The Treasury

Budget 2017 Information Release

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Fiscal Strategy and Budget Allowances in Light of Preliminary HYEFU Forecasts

Date:	4 November 2016	**Report No:**	T2016/2045
		File Number:	BM-2-9-3-2017

Action Sought

	Action Sought	Deadline
Prime Minister (Rt Hon John Key)	**Note** the recommendations **Discuss** at Budget Ministers meeting on 8 November **Agree** that changes to Budget allowances be included in the final HYEFU forecasts and the Budget Policy Statement	Tuesday 8 November, 2016
Minister of Finance (Hon Bill English)		Tuesday 8 November, 2016
Associate Minister of Finance (Hon Steven Joyce)		Tuesday 8 November, 2016
Associate Minister of Finance (Hon Paula Bennett)		Tuesday 8 November, 2016

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[34]	[34]	[39]	[23] (mob)	✓
Renee Philip	Manager, Macroeconomic and Fiscal Policy	[39]	[23] (mob)	

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: Fiscal Strategy and Budget Allowances in Light of Preliminary HYEFU Forecasts

Executive Summary

The Government's fiscal strategy includes building surpluses and reducing net debt in order to rebuild fiscal buffers to ensure New Zealand is well placed to manage future economic shocks or natural disasters. Net debt continues to increase in dollar terms. As a proportion of the economy, net debt has increased from around 5% of GDP in 2008 to around 25% in 2013 and has been largely stable since. The Treasury continues to consider that the current fiscal strategy remains appropriate, particularly the focus on reducing debt to around 20% in 2020.

Preliminary HYEFU forecasts show stronger economic growth than expected in Budget 2016. The Treasury estimates real GDP growth to be around 3.5% per annum currently and expects the economy will continue to expand at a similar pace for the next 18 months or so. Thereafter, growth is forecast to ease to a more sustainable pace.

Stronger growth in the real economy flows through to tax revenue, which is forecast to be $5.5 billion higher across the four years ending June 2020 than in Budget 2016. The higher tax revenue flows through to OBEGAL (particularly in the first two years), but reductions in Crown entity and SOE forecasts (most notably ACC) reduce the positive impact, leaving forecast OBEGAL surpluses similar to those in Budget 2016 over much of the forecast period.

Net debt is forecast to be lower throughout the forecast period than in Budget 2016, reflecting the lower starting position and higher tax revenue. Net debt is forecast to decline to 20.0% in 2019/20 and 18.1% of GDP in 2020/21. New Zealand Superannuation Fund (NZS Fund) contributions are forecast to resume in 2020/21 in line with current policy.

The Treasury's view is that there is a case to increase operating and capital allowances from their current levels of $1.5 billion and $0.9 billion per Budget if additional expenditure opportunities are of high enough value. Given the strong outlook for the economy, we do not see a case for fiscal stimulus at present. However, with interest rates expected to remain low for some time, the outlook provides some room to consider increases to discretionary expenditure or reductions to taxes without creating significant pressures for monetary policy in the near term.

There are choices about the size of operating and capital allowances and the timing of any change. There would be benefits for the transparency of fiscal policy to signal higher allowances in the Budget Policy Statement for Budget 2017 if there is sufficient certainty about what the Government intends to do.

The Government has already signalled its commitment to fund capital expenditure for the City Rail Link (CRL) and Housing Infrastructure Fund (HIF) and this has been included in the Preliminary HYEFU forecasts. We recommend the net capital allowance in Budget 2017 also include an additional $3 billion to fund worthwhile capital investments in the pipeline and other Government commitments. This would mean the total capital allowance for Budget 2017 would be $4.7 billion. We also recommend increasing the allowances for new capital expenditure from Budget 2018 onwards to $1.5 billion per Budget to fund future capital projects.

The cost of funding a settlement to the TerraNova claim is likely to be the largest single operating initiative in Budget 2017, and we recommend that this be provisioned for now and included in the final HYEFU forecasts (subject to ensuring inclusion or disclosure does not compromise negotiations in a material way). This would be over and above the existing operating allowances of $1.5 billion, and so is equivalent to an increase in the operating allowance.

This would mean that $1.5 billion is available for all other new operating expenditure, except any 'Track 1' social investment initiatives. We consider this allowance would be manageable for all other cost pressures, although it would still require some fiscal constraint. At this stage, we also recommend that a $1.5 billion operating allowance be retained for future Budgets.

If these recommendations are agreed to by Cabinet, they will be incorporated into final HYEFU forecasts. Based on the preliminary forecasts, the higher allowances would see net debt of 21.6% of GDP in 2019/20 and 19.2% of GDP in 2020/21. NZS Fund contributions would also restart one year later in 2021/22. There is some further fiscal headroom given that the fiscal strategy aims for net debt to be around 20% in 2020.

