The Treasury

Budget 2015 Information Release

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Update on BEFU 2015 Forecasts and Fiscal Strategy

Date:	27 March 2015	**Report No:**	T2015/281
		File Number:	MC-1-5-2

Action Sought

	Action Sought	Deadline
Prime Minister (Rt Hon John Key)	**Discuss** at Budget Ministers	12:00pm Tuesday 31 March 2015
Minister of Finance (Hon Bill English)	**Discuss** at Budget Ministers	12:00pm Tuesday 31 March 2015
Associate Minister of Finance (Hon Steven Joyce)	**Discuss** at Budget Ministers	12:00pm Tuesday 31 March 2015
Associate Minister of Finance (Hon Paula Bennett)	**Discuss** at Budget Ministers	12:00pm Tuesday 31 March 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[8]				✓
Renee Phillip	Acting Manager, Macroeconomic and Fiscal Policy	04 917 6046 (wk)	[8]	

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

Return the signed report to Treasury.

Enclosure: **No**

Treasury Report: Update on BEFU 2015 Forecasts and Fiscal Strategy

Executive Summary

This report provides an overview of the 2015 preliminary *Budget Economic and Fiscal Update* (BEFU) 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 BEFU.

The economic expansion continues to strengthen...

Annual growth in real GDP increased to 3.3 percent in the year to December 2014. The outlook for real GDP growth remains solid: sustained growth in employment and real wages is expected; net migration is expected to peak higher, reflecting the strength of the New Zealand economy relative to many other countries; investment is expected to continue to support buoyant domestic demand as construction activity in Christchurch and Auckland continues; and weaker inflationary pressure means interest rates are now expected to stay low for longer.

...although weak consumer price inflation reduces nominal GDP outlook

While the outlook for activity remains positive, nominal GDP is forecast to be cumulatively lower over the forecast period by around $4.5 billion compared to the *Half Year Update* (HYEFU). However, the change is unevenly distributed across the forecast period. Nominal GDP in 2015 is expected to be higher than was forecast in the HYEFU largely due to higher-than-expected services export earnings, while over 2016 – 2018 it is forecast to be significantly lower, mostly due to a lower inflation outlook.

Low inflation is putting pressure on the operating balance...

Low consumer price inflation is supporting higher real incomes for households. However, it has a net negative impact on the Crown's operating balance by reducing tax revenue. While weaker inflation has had some offsetting benefits for the fiscal position, such as lower finance costs, these effects are small. Most Government spending is not materially reduced by weaker inflation because of fixed nominal baselines and fixed operating allowances. However, purchasing power may be higher.

The Government's short-term goal has been to return to surplus in 2014/15. Whether this will be achieved will not be known until October 2015. While forecast tax revenues have been revised higher in 2014/15 (compared to HYEFU) following nominal GDP developments, expenses are also expected to be higher reflecting student loan impairments and other changes. Consequently, the forecast 2014/15 OBEGAL deficit is slightly larger than forecast at HYEFU. The OBEGAL is still forecast to return to surplus in 2015/16, but this forecast surplus has narrowed to $15 million, and the return to residual cash surplus is now forecast to occur one year later in 2018/19.

...but the OBEGAL is expected to be in broad balance in the short term

Fiscal consolidation, supported by a growing economy, has eliminated a large operating deficit over the last six years. However, the pace of future improvement in the fiscal position has slowed relative to the HYEFU forecasts. Compared to typical forecast variation, the forecast deficit in 2014/15 and forecast surplus in 2015/16 are small, and at less than half a percent of GDP, the fiscal position should be considered to be in broad balance. Rather than focus on the size of the surplus forecast for 2015/16, we think this is an appropriate time to shift the focus of decision making more towards your medium-term objectives. We will report back with an assessment of the appropriate fiscal indicators to support a medium term approach.

The fiscal outlook is on track to achieve medium-term objectives...

The preliminary fiscal forecasts remain consistent with making progress towards the Government's fiscal objectives of returning the operating balance to surplus and reducing net debt to 20 percent of GDP by 2020. Net debt is projected to fall to 19.8 percent of GDP in 2020/21, and a structural surplus is expected for 2016/17 (same timing as forecast in HYEFU). Core Crown expenses are expected to continue falling to below 30 percent of GDP.

A strengthening of the fiscal position over the medium term continues to help reduce pressure on interest rates and the exchange rate. In the near term, the contribution of the Government's fiscal stance to aggregate demand in the economy is expected to be broadly neutral, as tax revenues have weakened and capital spending is somewhat elevated, particularly related to Canterbury. Given the weaker inflation outlook, macroeconomic conditions are now less of a constraint on fiscal policy than envisioned a year ago, when one of the tests for changes to the operating allowance was avoiding material upward pressure on interest rates. In our judgment, maintaining a fiscal stance that avoids adding pressure on interest rates continues to have benefits. This is particularly so in a global environment where many other central banks are easing monetary conditions, keeping upward pressure on the New Zealand dollar.

...but risks remain...

Risks to the central forecasts remain broadly consistent with HYEFU, and overall, are skewed to the downside. However, we continue to expect that in most circumstances monetary policy would have scope to adjust in response to changing conditions. There would also be scope to allow the automatic fiscal stabilisers to operate in response to short-term fluctuations in the economy. The most salient risks we see at this juncture are upside risks to net migration, downside risks to global economic developments, and the risk that dairy prices and CPI inflation (and hence nominal GDP growth) do not rebound as expected.

If downside risks eventuate and imply (all else equal) a more sustained period of forecast structural deficits, there may be a need to adjust operating allowances in future years. This is particularly relevant to Budget 2017 and beyond where there is more scope to adjust allowances, given cost pressures in Budgets 2015 and 2016. With the current uncertainty around the outlook, continuing to emphasise conditionality around the Budget 2017 allowance would help to manage macroeconomic and fiscal risks.

...and some policy decisions have not yet been made

In addition to the economic risks to the forecasts, there are a number of policy decisions that could negatively affect OBEGAL if they are not met from operating allowances. These include any additional ACC levy reductions and social housing reform. With the exception of Tamaki, it is currently uncertain as to whether the latter will feature in final BEFU forecasts, as this will depend on potential decisions over the next month and the degree of certainty around the fiscal impact.

