The Treasury

Budget 2017 Information Release

Release Document July 2017

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Budget Policy Statement Cabinet Paper

Date:	23 November, 2016	**Report No:**	T2016/2179
		File Number:	MC-1-5

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Sign** the attached Cabinet paper and Cabinet submission form	

Contact for Telephone Discussion (if required)

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

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

Return the signed report to Treasury.

Lodge the Cabinet paper with Cabinet office**.**

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Treasury Report: Budget Policy Statement Cabinet Paper

Executive Summary

Attached is the Cabinet paper titled '*Budget Policy Statement 2017 and Proposed Spending Allowances*' for your consideration. The paper seeks Cabinet agreement to the capital and operating allowances for Budget 2017, and has been prepared in consultation with your office and the Prime Minister's office.

We ask that you sign the attached paper and accompanying cabinet submission form before 10.00am Thursday 24 November, for consideration by Cabinet on Monday 28 November.

Recommended Action

We recommend that you **sign** the attached Cabinet paper and Cabinet Submission Form before 10.00am Thursday 24 November 2016.

Renee Philip
Manager, Macroeconomic & Fiscal Policy

Hon Bill English
Minister of Finance

Office of the Minister of Finance

Chair, Cabinet

BUDGET POLICY STATEMENT 2017 AND PROPOSED SPENDING ALLOWANCES

Proposal

1. This paper seeks confirmation of our fiscal priorities and agreement to the operating and capital allowances to be included in the Budget Policy Statement 2017. It also informs Cabinet about the economic and fiscal forecasts for the Treasury's Half Year Economic and Fiscal Update (Half Year Update).

Executive Summary

2. The New Zealand economic outlook continues to improve with economic growth being supported by a growing population and strong domestic activity. The Treasury forecasts nominal GDP to be $23.7 billion higher cumulatively across the four years to June 2020, compared to Budget 2016 forecasts.

3. The South Island Earthquakes caused a significant amount of damage and will affect economic activity in the region considerably. However, this is not expected to disrupt the overall momentum of the economy, which is resilient and reflected in broad-based consumer and business confidence.

4. The economic outlook flows through to surpluses in the operating balance before gains and losses (OBEGAL) across the forecast period, and ongoing reduction in net debt. Net debt is now forecast to reach 18.8% of GDP by 2020/21, consistent with our current fiscal strategy.

5. The South Island Earthquakes highlight the drivers behind the Government's fiscal strategy. Getting on top of spending and paying down debt in the good times ensures we are in a good position to cope with economic shocks and natural disasters, and allows the Government to support New Zealand communities through challenging times.

6. While net debt is forecast to decline, this is still only a forecast and it is important for the credibility of fiscal policy to see material reductions in the ratio of net debt to GDP. Aiming for net debt to be around 20% by 2020 remains a sensible target to anchor the decisions made in Budget 2017.

7. The improved fiscal outlook means that there is some room to increase allowances without changing the Government's overall fiscal strategy. Budget 2017 will see a continuation of this Government's focus on responsible fiscal management and better public services.

8. I propose that we retain the current operating allowances at $1.5 billion per Budget for Budgets 2017 to 2020. The net cost of the TerraNova settlement will be in addition to these allowances. Track 1 will be used to invest in high quality social investment initiatives and the operating allowances may be increased if a large number of high quality initiatives are presented through this process.

9. I further propose that we increase the capital allowance to $3 billion for Budget 2017 and $2 billion for Budgets 2018-2020 to ensure that we continue to invest in priority infrastructure for New Zealand.

Economic context

10. The New Zealand economy continues to improve. The Treasury's forecasts in the Half Year Update show a more positive outlook for the New Zealand economy than was expected at Budget 2016. In particular, economic growth continues to be supported by a growing population, construction activity, exports (particularly tourism), and low interest rates.