However, it is also important to take into account pressures and risks that will need to be managed in Budgets 2018 through to 2020 and to be able to comfortably respond to any downside economic scenario without the current net debt target becoming a constraint. As a result, the Treasury recommends retaining some fiscal headroom to provide flexibility to respond to changing circumstances or emerging pressures over the next few years.

We will soon have more information on the potential amount of high return on investment social investment initiatives that may be developed through 'Track 1' of the Budget process. The Treasury would be likely to recommend further increases to new operating spending in order to accommodate these initiatives.

The further fiscal headroom also allows for considerations of potential tax reductions. The Minister of Finance will soon receive initial advice on potential changes to tax policy, with a number of packages that focus on achieving equity objectives through changes to tax brackets, thresholds and Working for Families tax credits and addressing efficiency objectives through adjustments for fiscal drag. Although these options have merit, at this stage we would not recommend making decisions that use up a significant proportion of the remaining fiscal headroom. Given the likely size of a tax package relative to the limited fiscal headroom, we would recommend this should not be undertaken at this time.

Recommended Action

We recommend that you:

a) **Note** that with net debt remaining close to its peak, the current fiscal strategy remains appropriate, particularly the current focus on reducing net debt to around 20% of GDP by 2020;

b) **Agree** that the overall fiscal strategy, as set out in the 2016 *Fiscal Strategy Report*, should not change;

Agree/disagree.

c) **Note** that net debt is forecast to fall below 20% of GDP which provides some fiscal headroom to consider increases to budget allowances;

d) **Note** that the Treasury considers there is a case to increase operating and capital allowances from their current level of $1.5 billion and $0.9 billion per Budget in order to fund valuable projects in the pipeline and other Government commitments;

e) **Note** that known pressures in the capital pipeline exceed current capital allowances and we would recommend increasing allowances to fund valuable projects in the pipeline and other Government commitments;

f) **Agree** to increase the net capital allowance in Budget 2017 to fund the Government's signalled commitment to fund the CRL and HIF and an additional $3 billion for other initiatives;

Agree/disagree.

g) **Note** that this means the total capital allowance for Budget 2017 would be $4.7 billion;

h) **Agree** to increase the capital allowance from Budget 2018 onwards from $0.9 billion to $1.5 billion;

Agree/disagree.

i) **Agree** to provision for the outcome of the TerraNova negotiations in the HYEFU forecasts, subject to ensuring inclusion or disclosure does not compromise negotiations in a material way;

Agree/disagree

j) **Agree** to maintain operating allowances for all other expenditure in Budget 2017 and future budgets of $1.5 billion per annum;

Agree/disagree

k) **Note** the fiscal impacts of the decisions in recommendations (f) to (j) would mean net debt is forecast to be 19.2% of GDP in 2020/21 based on preliminary forecasts, and NZS Fund contributions would be forecast to restart in 2021/22;

l) **Note** that there is some further fiscal headroom consistent with the Government's fiscal strategy and the Treasury would recommend that that this fiscal headroom is retained to provide the Government with flexibility to respond to changing circumstances or emerging pressures over the next few Budgets;

m) **Note** that if a large amount of high-quality operating initiatives are developed through 'Track 1' of the Budget process, then the Treasury would be likely to recommend further increases to new operating spending in addition to accommodate these initiatives;

n) **Note** that the Treasury is providing information to the Minister of Finance on a number of tax and welfare packages that focus on achieving equity objectives, but at this stage we consider that a tax package would use up too much of the remaining fiscal headroom;

o) **Note** that these decisions will inform the Treasury final HYEFU forecasts, which will be published on Thursday 8 December;

p) **Agree** to signal the decisions above in the Budget Policy Statement, to be released alongside the HYEFU on Thursday 8 December;

Agree/disagree

q) **Note** that Treasury will draft a Cabinet paper based on these decisions for Cabinet on Monday 21 November.

Renee Philip
Manager, Macroeconomic and Fiscal Policy

Rt Hon John Key
Prime Minister

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Paula Bennett
Associate Minister of Finance

Treasury Report: Fiscal Strategy and Budget Allowances in Light of Preliminary HYEFU Forecasts

Purpose of Report

1. This 'Roadcheck Report' provides you with the Treasury's advice on fiscal strategy and budget allowances, on the basis of the Preliminary Half-Year Economic and Fiscal Update (HYEFU) forecasts.

2. This advice is to inform Government decisions that will underpin the Budget Policy Statement (BPS) 2017, which will be published on December 8 alongside the HYEFU.

Summary of the Economic and Fiscal Outlook

Preliminary HYEFU Economic and Tax Forecasts

3. You have previously received advice on the Treasury's preliminary HYEFU economic and tax forecasts (T2016/1954 refers). Table 1 outlines the key forecast economic indicators compared with the Treasury's Budget 2016 forecasts.