The Budget Policy Statement stated that Budget 2015 would indicate the Government's intentions around ACC levy reductions. If you are intending to reduce ACC levies, this should be reflected in fiscal forecasts. There are two main options for levy reductions beginning on 1 April 2016:

1. Implement the ACC funding policy, agreed by Ministers in 2014, for the 2016/17 levy year. The funding policy would adjust levies more gradually to reach the agreed solvency target. This option is estimated to cause levies to fall by around $330 million

in the 2016/17 levy year (about $50 million impact in the 2015/16 fiscal year) under current economic assumptions. However, this number is very sensitive to changes in the applicable discount rate, and is likely to change before final levy rates are set later this year.

2. Implement larger levy reductions on 1 April 2016, and delay the application of the new funding policy to a subsequent year. This could be more in line with your pre-election signals of $700 – 900 million reductions, and could enhance ACC performance incentives. Ministers previously expressed interest in a period of larger levy reductions to reduce ACC over-funding more quickly before the funding policy was implemented.

A steer on these options would be needed by early April to allow any intended levy reductions to be included in final BEFU forecasts. Final decisions on 2016/17 levies would not be made until later in 2015, following consultation and recommendations by ACC.

ACC levy reductions can impact on macroeconomic outcomes, including interest rates, as they have similar economic effects to a tax cut. They also lead to both cash and non-cash impacts on OBEGAL. Counting the cash impact against operating allowances would help manage the impact on interest rates, and would also reduce net debt forecasts (as operating allowances are assumed to feed through to net debt in the forecasts, whereas ACC levy reductions do not affect net debt). Counting both the cash and non-cash impacts of levy reductions would avoid any impact on OBEGAL. However, it would be difficult to accommodate any ACC levy reductions within the $1 billion allowance for Budgets 2015 or 2016 given other pressures. The impacts could be managed by counting against the Budget 2017 allowance, but this would only offset OBEGAL impacts in 2017/18 and beyond (which is when the 2017 allowance is included in fiscal forecasts). Depending on the magnitude of levy reductions, counting these against the Budget 2017 allowance may also reduce the room for a meaningful tax package in Budget 2017. To reduce levies without impacting on OBEGAL in 2015/16, you may wish to explore options around reducing levies from 1 April 2017 rather than 1 April 2016.

We advise that parameters for operating allowances be maintained...

Preliminary BEFU forecasts assume operating allowances of $1 billion in Budgets 2015 and 2016, $2.5 billion in Budget 2017, and $1.5 billion in Budget 2018, growing at 2 percent per Budget thereafter. Given progress towards the fiscal strategy remains broadly on track (improving operating balance and reducing debt), we recommend keeping operating allowances consistent with those assumed in these preliminary forecasts (other than any re-phasing necessary to accommodate ACC levy reductions).

...while taking a hard look at parameters around capital expenditure

Capital decisions in Budgets 2015 and 2016 are expected to be funded from the remaining balance in the Future Investment Fund (FIF). From Budget 2017, forecasts assume new capital allowances of $900 million, growing at 2 percent per annum.

Separate advice is being prepared on appropriate capital spending parameters beyond the FIF. The key judgement will be balancing fiscal objectives with service delivery requirements. To the extent that gross capital allowances are reduced it is likely that options presented in that report will support lower interest rates than otherwise and faster progress towards net debt objectives over the medium term.

Recommended Action

We recommend that you:

a **note** that the outlook for economic activity remains solid with real GDP growth forecasts remaining around 3 percent on average over the forecast period b **note** that compared with the *Half Year Update*, nominal GDP is expected to be cumulatively lower over the forecast horizon, particularly in 2016 and 2017, reflecting a lower inflation outlook, which has negative implications for forecast tax revenues

c **note** that preliminary forecasts are consistent with your overall fiscal strategy to return to surplus and reduce debt, but show that a return to surplus will not be achieved until 2015/16, while net debt is projected to fall to 19.8 percent of GDP in 2020/21

d **note** that the risks to the economic forecasts are skewed to the downside overall, although there is some upside risk to net migration

e **note** that if downside risks eventuate there would be scope to allow the automatic fiscal stabilisers to operate in the short term, but if nominal GDP growth did not rebound as expected, an overall reduction in allowances over the Parliamentary term or beyond may be necessary to maintain progress towards your fiscal strategy over the medium term

f **note** that the 2015 *Budget Policy Statement* stated that Budget 2015 would indicate the Government's intentions around ACC levy reductions

g **note** that if the Government intends to reduce ACC levies beyond 2015/16, a steer on indicative reductions would be needed by early April to allow these to be reflected in final forecasts

h **note** that any ACC levy reductions beginning on 1 April 2016 are likely to reduce OBEGAL in 2015/16 and 2016/17, because there is unlikely to be scope to accommodate these within the Budget 2015 or Budget 2016 operating allowance, but counting levy reductions against the Budget 2017 allowance would reduce the impact of levy reductions on interest rates and reduce forecast net debt

i **note** that final decisions by the Government on 2016/17 ACC levies will be sought later in 2015, following consultation and recommendations by ACC

j **note** that upcoming policy decisions around social housing have the potential to reduce OBEGAL below that incorporated in the preliminary forecasts, but if the fiscal impacts are uncertain this will be included as a Specific Fiscal Risk in BEFU 2015

Renee Phillip
Acting Manager, Macroeconomic and Fiscal Policy

Rt Hon John Key **Prime Minister**	Hon Bill English **Minister of Finance**
Hon Paula Bennett **Associate Minister of Finance**	Hon Steven Joyce **Associate Minister of Finance**

Purpose of Report

1. This report summarises the Treasury's 2015 *Budget Economic and Fiscal Update* (BEFU) preliminary forecasts and projections, along with key developments since the 2014 *Half Year Economic and Fiscal Update* (HYEFU) 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 BEFU, which is due to be published alongside the 2015 *Fiscal Strategy Report* on 21 May 2015.

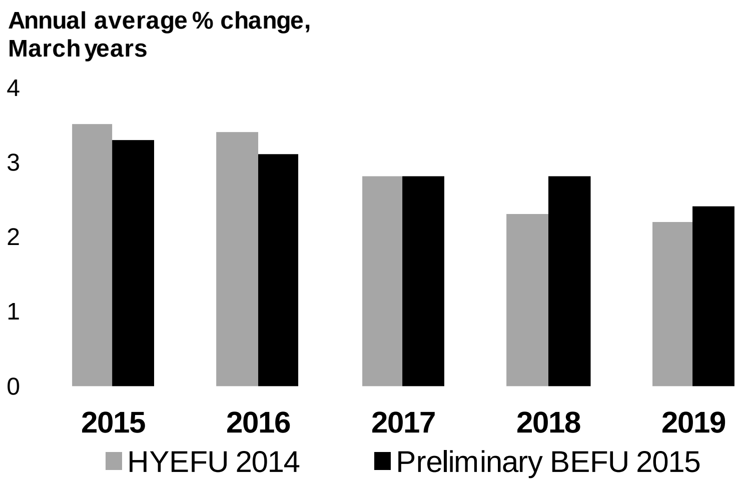
2. Preliminary economic forecasts were finalised on 27 February 2015, and preliminary fiscal forecasts on 23 March 2015. Final forecasts (inclusive of subsequent decisions) are expected on 15 April 2015 (economic) and 1 May 2015 (fiscal).

