The Treasury

Budget 2015 Information Release

Release Document July 2015

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[11] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

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[14] Not in scope

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Update on HYEFU 2014 Forecasts and Fiscal Strategy

Date:	7 November 2014	**Report No:**	T2014/1748
		File Number:	MC-1-5-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Discuss** at fiscal issues	10:30am, Monday 10 November
Associate Minister of Finance (Hon Steven Joyce)	**Note** the contents of this report	
Associate Minister of Finance (Hon Paula Bennett)	**Note** the contents of this report	

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[8]				✓
Tim Ng	Director, Macroeconomic Policy	04 917 6124 (wk)	[8]	

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

Return the signed report to Treasury.

Enclosure: No

Treasury Report: Update on HYEFU 2014 Forecasts and Fiscal Strategy

Executive Summary

This report provides an overview of the 2014 preliminary *Half Year Economic and Fiscal Update* (HYEFU) forecasts and projections along with their implications for the Government's fiscal strategy. It provides you with the opportunity to make changes to fiscal settings prior to the finalisation of forecasts for the HYEFU, which is due to be published alongside the 2015 *Budget Policy Statement* on 16 December.

The outlook for economic activity remains solid with real GDP growth expected to be higher on average over the period 2014/15 – 2017/18 compared with both the 2014 *Budget Economic and Fiscal Update* (BEFU) and the *Pre-election Economic and Fiscal Update* (PREFU). Sustained growth in employment and real wages is expected. The unemployment rate is forecast to fall to 4.5% while interest rates will likely stay low for longer, reflecting a downward adjustment to future inflation pressures. A stronger net migration outlook highlights the strength of the New Zealand economy relative to many other countries.

While the outlook for activity has strengthened, nominal income and expenditure in the economy (nominal GDP) is expected to be around 1.5% lower by March 2018 compared with BEFU, as the weaker outlooks for the terms of trade (primarily driven by lower dairy prices) and CPI inflation more than offset the stronger real economy path. Compared with Budget 2014, these developments have reduced the cumulative amount of nominal GDP over the forecast period by around $17 billion. This has negative implications for forecast tax revenues.

The preliminary forecasts and projections, which assume a $1.5 billion operating allowance for Budgets 2015-17, remain consistent with making progress towards your fiscal strategy of returning to surplus and reducing debt, but show a delay in meeting your fiscal targets on current fiscal settings. Operating balances are forecast to increase through time which will eventually put debt on a declining path, and core Crown expenses will continue to fall as a share of GDP. However, forecasts now indicate an OBEGAL deficit in 2014/15 of $1.0 billion and a small deficit in 2015/16 of around $100 million, compared with forecast surpluses for both years in both the BEFU and PREFU. Net debt is forecast to peak at a higher level, before falling to 20.3% of GDP in 2020/21.

Economic factors explain most of the weaker OBEGAL in 2014/15 since PREFU ($1.0 billion of the $1.3 billion downgrade), notably lower tax revenue from lower export prices and interest rates. Core Crown expenses are forecast to be $0.4 billion higher in 2014/15, largely reflecting the transfer of expenses by Departments from the previous year.

The Government's short-term fiscal intention to return to surplus in 2014/15 has always been "subject to any significant shocks". Given the magnitude of the reduction in dairy prices, a deficit in 2014/15 is unlikely to raise concerns in financial markets and rating agencies about fiscal intentions, as long as the overall fiscal strategy remains on track. That the latter remains true is indicated by the structural fiscal balance being forecast to return to surplus in the same year (2016/17), even though the path is a little lower than in the PREFU in each year of the forecasts.

How you might adjust fiscal settings in response to the forecast fiscal path beyond 2014/15 depends on a judgement about whether the recent downside surprises for dairy prices and CPI inflation (relative to previous forecasts) reflect temporary or permanent factors. Current forecasts assume that some of the reduction in dairy prices is temporary, and that prices will recover around 25% by the start of 2016. The forecasts also assume that CPI inflation returns to the midpoint of the target range more or less as in the previous forecasts (but with a lower peak in CPI inflation subsequently). If this outlook eventuates, a re-phasing of the operating allowances profile across the Parliamentary term (rather than an overall lowering of the allowances) would be sufficient to see forecast surpluses beginning in 2015/16.

We recommend a re-phasing of operating allowances across the Parliamentary term to $1 billion for Budgets 2015 and 2016, and $2.5 billion in Budget 2017, in line with the Government's pre-election announcements. This would see a forecast surplus of around $0.3 billion for 2015/16 and $2.2 billion in 2016/17 and mean somewhat faster progress towards your fiscal objectives. However, the forecast 2015/16 surplus under this scenario would be small and susceptible to unanticipated adverse expenditure or revenue developments.

A key risk to the outlook is if dairy prices and CPI inflation (and hence nominal GDP growth) do not rebound as expected. If this occurs, and implies (all else equal) a more sustained period of forecast structural deficits, there might emerge a need to adjust operating allowances more substantially, particularly in Budget 2017 and beyond. Given current uncertainty around the outlook, including the future path of dairy prices and domestic inflation, it would be worth waiting before making any firm decisions about allowances in later years. The *Budget Policy Statement* should emphasise the uncertainty around allowances in Budget 2017 and conditionality around any future tax reductions.

Given this uncertainty, and that the fiscal forecasts continue to show progress in achieving the Government's fiscal strategy, we recommend against setting a strict surplus target for 2015/16. Instead, any aim to return to surplus in that (or any other particular) year should remain conditional on the economic outlook.

An allowance of $1 billion for Budget 2015 would provide an opportunity to focus on the highest value government expenditure and drive further savings, efficiencies and reprioritisation in order to achieve this. Further rolling out the concepts of the investment approach at Budget 2015 and beyond will support this. Structural change in some sectors facing cost pressures could provide a longer term pay-off.