Table 1: Comparison of Key Economic Indicators between BEFU 2016 and Preliminary HEYFU 16 Forecasts

Economic variables		**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
June years		**Actual**	**Actual**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**
Economic growth[1]	BEFU16	3.3	2.6	2.9	3.2	2.8	2.5	
	HYEFU16	**3.3 (R)**	**2.8**	**3.7**	**3.4**	**3.1**	**2.7**	**2.5**
Unemployment rate[2]	BEFU16	5.9	5.6	5.6	5.1	4.6	4.6	
	HYEFU16	**5.5 (R)**	**5.1**	**4.9**	**4.8**	**4.3**	**4.3**	**4.3**
CPI inflation[3]	BEFU16	0.4	0.1	1.5	2.0	1.9	2.1	
	HYEFU16	**0.4**	**0.4**	**0.9**	**1.9**	**2.0**	**2.0**	**2.1**
Current account balance[4]	BEFU16	-3.5	-3.5	-4.6	-4.1	-4.3	-4.8	
	HYEFU16	**-3.7 (R)**	**-2.9**	**-3.2**	**-3.7**	**-4.2**	**-4.6**	**-4.6**
Nominal GDP[5]	BEFU16	2.8	3.5	3.6	5.6	5.1	4.1	
	HYEFU16	**2.8 (R)**	**4.2**	**4.8**	**5.2**	**5.0**	**4.4**	**4.1**
Nominal GDP ($billions)	BEFU16	241.6	250.1	259.2	273.6	287.4	299.2	
	HYEFU16	**241.6 (R)**	**251.8**	**263.9**	**277.8**	**291.7**	**304.4**	**316.9**
	change	0.0	1.7	4.7	4.2	4.2	5.2	

R - revised 1. Production GDP, annual average % change 2. June quarter 3. Annual % change 4. Annual as % of GDP
5. Expenditure measure

4. These forecasts show a more positive outlook for the New Zealand economy than expected at Budget 2016. Growth continues to be supported by high levels of inward migration, construction activity, exports (particularly tourism) and low interest rates.

5. Economic growth is estimated to be close to 3.5% at present and growth is expected to remain around this rate over the next 18 months or so. Also contributing to income growth, the terms of trade have improved as dairy prices have risen.

6. While the domestic outlook is largely positive there is continued weakness in the global economy and further risks going forward. Looking ahead, trading partner growth is expected to be slightly lower than was forecast at Budget 2016, largely reflecting the adverse impact from Brexit. The extent of this lower growth, however, remains uncertain due to the risks around the precise details of Brexit, the continued imbalances in the Chinese economy and the US presidential election.

7. Migration is providing a significant boost to aggregate growth, with real GDP per capita growth more muted at 0.7% in the year to June. Net migration appears to be at or close to its peak and is expected to decline in coming quarters, but at a slower rate than assumed in the Budget. Compared to the Budget forecast, this assumption lifts the working age population by 1.5%, and increases headline GDP by around 0.3 percentage points per year. The unemployment rate is expected to remain around current levels over the next 12-18 months, as the demand for labour matches growth in the labour supply.

8. Subdued inflation expectations, a high exchange rate and low global inflation, help contain growth in CPI inflation in the near term. Over the medium term, inflation is expected to pick up, helped by accommodative monetary conditions, returning to 2% in mid-2018, a little later than forecast at Budget.

9. Overall, higher levels of economic activity and the higher terms of trade support increases in nominal GDP, and these are only partially offset by lower forecast inflation. As a result nominal GDP is forecast to be $4.7 billion higher in the year ended June 2017 than forecast in Budget 2016. Across the four years to June 2020 the cumulative increase in nominal GDP is $18.3 billion.

10. Higher than expected revenue outturns in the current year combined with the stronger outlook for nominal GDP flows directly through to a higher forecast tax take, with tax revenue forecast to be $5.5 billion higher over the four years to 2020 compared to Budget 2016. In particular, stronger employment flows through into higher forecast revenue from PAYE tax. Higher consumption and residential investment increase the GST base, and business profits from a faster growing economy leads to higher corporate and other person's tax. However, moving in the other direction, reduced forecasts of interest rates have lowered the forecasts of interest Resident Withholding Tax (RWT).

11. New data received since the finalisation of these preliminary economic forecasts reinforce our view of a positive economic outlook in the near term. The economic forecasts, to be finalised on 10 November, will incorporate this economic data and other information.

Preliminary HYEFU Fiscal Forecasts

12. You have previously received advice on the Treasury's preliminary HYEFU fiscal forecasts (T2016/2084 refers). The preliminary HYEFU fiscal forecasts incorporate the improved economic outlook, operating allowances of $1.5 billion per Budget, capital allowances of $0.9 billion per Budget and updated forecasts of spending from departments. In addition, these forecasts have assumed additional capital spending of approximately $2 billion across the forecast period to fund precommitted capital spending for the Housing Infrastructure Fund (HIF) and the City Rail Link (CRL). These forecasts make no provision for TerraNova.

