The Treasury

Budget 2015 Information Release

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Office of the Minister of Finance

27 November 2014

Chair
CABINET

Budget 2015: PRIORITIES AND OPERATING ALLOWANCES

Proposal

1. This paper seeks agreement to the priorities and operating allowances for Budget 2015 and the current Parliamentary term, to be signaled in the *Budget Policy Statement 2015* due to be published on 16 December 2014.

Executive Summary

2. The economy is growing steadily and solid growth in activity is forecast over the next few years as the economy transitions to a more sustainable pace. This growth has flowed through to, and will continue to result in, growing employment and falling unemployment. However, price growth recently has been slower than expected and global dairy prices have fallen by more than anticipated, meaning that the dollar value of New Zealand's output is lower than previously forecast. This is expected to flow through to slower growth in tax revenue directly through lower GST, as well as indirectly because interest rates and therefore revenue from Resident Withholding Tax (RWT) are expected to be lower than previously forecast.

3. In this context, the Government's focus remains on successfully managing the growing economy and delivering our long-standing fiscal objectives. Over the past two Parliamentary terms the Government's fiscal strategy has ensured we have remained on a solid and credible path despite facing a number of severe economic and fiscal challenges. While the recent fall in global dairy prices has made the immediate goal of returning the operating balance to surplus more challenging, the Government remains on track to meet its longer-term objectives of reducing net core Crown debt and expenses.

4. The *Budget Policy Statement 2015*, to be released on 16 December 2014, will set out the priorities that will guide the preparation of the next Budget. I propose that Budget 2015 continue the four priority areas from the last Parliamentary term. These are: responsibly managing the Government's finances; building a more productive and competitive economy; delivering better public services; and rebuilding Christchurch. Continuing the focus on these four areas will help ensure the fundamentals are in place to sustain solid economic growth over the medium-term, as well as ensuring the

benefits are enjoyed widely across families, businesses, communities, and the most vulnerable.

5. Budget 2015 will have a particularly strong focus on enhancing public sector performance, across both operating and capital spending. The Government has made significant progress in recent years, with the Better Public Services programme already delivering measurable results, and the introduction of the welfare investment approach demonstrating a marked improvement in investment decisions. Starting in Budget 2015, the Government will extend the social investment approach to drive smarter interventions and a long-term client-driven focus across other areas of social spending.

6. This focus on enhancing public sector performance will enable us to fund our spending priorities. The Prime Minister has recently announced a key priority of this Government will be helping vulnerable children in material hardship. This will be a principal theme of Budget 2015, in addition to priority spending required in key sectors such as health and education.

7. Complementing this, Budget 2015 will continue the focus on more effectively managing the Crown's balance sheet and making better use of existing capital. Together, these efforts will enhance the effectiveness of public services, ensure greater value for money for taxpayers, and address the long-term drivers of government expenditure.

8. Budget 2015 will reiterate our commitment to the wide-ranging programme of reform through the Business Growth Agenda, aimed at helping New Zealand companies compete, invest and provide more jobs. It will also reaffirm our commitment to support the Canterbury reconstruction, which continues to underpin economic growth and jobs.

9. To better match the intentions signaled in our pre- and post-election announcements, I propose to re-phase the timing of operating allowances across the Parliamentary term to $1 billion in Budgets 2015 and 2016 and $2.5 billion in Budget 2017. I expect around $1 billion in each Budget to be allocated to new spending, unchanged from pre-election commitments. However, the re-phasing would shift the portion of the allowances nominally set aside for the consideration of modest tax reductions and/or additional debt repayment to Budget 2017, subject to economic and fiscal conditions.

10. Given the lower forecasts for tax revenue, under this operating allowance profile the forecasts to be published in the Treasury's *Half-Year Economic and Fiscal Update* (HYEFU) will show a return to surplus in 2015/16. However, with the underlying strength of the economy combined with constrained government spending, I remain confident we can still deliver a surplus this fiscal year when the final accounts are published in October 2015.