Given the weaker inflation outlook, macroeconomic conditions are now less of a constraint on fiscal policy than six months ago, when one of the tests for changes to the operating allowance was avoiding material upward pressure on interest rates (alongside achieving net debt of 20% by 2020). However, there would still be benefits in terms of lower interest rate and exchange rate profiles from counter-cyclical adjustments to fiscal policy. Any reduction to overall operating allowances over the Parliamentary term would take further pressure off monetary policy and allow even lower interest and exchange rates than would otherwise be the case.

In addition to the economic risks to the forecasts, there are also a number of policy decisions that that could negatively affect OBEGAL. These include any additional ACC levy reductions and social housing reform. It is currently uncertain as to whether these will feature in HYEFU forecasts, and will likely depend on whether Cabinet decisions are expected in the near-term.

We recommend delaying any decisions on ACC funding policy until next year alongside more detailed consideration of the path of future operating allowances and consideration of any tax package for Budget 2017, to allow the full macroeconomic and fiscal implications of ACC funding policy changes to be considered. Social housing reform is not likely to be incorporated into HYEFU given the expected timing of decisions.

There are also a number of options to support your fiscal objectives from improved capital management and capital recycling on the balance sheet. HYEFU forecasts include new capital allowances of $700 million at Budget 2015, in addition to pre-commitments of approximately $140 million on regional roads and urban cycleways, and $830 million at Budget 2016. These represent the remainder of the proceeds in the Future Investment Fund. Forecasts then return to the PREFU trend of $918 million at Budget 2017, growing at 2% thereafter. Including expenditure funded from baselines, forecasts include $23.1 billion of capital expenditure over the forecast period (2014/15-2018/19), compared with $24 billion at PREFU (over 2013/14-2017/18). [8]

Recommended Action

We recommend that you:

a **note** that the outlook for economic activity remains solid with real GDP growth expected to be higher on average over the forecast period compared with the previous forecasts

b **note** that compared with Budget 2014 the outlook for dairy prices and CPI inflation is lower, which has negative implications for forecast tax revenues

c **note** that preliminary forecasts assume operating allowances of $1.5 billion from Budget 2015, growing at 2% per Budget

d **note** that preliminary forecasts are consistent with your overall fiscal strategy to increase surpluses and reduce debt, but show a delay before your fiscal targets are met

e **note** that re-phasing operating allowances over the Parliamentary term in line with pre-election announcements to $1 billion for Budgets 2015 and 2016 with a higher allowance in Budget 2017 would be sufficient to ensure progress towards your fiscal objectives beyond 2015, assuming dairy prices rebound as currently forecast

f **note** that an allowance of $1 billion will provide an opportunity to focus on the highest value government expenditure and drive further savings, efficiencies and reprioritisation in order to achieve this. Further rolling out the concepts of the investment approach at Budget 2015 and beyond will support this.

g **agree** to set operating allowances of $1 billion in Budgets 2015 and 2016 and $2.5 billion in Budget 2017, subject to economic and fiscal conditions

h **note** that if nominal GDP growth does not rebound as expected, an overall reduction in allowances over the Parliamentary term may be necessary to maintain progress towards your fiscal strategy, and would have the benefit of taking more pressure off interest and exchange rates

i **note** that any additional ACC levy reductions or sales of social housing would further reduce OBEGAL beyond that incorporated in the preliminary forecasts

j **note** that other options to reduce capital investment or increase capital recycling may reduce net debt or reduce pressure on interest rates but, aside from social housing sales, are unlikely to have significant effects on OBEGAL

Tim Ng
Director, Macroeconomic Policy

Hon Bill English
Minister of Finance

Treasury Report: Update on HYEFU 2014 Forecasts and Fiscal Strategy

Purpose of Report

1. This report summarises the Treasury's 2014 *Half Year Economic and Fiscal Update* (HYEFU) preliminary forecasts and projections, along with key developments since the 2014 *Pre-election Economic and Fiscal Update* (PREFU) and the implications for fiscal strategy. It provides you with the opportunity to make changes to fiscal settings prior to the finalisation of forecasts for the HYEFU, which is due to be published alongside the 2015 *Budget Policy Statement* on 16 December 2014.

2. Preliminary economic forecasts were finalised on 7 October 2014, and preliminary fiscal forecasts on 3 November 2014. Final forecasts (inclusive of subsequent decisions) are expected on 10 November 2014 (economic) and 24 November 2014 (fiscal).

Analysis

Economic forecasts

3. The overall outlook for economic activity remains positive with real GDP growth expected to average 2.8% per year over the forecast period. The outlook for employment growth is strong, real wages are increasing and low inflation is keeping interest rates lower for longer. However, lower dairy payout forecasts and renewed concerns about global growth have weakened the export outlook. In contrast, strong migration and the continuing Christchurch rebuild mean strong domestic demand growth.