Analysis

Economic forecasts

3. Aide Memoire T2015/343 outlined preliminary Budget 2015 economic forecasts. It showed the outlook for economic activity remains positive with solid real GDP growth over the forecast period. Compared to HYEFU, real GDP growth is expected to be marginally slower in 2015 and 2016, unchanged in 2017, and faster in 2018 and 2019 (see Figure 1). Record high net migration continues to support strong employment growth, and labour force participation, also at record highs, continues to contribute to productive capacity. The terms of trade are expected to be slightly higher over the forecast horizon, largely as a result of recent oil price falls impacting on the outlook. Low inflation is expected to keep interest rates low for some time, and maintain strong real wage growth. Christchurch and Auckland construction activity continues to support buoyant domestic demand. However, there is a high degree of uncertainty in the global economic outlook, and overall, risks are skewed to the downside.

Figure 1 - Real GDP growth



4. Net migration inflows have exceeded HYEFU forecasts and annual inflows are expected to peak this quarter at around 55,000, up from around 52,500 expected in the HYEFU. New Zealand's solid economic performance relative to other countries is a factor supporting high net migration inflows, and a relatively solid domestic outlook means migration risks are skewed to the upside. However, as we have seen in recent years, the composition of flows is important for the net impact on domestic demand.

5. CPI inflation is low and the Official Cash Rate (OCR) is currently on hold at 3.5 percent. The output gap is estimated to be near zero and is expected to become positive over the forecast period as spare capacity is absorbed. Inflation is expected to return to the middle of the Reserve Bank's target band by the end of the forecast period, albeit at a slower pace than forecast at HYEFU.

6. Low inflation means there is less pressure on interest rates than a year ago. However, following a trend of low global inflation, central banks around the world have generally been adopting a more accommodative policy stance, meaning New Zealand interest rates remain relatively high. This, together with a relatively strong New Zealand growth outlook, is keeping upward pressure on the exchange rate. Developments in the US are playing a critical role in determining the path of the New Zealand dollar currently. In contrast to many other central banks, who have been easing policy, the US Federal Reserve is contemplating the first Federal Funds Rate hike since the Global Financial Crisis. Given the mix of domestic and global factors, the New Zealand exchange rate is assumed to remain around HYEFU levels over the forecast period.

7. The global environment is characterised by high uncertainty, particularly in the euro zone due to Greek-EU negotiations, and Russian sanctions. Closer to home, China's large domestic credit outstanding, and the potential for a slow transition in the drivers of growth from mining to non-mining sectors in Australia, are risks of more direct importance to New Zealand. While a high degree of global uncertainty has had limited impact on our central forecasts, it does make them vulnerable to downside global developments compared to HYEFU. Overall, the main risks to the forecasts relate to our key judgements on oil prices, dairy prices, net migration, and the output gap.

8. Nominal GDP growth in 2015 is expected to be faster than was forecast in HYEFU owing largely to higher-than-expected services export earnings. However, slower nominal GDP growth is expected in 2016 and 2017 due to lower inflation. In 2018 and 2019, nominal GDP growth is expected to exceed that of HYEFU driven by stronger real activity and higher inflation. In level terms, nominal GDP is expected to be higher in 2015 and 2019, but lower in between and lower on average (see Table 1). Key economic comparisons to HYEFU (including nominal GDP growth) are shown in Table 2.

Table 1 – Nominal GDP
(some rounding error present)

Fiscal Years ($ billions)	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
		Forecast	Forecast	Forecast	Forecast	Forecast
Nominal GDP (Expenditure Basis)						
Preliminary BEFU 2015	234.0	240.7	250.7	263.5	276.0	286.9
HYEFU 2014	234.2	239.2	253.1	266.2	277.0	286.6
Change	*-0.1*	*1.5*	*-2.4*	*-2.8*	*-1.0*	*0.3*
				2015 - 2019		
Cumulative change over forecast horizon				-4.5		

Table 2 – Summary of key economic forecasts

(Annual average percent change, unless specified otherwise.
Some rounding error present in difference calculations)

March Years	2014	2015	2016	2017	2018	2019
	Actual	Forecast	Forecast	Forecast	Forecast	Forecast
Nominal GDP (Expenditure Basis)						
Preliminary BEFU 2015	6.7	4.1	3.4	5.2	4.8	4.2
HYEFU 2014	6.7	3.0	4.9	5.7	4.1	3.6
Difference	*0.0*	*1.1*	*-1.5*	*-0.5*	*0.7*	*0.6*
CPI Inflation (ann % change, March quarter)						
Preliminary BEFU 2015	1.5	0.0	1.4	2.1	2.1	2.2
HYEFU 2014	1.5	1.3	2.0	2.1	2.0	2.0
Difference	*0.0*	*-1.3*	*-0.6*	*0.0*	*0.1*	*0.2*
Terms of Trade (SNA Basis)						
Preliminary BEFU 2015	13.8	1.1	-2.8	2.2	0.2	-0.5
HYEFU 2014	13.5	-3.9	-3.6	3.7	0.5	0.4
Difference	*0.3*	*5.0*	*0.8*	*-1.5*	*-0.3*	*-0.9*
Expenditure on GDP						
Preliminary BEFU 2015	2.4	3.1	3.2	2.9	2.8	2.5
HYEFU 2014	2.5	3.3	3.4	2.8	2.3	2.1
Difference	*-0.1*	*-0.2*	*-0.2*	*0.1*	*0.5*	*0.4*
GDP (production measure)						
Preliminary BEFU 2015	2.5	3.3	3.1	2.9	2.8	2.5
HYEFU 2014	3.2	3.5	3.4	2.8	2.3	2.2
Difference	*-0.7*	*-0.2*	*-0.3*	*0.1*	*0.5*	*0.3*
Potential GDP						
Preliminary BEFU 2015	2.1	2.4	2.6	2.8	2.7	2.6
HYEFU 2014	2.3	2.7	2.9	2.9	2.5	2.3
Difference	*-0.2*	*-0.3*	*-0.3*	*-0.1*	*0.2*	*0.3*
Output gap (March qtr,% of potential)						
Preliminary BEFU 2015	-0.5	0.3	0.5	0.5	0.7	0.3
HYEFU 2014	-0.1	0.3	0.7	0.4	0.3	0.0
Difference	*-0.4*	*0.0*	*-0.2*	*0.1*	*0.4*	*0.3*
Unemployment Rate (March quarter)						
Preliminary BEFU 2015	6.0	5.5	4.9	4.7	4.5	4.5
HYEFU 2014	6.0	5.4	5.1	4.7	4.5	4.5
Difference	*0.0*	*0.1*	*-0.2*	*0.0*	*0.0*	*0.0*