Economic Context

11. Economic activity is continuing to expand at a solid pace. Real GDP growth has slowed from the rapid rates recorded at the end of 2013 and early 2014, but remains robust and is forecast to continue. This has flowed through to, and will continue to result in, growing employment and falling unemployment. Business and consumer confidence remain high, agricultural production and construction activity are increasing and growth in the services sector appears to be steadily increasing.

12. Despite above trend growth, recent inflation outturns have been subdued with annual CPI inflation easing to 1.0 per cent in the September 2014 quarter. Recent high net migration inflows, high labour force participation, and increased investment expenditure are likely contributing factors, raising the productive capacity of the economy more than previously expected. This has been reinforced by persistent low global inflation, recent falls in oil prices, and the high exchange rate.

13. Commodity prices have been volatile recently with some prices increasing and others falling. Although the direct effects have been limited to date, export revenues are expected to decline significantly in coming quarters primary due to falling dairy prices. This is expected to result in reduced spending in the dairy sector and the rural economy more broadly. In the Treasury's HYEFU forecasts, these effects will be evident in large downward revisions to nominal GDP, particularly over the next two years. A key assumption in these forecasts is that dairy prices and the terms of trade recover over the medium-term, although at present these risks appear tilted towards a slower recovery.

14. Although the exchange rate has depreciated somewhat in recent months, it remains high and is impeding growth in services exports and export receipts more broadly.

15. Monetary policy stimulus was reduced in the first half of 2014, but with the Official Cash Rate (OCR) at 3.5 per cent it continues to provide support to domestic demand and overall economic growth. At its October OCR update, the Reserve Bank of New Zealand indicated a period of assessment remained appropriate before considering further policy adjustment. The Treasury is forecasting short-term interest rates to remain around their current levels until late 2015 before rising.

Budget 2015 Priorities

16. The Government's focus remains on successfully managing the growing economy. This involves ensuring both the fundamentals are in place to sustain solid growth over the medium-term, as well as ensuring the benefits are enjoyed widely across families, businesses, communities, and the most vulnerable.

17. Budget 2015 will continue the Government's solid fiscal and economic management achieved in recent years and, I propose, will continue the four priority areas from the last Parliamentary term: responsibly managing the Government's finances; building a more productive and competitive economy; delivering better public services; and rebuilding Christchurch. Budget 2015 will also have a particular focus on implementing the Prime Minister's priority on helping vulnerable children in material hardship.

Continuing to deliver responsible fiscal management

Current fiscal strategy

18. Returning the operating balance before gains and losses (OBEGAL) to surplus has driven our past Budget decisions. Over the past six years we have navigated a global financial crisis, a recession, the Canterbury earthquakes, and a slow global recovery. This required us to run temporary deficits and led to a build up of debt. However, our efforts over the past two Parliamentary terms have ensured that, through all of this, the fiscal position remains on a solid and credible path. As the economic recovery continues, our focus has moved to managing a growing economy. We aim to deliver sustained economic growth over the medium-term, keeping interest rates lower for longer to help households with mortgages, business investment, and exporters by taking pressure off the New Zealand dollar.

19. Our key target continues to be delivering an operating surplus in 2014/15, which will only be known once the final accounts are published in October 2015. The recent fall in global dairy prices and lower interest rates has made this goal more challenging. The lower dairy prices and resulting reduction in incomes earned by our dairy producers, means the growth in the Government's tax revenue is now expected to be lower than previously forecast. In addition, the forecast for interest rates to remain low for longer compounds the tax weakness by reducing RWT, which shows the largest downward revision of all tax types. These effects have not yet shown up in tax outturns, which have been relatively strong to date. However, tax revenue is anticipated to weaken later in the 2014/15 fiscal year.

20. Forecasts to be published in HYEFU will show a small deficit in 2014/15 of $572 million, with the return to surplus expected to be achieved in 2015/16 – a year later than forecast at Budget 2014. While a surplus in 2014/15 has long been a goal of this Government, I do not propose to respond with large adjustments to our tax and spending plans that may destabilise economic and social outcomes.

