The Treasury

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Treasury Report: Initial Advice on Scope for Increasing Budget Allowances

Date:	9 September 2016	**Report No:**	T2016/1683
		File Number:	MC-1-5-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** the contents of the report	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[34]	[34]	[39]	[23]	✓
Renee Philip	Acting Manager, Macroeconomic & Fiscal Policy	[39]	[23]	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Initial Advice on Scope for Increasing Budget Allowances

Executive Summary

Under the Government's current fiscal strategy, there is headroom to increase budget allowances from their current levels of $1.5 billion per year for operating expenditure and $0.9 billion of capital expenditure. This report provides analysis of possible increases to allowances that would leave net debt around 20% of GDP by 2020/21, interpreting "around 20%" to cover a range from slightly below 20% up to 22%.

To the extent that increased fiscal headroom reflects cyclical fluctuations in tax revenue, there would be benefits from using these revenue surprises to reduce net debt faster. However, a more gradual reduction in debt may be justified to invest in high quality operating and capital initiatives. If higher allowances were agreed, we would recommend that they be adhered to in future even if the economic and fiscal outlook changed. This would avoid the risk that future adjustments to fiscal policy settings would exacerbate the macroeconomic cycle.

Recent economic and fiscal developments have been stronger than forecast in the Budget Economic and Fiscal Update (BEFU) 2016, and these will be incorporated into the Half Year Economic and Fiscal Update (HYEFU) forecast round which is underway now. The forward path for net migration is a key uncertainty for the economy and the fiscal position. This report provides you with some initial analysis of the potential size of fiscal impacts if net migration is considerably higher than forecast in BEFU.

This report complements two other reports you have received from the Treasury this week, on fiscal exposures across government and a draft Budget Strategy Cabinet Paper. We will continue to provide you with more advice on overall fiscal strategy over the next two months in advance of the Government's publication of the Budget Policy Statement in December.

Recommended Action

We recommend that you:

a. **note** that the Government's current fiscal priorities include maintaining rising OBEGAL surpluses over the forecast period and reducing net debt to around 20% of GDP by 2020;

b. **note** that there is some fiscal headroom to increase operating and capital allowances consistent with your fiscal strategy, and we have provided you with scenarios that keep net debt between 20-22% of GDP in 2020/21;

c. **note** that regular changes in operating or capital allowances in response to cyclical revenue surprises should be avoided as doing so would result in pro-cyclical fiscal policy;

d. **indicate** if there are any specific scenarios for increased allowances that you would like us to provide you with in the lead-up to the Budget Policy Statement;

e. **note** that it appears that since BEFU 2016, economic and fiscal indicators have been stronger than expected, and these developments will be incorporated into the HYEFU forecast round which is currently underway;

f. **note** that a key uncertainty that affects the economic and fiscal forecasts is the forward path for net migration, and we have provided a higher net migration scenario to illustrate the potential fiscal impacts.

Renee Philip
Acting Manager, Macroeconomic & Fiscal Policy

Hon Bill English
Minister of Finance

Treasury Report: Initial Advice on Scope for Increasing Budget Allowances

Purpose of Report

1. This report provides you with initial advice on whether the current budget allowances could be increased across the next four years. It takes the Government's current overall fiscal strategy as given, but explores the extent to which there is headroom to increase allowances to provide Ministers with options to achieve their economic and social objectives, including investing in initiatives that will help to reduce long-term liabilities.

2. We also provide some information on recent movements in economic and fiscal indicators, reflecting developments since the Budget Economic and Fiscal Update (BEFU). Over the next two months the forecast round for the Half Year Economic and Fiscal Update (HYEFU) 2016 will take place, and the Treasury will provide more informed advice on the forecast fiscal outlook as that process unfolds.

3. The final section of the report presents the results of some initial macroeconomic modelling on net migration. It presents a scenario which illustrates the potential channels by which higher net migration could impact the economy, and how it might flow through to the fiscal position. This analysis is not a Treasury forecast, and our central assumptions for net migration will be considered as part of the HYEFU forecast round.