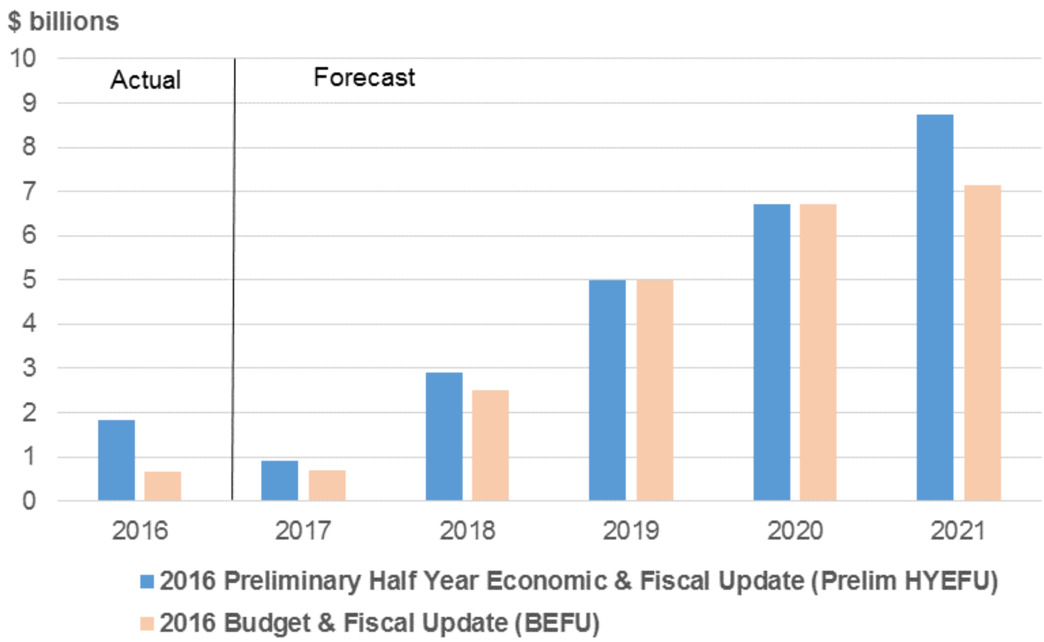
13. Overall, the preliminary HYEFU fiscal forecasts show a stronger fiscal outlook than expected at Budget 2016. Table 2 provides an overview of the key preliminary fiscal forecasts.

Table 2: Comparison of Key Fiscal Indicators between BEFU 2016 and Preliminary HYEFU 2016 Forecasts

	Actual			Forecast		
$ billion, June years	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
OBEGAL - 2016 Prelim HYEFU	**1.8**	**0.9**	**2.9**	**5.0**	**6.7**	**8.7**
OBEGAL - 2016 BEFU		0.7	2.5	5.0	6.7	7.1
Total Change		**0.2**	**0.4**	**0.0**	**(0.0)**	**1.6**
Residual Cash - 2016 Prelim HYEFU	**(1.3)**	**(2.5)**	**(1.6)**	**1.8**	**3.6**	**3.6**
Residual Cash - 2016 BEFU		(4.2)	(2.1)	2.0	3.9	2.0
Total Change		**1.7**	**0.5**	**(0.2)**	**(0.3)**	**1.6**
Net Debt - 2016 Prelim HYEFU	**61.9**	**64.7**	**66.2**	**64.4**	**60.9**	**57.3**
Net Debt - 2016 BEFU		66.3	68.3	66.3	62.3	60.2
Total Change		**1.6**	**2.1**	**1.9**	**1.4**	**(57.3)**
% of GDP, June years						
Net Debt - 2016 Prelim HYEFU	**24.6**	**24.5**	**23.8**	**22.1**	**20.0**	**18.1**
Net Debt - 2016 BEFU		25.6	25.0	23.1	20.8	19.3

14. The operating balance before gains and losses (OBEGAL) is forecast to rise strongly from 2016/17 with surpluses reaching $8.7 billion by the end of the forecast period (figure 1).

Figure 1: Comparison of operating balance before gains and losses (OBEGAL) between BEFU 2016 and Preliminary HYEFU 2016 Forecasts



15. OBEGAL surpluses are forecast to be higher than in Budget 2016 in the first two years, reflecting higher tax revenue. However, beyond the first two years, forecast OBEGAL surpluses are similar to those in Budget 2016 as a number of factors offset the higher tax revenue:

- ACC's forecast results are weaker than previously expected, compounded by levy reductions (which increases expenses by $1.4 billion across the forecast period)

- Net finance costs have increased (which increases expenses by $1.0 billion across the forecast period)

- SOE results are weaker than forecast in Budget 2016 (which increases expenses by $700 million across the forecast period), and