Fiscal forecasts

9. The overall fiscal outlook broadly follows that of the overall economic outlook: a sustained positive and improving fiscal position alongside a relatively high performing economy. However, while low consumer price inflation is supporting higher real incomes for households, it has a net negative impact on the Crown's operating balance by reducing tax revenue. Weaker inflation does have some offsetting benefits for the fiscal position, such as lower finance costs, but these effects are small. Government spending is not materially reduced by weaker inflation because of fixed nominal baselines and fixed operating allowances. However, purchasing power may be higher.

10. Preliminary BEFU forecasts assume operating allowances of $1 billion in Budgets 2015 and 2016, $2.5 billion in Budget 2017, and $1.5 billion in Budget 2018, growing at 2 percent per Budget thereafter. These forecasts exclude the impact of any further ACC levy reductions or any social housing decisions other than Tamaki.[1] ACC and social housing implications are discussed in detail later in this report.

11. Forecast core Crown tax revenues for 2014/15 have been revised upward, largely reflecting the impact of better than expected terms of trade and strong employment. Tax revenues in 2015/16, 2016/17 and 2017/18 have been revised downward, owing largely to lower corporate tax and RWT. Forecast revenue is higher in 2018/19 driven largely by higher GST receipts as nominal consumption and residential investment recover from a lower near-term outlook. Compared to HYEFU, the largest downward revision to core Crown tax revenues is in 2016/17 ($689 million) due to the combined impact of lower corporate tax and RWT. Table 3 shows these developments loosely follow the changes to the nominal GDP outlook. However, composition changes to GDP mean the impact on tax is less than would otherwise be the case.

Table 3 – Changes in core Crown tax revenue forecasts since HYEFU

June years, $ millions	2015	2016	2017	2018	2019
2014 HYEFU	**65626**	**69179**	**73072**	**76824**	**79980**
% of GDP	27.4	27.3	27.4	27.7	27.9
Forecasting changes by tax type:					
Corporate tax	169	-301	-456	-267	-33
RWT on interest	-7	-34	-202	-212	-167
Source deductions	131	59	-58	-136	-166
GST	-153	50	-77	219	487
Net other persons tax	196	-38	82	152	209
All other taxes	129	51	22	34	44
Total change	*465*	*-213*	*-689*	*-210*	*374*
2015 BEFU	**66091**	**68964**	**72383**	**76615**	**80354**
% of GDP	27.5	27.5	27.5	27.8	28.0
Forecasting changes by principal driver:					
Macroeconomic effects	366	-344	-547	20	500
Interest rates	-8	-55	-185	-194	-156
Everything else	107	186	43	-36	30
Total change	*465*	*-213*	*-689*	*-210*	*374*

[1] ACC levy reductions for the 2015/16 levy year of $480 million were already included in HYEFU fiscal forecasts, affecting the 2014/15 and 2015/16 years. On social housing, preliminary fiscal forecasts include a loan facility of $200 million to the Tamaki Redevelopment Company. However, forecasts exclude the asset transfer component as details about this part of the transaction are uncertain.

12. Core Crown expenses are expected to be around $240 million higher in 2014/15 compared with HYEFU, owing largely to higher student loan impairments and other changes. Over the period 2015/16 – 2017/18, core Crown expenses are forecast to be around $130 million lower on average per year, but $183 million higher in 2018/19. Core Crown expenses are forecast to continue to decline as a share of GDP, reaching 29.1 percent by 2018/19.

13. While the Crown accounts for the seven months to January 2015 show an overall improving fiscal position evidenced by an OBEGAL surplus of $77 million, preliminary forecasts show this turning around with a deficit of $665 million for the full 2014/15 year. A small surplus of $15 million is forecast for 2015/16, and a surplus of $1.7 billion for 2016/17. Surpluses are expected to increase over the rest of the forecast period. The combination of revenue and expense changes means the path of OBEGAL is slightly lower compared to HYEFU. Risks to the economic outlook are a key source of risks to the fiscal forecasts.

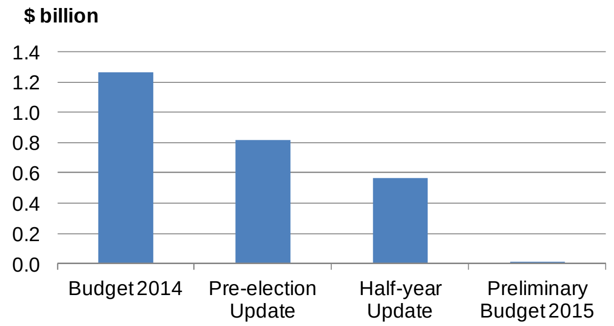
14. The forecast surplus in 2015/16 is sitting just above zero. This is so close to zero that even normally inconsequential changes to economic, tax or fiscal forecasts risk it being in deficit in the final BEFU forecasts.

15. Forecasts for the surplus in 2015/16 have been lowered significantly since BEFU 2014, when a surplus of $1.3 billion was forecast. Box 1 discusses the drivers of this change.

Box 1 – Forecast OBEGAL in 2015/16

The forecast OBEGAL surplus for 2015/16 has reduced markedly from $1.3 billion forecast in last year's Budget to $15 million in latest forecast. Negative forecast revisions have occurred in each of the forecast rounds since Budget 2014 (Figure 2).