4. This report is one of three priority reports that you will receive this week, as outlined in the overall plan for fiscal strategy advice over the next two months (T2016/1608 refers). There are important connections between these three reports, which we have drawn your attention to throughout this report. All of this advice will be developed and reported to you in order to support the Government's decision-making ahead of its Budget Policy Statement 2017, to be published in December.

Current Fiscal Strategy and Fiscal Targets

5. In the Fiscal Strategy Report (FSR) 2016, the Government set out its short-term fiscal priorities, which were:

- maintaining rising OBEGAL surpluses over the forecast period so that cash surpluses are generated and net debt begins to reduce in dollar terms;
- reducing net debt to around 20 per cent of GDP in 2020;
- if economic and fiscal conditions allow, beginning to reduce income taxes; and
- using any further fiscal headroom - including from positive revenue surprises - to reduce net debt faster.

6. The table below shows forecasts and projections for OBEGAL and net debt, as published in BEFU 2016. They are consistent with the Government's short-term fiscal intentions, as operating surpluses rise across the forecast period and net debt falls to 19.3 per cent of GDP in 2020/21.

Table 1: OBEGAL and Net Debt Forecasts from Budget 2016 (as a percentage of GDP)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Total Crown OBEGAL	0.3	0.3	0.9	1.7	2.2	2.3
Core Crown Net Debt	24.9	25.6	25.0	23.1	20.8	19.3

7. Those forecasts and projections assumed operating allowances of $1.5 billion per year and capital allowances of $0.9 billion in each of the Budgets from 2017 through to 2020.

8. You have asked us for advice on the amount of fiscal headroom there is to increase these budget allowances while still remaining consistent with the Government's fiscal strategy. A precise answer depends in part on the extent to which the Government choses to prioritise different elements of its existing fiscal strategy.

9. The Government's current long-term fiscal objective is to manage net debt within a range of 0 to 20 per cent of GDP over the next ten years. Maintaining a credible downward trajectory for net debt over the medium-term is more important than achieving a particular point target in a particular year (as reflected in the Treasury's advice to the Government in late-2015 on changes to the fiscal targets). Focusing too closely on a point target risks creating pro-cyclical fiscal policy if it results in cyclical revenue surprises being allocated to increased spending or revenue reductions. It also increases the risk that tighter fiscal policy would be required when the economy turns down, which could exacerbate an economic slowdown.

10. Recognising this the Government made a change to its short-term fiscal intentions by stating that it would focus on "reducing net debt to <u>around</u> 20 per cent of GDP by 2020" (previously "no higher than 20 percent of GDP by 2020"). This provides some flexibility to allow net debt to fluctuate in response to changing economic conditions, while maintaining a steady downward trajectory.

11. An implication of this short-term net debt intention is that there may be fiscal headroom to increase budget allowances consistent with net debt being around 20 per cent of GDP by 2020. However, to the extent that increased fiscal headroom reflects cyclical fluctuations in tax revenue, there would be benefits to macro stability from using these revenue surprises to reduce debt further.

12. Nevertheless, this does not prevent a one-off re-calibration in operating and/or capital allowances and a more gradual reduction in debt. However, we would recommend that new settings be adhered to in future to avoid ongoing pro-cyclical adjustments in policy settings. In the next section we present scenarios to give some sense of the potential range to increase budget allowances while reducing net debt to around 20% in 2020.

13. The Government has economic and social priorities in addition to its fiscal objectives, such as investing in public services, helping New Zealand meet its infrastructure requirements, and potential tax reductions. Increasing debt is one way to help deliver on these objectives but they could also be funded by exploring policy options that could deliver savings. The Treasury will provide further advice on these trade-offs as part of its fiscal strategy advice in early November.

14. You will be receiving a separate Treasury Report this week on the Draft Budget Strategy Cabinet paper. This will outline the rules and processes that will be introduced through Budget 2017 to lift the quality of initiatives (with a particular focus on evidence and impact) and embed the Social Investment Approach. The paper will also discuss the current operating and capital pressures in the pipeline and how they compare to the forecast allowance.

