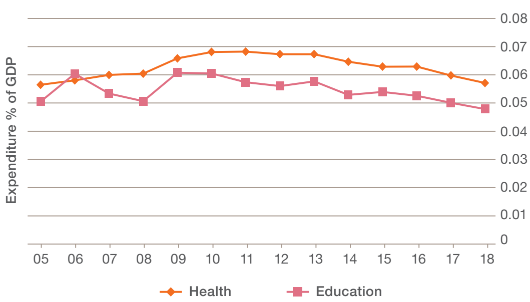
Superannuation Expenditure




Source: The Treasury, PwC Analysis

Similarly an ageing and growing population sees significant additional funding go into health and education. But the real levels of spending as a proportion of the economy are falling as the fiscal position leads to a focus on managing pressures as distinct from growing what the sector does.

Selected Spending Areas as a % of GDP




Source: The Treasury, PwC Analysis

# What’s the record?

***Minister of Finance Bill English has missed his target of getting back into surplus, which was set in the 2011 Election. Much has been (and no doubt will be) made in the media and by the Opposition about the seriousness of this miss, and when the Minister did or didn’t know about it. In reality, it doesn’t matter too much from a nationwide perspective.***

This kind of target is a vital focusing device when you are looking years into the future and it requires discipline to meet it. But it becomes increasingly irrelevant and hostage to fortune the closer it gets. Hitting the target this year or not was more a function of how tax revenue worked out – and in what direction various technical accounting adjustments would push the surplus – than it was of how well the Government has managed expenditure. And knee-jerk reactions to cut expenditure purely for the purpose of hitting this target would – as the Minister says – be needlessly damaging.

But that does beg the question of how well the Government has managed its expenditure over the past seven years and it’s worth a look in more detail.

## What did this Government inherit?

The starting position could have been a lot worse. The previous Government locked in a lot of expenditure during the boom years of the early and mid-2000s, but it was also one of the rare western governments that paid down debt and strengthened its balance sheet. The current Government inherited an economy in recession and expenditure locked in at unsustainable levels.

In 2011, the earthquake rattled a further huge hole in the Crown’s finances. In these circumstances, austerity would probably have been more damaging to the economy as a whole. At the same time, the Government could not continue to spend at a rate so divorced from its recession-hit tax take. Although levying more taxes might have helped the Government’s books, it would have transferred expenditure from one part of the economy to another. What was really needed at that time was to increase expenditure to boost demand.

## What’s happened since?

What didn’t happen were the wholesale cuts to expenditure that were seen in so many countries overseas. Instead, the Government picked an expenditure track that could be managed over the medium term and has largely stuck to it. If growth in expenditure is significantly below the rate of growth in the tax take, it’s just a matter of time before the two lines cross over again. Having set out on this path, the picture hasn’t changed that much over the past four years.

## Austerity lite

It’s important to take a look at what has been going on with the key components of the Government’s expenditure: pensions and benefits, core expenditure and the interest bill on its debt. What is apparent is that the austerity suffered in many countries simply didn’t happen here. Payments to pensioners and beneficiaries have continued to climb, particularly driven by the first wave of baby boomer retirement. It’s in the core expenditure where growth has been constrained.

## What is the impact on services?

Good measures of service quality are thin on the ground for the interested taxpayer or voter. However, what there is generally tells a story of service quality having been maintained or even improved over the past few years.

This all adds up to a pretty creditable record: a fiscal consolidation undertaken without serious austerity, over a period of many years. What service measures there are suggest that quality has improved – which is pretty good.

There is still unfinished business. So what’s to come? Expect more of what you have already seen.


of NZ CEOs are concerned about the Government’s response to fiscal deficit and debt burden as a threat to business growth, compared to 79% of concerned CEOs in Australia.

# Why does health matter?

*"This Budget has delivered financial certainty to the sector over the next three years with the DHBs now able to identify the scale of the challenge they face."*

Richard Forgan
PwC

Click to watch Richard's video

***This Budget substantially represents business as usual for the health sector with approximately $400 million of additional funding for 2015/16. An amount of $320 million has been provided to manage the expected cost growth with the remainder directed to targeted service improvement.***

While the sector will be pleased to see further investment in elective surgery and new targeted initiatives around end of life care, bowel cancer screening and support for high needs students with disabilities, the main focus remains on current services. This misses the opportunity to invest in preventative strategies and initiatives to keep people well, and which could have resulted in significantly reduced future growth in demand for healthcare.

## About the health sector

Every year, New Zealand spends around 20 per cent of Government spend on health. This equates to 7.5 per cent of GDP (compared to the OECD at 9 per cent, the UK at 9 per cent and the US at 17 per cent).

83 per cent of the overall spend is allocated to public sector health services.