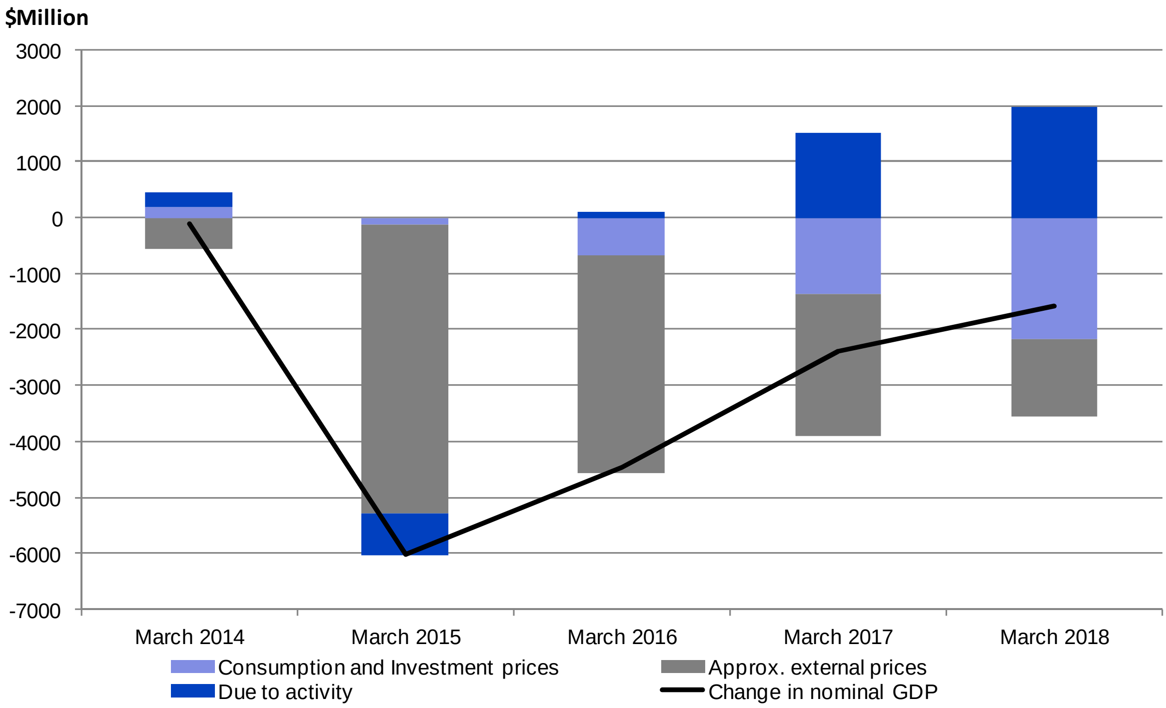
4. Relative to PREFU, real GDP growth is expected to be faster on average over the forecast period, owing largely to slightly higher potential output growth flowing from higher net migration increasing labour supply. Annual net migration inflows are forecast to peak at around 50,000 in the year ended March 2015 up from 42,500 in the PREFU. Higher potential output is a likely contributing factor to recent inflation outturns being lower than previously thought.

5. Tempering this positive economic picture is the much weaker outlook for export receipts coming from lower international prices for some of New Zealand's key commodity exports, especially dairy. While there are some offsets (e.g. lower oil prices), this negative shock to the terms of trade represents a loss of income to New Zealand that is not recovered over the forecast period. As a result, the terms of trade has moved from being a driver of demand to a constraining factor. Dairy prices are forecast to recover around 25% by the start of 2016, but the lower level in the intervening period, together with more muted domestic prices pressures, means the forecast size of nominal GDP is smaller. A further deterioration or slower than expected rebound in global dairy prices is a key risk to the outlook.

6. The recent decline in dairy prices has seen some adjustment in the exchange rate, but not enough to offset the income loss of dairy exporters. The exchange rate is assumed to remain around its current rate until late 2016, and to depreciate around 7% over the remainder of the forecast period. Reflecting a lower inflation outlook, interest rate expectations have been revised down with the Reserve Bank signalling a period of assessment before considering any further policy adjustment.

7. Figure 1 shows an approximation of the decomposition of the change in nominal GDP from the 2014 BEFU to preliminary HYEFU. It isolates the impact of domestic and external prices, and real economic activity. The cumulative difference over the forecast period is $17.4 billion. Movements in the terms of trade explain most of the change, particularly over 2014/15 and 2015/16.

Figure 1 – Decomposition of nominal GDP change since the 2014 BEFU



8. In a global context, a divergence between real and nominal GDP growth is not unique. Australia provides an example that is both recent and close to home.

9. Aide Memoire T2014/1683 provided an overview of the preliminary 2014 HYEFU economic forecasts. Key comparisons to the 2014 PREFU are shown in Table 1:

Table 1 – Summary of Key Economic Forecasts
(Annual average percent change, unless specified otherwise)

March Years	2014	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast	2019 Forecast
Nominal GDP (Expenditure Basis)						
2014 Prelim HYEFU	6.7	3.1	5.1	5.4	4.1	3.7
2014 PREFU	7.0	5.2	4.2	4.4	3.7	NA
CPI Inflation (ann % change, March quarter)						
2014 Prelim HYEFU	1.5	1.7	2.1	2.1	2.0	2.0
2014 PREFU	1.5	1.7	2.4	2.3	2.1	NA
Terms of Trade (SNA Basis)						
2014 Prelim HYEFU	13.5	-4.5	-2.5	3.3	0.7	0.7
2014 PREFU	13.5	-0.7	-3.3	1.1	-0.1	NA
EXPENDITURE ON GDP						
2014 Prelim HYEFU	2.5	3.3	3.3	2.6	2.3	2.2
2014 PREFU	2.5	3.8	3.0	2.2	2.1	NA
GDP (PRODUCTION MEASURE)						
2014 Prelim HYEFU	3.2	3.5	3.3	2.7	2.3	2.2
2014 PREFU	3.3	3.8	3.0	2.2	2.1	NA
Potential GDP						
2014 Prelim HYEFU	2.3	2.7	2.7	2.8	2.7	2.4
2014 PREFU	2.2	2.7	2.6	2.8	2.6	NA
Output gap (March qtr,% of potential)						
2014 Prelim HYEFU	-0.1	0.5	0.9	0.5	0.2	0.0
2014 PREFU	0.3	1.2	1.1	0.4	0.1	NA
Unemployment Rate (March quarter)						
2014 Prelim HYEFU	5.9	5.6	5.3	4.9	4.6	4.5
2014 PREFU	6.0	5.6	5.2	4.8	4.5	NA

Fiscal forecasts

10. Preliminary forecasts assume operating allowances of $1.5 billion from Budget 2015, growing at 2% per Budget, and exclude the impact of any future ACC levy and social housing decisions. Whether additional ACC levy reductions will be included in final forecasts will depend on whether any decisions are made in the near-term provide more certainty around the timing and size of levy reductions. Social housing decisions are unlikely to be included in HYEFU forecasts given the expected timing of decisions.