Scenarios Exploring the Fiscal Impacts of Higher Budget Allowances

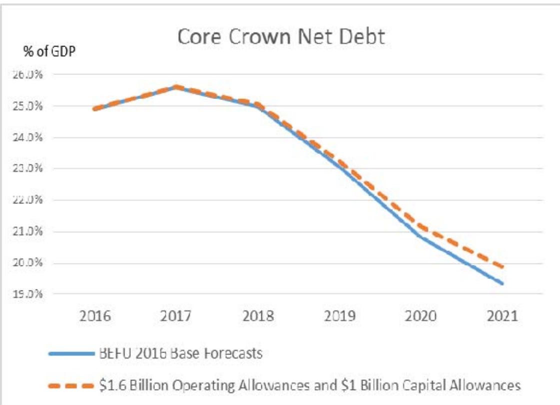
15. This section provides three scenarios showing higher operating and capital allowances over the next four budgets. The intention of these scenarios is to respond to your request for analysis that provides some sensitivity of the fiscal forecasts to the level of budget allowances.

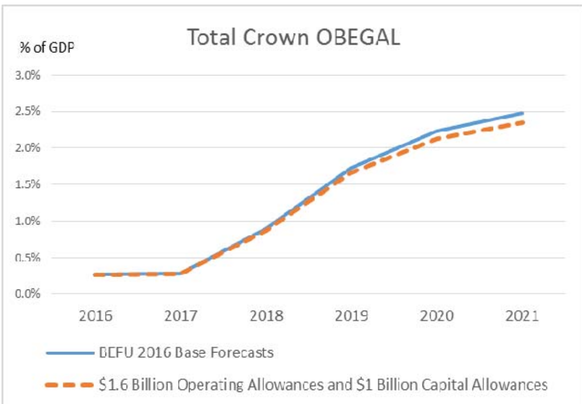
16. This advice is provisional because these scenarios are based on the economic and fiscal forecasts in BEFU 2016. We will be in a position to provide updated scenarios once preliminary fiscal forecasts have been completed in late October.[1]

17. The scenarios show the range of possible increases to allowances that would leave net debt around 20% by 2020/21. We have interpreted "around 20%" to cover a range from slightly below 20% up to 22% of GDP.

18. Figure 1 shows the impact of increasing operating allowances to $1.6 billion and capital allowances to $1.0 billion in each of the next four budgets. This is a very small increase in allowances compared to those included in Budget 2016 forecasts and results in net debt of 19.9% of GDP in 2020/21.

Figure 1: Increased Allowances that Keep Net Debt Below 20% of GDP by 2020/21



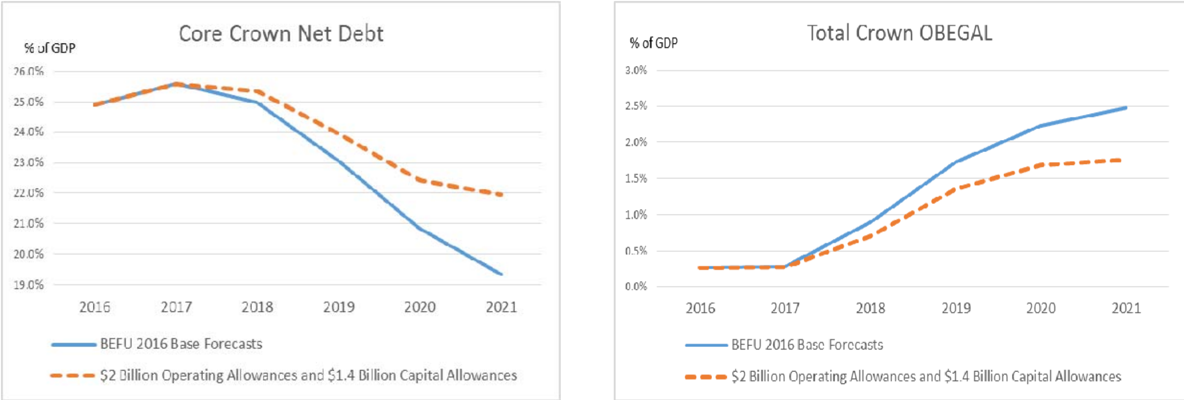


19. Figure 2 shows the impact of increasing operating allowances to $2.0 billion and capital allowances to $1.4 billion in each of the next four budgets. This is an increase of 33% in operating allowances and 56% in capital allowances over the next four years relative to those included in Budget 2016 forecasts.