21. At only 0.2 per cent of GDP, the forecast deficit in 2014/15 is unlikely to raise concerns among financial markets and rating agencies about our fiscal intentions. This is particularly so given our goal to return to surplus in 2014/15 has always been "subject to any significant shocks", such as the recent significant fall in global dairy prices. Conditions in global dairy markets are also expected to be largely temporary, with prices expected to recover through 2015. As a result, despite the delay in achieving an operating surplus, the Government remains on track to meet its longer-term fiscal objectives. The core Crown residual cash balance is now expected to return to surplus in 2017/18, a year earlier than at Budget 2014, due to lower forecast capital spending. As a result, net core Crown debt is forecast to be $1.5 billion lower by the end of the forecast period and is projected to fall to under 20 per cent of GDP by 2020/21. Core Crown expenses are also forecast to reduce to around 30% of GDP by 2015/16.

22. It is also worth noting that the HYEFU forecast for 2014/15 is not yet a reality and forecasts can move significantly in a short period of time. The underlying strength of the economy combined with constrained government spending can still deliver a surplus this fiscal year when the final accounts are published. While many of the swings in tax revenue such as those from movements in global dairy prices are beyond our control, we do have more control over government spending. Over the past six

years we have shown that increases in government spending are not required to deliver better public services if we address the drivers of public service costs and demand.

23. Part of the weaker forecast in 2014/15 represents higher spending forecasts by departments of around $400 million, mainly reflecting spending transferred into 2014/15 from the previous year through expense transfers and automatic roll-overs of unallocated spending in multi-year appropriations (MYAs). Some examples of these increases included in HYEFU were expense transfers totaling over $200 million for health spending, Aquaculture Settlements, Ultra-Fast Broadband and Apprenticeships Re-Boot, among others. A continued strong focus on managing spending over the next few months will increase our chances of turning this deficit around.

24. The weaker forecasts for the operating balance also emphasise the importance of another long-held priority for this Government – more effectively managing the Crown's balance sheet and making better use of existing capital spending. Strong balance sheet management ensures the provision of better public services to those who need them, ensures value for money for taxpayers, and helps to buffer shocks. Also, by reducing the need to borrow for new investment, it may allow us to pay down debt faster and achieve this milestone earlier. We have made some progress to date, for example with the capital reprioritisation achieved in the last Parliamentary term through the Future Investment Fund.

25. I propose the *Budget Policy Statement 2015* signals the Government's strong intention to continue the focus on effective management of the balance sheet, and reiterate the commitment given in the *Fiscal Strategy Report 2014* to develop specific performance targets for managing the Crown's capital and balance sheet.

26. The HYEFU projections will show the Government is expected to resume contributions to the New Zealand Superannuation Fund in 2020/21 – the same as projected in the *Pre-Election Economic and Fiscal Update* and one year later than at Budget 2014.

New spending allowances in future Budgets

27. In Budget 2014, we increased operating allowances for the next Parliamentary term to an average of $1.5 billion per annum from Budget 2015, growing after that at 2 per cent each Budget. We signaled that this could be used for increased investment in public services and/or modest tax reductions, and the exact amount of allowances may be shifted between Budgets.

28. To better match the intentions signaled in our pre- and post-election announcements, I propose to re-phase the timing of operating allowances across the Parliamentary term to $1 billion in Budgets 2015 and 2016 and $2.5 billion in Budget 2017. I expect around $1 billion in each Budget to be allocated to new spending, unchanged from pre-election commitments. However, the re-phasing would shift the portion of the allowances nominally set aside for the consideration of tax reductions or additional debt repayment to Budget 2017, subject to economic and fiscal conditions at the time.