Table 1 – Summary of the Treasury's economic forecasts

June years	2016 Actual	2017 Forecast	2018 Forecast	2019 Forecast	2020 Forecast	2021 Forecast
Real GDP (annual average % change)	2.8	3.6	3.5	2.9	2.4	2.3
Consumers Price Inflation (annual % change)	0.4	1.5	2.0	2.1	2.0	2.1
Employment Growth (annual % change)	2.3	4.8	1.6	1.5	1.1	0.9
Unemployment Rate (June Quarter)	5.0	4.8	4.6	4.2	4.3	4.3
Wage Growth (annual % change)	2.1	1.6	2.2	2.8	3.1	3.0
Current Account (% of GDP)	-2.9	-3.0	-3.8	-4.1	-4.4	-4.4

11. Economic growth is forecast to be 3.6% in 2016/17, and then to ease to a more sustainable pace across the rest of the forecast period. The terms of trade are expected to remain high, partly reflecting higher near-term dairy prices and lower import prices than in the Budget Update.

12. The South Island Earthquakes caused a significant amount of damage and will affect economic activity in the region considerably. However, this is not expect to disrupt the overall momentum of the economy, which is resilient and reflected in broad-based consumer and business confidence.

13. While the domestic outlook is largely positive there is continued weakness in the global economy and further risks going forward. Looking ahead, growth of our trading partners is expected to be slightly weaker than was forecast at Budget 2016, largely reflecting the impact of Brexit and lower long-term growth in the US. The extent of lower trading partner growth remains uncertain due to the risks around the precise details of Brexit, the continued imbalances in the Chinese economy, and the transition of the Australian economy away from mining investment.

14. Migrant inflows are adding to labour supply and are dampening wage growth, which is projected to slow to 1.6% over the year ahead, marginally above inflation. The unemployment rate is expected to decline modestly over the next two years or so as the demand for labour broadly matches growth in the labour supply. As migration inflows slow the unemployment rate is expected to decline a little more quickly and to stabilise at around 4.3% in 2019/20.

15. Subdued inflation expectations, a high exchange rate and low global inflation have been keeping inflation low. The Reserve Bank cut the official cash rate on the 10th of November to 1.75%. This will support an increase in inflation in the medium term and continue to stimulate demand.

16. Overall, higher levels of economic activity and the higher terms of trade support increases in nominal GDP. As a result across the four years to June 2020 nominal GDP is forecast to be cumulatively $23.7 billion higher than in Budget 2016.

17. Higher than expected revenue outturns in the current fiscal year to date, combined with the stronger outlook for nominal GDP, flows directly through to a higher forecast tax take, with tax revenue forecast to be $7.7 billion higher over the four years to 2020 compared to Budget 2016.

Fiscal Forecasts

18. The Treasury's fiscal forecasts include the impact of the improved economic outlook, the impact of the recommendations in this paper, and an adjustment for the South Island Earthquakes where reasonable estimates are available. Table 2 summarises the forecasts that will be included in the Half Year Update.

Table 2 – Summary of the Treasury's fiscal forecasts

	Actual			**Forecast**		
$ billion, June years	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
OBEGAL - 2016 HYEFU	**1.8**	**0.5**	**3.3**	**5.4**	**6.8**	**8.5**
OBEGAL - 2016 BEFU		0.7	2.5	5.0	6.7	..
Total Change		**(0.2)**	**0.8**	**0.4**	**0.1**	**8.5**
Residual Cash - 2016 HYEFU	**(1.3)**	**(2.2)**	**(2.1)**	**1.4**	**3.0**	**2.6**
Residual Cash - 2016 BEFU		(4.2)	(2.1)	2.0	3.9	..
Total Change		**2.0**	**0.0**	**(0.6)**	**(0.9)**	**2.6**
Net Worth attributable to the Crown - 2016 HYEFU	**89.4**	**93.0**	**99.1**	**107.4**	**117.3**	**129.3**
Net Worth attributable to the Crown - 2016 BEFU		86.6	91.6	99.2	108.9	..
Total Change		**6.4**	**7.5**	**8.2**	**8.4**	**129.3**
Net Debt - 2016 HYEFU	**61.9**	**64.4**	**66.4**	**65.0**	**62.1**	**59.6**
Net Debt - 2016 BEFU		66.3	68.3	66.3	62.3	..
Total Change		**1.9**	**1.9**	**1.3**	**0.2**	**(59.6)**
% of GDP, June years						
Net Debt - 2016 HYEFU	**24.6**	**24.3**	**23.8**	**22.2**	**20.3**	**18.8**
Net Debt - 2016 BEFU		25.6	25.0	23.1	20.8	..

