Budget Summary 2022

1. Background

Budget 2022, entitled *"Wellbeing Budget 2022 – A Secure Future"* was delivered against a backdrop of considerable uncertainty and ongoing risks domestically and internationally.

On the positive side of the equation, the NZ economy still has a number of favourable outcomes: reasonable economic growth, low unemployment, and manageable levels of net Crown debt. Combined with relatively high commodity prices (until recently), this is providing historically high returns to our agricultural producers. Covid infections also appear to be well past their peak while households and businesses are starting to get back to some sort of normality, despite continued restrictions affecting everyday activities.

Despite these positives, both business and consumer confidence are in the doldrums for a range of reasons.

While borders are being finally reopened in a very measured way, businesses still face significant supply-side constraints with limited migration adding to rising prices and shortages of materials, due to constraints on ports and broader supply chains.

Broader inflationary pressures as a result of domestic policies and international factors (e.g. Russia/Ukraine conflict) is compounding inflationary pressures, while a number of regulatory proposals in the pipeline will exacerbate cost pressures on businesses and households.

As the Reserve Bank reins in its quantitative easing (money printing) programme and progressively raises the Official Cash Rate (OCR) back towards more neutral levels, households and businesses will be faced with rising interest rates, a shock for many who thought low interest rates were here to stay.

While interest rate hikes still have some way to go, many households will not feel the major effects until they re-price their mortgages later this year. This will likely result in a doubling in rates from what many people have come accustomed to over the past couple of years. Combined with elevated levels of household debt, this will potentially put significant pressure on budgets, particularly if employment falters down the track.

On the international scene, most international forecasting agencies have downgraded global economic growth for this year and beyond, while there are still simmering trade tensions and significant geopolitical uncertainty on several fronts including, but not limited to the current Russian invasion of Ukraine.

China is still taking a stringent line of Covid restrictions with many large cities in hard lockdown. A number of commentators have considered that China's growth rate might be negative for the June quarter as a result and given NZ's reliance on China to take large volumes of our agricultural commodities, this could put further downward pressure on dairy prices over coming weeks - although acknowledging that current prices remain well above their historical average.

2. Budget 2022 Economic and Fiscal Outlook

Key Points

- **Economic activity** (GDP) is expected to peak at 4.2% in the year to June 2023 before falling to 0.7% in the year to June 2024, before recovering slightly in the outyears to 2026.
- **Inflationary pressures** are expected to subside after reaching 6.7% in the year ending June 2022 to 5.2% in the year to June 2024, and continue to fall to reach 2.2% by June 2026 (i.e. well within the Reserve Bank's Target band of 1-3%).
- **Unemployment** is forecast to drift higher over time from the 3.1% forecast in the year ending June 2022 to reach 4.7% by June 2026. Employment growth is expected to be modest over the forecast period with participation rates remaining relatively stable.
- The **current budget deficit** (before gains and losses) is forecast to be $19 billion in the year to June 2022 before improving in the following years to reach a small surplus ($2.6 billion) by June 2025.
- **Core Crown tax revenue** is forecast to increase from $103.8 billion in the year ending June 2022 (28.6% of GDP) to reach $138.5 billion in the year ending June 2026 (29.8% of GDP)
- **Core Crown expenses** are forecast to generally increase slowly in nominal terms from $128.4 billion in the year ending June 2022 (35.4% of GDP) to $138.2 billion (29.8% of GDP).
- **Net Core Crown debt** is forecast to increase from $61.2 billion in the year ending June 2022 to $75.0 billion the year after and to $83.6 billion the year after that (year ending June 2024), before falling back in the outyears as the Government forecasts return to Budget surplus.

It should be noted that the Government recently changed its definition of net Crown Debt to ensure it was more in line with international measures. This includes a broader range of Government financial assets within the debt measure (for example the Government's Superfund).

While the key Economic and Fiscal Indicators look reasonable going forward, there are still significant risk to these forecasts being realised.

While NZ's net Crown debt is still relatively low leaving some headroom for the Government to spend even more, if necessary, before NZ's credit rating will come under attack, given NZ's reliance on international trade and its vulnerably to natural hazards, reining in expenditure would be wise.