20. In this scenario, net debt declines and reaches 22.0% of GDP in 2020/21. However, net debt rises in nominal terms until 2018/19 and is $8.1 billion higher than in the BEFU forecast by 2020/21. Operating surpluses still rise across the forecast period.

[1] Preliminary fiscal forecasts will be prepared assuming that allowances remain unchanged. Final decisions on allowances will be reflected in the final fiscal forecasts.

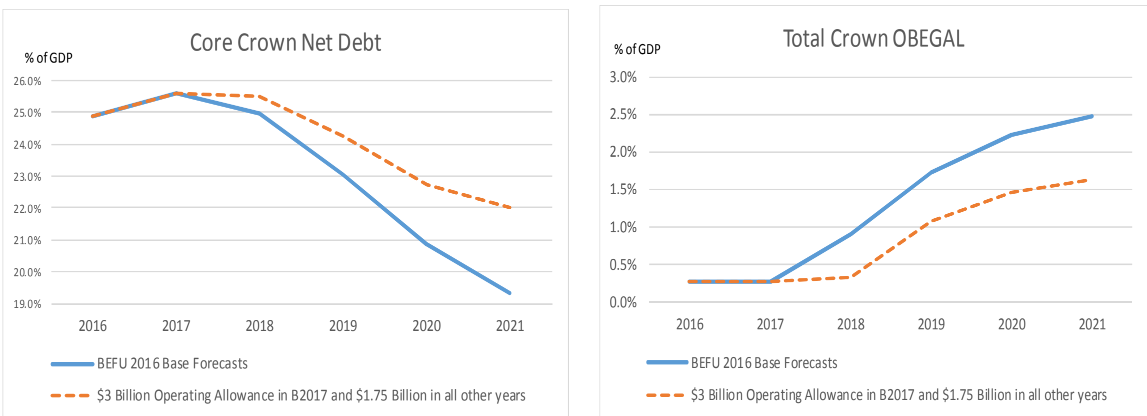
Figure 2: Increased Allowances that leave Net Debt at 22.0% of GDP by 2020/21



21. The two scenarios above assumed that increases in budget allowances would be evenly spread across the next four Budgets. However, if the Government were to consider introducing a tax package, a 'lumpy' profile for allowances would be more appropriate. Figure 3 shows the impact of a much larger increase in the operating allowance for Budget 2017 to $3 billion, and increases in operating allowances in Budgets 2018-2020 to $1.75 billion. For simplicity this scenario does not assume any increase to capital allowance across the next four Budgets, so they remain at $0.9 billion per Budget.

22. In this scenario, net debt declines and reaches 22.0% by 2020/21, following a similar trajectory to the scenario depicted in Figure 2. However, the forecast track for the OBEGAL is notably different. In this scenario, the OBEGAL surplus is less than $1 billion in 2017/18, and only begins to grow as a percentage of GDP thereafter, a year later than in the BEFU forecasts. This reflects the 'front-loading' in this scenario.

Figure 3: Large Increase in B2017 Operating Allowance, and Smaller Increases Thereafter



Indication of Changes in the Economic and Fiscal Outlook since BEFU 2016

23. The previous analysis was based on the BEFU 2016 economic and fiscal forecasts. Since BEFU 2016, economic and fiscal indicators have been stronger than expected, and these developments will be incorporated into the HYEFU forecast round which is currently underway. Below we provide you with a brief summary of some recent economic developments. You will receive a scene-setting Treasury Report on the HYEFU forecast round on 14 September and a write-up of the preliminary economic forecasts on 20 October.

24. Even if HYEFU 2016 forecasts are stronger than BEFU 2016, it is unclear at this stage whether the improvement would be cyclical or structural. A medium-term approach to fiscal management would mean looking through cyclical ups and downs in the economy to avoid exacerbating the economic cycle.