Figure 2 – Forecast OBEGAL in 2015/16

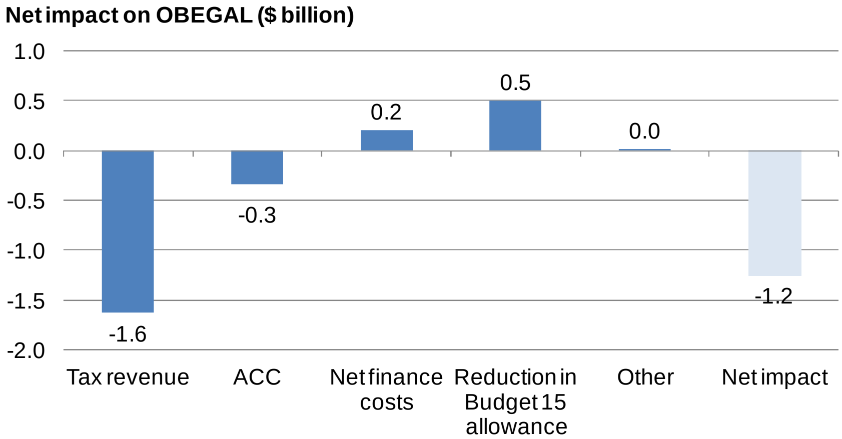


The main factor behind these revisions is lower expected tax revenue (see Figure 3) due to a downward revision in the forecast of nominal GDP of around $5 billion in 2015/16 and a lower interest rate track. Between *Budget* 2014 and the *Half Year Update* the downgrade to nominal GDP was primarily driven by lower export prices, while between the *Half Year Update* and preliminary *Budget* 2015 this was primarily driven by lower consumer price inflation.

Adverse revisions to ACC's forecasts have also reduced the forecast surplus by $0.3 billion.

Some partial offset comes from lower net finance costs ($0.2 billion) due to lower interest rates, CPI inflation, and the re-phasing of the Budget 2015 operating allowance ($0.5 billion).

Figure 3 – Drivers of forecast revisions to 2015/16 OBEGAL between Budget 2014 and preliminary Budget 2015 forecasts



The latest forecast is roughly at the midpoint between Budget 2014's main forecast and the downside scenario, which modelled a sharp terms of trade shock. In that downside scenario, an OBEGAL deficit of 0.6 percent of GDP in 2015/16 was projected.

Large risks remain as the figure will be revised again in subsequent forecast rounds. Standard forecast errors for one-year-ahead forecasts of tax revenue are around 3 percent of tax revenues (±$2 billion).

16. Net core Crown debt is forecast to peak at 26.4 percent of GDP in 2015/16 (slightly down from 26.5 percent in HYEFU), before dropping to 19.8 percent in 2020/21. In nominal terms, net debt peaks at $67.9 billion in 2017/18, declining to $66.0 billion by the end of the forecast period. New Zealand Superannuation Fund contributions are expected to restart in 2020/21, the same year as in HYEFU.

17. Residual cash is forecast to be in deficit by $3.2 billion in 2014/15 and $4.3 billion in 2015/16. The higher cash deficit in 2015/16 reflects favourable impacts of proceeds from the Government Share Offer in 2014/15 and higher Canterbury related spending of around $600 million in 2015/16. A return to residual cash surplus of $1.9 billion is forecast for 2018/19 (a year later than expected at HYEFU).

18. Table 4 provides key fiscal indicator comparisons to HYEFU.

Table 4 – Key fiscal indicators
(Some rounding error present in difference calculations)

Fiscal years	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast	2019 Forecast	2020 Projection	2021 Projection	2022 Projection
Core Crown Revenue ($ billion)								
Preliminary BEFU 2015	71.9	74.8	78.5	83.2	87.2	90.9	95.1	99.5
HYEFU 2014	71.5	75.3	79.4	83.5	87.0	90.6	94.9	99.5
Difference	*0.4*	*-0.5*	*-0.9*	*-0.4*	*0.2*	*0.3*	*0.2*	*0.0*
Core Crown Expenses ($ billion)								
Preliminary BEFU 2015	73.3	74.9	76.8	80.5	83.3	85.2	88.5	91.9
HYEFU 2014	73.0	75.1	76.9	80.7	83.2	85.0	87.9	90.9
Difference	*0.2*	*-0.2*	*-0.1*	*-0.1*	*0.2*	*0.2*	*0.6*	*1.0*
Total Crown OBEGAL ($ billion)								
Preliminary BEFU 2015	-0.7	0.0	1.7	2.4	4.0	5.5	6.3	7.3
HYEFU 2014	-0.6	0.6	2.6	3.1	4.1	5.9	7.4	8.9
Difference	*-0.1*	*-0.5*	*-0.9*	*-0.6*	*-0.1*	*-0.4*	*-1.0*	*-1.6*
Core Crown residual cash ($ billion)								
Preliminary BEFU 2015	-3.2	-4.3	-1.6	-0.1	1.9	3.3	1.3	2.2
HYEFU 2014	-4.0	-3.5	-0.1	0.6	1.8	2.4	2.5	4.1
Difference	*0.8*	*-0.8*	*-1.5*	*-0.7*	*0.0*	*0.9*	*-1.3*	*-1.9*
Net core Crown debt ($ billion)								
Preliminary BEFU 2015	62.2	66.2	67.8	67.9	66.0	62.9	61.8	59.7
HYEFU 2014	63.5	67.0	67.0	66.4	64.5	62.1	59.6	55.5
Difference	*-1.3*	*-0.7*	*0.7*	*1.5*	*1.5*	*0.7*	*2.2*	*4.2*
Net core Crown debt (% of GDP)								
Preliminary BEFU 2015	25.8	26.4	25.7	24.6	23.0	21.0	19.8	18.3
HYEFU 2014	26.5	26.5	25.2	24.0	22.5	20.8	19.1	17.0
Percentage point change	*-0.7*	*0.0*	*0.5*	*0.6*	*0.5*	*0.2*	*0.7*	*1.3*
Total Net Worth attributable to Crown (% GDP)								
Preliminary BEFU 2015	30.3	30.2	30.5	31.0	32.2	33.6	35.2	37.0
HYEFU 2014	32.3	32.0	32.5	33.5	35.0	35.9	37.6	39.5
Percentage point change	-2.1	-1.7	-2.0	-2.5	-2.7	-2.3	-2.4	-2.5

Macroeconomic implications

19. The 2014 *Fiscal Strategy Report* outlined the Government's short term goal to carefully manage spending and revenue so that changes in fiscal policy settings – and in particular changes to operating allowances – do not have a material adverse impact on interest rates.

20. A strengthening of the fiscal position over the medium term will help reduce pressure on interest rates and the exchange rate. In the near term, the contribution of the Government's fiscal stance to aggregate demand in the economy is expected to be broadly neutral, as tax revenues have weakened and capital spending is somewhat elevated, particularly related to Canterbury. Annex 1 provides further information on the estimated fiscal impulse.