11. Forecast tax revenues have been revised down reflecting the large fall in nominal GDP over the forecast period. The reduction in forecast tax revenue reflects lower GST, owing to lower aggregate expenditure, and lower RWT, owing to lower forecast interest rates. Compared with PREFU, the largest reduction in the tax forecasts is in the 2015/16 year.

12. Core Crown expenses are forecast to continue to decline as a share of GDP, reaching 29.8% by 2018/19, although there is little change in 2014/15. Core Crown expenses are expected to be around $350 million higher in 2014/15 compared with PREFU, but slightly lower over the rest of the forecast period. This reflects lower benefit expenses stemming from a lower wage track to which New Zealand Superannuation is indexed,

and lower recipient numbers for sole parent support due to a more positive employment outlook.

13. OBEGAL is forecast to be in deficit by $1.0 billion in 2014/15 and $0.1 billion in 2015/16, with a surplus of $1.2 billion in 2016/17.

14. Net core Crown debt is expected to peak at 27.4% of GDP in 2015/16 (26.8% of GDP at PREFU), which is a year later and higher than previously expected, before dropping to 20.3% in 2020/21. In nominal terms net debt peaks at $69.4 billion in 2016/17 and stays flat for a year before declining. NZS Fund contributions are projected to restart in 2021/22, one year later than at PREFU.

15. A modest residual cash surplus of $11 million is expected in 2017/18 which is a year earlier than predicted at the PREFU, mainly due to re-phasing of capital expenditure. The residual cash surplus is more substantive in 2018/19, and as a result net core Crown debt starts reducing in nominal terms in that year.

16. Table 2 provides key fiscal indicator comparisons to PREFU. Projections begin in 2018/19 and 2019/20 for PREFU and HYEFU respectively.

Table 2 –OBEGAL, core Crown residual cash and net debt

Fiscal years							
Total Crown OBEGAL ($ billion)	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
2014 Prelim HYEFU	-1.0	-0.1	1.2	2.6	3.5	5.4	6.9
2014 PREFU	0.3	0.8	1.9	3.0	5.1	6.9	7.8
Total Change	**-1.3**	**-0.9**	**-0.7**	**-0.4**	**-1.6**	**-1.5**	**-0.9**
Core Crown residual cash ($ billion)							
2014 Prelim HYEFU	-4.4	-4.1	-1.3	0.0	1.2	1.9	4.4
2014 PREFU	-4.6	-2.9	-0.4	-0.3	1.9	4.5	3.0
Total Change	**0.2**	**-1.2**	**-0.9**	**0.3**	**1.2**	**-2.6**	**1.4**
Net core Crown debt ($ billion)							
2014 Prelim HYEFU	64.0	68.0	69.4	69.4	68.2	66.3	61.9
2014 PREFU	64.3	67.0	67.5	67.9	66.0	61.5	58.5
Total Change	**-0.3**	**1.0**	**1.9**	**1.5**	**2.2**	**4.8**	**3.4**
Net core Crown debt (% of GDP)							
2014 Prelim HYEFU	27.3	27.4	26.7	25.6	24.3	22.7	20.3
2014 PREFU	26.8	26.7	25.8	25.0	23.3	20.8	19.0
Percentage point change	**0.5**	**0.7**	**0.9**	**0.6**	**1.0**	**1.8**	**1.3**

Macroeconomic implications

17. Managing government spending and revenue so that changes in fiscal policy settings do not have a material adverse impact on interest rates is a key part of the Government's fiscal strategy.

18. At Budget, Treasury advised that an increase in the operating allowance from $1 billion to $1.5 billion per Budget on average over the next term would not have a material impact on interest rates. Moreover we advised that the Government's planned fiscal stance was such that the Official Cash Rate (OCR) will be around 50 basis points lower than otherwise by 2018. Preliminary fiscal forecasts show that the fiscal stance is forecast to be largely unchanged in 2014/15 from a year earlier (i.e. neither adding to, or subtracting from demand pressure in the economy), before becoming in tighter in

2015/16 and subsequent years. Over the period 2014/15 to 2017/18 the aggregate stance of fiscal policy is similar to PREFU (Annex 2 refers).

19. As noted above, the real economy is still expected to be in a cyclically strong position over the next few years, with output above potential albeit to a more modest extent than expected previously. However, CPI inflation has been weak, and forecast inflation has also reduced. As a result, expectations of interest rate increases have been revised down as the Reserve Bank has signalled a period of assessment before considering any further adjustment. Treasury still expects higher interest rates later in the forecast period.

20. The exchange rate has adjusted somewhat in response to dairy price falls. However, we still view the exchange rate as being overvalued relative to economic fundamentals (i.e. it is acting as a constraining force on exports). This partly reflects the interest rate differentials between New Zealand and many other advanced economies, some of which comes from relative expectations about future growth. While pressure on interest rates from other sources has eased (e.g. the terms of trade), we continue to see benefits from a modest fiscal tightening to reduce the pressure on monetary policy from fiscal policy, to allow for lower interest rates and exchange rate than would otherwise be the case. This will continue to support exporters and households with mortgages in the near term. A more counter-cyclical fiscal policy with allowances lower than this would further reduce pressure on interest rates and the exchange rate, which may help with rebalancing objectives.

21. On balance, we think the lower interest rate path and easier fiscal stance this year, is appropriate given the economic outturns, changes to the outlook and ongoing uncertainties and risks particularly around the path of dairy prices. If the outlook for the economy weakens (e.g. because dairy prices turn out to be lower or the impact of recent falls is more negative than forecast), macro policy has room to provide additional support to activity. Monetary policy remains able to respond to any further downturn and should be the first to provide additional support.