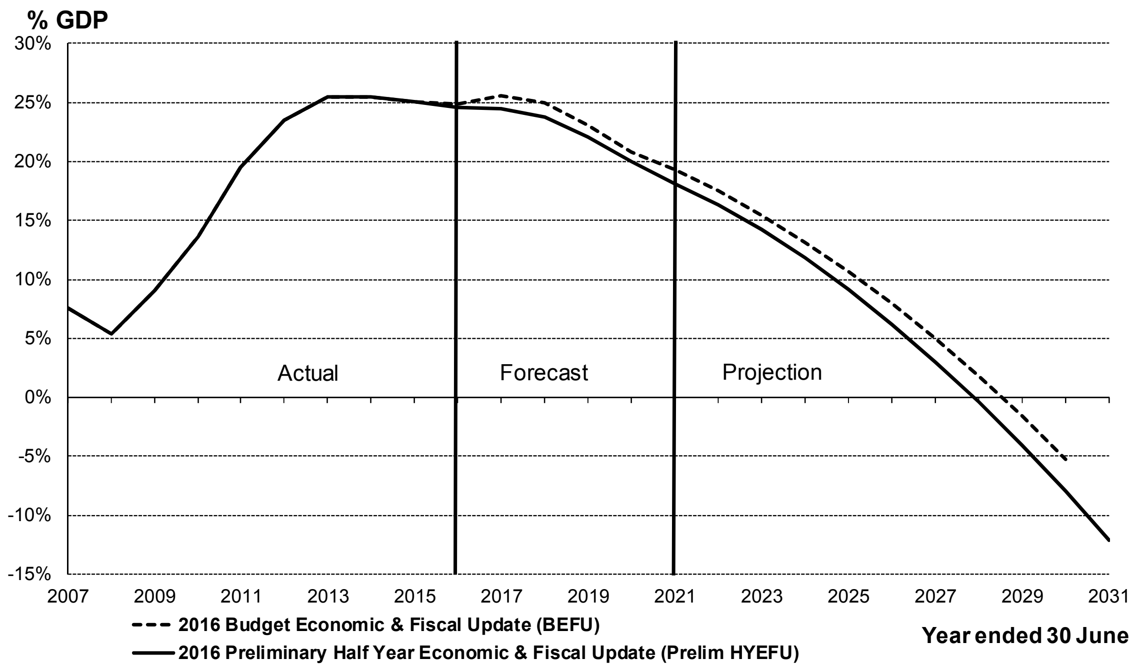
- Changes to our top-down adjustment assumption (which increases expenses by $400 million across the forecast period).

16. Core Crown expenses are forecast to increase in nominal terms across the forecast period, rising from $77.9 billion in 2016/17 to $87.0 billion in 2020/21. As a percentage of GDP, expenses are forecast to continue to decline gradually from around 29.5% of GDP in 2016/17 to 27.5% in 2020/21.

17. Over the next five years, beginning in 2016/17, we forecast $26.2 billion of capital expenditure, excluding contributions to the NZS Fund. This compares with $18.4 billion over the previous five years ending in 2015/16. The main components of the extra $7.8 billion is nearly $3 billion of transport projects by the New Zealand Transport Agency (NZTA), nearly $1.5 billion for the CRL, $1 billion for the Housing Infrastructure Fund and nearly $1 billion extra each for the Ministry of Education and the New Zealand Defence Force.

18. The combination of improved operating cash flows (reflecting stronger tax receipts) and higher capital spending means residual cash is forecast to reach surplus in 2018/19, the same year as in Budget 2016, allowing net debt to begin to fall in nominal terms. Net debt as a percentage of GDP has already reached its peak and we forecast it to fall to 18.1% by 2020/21, lower than the Budget 2016 projection of 19.3% (Figure 2).

Figure 2: Comparison of net debt as a percentage of GDP between BEFU 2016 and Preliminary HYEFU 2016 Forecasts



19. Contributions to the NZS Fund are forecast to start in 2020/21, in line with the current policy to resume contributions once net debt falls below 20% of GDP.

Uncertainties and Risks in the Outlook

20. Forecasts are uncertain and are dependent on a number of key assumptions. While this set of forecasts show an improvement from the forecasts at Budget 2016, this could change by Budget 2017 if downside or upside risks eventuate, such as a worsening of the global economic outlook, changes to migration, or higher interest rates.