While the Government has been quick to push the line that extraordinary times require extraordinary measures (e.g. increased fiscal support), the other side of the coin also must be addressed given that many of the things that NZers have taken for granted may need to be pruned back in a major way if the Government is to get its books in order over a reasonable time period before another "one-off" event hits us. In economic terms, there is no such thing as a free lunch.

Secondly, the Government's continued spend-up makes it difficult to rein in expenditure as many households and even businesses have become dependent, at least to some extent) on taxpayer support payments of one form or another.

The ability of the Government to turn off the tap on future expenditure in the outyears seems to be an unrealistic assumption despite the fact that the last couple of years saw extraordinary expenditure increases as direct result of fiscal initiatives to soften the blow of Covid.

All Government (taxpayer) funded projects should still require sound cost/benefit analysis given the potential costs of making poor decisions. This is an issue about which the Auditor-General, John Ryan, has been having some strong words to say, regarding the quality and transparency of expenditure decisions.

Ryan has written to the Treasury (4th May 2022) saying that he wants still more accountability for how the $74.1 billion Covid Response and Recovery Fund (CRRF) is being spent. In his letter he stated that the fund was so big that it would have an impact on Government Finances and debt for years to come.

And there are legislative proposals coming down the track that similarly have the potential to reduce NZ businesses' flexibility and competitiveness. For example, recent announcements in respect to employment relations changes (Fair Pay Agreements in particular) will, if implemented, lead to greater centralisation of wage bargaining.

As well, climate change proposals, while well-intended, have the potential to impose increased costs on businesses and households during the transition phase. Government must, therefore, remain committed to ensuring NZ businesses and households are able to meet our international commitment to net carbon emissions reduction at least overall cost to the economy.

3. Key General Initiatives in the Budget

The Budget, as expected had a strong emphasis on Health-related polices and Climate Change Initiatives which were clearly signalled well ahead of Budget Day.

Budget 2022 pumps $11.1 billion in new funding to put the health system on a more sustainable footing for a wide range of initiatives from mental health, Pharmac, along with capital investment in hospitals and targeted funding to Māori and Pacific healthcare providers.

There were also a number of not unexpected policies such as supporting NZers to meet the cost-of-living pressures through a targeted ($ 1 billion) package of support focusing on low and middle income New Zealanders.

The overall cost of living package includes:

- an extension to the reduction of fuel excise introduced in March, by two months until mid-August
- an extension of the road user charges (RUC) cuts introduced in April, until mid-September, and
- an extension of half-price public transport fares introduced on April 1, until the end of August.

There will also be a short-term targeted support payment to low and middle income earners through a $350 Cost of Living Payment across three monthly instalments from August 1. This works out to be about $27 per week for an estimated 2.1 million New Zealanders.

This payment will be available to people aged 18 and over who earn below $70,000 per annum, based on last year's tax data, and who are not eligible for the Winter Energy Payment.

While such initiatives might well be appreciated by those eligible for them, it does have a distinct flavour of being a bit ad hoc rather than focusing on those issues which are driving inflationary pressures within NZ or whether longer-term proposals such as the indexing of tax thresholds would have been more appropriate.

Secondly, the issue of temporally reducing fuel excise and RUC is simply moving the deck chairs given that it will result in either less money being available for roading projects and/or the Government diverting other taxpayer money to make up for the shortfall.

Reducing excise duty and RUC will be welcomed by road users; it tends to work against the Government using the Emissions Trading Scheme (ETS) as a mechanism to change behaviour towards less use of fossil fuels. At the same time the Government has reduced (subsidised) the cost of public transport.

4. Business-focused Initiatives

While there are many other general initiatives, the following outlines are particularly relevant to business.

Climate Change

As signalled pre-Budget, the overall focus of the Budget was principally on Health and Climate Change, with the Emission's Reduction Plan (ERP) released earlier this week.