22. You have publicly indicated ACC levy reductions from 1 April 2016 and Cabinet has agreed to a new ACC funding policy, although the timing needs to be addressed as Ministers have not yet made a final decision on the transition path to the new ACC funding policy. ACC levy reductions transmit through the economy the same way as a tax reduction, increasing the disposable income of households. Managing ACC levy reductions from within operating allowances would keep the overall impact on demand within the limits consistent with not putting additional pressure on monetary policy. To the extent that ACC levy reductions cause non-cash movements that impact on the OBEGAL (i.e. the unexpired risk liability (URL)), these non-cash impacts could be looked through for the purposes of avoiding pressure on monetary policy (although they would still reduce the OBEGAL). If average operating allowances are reduced over the term, there would be a case to consider ACC levy reductions in addition to allowances (from a macro perspective this is equivalent to counting ACC levy reductions against a higher allowance).

23. Proposed social housing sales have no immediate macroeconomic implications, and so from the perspective of avoiding any impact on interest rates, fiscal impacts of social housing sales could be "looked through".

Fiscal implications

24. Your overall fiscal strategy is to return to a path of rising operating surpluses and falling net debt. The 2014 *Fiscal Strategy Report* outlined the following short-term intentions and long-term objectives:

- Return to OBEGAL surplus in 2014/15 and to run increased surpluses thereafter, and

- Reduce net debt to 20% of GDP by 2020, and maintain it within 10-20% over the economic cycle.

25. Preliminary forecasts and projections show the Government is broadly on track to achieving its fiscal strategy, although progress towards the fiscal intentions and objectives has been delayed compared with Budget 2014. This section discusses each objective in turn.

OBEGAL

26. The Government's preferred fiscal balance measure, OBEGAL, remains on an improving path. The OBEGAL deficit is forecast to continue declining and return to surplus. However, current forecasts show the return to surplus is delayed until 2016/17. The goal to return to surplus in 2014/15 has always been "subject to any significant shocks". The large negative shock to dairy prices and uncertainty around the forward path suggest a need to reconsider the appropriate timeframe for returning to surplus. The structural balance is forecast to return to surplus at the same time as previously estimated (2016/17).

27. There are limited options for returning to surplus in 2014/15, although some options remain. Increasing revenue, through levies and excises or pharmaceutical payments, or reducing expenses, e.g. treaty spending and ODA, would improve the fiscal position in 2014/15. If expenditure is pushed out to future years, the impact on 2015/16 should be considered. Any decisions you take to reduce the forecast deficit in 2014/15 will be reflected in final fiscal forecasts.

28. Forecasts assume operating allowances of $1.5 billion from Budget 2015, growing at 2% per Budget. Adjusting the phasing of allowances over the Parliamentary term while remaining within the previously-signalled $1.5 billion <u>on average</u> could bring forward the forecast OBEGAL surplus. With uncertainty around the macroeconomic and fiscal outlook, a phased approach to the next three Budgets, combined with conditionality around a higher allowance in Budget 2017 (to allow for any tax package), will help to manage risk.

29. Your pre-election announcement signalled that around $1 billion of operating allowances will be used for spending, with the remainder for tax cuts and/or debt reduction. Re-phasing allowances to $1 billion, $1 billion and $2.5 billion in Budgets 2015, 2016 and 2017 respectively will achieve a small surplus of $0.3 billion in 2015/16, growing to $2.2 billion in 2016/17 and $2.7 billion in 2017/18 (see table 4 for operating allowance scenarios). However, the 2015/16 surplus would be small and susceptible to unanticipated adverse economic, expenditure or revenue developments. Given this uncertainty, and that the fiscal forecasts show progress in achieving the Government's fiscal strategy, we recommend against a strict surplus target for 2015/16. Instead, any aim to return to surplus should remain conditional on the economic outlook.

30. Four-year plans indicate that an allowance of $1 billion in Budget 2015 will be challenging but manageable. In particular it will provide an opportunity to focus on the highest value government expenditure and drive further savings, efficiencies and reprioritisation in order to achieve this. Further rolling out the concepts of the investment approach at Budget 2015 and beyond will support this.

31. However, potential ACC levy reductions in 2016 would further reduce OBEGAL. The main impact on OBEGAL would be from a reduction in total Crown revenue, and an increase in the URL which will increase expenses. While there are options for

managing the speed of transition to the new funding policy, a sharp reduction beginning in April 2016 would see a forecast OBEGAL deficit in 2015/16 based on current forecasts. The impact is driven by the URL in the first year, after which the levy reductions themselves have the largest impact.

32. Cabinet has not yet made decisions on the transition to the new ACC funding policy, or whether or not these will be counted against operating allowances.[1] Final decisions on levies for the 2016/17 year are not needed until November 2015. ACC must consult and make recommendations to the Minister on levy rates before final levy decisions can be made.

33. Table 3 provides a PREFU based estimate of the OBEGAL impact of a period of low flat levies, which corresponds with levy reductions signalled in September 2014. This is only one option for transitioning to the new funding policy. Under this option, 2016/17 levies would be set at the rate estimated to get funding levels down to the target within the specified timeframe. Forecasts closer to the time would determine what those rates would be. Note that if ACC levy reductions were to be included in HYEFU forecasts, these estimates would likely be updated to reflect updated economic information.