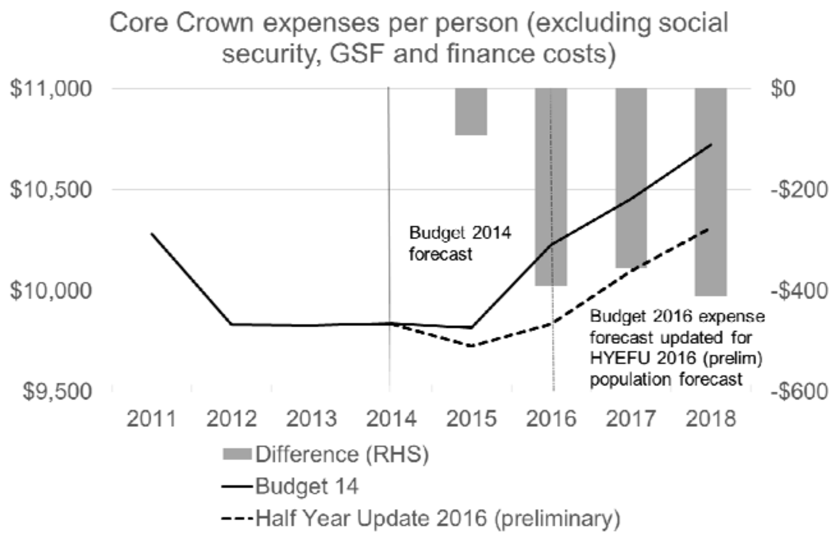
21. In particular, the future path for population and net migration is a key source of uncertainty. Compared to Budget 2016, we are now assuming a cumulative increase to the population of an additional 59,000 people. There remain both upside and downside risks to this assumption, and the composition of flows will determine the impact on both the economy and the fiscal position.

22. Migration affects the fiscal position through both higher tax revenue and higher spending pressures in some areas (such as health and education). The fiscal impact of higher migration is likely to be positive over the forecast period, however, the precise magnitudes are very uncertain, particularly on the spending side [T2016/1683 refers]. To give you some idea of the sensitivity of the fiscal outlook to net migration, if we assume that the population increase from net migration was 90,000 higher (compared to our preliminary HYEFU forecasts), then net debt could be 1.1% of GDP lower in 2020/21 (17.0%).

23. Another way to examine the potential impact of migration on the fiscal position is to compare forecasts of per capita spending. Compared to forecasts in 2014 when operating allowances were set at their current levels, stronger than expected net migration has meant that New Zealand will have 150,000 more people by 2018 than was previously expected. The corollary of this faster population growth has therefore been a lower level of government spending per capita (Figure 3).To bring per capita spending back to the levels we expected in Budget 2014 would require an increase in operating spending in Budget 2017 of around $600 million per annum.

24. The Treasury will provide further analysis on the link between net migration and Government expenditure in a report next week. In particular the report will discuss changes in migration assumptions since Budget 2016, the main spending areas that are affected by population, how these changes in spending would be treated under the Fiscal Management Approach, and what information needs to be collected in the future to tell a fuller story around the impact of population changes on spending pressures.

Figure 3: Core Crown Expenses per Capita (excluding Social Security, GSF and Finance Costs)



A focus on reducing net debt continues to remain appropriate….

25. The Government's current fiscal strategy prioritises building surpluses and reducing debt in order to rebuild fiscal buffers to ensure New Zealand is well placed to manage future economic shocks or natural disasters. In the Fiscal Strategy Report (FSR) 2016, the Government's current fiscal priorities were set out as:

- 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.

26. We consider that these priorities remain appropriate. The focus on debt reduction is still prudent to rebuild fiscal buffers so that fiscal policy has more space to respond to a significant negative shock. Net debt is still rising in nominal terms, and increased from around 5% of GDP in 2008 to around 25% today. By international standards, New Zealand has a relatively low level of net debt, and the Treasury would emphasise the importance of a declining net debt trajectory rather than a particular net debt target in any given year.

27. The declining trajectory is still only a forecast and we think it is important for the credibility of fiscal policy to see actual reductions in the ratio of net debt to GDP before considering a change to the Government's overall fiscal strategy. As a result, we recommend retaining the main priorities of the current fiscal strategy and consider that aiming for net debt to be around 20% by 2020 remains a sensible target to anchor the decisions you make in Budget 2017.

...and we do not consider there is a need for fiscal stimulus at this point…

28. There are calls around the world for fiscal policy to do more to stimulate the economy so as to support monetary policy. Many countries are facing weak aggregate demand, very low inflation, and interest rates are near, or even below, zero in some countries. We do not think those arguments apply to New Zealand at this point, as monetary policy is not yet at the effective lower bound. Under the Treasury's central forecasts, the economy is forecast to grow strongly over the next four years and inflation is forecast to return to around 2% by the end of the forecast period. On current forecasts, the level of economic activity is not likely to require additional support from government expenditure.

29. As we noted above, there are downside risks to this economic outlook. In the event of a significant economic downturn, it is possible that monetary policy may face constraints given that interest rates are currently at very low levels. This may mean a fiscal stimulus should be considered in the event of a large downturn. In part, this is what motivates our judgement to prioritise debt reduction, as rebuilding fiscal buffers when the economy is doing well is important to provide room to comfortably allow fiscal policy to be more expansionary when the economy may need more support.