21. As noted above, interest rate pressures have moderated as the Reserve Bank has moved to an on-hold stance. In our judgment, maintaining a fiscal stance that avoids adding pressure to interest rates continues to have benefits. This is particularly so in a global environment where many other central banks are easing monetary conditions, keeping upward pressure on the New Zealand dollar.

Fiscal implications

22. In terms of responsibly managing the Government's finances, the 2015 *Budget Policy Statement* outlined the following priorities:

    1. Return to OBEGAL surplus in 2014/15 and maintain surpluses over subsequent years

    2. Reduce net debt to 20 percent of GDP by 2020, including repaying net debt in dollar terms in 2017/18

    3. Further reduce ACC levies on households and businesses

    4. Begin to reduce income taxes from 2017 with a focus on low and middle-income earners, and

    5. Using any further fiscal headroom – including from positive revenue surprises – to get debt down to 20 percent of GDP sooner than 2020.

23. In addition to the above, the Government's longer term intention is to maintain net debt within a range of around 10 – 20 percent of GDP once the 20 percent net debt objective is achieved.

24. Preliminary forecasts and projections show the Government is broadly on track to achieving its fiscal strategy. However, the pace of future improvement in the fiscal position has slowed relative to HYEFU. This section discusses progress towards your OBEGAL and net debt objectives.

OBEGAL

25. The Government's current headline fiscal balance measure, OBEGAL, remains on an improving path. The OBEGAL deficit is forecast to continue declining with a forecast return to surplus in 2015/16. The fiscal position over the next two years can be considered to be in broad balance, with the size of the forecast deficit and surplus less than half a percent of GDP. The structural balance is forecast to return to surplus at the same time as previously estimated (2016/17), although slightly lower compared to HYEFU.

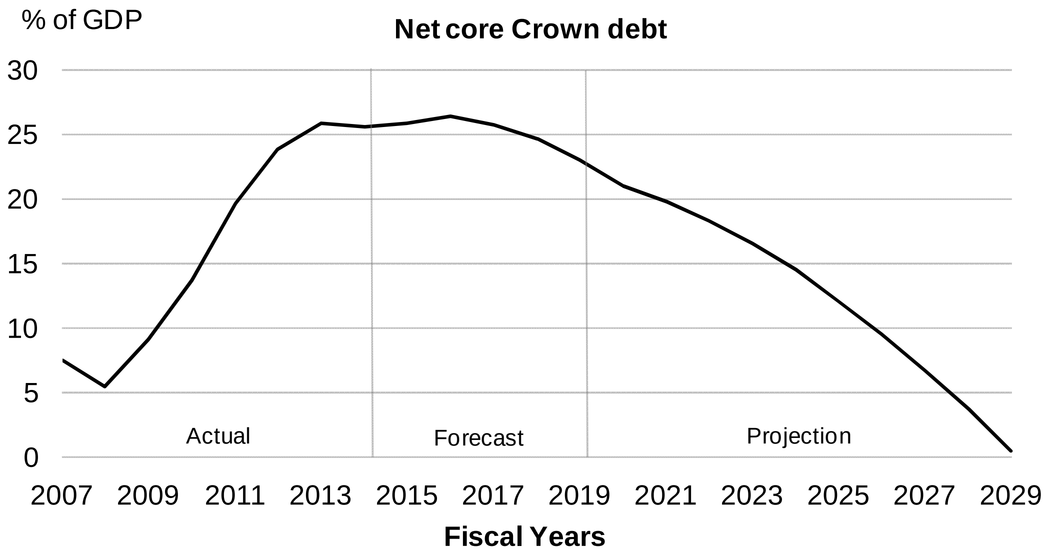
26. The forecast 2015/16 OBEGAL balance is small and could land either side of zero following unanticipated economic, expense or revenue developments. Given this uncertainty, and that the fiscal forecasts show progress towards achieving the Government's fiscal strategy, rather than focus on the size of surplus forecast for 2015/16, we think this is an appropriate time to shift the focus of decision making more towards your medium-term objectives. While the OBEGAL surplus target for 2014/15 has proved a useful tool in reducing the large operating deficit, there is a risk that short-term fiscal targets that are treated as strict or "hard" could lead to inappropriately sharp fiscal policy adjustments. We will report back with an assessment of the appropriate fiscal indicators to support a medium-term approach.

27. Given progress towards the fiscal strategy remains broadly on track, we recommend keeping operating allowances consistent with those assumed in these preliminary forecasts. If downside risks eventuate, there would be scope to allow the automatic fiscal stabilisers to operate in response to short-term fluctuations in the economy. In the event of a more long-lasting downturn that led to a more sustained period of forecast structural deficits, there may be a need to adjust operating allowances in future years. This is particularly relevant to Budget 2017 and beyond where there is more scope to adjust allowances, given cost pressures in Budgets 2015 and 2016. With the current uncertainty around the outlook, continuing to emphasise conditionality around the Budget 2017 allowance would help to manage macroeconomic and fiscal risks.

Net core Crown debt

28. Forecasts and projections show that fiscal settings are on track towards meeting your debt objectives. Net debt is expected to reach 19.8 percent of GDP in 2020/21, in line with the 20 percent by 2020 objective, and given projection assumptions, net debt continues to decline beyond 2020 (see Figure 4). A separate report will outline the preliminary projections, including key assumptions.

Figure 4 – Net core Crown debt



29. Capital decisions in Budgets 2015 and 2016 are expected to be funded from the remaining balance in the Future Investment Fund (FIF). From Budget 2017, forecasts assume new capital allowances of $900 million, growing at 2 percent per annum. Forecasts include capital expenditure of $23.4 billion (excluding final proceeds from the Government Share Offer) over the forecast horizon (2014/15 – 2018/19), compared with $22.9 billion in the HYEFU.

30. Separate advice is being prepared on appropriate capital spending parameters beyond the FIF. The key judgement will be balancing fiscal objectives with service delivery requirements. To the extent that gross capital allowances are reduced, it is likely that options presented in that report will support faster progress towards net debt objectives over the medium term.

Macroeconomic and fiscal implications of upcoming decisions

ACC

31. The 2015 *Budget Policy Statement* stated that Budget 2015 would indicate the Government's intentions around ACC levy reductions. If you are intending to reduce ACC levies, this should be reflected in fiscal forecasts.