Table 3 – Potential impact on OBEGAL of ACC levy changes

Fiscal years ($ million)	2015/16	2016/17	2017/18	2018/19
Levy Revenue	-155	-767	-870	-872
URL	-375	-100	-27	-14
Investment Income	-1	-8	-29	-58
OBEGAL	**-531**	**-875**	**-926**	**-945**
Investment Gains/Losses	-1	-6	-21	-42
Total	**-531**	**-881**	**-947**	**-987**

34. Managing ACC levy reductions from within operating allowances would eliminate the impact on OBEGAL, although this would be difficult in any years that allowances are reduced, in the absence of offsetting saving options. Given the potential size and impact of ACC levy reductions, we recommend decisions are taken next year alongside more detailed consideration of the path of future operating allowances and consideration of any tax package for Budget 2017, to allow the full macroeconomic and fiscal implications to be considered.

35. [11]

Net core Crown debt

36. Forecasts and projections show that fiscal settings are broadly on track towards reducing net debt over the forecast period. Although notably there is no change in the core Crown residual cash deficit forecast between 2013/14 and 2015/16 and it increases this year (table 4 refers).

37. If you decide to re-phase allowances to $1 billion, $1 billon and $2.5 billion in Budgets 2015, 2016 and 2017 respectively, net core Crown debt would fall to 19.6% in 2020/21, marginally below the 20.3% in the preliminary projections.

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1 Decisions have already been made on levy rates for the 2015/16 levy year (which affect the 2014/15 and 2015/16 fiscal years).

38. [8]

Scenarios

39. Table 4 shows OBEGAL, net debt and residual cash under the following operating allowance scenarios:

    a. $1 billion for Budgets 2015 – 2017

    b. $1 billion for Budgets 2015 and 2016 with $2.5 billion in 2017

    These assume operating allowances return to $1.5 billion (growing at 2%) from Budget 2018. In the first scenario, New Zealand Super Fund (NZSF) contributions restart in the same year as PREFU (2020/21), one year earlier than preliminary forecasts and the second scenario.

Table 4: OBEGAL, net core Crown debt and residual cash[2]

Fiscal Years	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Total Crown OBEGAL ($ billion)									
$1.5b operating allowances 2015 -2017 (Prelim HYEFU)	-2.9	-1.0	-0.1	1.2	2.6	3.5	5.4	6.9	8.2
$1b operating allowances 2015 -2017	-2.9	-1.0	0.3	2.2	4.2	5.2	7.3	8.8	10.2
$1b operating allowances 2015 and 2016, $2.5b in 2017	-2.9	-1.0	0.3	2.2	2.7	3.6	5.6	7.0	8.4
2014 PREFU	-2.6	0.3	0.8	1.9	3.0	5.1	6.9	7.8	8.9
Net core Crown debt (% of GDP)									
$1.5b operating allowances 2015 -2017 (Prelim HYEFU)	26.2	27.3	27.4	26.7	25.6	24.3	22.7	20.3	18.4
$1b operating allowances 2015 -2017	26.2	27.3	27.2	26.1	24.5	22.6	20.4	18.3	15.8
$1b operating allowances 2015 and 2016, $2.5b in 2017	26.2	27.3	27.2	26.1	25.1	23.7	22.1	19.6	17.7
2014 PREFU	25.9	26.8	26.7	25.8	25.0	23.3	20.8	19.0	16.9
Core Crown Residual Cash $ billion									
$1.5b operating allowances 2015 -2017 (Prelim HYEFU)	-4.1	-4.4	-4.1	-1.3	0.0	1.2	1.9	4.4	3.3
$1b operating allowances 2015 -2017	-4.1	-4.4	-3.6	-0.3	1.7	2.9	3.7	3.9	5.4
$1b operating allowances 2015 and 2016, $2.5b in 2017	-4.1	-4.4	-3.6	-0.3	0.1	1.3	2.0	4.5	3.5
2014 PREFU	-4.2	-4.6	-2.9	-0.4	-0.3	1.9	4.5	3.0	4.1

Annex 1 – Projections

40. The purpose of this annex is to outline preliminary fiscal projections, along with the key assumptions underlying them.

41. The 2014 *Budget Policy Statement* included projections extending to 2020. We recommend including projections again in the 2015 *Budget Policy Statement*.

Projection assumptions

42. Fiscal projections are extended using the final forecast year as a base. Key assumptions include:

    a. Non-welfare spending growth is largely determined by operating allowances;

[2] Savings in 2014/15 are less than $500 million because the modelling was based on annual budgets that exclude pre-commitments, and hence average only $1,438 million each year for Budget 2015. This is a modelling assumption that can be changed to reflect a full $500 million saving if desired.

b. Operating allowances: $1.5 billion in Budget 2015, growing at 2% per annum for subsequent budgets;

c. New capital spending: $0.9 billion in Budget 2016, then growing at a rate of 2% per annum for subsequent Budgets. New capital spending is funded from the existing balance sheet until Budget 2016 by drawing on proceeds from the Government share offers via the Future Investment Fund;

d. Tax revenue is assumed to be constant as a share of GDP beyond 2022/23 because of delays between interest rate and consumption recovery and their impacts being fully reflected in RWT and GST; and

e. The economy is assumed to grow at trend growth rates with no economic cycles two years after the forecast period.

Projections overview

43. The following projections are based on preliminary forecasts and the above assumptions, and exclude the impact of any future ACC and social housing decisions. These projections may vary from those based on final forecasts. Some PREFU and BEFU comparisons are provided.

44. Figure A1.1 shows net core Crown debt declining to 20.3% of GDP in 2020/21. NZSF contributions are projected to resume in 2021/22 (one year later than projected in the PREFU).

45. Total Crown OBEGAL projections are provided in Figure A1.2. The projection period shows surpluses rising steadily over time, rising from around 2% of GDP to around 4% of GDP through the 2020s. Likewise, Figure A1.3 shows core Crown residual cash growing to over 3% of GDP by the late 2020s.

46. In line with the above, Figure A1.4 displays a widening gap between revenue and expenses. Tax revenue is assumed to remain constant as a share of GDP. Core Crown expenses decline to around 27% of GDP at the end of the projection period. This reflects the assumption that spending will grow in line with the $1.5 billion operating allowances.