30. The current low inflation and low interest environment mean that there is less concern about higher government expenditure placing upward pressure on interest and exchange rates than was the case at Budget 2014, when the current level of operating and capital allowances were set. At that time, potential interest rate increases weighed more strongly against increasing Government expenditure. However, at the margin, even slightly higher interest rates than otherwise may lead to upward pressure on the exchange rate, given extremely low interest rates in many countries.

…although the stronger fiscal outlook provides some headroom.

31. The preliminary HYEFU forecasts are for net debt to decline to 18.1% of GDP in 2020/21, 1.2 percentage points lower than we projected in Budget 2016. This means that there is fiscal headroom to increase Budget allowances without changing the Government's fiscal strategy or priorities.

32. Normally, our advice would be to 'look through' any upward revision to tax revenues in order to avoid spending cyclical, or temporary, revenue and generating procyclical fiscal policy. However, with part of the strength in tax revenue forecasts reflecting a larger population, this revenue increase is unlikely to be temporary, and so the case for saving all of the revenue 'surprise' is weaker.

33. We consider that there is a case to increase new discretionary operating and capital allowances from their current levels of $1.5 billion and $0.9 billion per Budget if additional initiatives are aligned to the Government's priorities and have a high return on investment.

34. We recommend a number of changes to allowances for HYEFU. Table 3 below sets out the net debt impacts of our recommended increases to new operating and capital allowances. Together, these recommendations push forecast net debt to 19.2% of GDP by 2020/21. They also delay the resumption of NZS Fund contributions by one year to 2021/22.

35. Given our understanding of likely investment opportunities and pressures in Budget 2017 and future Budgets, we recommend increasing net capital allowances to $4.7 billion in Budget 2017, and $1.5 billion per Budget in subsequent Budgets. This capital allowance includes approximately $1.7 billion of new capital expenditure for CRL that has already been incorporated into the preliminary HYEFU forecasts. The HIF is included in forecasts but treated as fiscally neutral for the purpose of setting the capital allowance. This would leave $3 billion available for other initiatives. As this is a net allowance, any capital recycling would provide room for additional capital expenditure.

36. We also recommend provisioning for the likely settlement of the TerraNova negotiation in the final HYEFU forecasts, on top of the $1.5 billion operating allowance. This is subject to ensuring that inclusion or disclosure does not compromise negotiations in a material way. Estimated costs are expected to start at $600 million in 2017/18 and rise to $800 million in 2020/21. This would be roughly equivalent to increasing the Budget 2017 operating allowance to approximately $2.2 billion per annum on average over the forecast period.

Table 3: Net Debt Impacts from Forecast Changes and Treasury Recommendations (as % of GDP)

	15/16	16/17	17/18	18/19	19/20	20/21
BEFU 2016 Forecast	**24.9**	**25.6**	**25.0**	**23.1**	**20.8**	**19.3**
Changes from Forecasts	*-0.3*	*-1.1*	*-1.2*	*-1.0*	*-0.8*	*-0.8*
Prelim HYEFU 2016 Forecast *(Includes Capital Expenditure on HIF and CRL)*	**24.6**	**24.5**	**23.8**	**22.1**	**20.0**	**18.1**
Increasing unallocated Budget 17 Capital Allowance to $3 billion	*0.0*	*0.0*	*+0.4*	*+0.7*	*+0.7*	*+0.7*
Increasing Capital Allowance from Budget 2018 onwards to $1.5 billion	*0.0*	*0.0*	*0.0*	*+0.1*	*+0.2*	*+0.4*
Including Terranova in HYEFU Forecasts	*0.0*	*0.0*	*+0.2*	*+0.4*	*+0.7*	*+0.9*
Forecast Net Debt if Treasury Recommendations are Agreed[1]	**24.6**	**24.5**	**24.4**	**23.3**	**21.6**	**19.2**
Scenario to Illustrate Further Fiscal Headroom (Assumes a further $2 billion increase to operating allowance in B17)	*0.0*	*0.0*	*+0.7*	*+1.4*	*+2.1*	*+2.7*
Maximum Net Debt consistent with Current Fiscal Strategy[2]	**24.6**	**24.5**	**25.2**	**24.7**	**23.7**	**21.9**

37. Table 3 also includes a scenario to illustrate the further use of fiscal headroom that would leave net debt just below 22 percent in 2020/21, roughly consistent with your current fiscal strategy but stretching the flexibility in the fiscal target. It shows the net debt impact of adding an additional $2 billion to the operating allowance for Budget 2017.

[1] In this scenario, contributions to the NZS Fund restart in 2021/22, one year later than in the Preliminary HYEFU Forecast.
[2] In this scenario, contributions to the NZS Fund restart in 2021/22, two years later than in the Preliminary HYEFU Forecast.