32. Last year, Ministers agreed a funding policy for ACC, which will clarify the basis for ACC's levy recommendations to Government (but would not require Government to accept the recommended levy rates). The policy would result in lower levy rates being recommended, because the new solvency target is lower than current solvency levels in the Earners' and Work Accounts. Ministers have considered a range of options for when the policy would be implemented. The Minister for ACC plans to consult with joint Ministers on whether to issue the Government funding policy to allow it to be implemented for 2016/17.

33. There are two main options for levy reductions beginning on 1 April 2016: to implement the new ACC funding policy from 2016/17, or to implement larger levy reductions on 1 April 2016 before moving to the new funding policy, which could be more in line with your pre-election signals of $700 – 900 million reductions. Indicative estimates for each option are shown in Table 5. The main argument in favour of considering larger reductions would be to reduce ACC over-funding more quickly. Larger levy reductions could also enhance ACC performance incentives. A steer on these options would be needed by early April to allow any intended levy reductions to be included in forecasts.

34. We have previously recommended that decisions should be taken in the context of your fiscal strategy, because ACC levy reductions can have material effects on fiscal and macroeconomic:

- ACC levy reductions affect OBEGAL in three ways: reduced levy revenues, an increase in the unexpired risk liability (URL) (which is a non-cash expense), and reduced investment income (which has a relatively minor impact)

- ACC levy reductions transmit through the economy in a similar way to a tax reduction, increasing the disposable income of households or reducing operating costs for firms. Reductions in levies from April 2016 would coincide with a period where the output gap is estimated to be more positive than that in HYEFU, and may therefore add to pressure on interest rates. Depending on the magnitude, ACC levy reductions could be large enough to materially impact on the fiscal impulse.

35. Counting the cash impact of ACC levy reductions against operating allowances would keep the overall impact of levy reductions on demand within the limits consistent with not putting additional pressure on monetary policy (movements in the URL do not impact on interest rates). It would also reduce net debt forecasts, as operating allowances are assumed to feed through to net debt in the forecasts, whereas ACC levy reductions do not affect net debt. Counting both the cash and non-cash impacts against allowances would be necessary to avoid an impact on OBEGAL.

36. However, it would be difficult to accommodate any ACC levy reductions within the $1 billion allowance for Budgets 2015 or 2016 given other pressures (in the absence of other savings options). Instead, ACC levy reductions could be counted against the Budget 2017 allowance (which is $2.5 billion for a mix of expenditure/tax reductions/debt repayment). However, if ACC levy reductions are to begin on 1 April 2016, this would require shifting part of the Budget 2017 allowance forward to the 2015/16 fiscal year. This means that either of the options chosen for ACC levy reductions on 1 April 2016 would reduce OBEGAL in 2015/16 and 2016/17. If you are concerned about the impact on OBEGAL in 2015/16, you may wish to explore options around reducing levies on 1 April 2017. Depending on the magnitude of levy reductions, counting these against the Budget 2017 allowance may reduce the room for a meaningful tax package in Budget 2017.

Table 5 – Potential impact on OBEGAL of ACC levy changes beginning 1 April 2016 (relative to preliminary BEFU submission)

Scenario: Implement new funding policy from 2016/17

Fiscal years ($ million)	2015/16	2016/17	2017/18	2018/19
Levy Revenue	-51	-377	-378	-340
URL	-95	-22	-31	17
Investment Income	0	-9	-26	-42
Impact on OBEGAL	**-146**	**-408**	**-435**	**-365**
Investment Gains/Losses	0	-2	-5	-8
Total	**-146**	**-410**	**-440**	**-373**

Scenario: Reduce levies by $700 million in 2016/17

Fiscal years ($ million)	2015/16	2016/17	2017/18	2018/19
Levy Revenue	-147	-776	-835	-733
URL	-382	-66	-70	328
Investment Income	0	-17	-50	-84
Impact on OBEGAL	**-529**	**-859**	**-955**	**-489**
Investment Gains/Losses	0	-3	-10	-16
Total	**-529**	**-862**	**-965**	**-505**

37. The estimates in Table 5 incorporate economic factors and projections up to 31 January 2015. There are a number of caveats that accompany these estimates, which mean the actual impact on OBEGAL could fluctuate significantly from these scenarios. For final BEFU estimates these would be recalculated using information as at 31 March. The forecast ACC impacts (particularly after 2014/15) are highly sensitive to subsequent movements in the applicable discount rate, which has been particularly volatile over recent months[2]. In addition, recent claims performance (which is expected to reduce ACC's funding position) will not be factored in until later this year.

38. Estimates for these options are provided to support decisions about whether any ACC levy reductions should be included in final Budget forecasts. They do not represent our advice on 2016/17 levy rates, and no decisions on those rates are being sought now. ACC levy decisions can only be made by the Government after consultation and recommendations by ACC. This work will be undertaken later in 2015.

Social Housing

39. With the exception of Tamaki, preliminary fiscal forecasts do not include the fiscal impacts of social housing transactions. Whether or not social housing transactions are included in final forecasts will depend on how certain they are. If the fiscal impacts are uncertain this will be included as a Specific Fiscal Risk in BEFU 2015. However, decisions would ultimately impact on fiscal indicators when the transactions occur.

[11]

40. Social housing reform initiatives (SHRI) that represent a transfer of ownership have no immediate macroeconomic implications, so from the perspective of avoiding additional pressure on interest rates, the fiscal impacts of social housing sales could be looked through. However, funding arrangements for housing investment made outside of the

2 Discount rate changes between December 2013 – January 2015 have caused the estimated size of the levy reduction associated with applying the funding policy from 2016/17 to reduce from $570 – $200 million.

FIF, such as the loan facility for Tamaki regeneration activities, will contribute to demand pressure, because they result in higher capital spending than otherwise.