25. Most data releases in the last few months indicate stronger GDP growth than expected in BEFU 2016, and June quarter GDP figures are released on 15 September. Growth continues to be underpinned by strong construction and tourism activity and high net migration. Solid labour demand also has driven growth in aggregate labour earnings, which has boosted household spending, and business and consumer confidence are both running above their long-term averages. Trade data showed that economic activity has been supported by strong export volumes, particularly for dairy and meat.

26. In August, the Reserve Bank reduced the Official Cash Rate to 2.0 percent and signalled that further policy easing will be required. Weak global conditions are continuing to place upward pressure on the New Zealand dollar exchange rate and this is contributing to negative tradeables inflation, with a risk that this might lead to further declines in inflation expectations.

27. The global outlook remains a source of risk and uncertainty. Although global financial markets stabilised in July after the turbulence of Brexit, June quarter data for the US and Japan were below expectations and indicators of activity in the UK and the Euro area have slowed.

28. Initial results for the year ended June 2016 suggest the OBEGAL and net debt outturn will be better than forecast at Budget 2016 with tax revenue coming in stronger than expected while operating expenses are lower than forecast. However, it is likely the Crown will record a significant operating deficit overall once gains and losses are included reflecting large actuarial losses on the ACC and Government Superannuation Fund long term liabilities as well as losses incurred on the Emissions Trading Scheme as a consequence of an increase in the carbon price.

Exploring a Macroeconomic Scenario of Higher Net Migration

29. One of the key uncertainties that affects the economic and fiscal forecasts is the forward path for migration. To illustrate the sensitivities, this section presents the results of some initial macroeconomic modelling that shows how continued higher net migration could impact the economy, and how it might flow through to the fiscal position on both the revenue and expenditure side.

30. There are some limitations to this macroeconomic modelling exercise, particularly in our ability to model the impacts of higher net migration on government expenditure. The approach taken in this report uses 'top-down' assumptions for how higher migration will affect the main components of government expenditure, rather than being a bottom-up aggregation of the impact on individual agencies.

31. Table 2 shows the aggregate results of this higher migration scenario, and the key assumptions and channels are explained below. There are ranges for the estimates of nominal GDP and tax revenue, reflecting the sensitivity of the modelling to the assumed monetary policy response.

32. The estimate for higher government expenditure is partial, and we have focussed on analysing the potential fiscal impacts on health, education, law and order and welfare. We also assume that cost pressures from the migration forecast in BEFU 2016 can be accommodated within existing Budget allowances, and we do not attempt to model higher capital expenditure.

33. The related Treasury Report you have received this week on fiscal exposures across Government has a description of how demographic drivers like immigration flow through to cost pressures.

Table 2: Results of Macroeconomic Modelling of Higher Net Migration Scenario to 2019/2020

Cumulative Increase in Nominal GDP by 2019/20	$10 to $27 billion higher, compared to BEFU 2016 forecasts
Cumulative Impact on Core Crown Tax Revenue by 2019/20	$3 to $9 billion higher, compared to BEFU 2016 forecasts
Cumulative Additional Government Operating Expenditure by 2019/20	$1.2 billion higher, compared to BEFU 2016 forecasts

Economic Assumptions Underpinning Migration Scenario

34. This scenario is constructed by assuming a level of net migration that remains significantly higher than in the BEFU forecast to 2019/2020. The net impact is an increase in the population of 120,000 people and an increase in the working age population of 99,000. In BEFU 2016, net migration was forecast to contribute an additional 129,000 people to the economy by 2020, and the scenario is assuming an increase on top of that.

35. We assume that the average productivity level of this extra net inflow of migrants matches the general population, and also that additional labour supply is matched with labour demand. This means that in our scenario the unemployment rate is broadly similar to the BEFU forecast.

36. On the demand side of the economy, higher migration affects demand through three main channels:

- Residential investment grows significantly faster than in the BEFU forecast in order to increase the housing stock to accommodate this larger population. A key assumption is that there is sufficient construction capacity to match this lift in residential investment.