19. The surplus in 2015/16 was larger than expected at $1.8 billion. However, going forward, surpluses are expected to be more in line with prior expectations. This is largely due to the improved tax forecasts being offset by the fiscal impact of the South Island Earthquakes, weaker results from ACC and increased benefit expenses (mostly New Zealand Superannuation).

20. Treasury's initial estimate is that the gross cost to the Government of the South Island Earthquakes will be between $2 billion and $3 billion. This is still an early estimate, and it is unclear the extent to which this will be covered by insurance, reprioritising other spending or reducing debt repayment.

21. As a result, only a portion of the costs ($1 billion) has been added to the forecasts on top of existing spending, representing the net costs of the earthquakes that are not expected to be funded from other sources. This has an impact on the OBEGAL surplus in 2016/17. However, there is considerable uncertainty and these numbers will need to be updated in the Budget.

22. Core Crown expenses are forecast to increase in nominal terms across the forecast period, rising from $78.3 billion in 2016/17 to $87.8 billion in 2020/21. As a percentage of GDP, expenses are forecast to continue to decline gradually from around 29.6% of GDP in 2016/17 to 27.7% in 2020/21.

23. The higher tax forecast flows directly through to lower net debt, partly offset by higher benefit expenses and capital expenditure. As a percentage of GDP net debt has already reached its peak and is forecast to fall to 18.8% by 2020/21, lower than the Budget 2016 projection of 19.3%. Crown net worth is forecast to continue to increase in line with the reduction in net debt.

24. In nominal terms net debt is still rising, and 2018/19 is the first year when net debt is forecast to decrease in dollar terms, when a residual cash surplus is forecast. 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.

25. 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 a greater impact from the earthquake than has been assumed.

Fiscal Strategy

26. The Government's current fiscal strategy prioritises building surpluses and starting to pay down debt in order to rebuild fiscal buffers to ensure New Zealand is well placed to manage future economic shocks or natural disasters.

27. The South Island Earthquakes highlight the importance of delivering on the Government's fiscal strategy. While the earthquakes are significant both in terms of their impact on the community, and their fiscal cost, the strength of the Government's books means we are able to respond as needed. Cost will not be a constraint on the recovery effort.

28. Net debt increased over the past decade, from around 5 per cent of GDP in 2008 to 25 per cent today, and crown net worth is lower than it was in 2008. This reflected the Global Financial Crisis, the Canterbury earthquakes and unsustainable spending increases in the early 2000s. While net debt is now expected to decline, this trajectory is still only a forecast and it is important for the credibility of fiscal policy to see material reductions in the ratio of net debt to GDP before considering a change to the Government's overall fiscal strategy.

29. As a result, I recommend retaining the current fiscal strategy and priorities, as set out in the Fiscal Strategy Report 2016, and consider that aiming for net debt to be around 20% by 2020 remains a sensible target to anchor the decisions made in Budget 2017.

30. The Government's short-term fiscal priorities, set out in the attached draft Budget Policy Statement 2017, are:

- 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
- Using any further fiscal headroom - including from positive revenue surprises - to reduce net debt faster.

31. The improving fiscal situation gives the Government choices around progressing these objectives while also supporting communities hit by the South Island Earthquakes and investing in priority public services and infrastructure.

32. When it is affordable, and when economic conditions permit, the Government would like to lower income taxes, with a focus on lower and middle income earners. However, responding to the South Island Earthquakes and reducing debt are currently of higher priority.

33. The improved fiscal outlook means that we are able to increase Budget allowances without changing the Government's fiscal strategy or priorities.