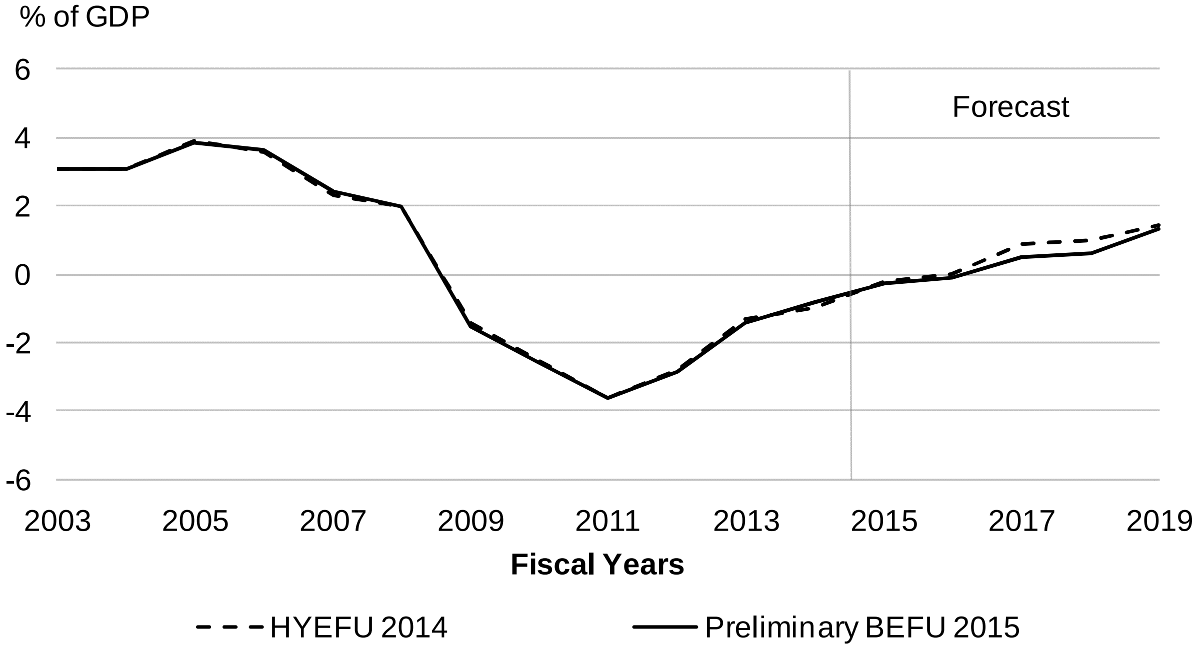
Annex 1 – Preliminary BEFU additional fiscal indicators

Cyclically-Adjusted Balance

41. The structural fiscal position, assessed using the cyclically-adjusted balance (CAB), is estimated to be lower across the forecast period than at HYEFU. Deficits of 0.3 percent and 0.1 percent of GDP are now forecast for the CAB in 2014/15 and 2015/16 respectively (compared to a deficit of 0.2 in 2014/15 and 0.0 in 2015/16 at HYEFU). The forecast return to surplus occurs in 2016/17 at 0.5 percent – the same time as HYEFU, but 0.4 percentage points lower. By 2018/19, the CAB is expected to reach a surplus of 1.3 percent, 0.1 percentage points lower than HYEFU.

42. Over the forecast horizon, the average change in the CAB from HYEFU is the same as the average change in the OBEGAL. This indicates that lower structural revenues and higher expenses are driving most of the deterioration in the CAB since HYEFU. However, fiscal revisions have been accompanied by a lower output gap over 2013/14 – 2015/16, and a higher output gap 2016/17 – 2018/19 (with the output gap turning positive in 2014/15). The lower output gap in the near-term means the change in the CAB is driven more by fiscal changes. In contrast, the slightly stronger cyclical position in latter forecasts (a more positive output gap relative to HYEFU) means the change in the CAB is larger than the change in OBEGAL due to estimated cyclical revenues being higher as a percent of total revenues.

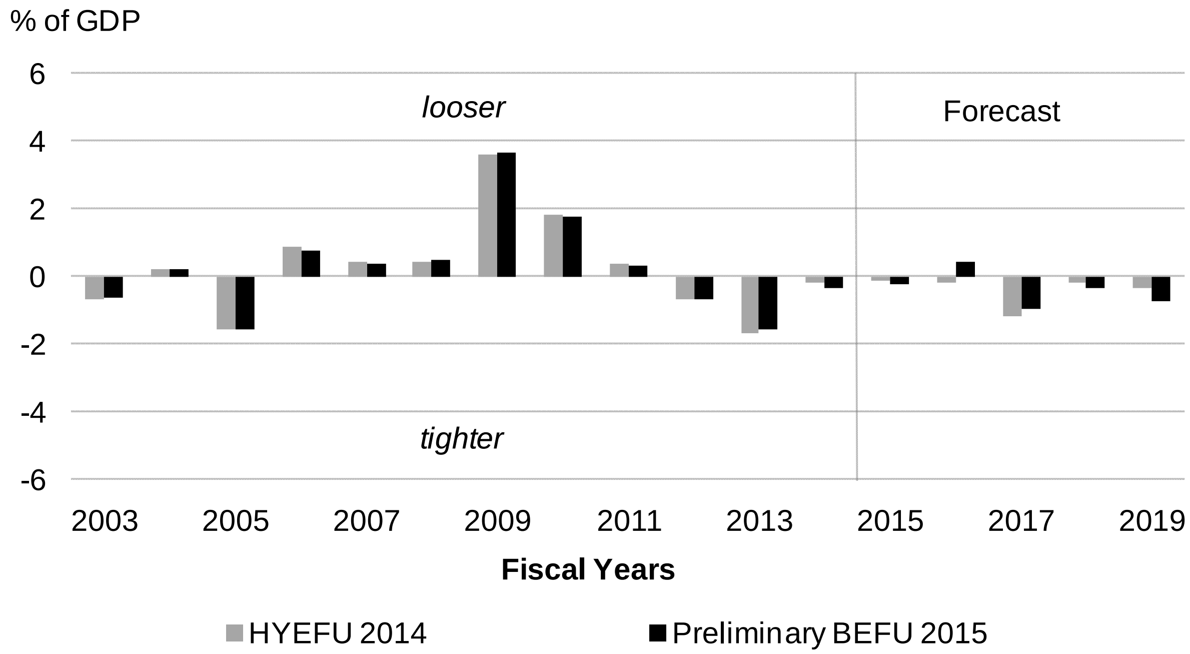
Figure A1.1 – Cyclically-Adjusted Balance



Fiscal Impulse

43. Preliminary BEFU estimates show some change to the profile of the fiscal impulse from HYEFU. In the near term, the contribution of the Government's fiscal stance to aggregate demand in the economy is expected to be broadly neutral, as tax revenues have weakened and capital spending is somewhat elevated, particularly related to Canterbury. Fiscal policy is expected to be contractionary in the latter part of the forecast horizon. The estimated fiscal impulse shows that fiscal policy is expected to withdraw 1.0 percent of GDP from aggregate demand in 2016/17 and around 0.5 percent of GDP in 2017/18 and 2018/19.

Figure A1.2 – 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.