29. As a result, the forecasts published in the Treasury's HYEFU will show a return to surplus in 2015/16 – still one of the first countries in the OECD expected to achieve

this. The return to surplus, and remaining in surplus thereafter, will allow us to start repaying debt, rebuild our resilience to shocks, reduce future finance costs, and keep interest rates lower than they would otherwise be.

Supporting a more productive and internationally competitive economy

30. The economy is continuing to display considerable momentum. But the challenge we face now is ensuring that constraints in the New Zealand economy, as well as global shocks such as recent conditions in export markets, don't inhibit the ability of businesses to further invest, create jobs, and raise the wages of New Zealanders. Our focus is on ensuring recent solid economic conditions translate into a sustained and long-term lift in growth, despite the headwinds of uncertainty in global markets and a high New Zealand dollar.

31. We remain committed to supporting the Business Growth Agenda, the wide-ranging program of policies aimed at helping New Zealand companies compete, invest and provide more jobs. Significant progress has already been made, with HYEFU forecasts showing that existing policies will support 150,000 jobs and lift the average wage to around $63,000 by early 2019. The *Budget Policy Statement 2015* will reiterate our commitment to the Business Growth Agenda and provide an update on progress.

32. I propose that the *Budget Policy Statement 2015* will also reiterate our intention to announce further reductions in ACC levies. We have already implemented reductions in recent years, saving households and businesses around $387 million in the 2014/15 levy year and a further $480 million to come in the 2015/16 levy year. With ACC now in good financial health, it is appropriate to reduce levies further to ensure it is not unjustifiably overcharging households and businesses.

33. For the economy, the benefits and economic impacts of ACC levy reductions will be similar to a tax cut, reducing costs for businesses and households and freeing up income for more productive uses. Also, as funding levels in the ACC Earners' and Work accounts remain high (above the target levels recently agreed by Ministers), making levy reductions sooner rather than later would help to reduce ACC funding to agreed levels earlier and maintain performance incentives for ACC.

34. Due to the significant impact ACC levy changes can have on the economy and the Government's accounts, decisions about the general direction of levies beyond 2015/16 are expected to be taken early next year in the context of Budget decisions, with final decisions on levy rates for 2016/17 and 2017/18 to be made following public consultation and recommendations by ACC.

35. Beyond Budget 2015, we will also continue to look to make modest income tax reductions during this Parliamentary term, subject to economic and fiscal conditions. Any tax reductions will focus on ensuring the tax system continues to reward New Zealanders' hard work and enterprise, with a particular focus on low and middle income earners.

Enhancing long-term outcomes from public services

36. In Budget 2015, the Government will step up the progress achieved to date in improving the quality of public services.

37. During the last Parliamentary term, the Prime Minister set the public service ten challenging results to achieve over five years across a range of areas. Significant progress has been made toward these results. The Justice sector has already reached and surpassed two of its four results, three years ahead of schedule, and significant progress has been made in others, including increasing the proportion of students achieving NCEA Level 2 and reducing long-term welfare dependency.

38. Underlying this progress has been a fundamental change in the way the public sector has approached these issues. Agencies have made better use of data to drive services that are best for communities and the system as a whole. They've been required to work more collaboratively and innovatively, recognising the many cross-sector links on these issues and focussing on achieving meaningful long-term improvements rather than grabbing quick short-term gains.

39. Starting in Budget 2015, the Government will build on this progress by stepping up its social investment approach — a long-term and client-driven focus on system-level social spending initiatives — in what will be the start of a three-to-four year change process.

40. As previously reported to Cabinet, Budget 2015 will continue to evolve an approach that:

- identifies solutions for the most at-risk groups who need individualised solutions based on local circumstances;
- includes an appropriate level of tension from external challenge around new ideas and current approaches;
- recognises and challenges the effectiveness of existing spending and delivery mechanisms;
- involves clients, communities and providers in ideas sourcing; and
- is expandable in the future, based on better joined up data that tells us where, when and who to invest in.