## Key challenges faced

There are a number of key drivers for healthcare provision where we would have liked to have seen the Government focus resources:

1. New Zealand's population is ageing rapidly with the number of people aged 65 and over doubling since 1980 and predicted to double again by 2036. As people age, their need to access healthcare increases.

   There has been further funding for end of life care but there appears to be little recognition of the age related growth in the demand for healthcare being seen by DHBs.

2. As the general population ages, so does the average age of health professionals – over the next 25 years, many more workers will retire than be recruited.

   The challenge of ageing health workforce would have been an interesting one to address. Indeed, at present, it takes approximately 15 years to train a doctor (to become a Consultant) meaning any investment now would take until 2030 before the benefit to the New Zealand health system is delivered.

3. The incidence and impact of long-term conditions (such as diabetes, heart disease and obesity) is also increasing. It is estimated that around 70 per cent of unplanned admissions to hospitals are long-term condition related and these will further increase as lifestyles and an ageing population increase the demand.

   We could see a missed opportunity not to have further extended the current efforts to tackle long-term conditions. Additional funding could have been allocated to pump 'prime initiatives' that would potentially deliver real change in people's lifestyles and ultimately, improvements in their health.

4. A significant number of unplanned admissions could be prevented by timely access to primary health care services. Access to primary health care in rural locations and deprived areas is often difficult and unmet needs are more common in those areas.

   It would have been beneficial to look into working towards balancing inequities and on the growth in Emergency Department attendances as some patients cannot access appropriate primary health services.

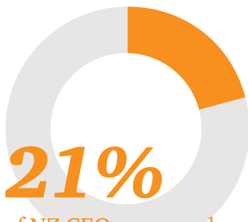
5. The future impact of technology on all aspects of healthcare will be significant. Central to this is improving information sharing and liaison between professionals and provider organisations together with using technology to deliver services differently. Investment in technologies such as telemedicine and mobile health (mHealth) has the potential to mitigate some of the cost growth pressures and provide a better patient experience.

   Technology across the health sector would have helped leverage innovation and research funding to support the more efficient and effective delivery of healthcare.

This Budget has delivered financial certainty to the sector over the next three years with the DHBs now able to identify the scale of the challenge they face. The recent focus on improved cancer and elective treatment wait times, with additional funding, will represent real service improvements for patients and assist the DHBs to achieve key national targets.

**61%**

of NZ CEOs say the Government has been effective or greatly effective in achieving good health and well-being of the workforce, compared to 32% of CEOs globally.



**21%**

of NZ CEOs say good health and well-being of the workforce should be a top-three priority for the government, compared to 12% of Australia CEOs.

***New Zealand's population is ageing rapidly with the number of people aged 65 and over doubling since 1980 and predicted to double again by 2036.***

# What's going on with the housing market?

*"Increasing supply will take time. New dwellings aren't built overnight and neither is the infrastructure to serve the growing population. The demand-side measures might have some impact, but none will really address the fact that population is growing much faster than supply."*

Richard Forgan
PwC

Click to watch Richard's video

Auckland housing is still a huge risk. Some observers say it's domestic and foreign speculators driving the prices up.

What it's really all about is population – the number of people in the Auckland region is growing rapidly and the number of houses is not. This pressure is now being brought to bear on both demand and supply sides.

To curb demand, the following measures have been imposed: a speculators' tax, bringing non-resident buyers firmly into the tax net, and tougher loan-to-value ratios for banks to apply to both Auckland and residential investors.

To boost supply, the Government is focused on Special Housing Areas and bringing Crown-owned land to the developer market, together with a $52 million fund.

But will it work? Increasing supply will take time. New dwellings aren't built overnight and neither is the infrastructure to serve the growing population. The demand-side measures might have some impact, but none will really address the fact that population is growing much faster than supply.

Could anything else be done? Two actions are standing out as possibilities. First, there could be more active investment in social and economic infrastructure to open up greenfield areas and outlying sites. Secondly, building product regulation could be liberalised.

## Taxes and the housing market

The Government's 2015 Budget contains several tax measures including for those dealing with real estate, housing and property. We doubt that these tax measures will have a material impact on housing prices as the price issue is largely related to supply.

As previously signalled, Budget 2015 includes measures intended to ensure that anyone buying and selling residential property for profit in New Zealand, pays tax on that profit.