The plan, the first produced under the Zero Carbon Act, contains around 300 initiatives, with a big emphasis on cutting transport emissions and cutting out the use of coal for heating, and for industrial use. However, around half the actions are not necessarily plans at all but are plans to make plans further down the track. A lot of detail still needs to be fleshed out. The plan confirms that agriculture will face an emissions pricing mechanism from January 2025, although the exact form is still to be determined.

The emissions budgets are set as a sinking lid, the first three budgets take us to 2035. Those budgets are now set:

1st Budget until 2026: 290mt, 72mt per year.
2nd Budget 2026-2030 (set only in principle) 305 mt, 61mt per year.
3rd Budget 2031-2035 (set only in principle) 240 mt, 48mt per year.

A number of the initiatives will be funded from Climate Emergency Response Fund (CERF), outlined in the Budget. The fund will initially be set at $4.5 billion based on the expected cash proceeds from the emissions trading scheme (ETS) i.e. initiatives will be funded correctly from the ETS, not general tax revenue per se.

As announced earlier this week, the CERF investments for Budget 2022 total $2.9 billion.

$1.17b of this will be spent in the first 2 years, with most of it used to: convert industrial coal boilers ($230m); fund efforts to encourage transport mode shift ($373m); reduce emissions from waste ($100m); pay for tech R&D to reduce agricultural emissions ($92m); and contribute to funding of low public transport usage during Covid ($47m).

$338.8m to be invested over the next four years in a new science and commercialisation of new products to reduce greenhouse gas emissions from agriculture.

While there will be numerous views on the merits of some of the proposals (for example, the proposal for $61 million to be allocated to recruit and retain bus drivers through better terms and conditions to be set at a nationally consistent level), it is important that proposals do not unnecessarily undermine the Emissions Trading Scheme (ETS) as the principal tool to influence where emission reduction can be made at least cost. There is also the important point of trying to achieve broad political consensus across the main political parties as to what will or will not be supported as yoyoing on policy decisions would be extremely unhelpful for long-term planning and investment decision-making by both businesses and households.

Infrastructure

It has been well signalled that infrastructure over a number of areas requires large dollops of capital, most recently portrayed by the 30-year NZ Infrastructure Strategy.

Budget 2022's new investment in infrastructure includes $349 capital funding to replace and modernise rail assets, and $1.3 billion to upgrade health infrastructure.

In total, Budget 2022 includes $4.7 billion of capital investments from the $9.8 billion multi-year capital allowance.

There is a focus in transitioning to a digital economy, improving how public services are delivered and keeping existing digital services safe from cybersecurity risks. Key investments include:

- Setting aside funding for a new digital system for the Courts
- $220 million operating and $100 million capital set aside for investments in health system data and digital infrastructure and capability.
- $60 million to improve broadband infrastructure the worst-served areas, enabling stronger connections and greater productivity.

<u>Industry Transformation Plans (ITP)</u>

- $37 million for the Construction Sector Accord Transformation Plan to increase the productivity, capability, and resilience of the construction sector.
- $30 million for the Advanced Manufacturing ITP. This plan focuses on identify existing and emerging points of comparatives advantage, maximising our global brand and international connections.
- An additional $5 million for the Agritech ITP to build the skills and practices required to transform the sector into a sustainable and competitive export industry.
- $20 million for the Digital ITP to grow the software-as-a-service sector and ensure the skills and talent to need to grow.

<u>Education and Training</u>

The budget 2022 package includes a total of $2 billion in operating funding and $855 million capital for the education system, including investments in infrastructure, new initiatives, and funding to address critical cost pressures.

Of particular relevance, the Budget announced the extension of the Apprenticeship Boost Initiative, supporting firms to keep early-stage apprentices employed, bring on new apprenticeships, and strengthen the skilled workforce. 38,000 apprentices are expected to benefit from the extension of the Apprenticeship Boost though to the end of 2023.

<u>Small Business/other</u>

- $100 million of capital funding for a Business Growth Fund is being developed alongside NZ's major banks. This is intended to improve access to finance and enable them to grow.

- Fully funding the $200 million Regional Strategic Partnership Fund to invest in local projects tailored to a region's particular needs and advantages.