41. The social investment approach will be extended over the Parliamentary term to groups for whom outcomes can be improved and costs reduced through smarter interventions and a more joined up approach across the social sector. There are no silver bullets when dealing with these difficult social issues. Instead, the system needs to take a test, learn and adapt approach. We need to identify measures and initiatives that provide best promise of improving future outcomes, and then expand or amend existing services to better effect as well as trialling new localised or citizen-centered services. This will ensure interventions can be better focused at addressing individual needs, thereby reducing long-term dependence on the state and the associated fiscal costs. I propose that the *Budget Policy Statement 2015* signals this intention.

42. Budget 2015 will also once again be based around Four-Year Plans, continuing the progress achieved in previous Budgets. The plans help agencies to take a longer-term view in their budgeting and to be clear on their investment cases. They should focus on agency performance and their ability to deliver results efficiently and effectively. Agencies that demonstrate a good understanding of their customers (where applicable) and their business, including cost-drivers and service delivery risks, should receive priority where new funding is sought. As with the Budget 2014 process, I encourage Ministers to ask their agencies how they are improving results and outcomes, how they are reducing costs, and question their ambition to deliver better public services.

43. Continuing the Government's strong focus on the performance and management of the Crown's capital and balance sheet will further drive more effective public service delivery. As I have previously discussed with Cabinet, the recently established Investment Ministers Group is a new initiative that will play a key role through to, and beyond, Budget 2015. It will help to co-ordinate information on investment intentions across the State sector, prioritise investments that align to the Government's results areas, and establish clear expectations of officials. The scope of the Group's work program includes new major investment, divestment and capital reprioritization proposals, and thus will help to deliver better service performance from both new and existing capital.

44. In line with previous announcements, priority for new spending in Budget 2015 will be given to health, education, and initiatives that contribute to the Prime Minister's recent commitment to help vulnerable children in material hardship. Most other areas of government spending will be expected to remain within existing baselines.

Supporting the rebuild of Christchurch

45. Finally, the Government remains committed to supporting the Canterbury reconstruction as it continues to underpin economic growth and jobs.

46. Supported by the Government, construction of key anchor projects and horizontal infrastructure proceeds apace, with work on the Avon River Precinct, East Frame, and the Justice Precinct progressing well.

47. In 2015, the Canterbury Earthquake Reconstruction Authority will also be brought into the Department of Prime Minister and Cabinet to ensure an orderly transition and ongoing Government support for the rebuild.

Consultation

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

Publicity

49. The *Budget Policy Statement 2015* is due to be released on Tuesday 16 December 2014.

Recommendations

50. I recommend that Cabinet:

1 **note** the *Budget Policy Statement 2015* is due to be released on Tuesday 16 December 2014 and will set out the priorities that will guide the preparation of the next Budget

2 **agree** that the *Budget Policy Statement 2015* will continue the four priorities from the previous Parliamentary term:

2.1 responsibly managing the Government's finances;

2.2 building a more productive and competitive economy;

2.3 delivering better public services;

2.4 rebuilding Christchurch

3 **note** that a principal theme of Budget 2015 will be a focus on assisting children in material deprivation

4 **note** that the economy has been growing strongly and the outlook for economic activity remains solid

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

6 **note** that progress continues to be made towards the Government's fiscal targets, as the OBEGAL deficit has declined and net debt is projected to fall to under 20 per cent of GDP by 2020/21

7 **note** that forecasts in the *Half-Year Economic and Fiscal Update* will show the return to surplus has been delayed until 2015/16, reflecting the sharp downturn in dairy prices

8 **note** that future operating allowances in Budget 2014 were set at $1.5 billion per annum on average from Budget 2015, growing at 2 per cent per annum

9 **agree** to re-phase the timing of operating allowances over the Parliamentary term to be $1 billion in Budgets 2015 and 2016 and $2.5 billion in Budget 2017

10 **note** that an operating allowance of $2.5 billion in Budget 2017 will allow room for us to consider tax reductions or additional debt repayment, subject to economic and fiscal conditions at the time

Hon Bill English
Minister of Finance

Date: