2017

Budget Report

Thursday, 25 May 2017

This report has been prepared by CCH in-house analysts with the assistance of specialist practitioners from **EY** and **Bell Gully**

This 2017 Budget Report has been prepared with the assistance of specialist practitioners from Bell Gully and EY. It covers announcements of interest to tax practitioners and the business community.

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In this Budget Report

Family income and tax rates

Ministerial statement

It is now seven years since we last altered the income tax system. Over that time the average wage has risen from $49,500 to $58,900.

That's good news. But because of that change many more middle income earners are faced with a marginal tax rate of 30 per cent cutting in at just $48,000.

We also have a number of lower income people with young families that are struggling to get ahead.

And we have a system that is becoming too complex. As a result of Working for Families and other changes, it can be very hard for people to work out what they are entitled to, and how the work they do is linked to the income they receive.

If the level of complexity is indicated by the number of businesses advertising to do people's tax returns, then confusion is at near record highs.

Today I am announcing a $2 billion a year Family Incomes Package commencing 1 April next year that will start addressing some of these issues.

The Package will make changes to tax thresholds, Working for Families and the Accommodation Supplement to help Kiwi families get ahead.

It is a first step towards simplifying the income tax system.

The Family Incomes Package is carefully designed to assist low and middle income earners with young families and higher housing costs.

It will benefit 1.3 million working-age families in New Zealand by, on average, $26 per week.

Editorial comment

The Family Incomes Package has been carefully targeted at middle New Zealand. There have been no changes in tax rates, but the thresholds where the progressive tax rates kick in will increase from 1 April 2018. The $14,000 income tax threshold will increase to $22,000, and the $48,000 tax threshold to $52,000.

The changes are intended to correct, or at least mitigate, the effects of "fiscal drag". Fiscal drag is the effect of rising wages pushing people into a higher tax bracket. When the brackets were last amended in 2010, the average wage was $49,500. The average wage has since risen to $58,900, but part of this increase only compensates workers for inflation; their real (ie after inflation) wages have risen by much less, even in the low inflation environment we have enjoyed for the last decade.

In 2010, the average worker would have had only the last $1,500 of their income taxed at 30% and the bulk of their earnings taxed at 17.5%. As at today, $10,900 of their income will be taxed at 30%. Increases in the tax bands will go some way to addressing this. Anyone earning over $52,000 will be $20 per week better off under the changes.

The changes were expected in an election year. High-income earners will inevitably receive the largest tax cut, because the increased thresholds will leave these taxpayers with more income exposed to the lower rates. That said, the changes are unashamedly targeted at low- and middle-income earners. As it stands, the top tax rate will kick in at just 1.2 times the average full-time wage – one of the lowest ratios in the OECD.

The tax rate changes are combined with a simplification to, and increased funding of, Working for Families. The Independent Earner Tax Credit, which less than a third of eligible people actually claim during the year, is being scrapped. The Family Tax Credit is being aligned so that it is the same no matter how old a taxpayer's children are (up to 18 years of age) — a significant simplification compared to the five different rates we have today.

A central theme is simplification. Mr Joyce wants people to be able to see marginal benefit in their own pockets when they earn more. The impact of the increased thresholds goes some way towards reducing the marginal tax rates of low-income New Zealanders, but is partially counteracted by the effect of the adjusted rate for the abatement of the Family Tax Credit to 25c in the dollar. Mr Joyce commented that the elements of his Family Incomes Package work together; arguably this was essential. The higher abatement of the Family Tax Credit and abolition of the Independent Earner Tax Credit could be politically unsavoury without the rest of the package.

The final component of the Family Incomes Package sees an increase to the Accommodation Supplement. The Accommodation Supplement rates have been unchanged since 2007, and were based on 2005 rents, so are well overdue for review.

There is a risk that the increased Accommodation Supplement will simply increase rentals and make landlords the true beneficiaries, especially given the length of time required to build additional housing. Given that, it might be appropriate to have a more comprehensive review of the Accommodation Supplement, which has been part of housing assistance since the 1990s.

Business growth agenda

Ministerial statement

The Government's plan for growth is sensible conservative fiscal policy, strong orthodox monetary policy, and an ongoing programme of microeconomic reform that enhances the competitiveness and confidence of Kiwi businesses.

It is crucial that we pull on all three of these levers.

Our programme of microeconomic reform is called the Business Growth Agenda. It includes measures to boost New Zealand's trade, lift the skills of our workforce, recruit skilled migrants our companies need to grow, boost innovation, attract new investment especially in regional New Zealand, and build the infrastructure that a growing economy needs.

Budget 2017 invests $1 billion over four years in sustaining the strong economic plan that is getting New Zealand to grow.

First, the Government is allocating $373 million in the second round of our Innovative New Zealand programme.

Innovative New Zealand is a series of science, R&D and skills initiatives that are working together to lift the innovation activity of New Zealand companies.

The funding includes $82 million for the Government's pre-eminent applied science fund – the Endeavour fund; $132 million for Tertiary Education to ensure young New Zealanders obtain the skills we need; and $75 million for Callaghan Innovation's R&D grants to help our tech companies succeed.

It's all about adding more value to our export volumes. Investment in innovation is hugely important for lifting our productivity and providing for our future prosperity.

Budget 2017 allocates $134 million over four years to advance New Zealand's Trade Agenda 2030, including opening new embassies in Dublin and Colombo, as we work towards our ambitious target of having 90 per cent of goods exports covered by trade agreements.

There is $304 million towards the ongoing development of our screen sector, and $146 million in new funding to grow our tourism infrastructure around the country so every region can benefit from the growth in our tourism industry.

Editorial comment

These measures are intended to reinforce the strong economic growth New Zealand has experienced in the recent past and which is projected to continue in the immediate future.

The Budget observes that over 200,000 more jobs have been created over the last three years to arrive at a real GDP growth rate of 2.7% in the 2016 fiscal year. The annual GDP growth rates for 2017–2020 are forecast to be 3.1%, 3.5%, 3.8% and 2.9%.

The growth has been supported by low interest rates, rapid population growth, residential investment and earthquake rebuilds.

Inflationary pressures are expected to build to over 2% in 2019, leading to interest rate rises. Net migration is expected to fall as the attractiveness of New Zealand declines, although net migration of 212,000 people over the next four years is still expected. The annual long-run increase of 15,000 per annum may emerge in 2022.

Housing investment has been strong up until recently, but currently investment has flattened because of tighter loan-to-value ratios, uncertainty around the Auckland Unitary Plan, capacity constraints and tighter credit conditions. These temporary headwinds are expected to subside so that house price growth may pick up once more in 2018, but ease from 2019 onwards as supply increases to match demand.

Earthquake expenditure includes the $9.5 billion paid out by the National Disaster Fund to assist with the Christchurch rebuild. It is expected that rebuilding State Highway 1 from Picton to Christchurch following the Kaikoura earthquake will cost $812 million.

The Budget papers note that the strong economy and prudent fiscal management have resulted in the New Zealand Government receiving high credit ratings. Moody's has assigned an AAA rating, with an AA rating from both Standard & Poor's and Fitch.

A slight shadow over the prospects of continued good economic health is cast by a number of factors. These include uncertainty as to the sustainability of growth in China, the possibility of slower growth in Australia should a significant weakening in its housing market develop, and abatement of the very stimulating monetary conditions currently in place in Japan and in the euro region.

Business growth agenda expenditure totalling $1 billion over four years is allocated as $39 million in 2017, $200 million in 2018, $264 million in 2019, $268 million in 2020 and $268 million in 2021. The breakdown of the total expenditure is set out in the Minister's speech.

Interestingly, the Budget papers forecast a total of $6 million expenditure on the multinational corporation research and development attraction programme. The programme aims to attract the research and development facilities of 10 multinational companies to New Zealand by 2020.

The Budget papers also project revenue increases totalling $250 million relating to the taxation of multinational companies operating in New Zealand. No further detail was provided beyond a revenue impact of $50 million in 2019, $100 million in 2020 and $100 million in 2021.

Black hole feasibility expenditure

Ministerial statement

Some costs of investigating the viability of a new proposal or project – that is, feasibility expenditure – are currently neither immediately tax deductible, nor depreciable. As a result, it falls into what businesses describe as the black hole.

Tax consequences should not be an obstacle to businesses innovating and pursuing opportunities for growth. The discussion document we are releasing today therefore proposes improved tax treatment for feasibility and black hole expenditure.

Where no asset is created on the balance sheet, feasibility expenditure would be immediately deductible for income tax purposes. Where an asset is created we're proposing that the feasibility expenditure would be capital expenditure for tax purposes.

In addition, capitalised feasibility expenditure and other expenditure on an asset abandoned part way through construction would become immediately deductible if it is also expensed under International Financial Reporting Standards.

Editorial comment

As part of the budget documents, the government has released a discussion document to address the problem of "black hole" and feasibility expenditure. Black hole expenditure refers to amounts of expenditure where, despite incurring a real economic cost, the taxpayer is unable to get either a tax deduction or a depreciation expense. This occurs most commonly where projects are started but abandoned before an asset comes into existence. This mismatch between the economic reality and the tax outcome discourages otherwise sensible (but possibly risky) investment.

The Government has proposed that in relation to feasibility expenditure taxpayers will be able to follow their accounting treatment. This means amounts will generally either be expensed when the cost is incurred or, at worst, deducted when the project is scrapped.

The discussion document proposes creating a legislative definition of "feasibility expenditure" so that expenditure meeting this definition, if immediately expensed in general purpose financial statements, would be immediately deductible for income tax purposes. Further, expenditure that would be "feasibility expenditure", but for the fact that it would be depreciable property if capitalised, would be immediately deductible if it was abandoned before the project was completed. Together, these would provide relief in many cases in which black hole expenditure arises.

International Financial Reporting Standards (IFRS) are central to the proposals. If taxpayers do not prepare financial statements under IFRS, then the discussion document proposes that IFRS principles will still apply. Smaller companies might conceivably have higher compliance costs in relation to black hole expenditure than larger companies. The Government has also proposed that a de minimis rule could apply in certain circumstances to mitigate the compliance costs.

Earthquake Commission (EQC) premium rate increase

Ministerial statement

With the help of international re-insurance, the [National Disaster] Fund has so far paid out over $9.5 billion in claims to those affected by the Canterbury earthquakes. It is currently expected to pay out another $550 million in claims for the Kaikōura earthquakes.

Those claims will completely exhaust the National Disaster Fund. We need to re-start the process of replenishing it.

I am therefore announcing that from 1 November this year the EQC premium rate will increase from 15 cents per $100 in cover to 20 cents per $100 in cover.

This will have the effect of increasing home owners' annual EQC premiums by up to $69 per year.

The change will mean that we are well on the road to restoring the National Disaster Fund to around $1.75 billion within 10 years.

Editorial comment

Resilience was a key theme of Mr Joyce's pre-Budget speeches. Besides the Government's own fiscal resilience, the focus also turned to New Zealand's ability to cope with natural disasters. The dwindling Natural Disaster Fund (NDF) is naturally a cause for concern.

One of EQC's statutory functions, and that which the public is most familiar with, is to provide natural disaster insurance for residential property. This is funded by the NDF through the payment of EQC premiums, and provides homeowners with maximum cover of $100,000 (plus GST) for their houses and $20,000 (plus GST) for contents. The levy is currently capped at a maximum of $207 per year.

Following the budget announcements, that cap is set to increase to $276 per year.

The Government is also reviewing the EQC Act, and has stated that the review will not have any further impact on levy rates.

Infrastructure investment

Ministerial statement

The Government's second fiscal priority in this budget is investing in the infrastructure for a growing economy.

This Government has a strong track record as New Zealand's infrastructure government. Over the last several years we have grown infrastructure spending considerably and commenced some major transformative investments in New Zealand's public infrastructure on behalf of taxpayers.

We are completely modernising our telecommunications system with the ultrafast broadband and rural broadband programmes. We have embarked upon the most ambitious development of new motorways and expressways seen in several decades, and invested more than $4 billion in our railway system including funding new commuter rail fleets in both Auckland and Wellington. And we are in the process of building more new hospitals and schools than New Zealand has seen in generations.

However Budget 2017 takes New Zealand infrastructure investment to another level.

For the first time, the Government is allocating $4 billion in new capital funding in one budget across the Education, Health, Defence, Justice, Housing, Primary Sector and Transport portfolios.

The new investment includes a further $392 million for more new schools and classrooms around New Zealand – taking our total investment to $1.4 billion over the last four budgets.

The new money will provide for six new schools, two major school expansions, the relocation of two special education schools, 11 new special education satellite units and around 305 new classrooms nationwide.

Budget 2017 includes $150 million in additional capital for the Health Sector, $576 million for Defence Force upgrades, $763 million for new prison capacity, $63 million for Crown Irrigation to invest in new water storage and $100 million for the Crown Land Programme, which frees up more Government land for housing.

$1.8 billion of the new budget spend is in the Transport portfolio. This includes $450 million for KiwiRail for the rail network around New Zealand, $436 million for the first stage in Auckland's City Rail Link, $812 million for the reinstatement of State Highway

1 north and south of Kaikōura, and $98 million for upgrades to Wellington's metro rail network.

I am also confirming today the Government's intention to allocate a further $7 billion in new capital spend in the next three budgets, taking our total additional capital spend to $11 billion.

Through this new capital spend and existing commitments the Government and its key infrastructure agencies will invest a total of $32.5 billion over the next four years in new infrastructure.

That's a 40 per cent increase on the last four years.

The New Zealand Transport Agency alone will invest $9.17 billion in new State Highways over the four years, and will open over 540 lane kilometres of new highways.

And Housing New Zealand will invest $2.2 billion in the Auckland Housing Programme as announced by Minister Adams last week, which will contribute to the 34,000 new houses that we will build in Auckland over the next 10 years alongside the huge growth in private sector housing construction which is underway.

This is an unprecedented level of infrastructure investment for any New Zealand government, even including the period of funding the Christchurch rebuild.

We intend to extend that investment further with a greater use of partnerships between central and local government, and between government and the private sector. I will have more to say on that subject in the coming weeks.

Editorial comment

The Budget papers provide a little more detail on how the $4 billion of expenditure is proposed to be outlaid.

In relation to education:

- four of the six new schools will be in Auckland
- 170 of the 305 new classrooms will be in Auckland
- $350 million will be applied in Christchurch to redevelop Linwood College, Hornby High School, Christchurch Boys High and Ao Tawhiti Unlimited Discovery
- major redevelopments of $79 million for Western Springs College, $39 million for Wellington Girls College and $9 million for Cambridge High School, and
- public/private partnerships to deliver 11 schools by 2021.

The capital funding for health includes $2.39 billion for Crown Health facilities and district health boards. Some $535 million is to be spent on Christchurch Hospital Outpatient and Acute Services buildings. The acute mental health facility of Middlemore Hospital is to receive $54 million and Grey Hospital $77 million.

The New Zealand Defence Force is to receive $576 million for new capabilities and modernisation. For example, $28 million is to be applied to the counter explosive hazards project.

The justice sector allotment of $786 million comprises $764 million for new prison capacity and $19 million for additional police numbers.

The injection into housing largely comprises $2.72 billion over the next four years for a Crown Building Project aiming to construct 34,000 homes in Auckland over a ten-year period.

The house build rate is said to now be running at a level of 30,000 homes per annum.

The transport expenditure is itemised at $9.17 billion over the next four years. Work will be undertaken on Auckland's motorway network, the Peka Peka to Otaki expressway, Transmission Gully, the Puhoi to Warkworth motorway link and the Southern Motorway extension and northern arterial road in Christchurch. The funding will also finance construction of the bypasses of Awakino Gorge and Mt Messenger in Taranaki.

Public services investment

Ministerial statement

Mr Speaker, the Government's biggest single fiscal priority in Budget 2017 is to invest in the public services necessary for a growing country.

We are therefore allocating $7 billion over four years to sustain and expand public services in health, education, law and order and social development.

This investment reflects our commitment to meet the requirements of a growing population while investing prudently in the core services Kiwis rely on.

The new funding in Budget 2017 includes $3.9 billion over four years for New Zealand's Health Sector – taking health investment to a record $16.7 billion next year.

DHBs will benefit most, with an extra $1.76 billion added over four years to invest in services, improve access, and help meet cost pressures and population growth. Over $200 million will be invested in Disability Support Services, and $38 million more in primary care.

Mr Speaker, we are committing $1.1 billion over four years in additional operating expenditure for schools and early childhood centres, including $767 million for roll growth, a $61 million increase in operational grant funding for schools, and $35 million in targeted additional funding for early childhood centres.

We are investing $1.2 billion in new operating expenditure over four years for law and order.

This includes funding 10 per cent more police staff to reduce crime and reoffending and ensure 95 per cent of the population will live within 25 kilometres of a 24/7 police presence.

We're also upping our investment in justice, courts and corrections services, and introducing new initiatives in burglary prevention, reducing youth reoffending, and supporting at-risk prisoners.

Editorial comment

Mr Joyce has continued in the same vein as his predecessor, by placing the Government's mantra of "Better Public Services" at the forefront of his first budget.

The investment in health is set to benefit district health boards (DHBs), in a response to New Zealand's growing and ageing population and increasing cost pressures. The additional health spending is supported by infrastructure investment across regional New Zealand.

Further spending includes $59 million in ambulance services, which builds on additional funding committed in the 2016 Budget. $60 million is also committed to Pharmac to increase access to medicines. This follows recent media scrutiny of the Pharmac model and public campaigns for Government subsidies of certain medicines.

Education spending is largely to meet additional student numbers, though there is also a particular focus on additional funding for students with particular learning needs. The operational spending is coupled with separate investment in school infrastructure, and comes at an opportune time in election year.

The investment in justice, courts and corrections services largely follows earlier announcements, and reflects the implementation of the Safer Communities package. The Government expects to create 1,125 police roles.

Overall, net new operating spending in the Budget totals $1.8 billion per year.

Social investments

Ministerial statement

Budget 2017 includes $321 million for fourteen cross-agency social investment initiatives that are designed to tackle long-term issues for vulnerable New Zealanders.

These cover areas like helping kids get a better start in life; addressing barriers to employment and independence; and reducing criminal reoffending.

A big focus in our social investment programme is mental health, so we've ring-fenced $100 million in a special social investment fund to support innovative solutions to address mental health issues.

Overall the Government has budgeted an additional $224 million over four years for mental health services.

Editorial comment

The Budget papers explain that the $321 million over four years to tackle issues faced by vulnerable New Zealanders is to be applied as follows:

- $116 million to test approaches to dealing with mental health problems
- $79 million on programmes to reduce criminal reoffending

- $73 million to support children with high at-risk poor life outcomes, and
- $54 million to address barriers to employment and independence.

The $424 million to be invested in the new Ministry for Vulnerable Children, Oranga Tamariki, receives little further breakdown. The Budget papers merely allocate $20 million in 2018, $24 million in 2019, $24 million in 2020 and $24 million in 2021 to meet increasing client demands, inflationary pressures and rising remuneration costs.