38. We do not recommend the Government uses this further fiscal headroom at this juncture. Given uncertainty around the economic outlook and the likelihood that additional operating or capital pressures arise between now and 2020, it would be prudent to avoid increasing net debt right up to this limit. Doing so would use up much of the option value to undertake higher expenditure or tax reforms over the next several budgets, as there would be no further headroom in any of Budgets 2018 through to 2020. It would also reduce the options available to respond to any downside risks that eventuate. In addition, this scenario would see net debt increase as a percentage of GDP in 2017/18. We have not consulted the RBNZ on this report, but it is possible that using all available fiscal headroom may begin to impact on monetary policy.

Operating and capital priorities in Budget 2017 and Beyond

39. This section sets out our view of specific initiatives that are likely to be a priority in Budget 2017 and known information on cost pressures. Judgments about these priorities have informed our recommendations on overall budget allowances as set out above.

40. We recommend that priority be given to increasing capital and operating allowances with a focus on funding investment opportunities that have a high return and are aligned to your strategic priorities, ahead of other choices such as undertaking tax cuts.

41. There is a relatively clear view of particular capital expenditure projects in the pipeline, at least over the next couple of years. Based upon these known pressures, we recommend a capital allowance of $4.7 billion. This allows for $3 billion of capital expenditure in addition to the approximately $1.7 billion funding already committed for the CRL. The commitment for the HIF has also been entered into forecasts. This is treated as fiscally neutral with regards the capital allowance as it is expected to be repaid, but does increase net debt in 2020/21 as the repayments are not made until after this date.

[33]

43. Restricting capital expenditure to an additional $3 billion will still require fiscal restraint. For example, four initiatives total just over $3 billion: the [33] , the Defence White Paper costs for Budget 2017, [33] [33] and the KiwiRail funding request. Investment in school infrastructure and would place further pressure on the allowance. In addition, $87 million has already been pre-committed against Budget 2017, with a further $130 million expected from Defence in November.

44. There are a range of other capital projects in the pipeline that Treasury will consider. Capital recycling and scaling options are likely to be required to manage within this allowance. However, we consider that this is possible to manage through the Budget 2017 process, and so our judgment is that a total net capital allowance of $4.7 billion is appropriate.

45. Note that although a Budget 2017 capital allowance of $4.7 billion would be a significant increase from the current level of $0.9 billion, the actual expenditure involved would be spread through time. The timing of the cash flow impact would depend on the capital items that are progressed at Budget 2017. If a $3 billion allowance is agreed, in addition to HIF and CRL, a likely cash flow impact might be approximately $2 billion in 2017/18, $1.5 billion in 2018/19, $1 billion in 2019/20 and the remainder in 2020/21 and beyond.

[33]

46. From Budget 2018 onwards, there is less visibility of capital intentions but we consider that a $900 million capital allowance per budget is likely to be difficult to deliver without significant savings. [33]

47. If the funding requests for Budget 2017 are scaled so that only the first year cost is met, this will push up pressures in future budgets and we would expect more initiatives to appear closer to the time. Given this, we would recommend increasing ongoing capital allowances to $1.5 billion.

48. We do not currently have the same detailed visibility over operating initiatives in Budget 2017. There are a range of likely pressures that we have previously signalled to you, and the cost of settling the TerraNova negotiations is likely to be the largest single operating initiative in Budget 2017. We consider that it would be difficult to keep operating expenditure to $1.5 billion per annum in Budget 2017 if that included any TerraNova settlement.

49. As a result, we recommend that the new expenditure to settle TerraNova negotiations should be provisioned in the HYEFU forecasts (subject to ensuring inclusion or disclosure does not compromise negotiations in a material way) in addition to the $1.5 billion operating allowance. This has the same fiscal impact as increasing the operating allowance to make room for TerraNova, but avoids the need to set a large allowance inclusive of TerraNova in advance of the negotiations. Once the Terranova negotiations have been settled, you could consider whether final Budget 2017 allowances are inclusive or exclusive of TerraNova.

50. This would mean that $1.5 billion per annum is available for all other new operating expenditure in Budget 2017, which we consider would be manageable. The Government will continue to have choices about the level of new operating spending it intends to allocate at Budget 2017. For example, if a large amount of high-quality, high return on investment, social investment initiatives are developed through 'Track 1' of the Budget 2017 process, then the Treasury would likely recommend further increases to accommodate these initiatives.

51. We recognise that one of your fiscal priorities is to reduce income taxes, should fiscal and economic conditions allow. The current fiscal headroom available allows for consideration of potential tax reductions. The Minister of Finance will soon receive initial advice on potential changes to tax policy, with a number of packages that focus on achieving equity objectives through changes to tax brackets, thresholds and Working for Families tax credits and addressing efficiency objectives through adjustments for fiscal drag. This advice will consider tax and transfer options of around $1.4 billion to $1.7 billion [T2016/1948 refers].

52. Although these options have merit, at this stage we would not recommend making decisions that use up a significant proportion of the remaining fiscal headroom. Given the likely size of a tax package, we would recommend this should not be undertaken at this time.