47. Figure A1.5 shows net worth is projected to increase, reflecting growing operating surpluses. Net worth attributable to the Crown is projected to recover to the pre-crisis peak in 2028/29, where it reaches 57% of GDP.

Figure A1.1.

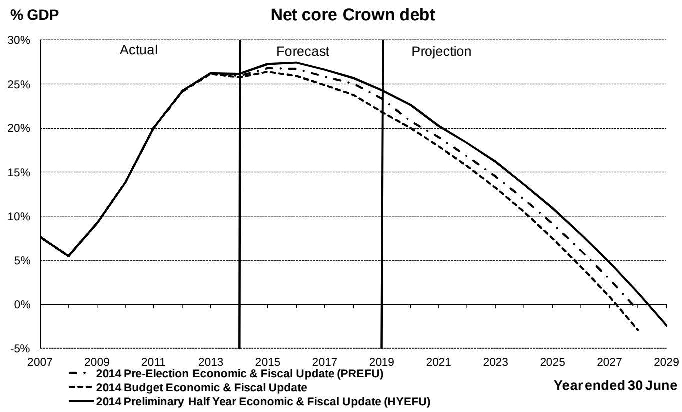


Figure A1.2.

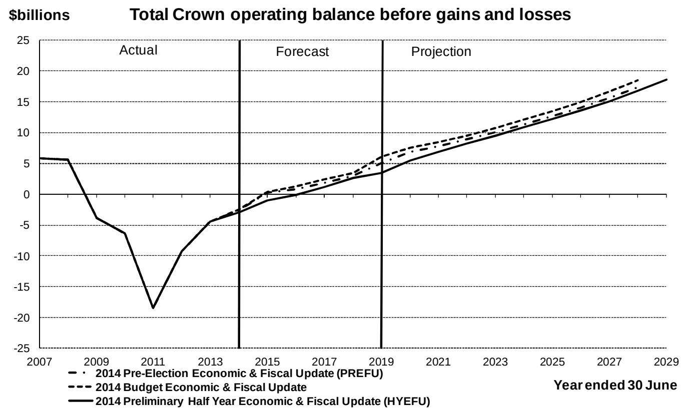


Figure A1.3.

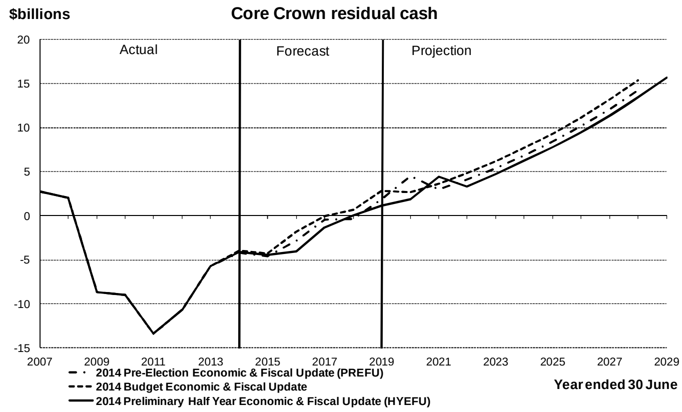


Figure A1.4.

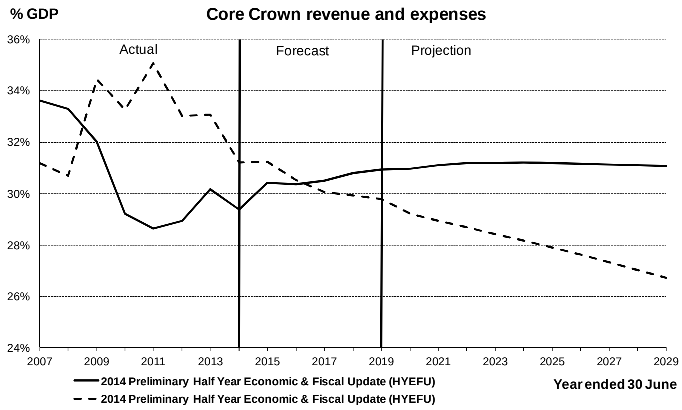
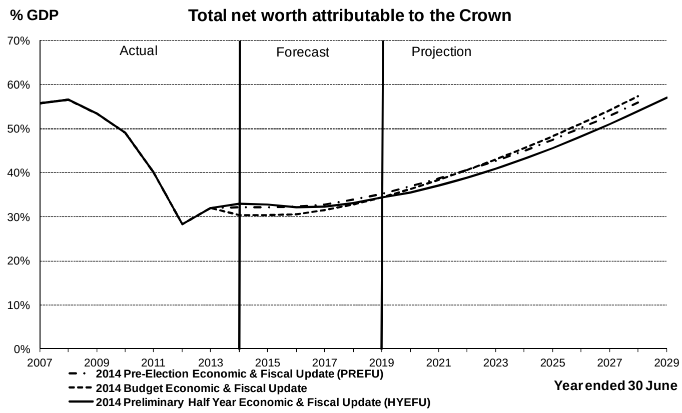


Figure A1.5.