Budget 2017 Priorities and Allowances

34. Budget 2017 will continue to progress the Government's programme and priorities. These have been updated in light of the recent earthquake. These priorities are:

- Responsibly managing the Government's finances
- Building a more productive and competitive economy
- Delivering better public services within tight financial constraints, and
- Rebuilding Christchurch and Responding to the South Island Earthquakes

35. The stronger fiscal position has been achieved due to an improving economic outlook and through tight expenditure control. Budget 2017 will continue our approach of responsible fiscal management – the hallmark of this Government's previous eight Budgets, providing the Government with choices. Budgets are about achieving better results for New Zealanders and their families and the choices we make need to reflect this.

36. This Government has announced its commitment to a number of significant projects over the past year. These include the City Rail Link (CRL) and the Housing infrastructure fund (HIF), and together these are expected to add nearly $2 billion to net debt by 2020/21. In order to fund these and other emerging capital priorities, it is necessary to increase capital allowances from the current levels of $0.9 billion per Budget.

37. I propose that the capital allowance in Budget 2017 be increased to $3.0 billion and that the capital allowance for Budgets 2018 – 2020 be increased to $2 billion, increasing by 2% in each Budget thereafter. At this level the Budget 2017 allowance will require significant prioritisation given known pressures.

38. I propose that the operating allowance remain at $1.5 billion per annum for Budgets 2017 – 2020, growing at 2% thereafter.

39. As previously agreed, negotiations to settle the TerraNova claim will begin soon. This will have a significant fiscal cost. While the net cost will be provisioned for in the Treasury's fiscal forecasts, I propose that it be funded in addition to the operating allowance. This ensures the operating allowance remains an effective tool to manage new spending proposals.

40. These operating allowances will continue to require effective prioritisation and restraint in order to manage emerging pressures. Achievement of this restraint however, will allow this Government to begin reducing debt and increases the choices available to us in the future, including on tax reduction.

41. Budget 2017 will also have an increased focus on evidence based policy. This builds upon the improvements made in Budget 2016 and has been previously agreed by Cabinet (CAB-16-MIN-0496 refers). Track 1 will be used to invest in high quality social investment initiatives and the operating allowance may be increased if a large number of high quality initiatives are presented through this process. An investment threshold will apply to these initiatives to reflect the higher evidence and expectations required for this track.

42. The Government will do what is required to support the recovery from the recent major earthquakes. It is too early to know exactly the extent of damage and the likely fiscal cost. The most significant impacts are likely to be increased infrastructure spending to repair roads and other utilities. To the extent this cannot be managed within existing operating and capital allowances, these allowances may be increased at Budget 2017.

Consultation

43. This paper was prepared by Treasury. The Department of Prime Minister and Cabinet was informed.

Publicity

44. The Budget Policy Statement is due to be released on 8 December 2016, along with the Half Year Update.

Recommendations

45. I recommend that Cabinet:

a) **note** that the Budget Policy Statement 2017 (BPS) and the Half Year Economic and Fiscal Update are due to be released publically on 8 December;

b) **note** that the economic outlook continues to improve with strong economic growth being supported by a growing population and strong domestic activity;

c) **note** that the forecast operating balance before gains and losses (OBEGAL) is broadly in line with expectations at Budget 2016;

d) **note** that net debt is forecast to continue to decline, reaching 18.8% of GDP by 2020/21;

e) **note** that aiming for net debt to be around 20% by 2020 remains a sensible target to anchor the decisions made in Budget 2017;

f) **agree** that the operating allowance remain at $1.5 billion per Budget for Budgets 2017 to 2020, growing at 2% per Budget thereafter;

g) **note** that the net cost of the TerraNova settlement would be in addition to this allowance;

h) **note** that this government has publically committed to funding several significant capital projects including the City Rail Link and the Housing Infrastructure fund;

i) **agree** that the capital allowance in Budget 2017 be increased to $3.0 billion and that the capital allowances for Budgets 2018 to 2020 be increased to $2 billion per Budget, growing at 2% per Budget thereafter;

j) **note** that Government is committed to funding what is required to respond to the South Island Earthquakes and if these costs are cannot be managed within existing operating and capital allowances, these allowances may be increased at Budget 2017;

k) **note** that the attached draft Budget Policy Statement will set out this fiscal strategy and the Government's Budget priorities.

Authorised for lodgement

Hon Bill English, **Minister of Finance**