- Market investment also increases, as the construction industry invests more in order to service residential investment demand, and other industries invest more in response to the additional labour supply from an increase in the working age population.

- Private consumption increases, but only modestly, reflecting the fact that recent migrants appear to have a lower propensity to spend than migrants in previous cycles and the usual consumption lag as new migrants establish themselves.

- Part of the increase in investment and consumption is met through increased imports of goods and services. This reduces net exports and provides a small offset to the overall impact on the economy.

37. On the whole, this increase in demand is greater than the increase in supply (through additional labour supply). This means spare capacity in the economy reduces faster than in BEFU, resulting in greater inflationary pressure. Monetary conditions tighten faster in response, but even with that response, inflation is around 2.4% in the last three years of the forecast period.

38. Owing to higher real GDP growth and inflation, nominal GDP is cumulatively $27 billion higher than BEFU. The results of this scenario are very sensitive to the assumed response of monetary policy, as this makes a significant contribution to higher nominal GDP. If we assume that monetary policy keeps inflation closer to 2% then the cumulative nominal GDP impact is closer to $10-15 billion.

Modelled Revenue Impacts in this Migration Scenario

39. Higher nominal GDP in this scenario flows through to higher core crown tax revenue of between $3 to $9 billion. The different macroeconomic channels impact on all of the major tax types, and the effects are sensitive to the composition of changes in GDP. But broadly speaking all major tax types increase, and in decreasing order of magnitude the following changes occur:

- Higher investment and stronger economic growth lead to higher operating surplus and entrepreneurial income in the private sector, leading to an increase in business income taxes (corporate tax and other persons tax);
- The larger labour force and higher employment flows through to higher personal income tax;
- Higher consumption and residential investment results in an increase in GST;
- Resident withholding tax and all other taxes also increase.

40. The impact of higher net migration on tax revenue is sensitive to the same assumptions that affect the economic impacts outlined above. If the overall impact of higher net migration is less inflationary, then tax revenues would also be lower by a broadly proportional amount, because they are related to nominal GDP.

Modelled Expenditure Impacts in this Migration Scenario

41. To estimate the impact of higher migration on government expenditure, our approach was to model the effect of a larger increasing demographic base of recipients in health, education, justice and welfare spending. This allows us to estimate the marginal expenditure of a higher population on these expenditure categories.

42. The baseline expenditure was the BEFU forecasts, with a proportion of future allowances allocated to health, education, and justice. Base expenditure on welfare is as forecast in BEFU because it increases in expenditure is not charged against budget allowances. The implicit assumption this represents is that baseline population pressures from migration (as forecast in BEFU) would be able to be managed within the existing allowances.

43. We assume that the age and gender profile of the additional 120,000 migrants by 2019/20 has the same average profile as net migrants in the last two years. This allows us to create a new higher population base, by adding these additional migrants to the baseline population base from the BEFU forecasts.

44. We can calculate the per recipient expenditure on health, education, justice and welfare. Where possible, this can be weighted by age and/or gender profile such as in health, education and welfare expenditure. For justice spending, we do not have reliable demographic weightings of expenditure.

45. Those per recipient expenditures in each category can then be increased by the ratio of the new population base to the baseline population base. This can then be aggregate to provide an estimate of the increased expenditure in each year of the forecast period. These are added across the forecast period to generate the $1.2 billion estimate in Table 2, and the key drivers are summarised in Table 3 below.

Table 3: Cumulative Increases in Expenditure for Higher Net Migration Scenario by 2019/2020

Increase in Health Expenditure	$354 million
Increase in Education Expenditure	$396 million
Increase in Justice Expenditure	$111 million
Increase in Welfare Expenditure (NZ Super, benefit payments and Working for Families Tax Credits)	$380 million

46. Our view is that the estimate we have produced here is a lower bound on increased expenditure from higher net migration. We did not try to model increases in all operating expenditure categories. We also did not attempt to model higher capital expenditure, although it is likely that a higher population would eventually require new investment in infrastructure.

47. As indicated above, other advice you have received this week provides a short description of the way immigration can be a cost driver in the social sector.