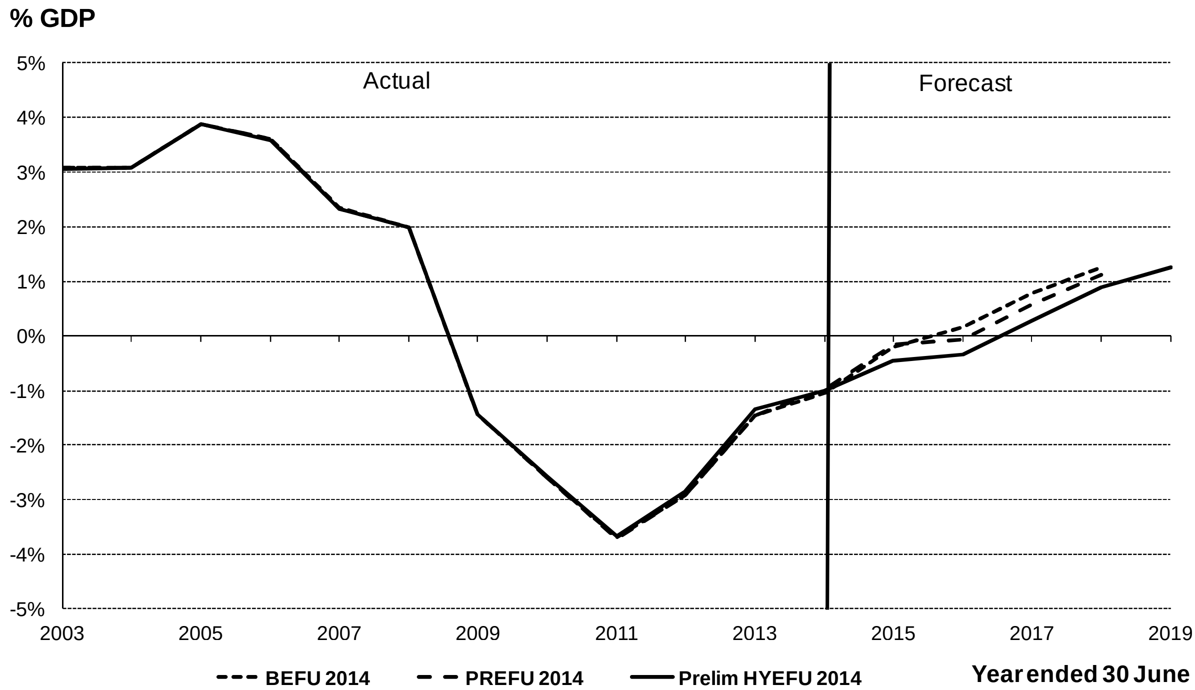
Annex 2 – Preliminary HYEFU additional fiscal indicators

Cyclically-Adjusted Balance

48. The structural fiscal position, assessed using the cyclically-adjusted balance (CAB), is estimated to be lower across the forecast period than at PREFU. Deficits of 0.5% and 0.3% of GDP are now forecast for the CAB in 2014/15 and 2015/16 respectively, 0.3% of GDP lower in both years than previously.

49. The change in the CAB from PREFU is smaller than in the OBEGAL. As the downward fiscal revisions have been accompanied by smaller positive output gap estimates for the first two years of the forecasts, some of the lower fiscal balance is attributed to a cyclically lower economic position rather than a structural fiscal deterioration. The forecast return to surplus for the CAB occurs in 2016/17 – the same as at PREFU. While there is only modest change since PREFU, this is a further reduction in the CAB from BEFU.

Figure A2.1 – Cyclically-Adjusted Balance

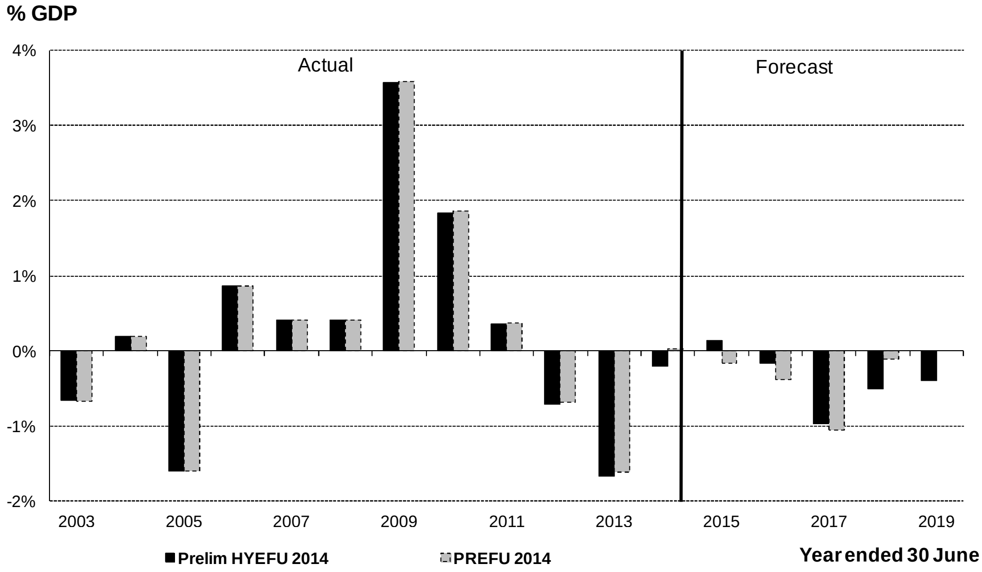


Fiscal Impulse

50. Preliminary HYEFU estimates show some change to the profile of the fiscal impulse from PREFU. The HYEFU estimates show the fiscal impulse is broadly neutral in 2014/15 and 2015/16 and then expected to have a contractionary impact on demand in 2016/17 to 2018/19. The average fiscal impulse across the forecast horizon remains the same as PREFU. Fiscal policy is expected to withdraw 0.4% of GDP from aggregate demand on average in each year to 2017/18.

51. As discussed elsewhere, these forecasts assume operating allowances of $1.5 billion in Budgets 2015-17. If allowances of $1.0 billion in Budgets 2015 and 2016 and $2.5 billion in Budget 2017 were chosen, it would likely result in a slightly smoother profile, all else equal. Fiscal policy would be marginally more contractionary over the first two years of the forecasts and broadly neutral in 2016/17.

Figure A2.2 – Fiscal Impulse[3]



[3] The fiscal impulse measure shown is for the core Crown plus Crown Entities, excluding EQC and Southern Response payments and receipts.