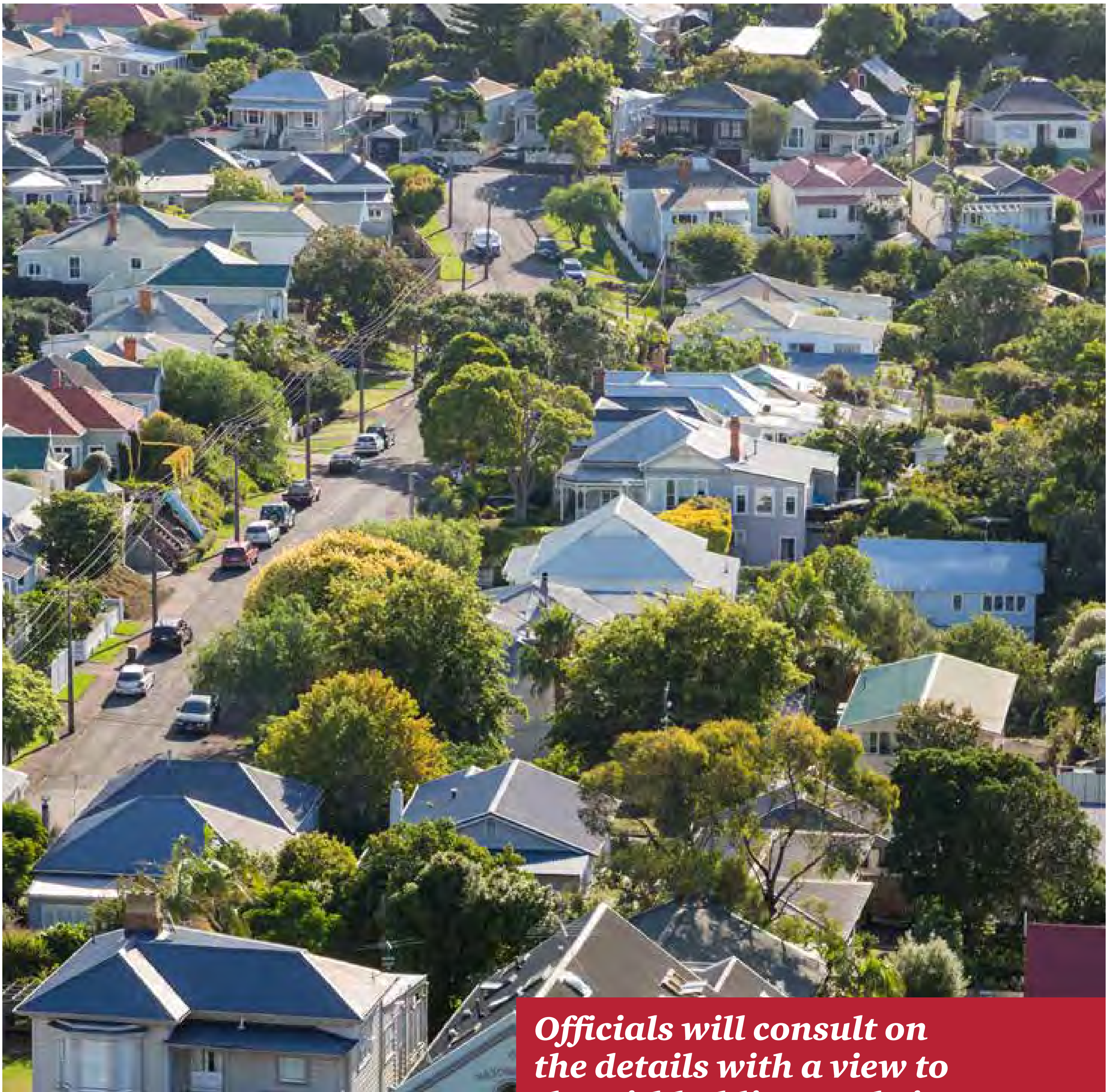
The measures include a new 'bright line' test to tax gains from residential property bought and sold within two years of purchase, unless the property is the vendor's main home, inherited or transferred in a relationship property settlement. Over the next few months, the Government will engage in consultation on the measures announced in today's Budget. An issues paper will be released in July on the 'bright line' test before legislation is introduced by late August. The new test will then apply to properties bought on or after 1 October 2015.

New Zealanders and non-residents buying and selling any property other than their main home will be required to provide a New Zealand Inland Revenue Department (IRD) number. Non-residents must have a New Zealand bank account before they can get a New Zealand IRD number to ensure that they are subject to New Zealand's full anti-money laundering rules. To further ensure overseas property buyers meet both existing tax requirements and those of the new test, the Government will investigate introducing a withholding tax for non-residents selling residential property.

To further ensure non-resident property investors meet both existing tax requirements and those of the new test, the Government will also investigate introducing a withholding tax for non-residents selling residential property by mid-2016.

Budget 2015 also provides Inland Revenue with an additional $29 million over the next five years to enforce property tax compliance. The extra information disclosure requirements for property investors will help Inland Revenue to enforce the rules and enable Inland Revenue to share information with overseas tax authorities.

The Budget also mentions changes for social housing. Another proposed amendment will clarify that payments made by the Ministry of Social Development to social housing providers (to the extent the payments relate to the provision of social housing) are exempt from goods and services tax. This is generally more consistent with payments for residential accommodation.



***Officials will consult on the details with a view to the withholding tax being introduced in the middle of 2016.***

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