The Treasury

Budget 2017 Information Release

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[40]	Not in scope	

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) and section 18 of the Official Information Act.

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Fiscal Strategy for Budget 2017

Date:	30 March 2017	Report No:	T2017/762
		File Number:	MC-1-5-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	**Agree** to increase operating allowances from Budget 2018 onwards to $1.7 billion **Agree** to a greater focus on the mid-point of the 0-20 per cent of GDP net debt range in the Fiscal Strategy Report	Read prior to Budget Ministers at 9.30am on Monday 3rd April, 2017

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Neil Kidd	Senior Analyst, Macroeconomic & Fiscal Policy	[39]	[23]	✓
Renee Philip	Manager, Macroeconomic & Fiscal Policy	[39]	[23]	

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

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Fiscal Strategy for Budget 2017

Executive Summary

The fiscal outlook remains positive and consistent with your fiscal strategy. The preliminary fiscal forecasts show operating surpluses rising, core Crown expenses falling as a share of GDP and net debt falling below 20% of GDP by 2020. A stronger outlook for tax revenue compared to previous forecasts provides some headroom to consider higher spending or tax reductions while remaining on track to achieve your fiscal targets.

The improved outlook for tax revenue is judged to be mostly structural. This structural improvement reflects a larger working-age population as net migration is expected to remain elevated for longer than in the Half Year Update. A structural improvement implies that a lift in spending or tax reductions can be fiscally sustainable. However, while population growth is built into forecast tax revenues, population pressures may create expenditure pressures that could take some time to manifest and may be difficult to manage within existing allowances. As always there are other risks to the economic and fiscal outlook that may result in fiscal outcomes being stronger or weaker than forecast.

The fiscal stance is expected to be mildly stimulatory in 2016/17 and 2017/18, reflecting elevated capital and earthquake-related spending. A tighter fiscal stance is forecast from 2018/19. We consider this fiscal stance to be broadly appropriate in the context of high population growth and in response to a natural disaster. An increase in Budget allowances and a tax and transfer package would generate relatively more fiscal stimulus in both 2017/18 and 2018/19, although the overall fiscal stance would still be mildly contractionary from 2018/19. A relatively looser fiscal stance will place upward pressure on the Reserve Bank's setting of the Official Cash Rate at the margin, but is occurring in the context of subdued underlying inflationary pressures and very low interest rates.

Net debt as a share of GDP has been relatively constant and close to its cyclical peak for the past five years. While there is always uncertainty around the economic outlook, we are increasingly confident that net debt is on a trajectory to below 20% of GDP, absent a significant shock. Improved economic and tax forecasts have generated fiscal headroom within the net debt target of around 20 per cent of GDP by 2020/21.

Given this headroom and the recent experience of fiscal pressures, the Treasury recommends using some of this headroom to increase current and future allowances. The Treasury recommends a package of measures in Budget 2017 with a cost of approximately $1.8 billion per annum on average of operating expenses and $3.5 billion of capital expenses. [33]

We recommend a tax and transfer package of around $2 to $2.5 billion per annum. A tax package of $2.3 billion, with phasing, would allow operating allowances to increase by $200 million per budget to $1.7 billion from Budget 2018 onwards. At this stage, we do not recommend further increasing capital allowances from Budget 2018 onwards because these were increased in the Budget Policy Statement 2017. However, it would be prudent to maintain some net debt headroom to reconsider these allowances in the future.

The package of policy changes recommended in this report would see net debt forecast to fall to 19.4% of GDP in 2020/21 based on the preliminary forecasts. However, there are some downside risks to the final economic and tax forecasts reflecting the recent GDP outturn for the December quarter of 2016. There is a possibility that final forecasts may show net debt closer to, or slightly above, 20 per cent of GDP in 2020/21, based upon this package of policy changes.

Gross operating allowances have been rising over time. A greater focus on efficiency and the quality of baseline expenditure will be necessary to manage cost pressures and drive greater value for money in coming Budgets. If sufficient savings are found, an increase in operating allowances beyond Budget 2017 may not be necessary.

A stronger fiscal anchor will be needed for beyond 2020. In the Fiscal Strategy Report, we recommend communicating a focus on reducing net debt toward 10% of GDP, which is the midpoint of the range of 0 to 20 per cent of GDP in the current long-term debt objective.

Recommended Action

We recommend that you:

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

b **note** that net debt is forecast to fall well below 20% of GDP by 2020/21, which provides some fiscal headroom to increase budget allowances;

c **note** that beyond 2020/21 there is significant headroom to increase allowances and you may wish to provide more detail about your longer term net debt objectives;

d **agree** to augment the current objective to maintain net debt within a range of 0-20 per cent of GDP, by focussing on the mid-point of 10 per cent of GDP;

Agree / disagree.

e **note** that the exact wording of the long-term debt objective can be considered during the production of the Fiscal Strategy Report;

f **note** that the Treasury considers there is a case to increase operating and capital allowances from their current level of $1.5 billion and $3 billion in Budget 2017 in order to fund valuable projects in the pipeline and other Government commitments;

g **note** that this means the total capital allowance for Budget 2017 would be approximately $3.5 billion and that the operating allowance for Budget 2017 would be approximately $1.8 billion;

h **note** that the Treasury recommends a tax and transfer package of around $2 to $2.5 billion per annum to promote work incentives, with consideration for helping those in financial hardship;

i **note** that the Treasury recommends any tax and transfer package should be consistent with the net debt target and allow headroom for increased Budget allowances beyond Budget 2017;

j **note** that a residual cash surplus would be achieved one year later, in 2019/20, as compared with HYEFU under any of the tax and transfer scenarios considered in this report alongside higher Budget 2017 allowances;

k **note** the fiscal impact of increasing Budget 2017 operating and capital allowances to $1.8 billion and $3.5 billion respectively alongside a tax and transfer package of around $2.3 billion, with phasing, would mean net debt is forecast to be around 19.0% of GDP in 2020/21 based on preliminary forecasts, and NZS Fund contributions would be forecast to restart in 2020/21;

l **note** that there are risks to the preliminary fiscal forecasts, in particular the latest GDP estimate in the December quarter of 2016 may result in weaker economic and fiscal forecasts, which may result in net debt being closer to 20 per cent of GDP in 2020/21;

m **note** that the allowance changes described in recommendation k) would leave enough net debt headroom to increase operating allowances from Budget 2018 onwards;

n **agree** to increase operating allowances to $1.7 billion from Budget 2018 onwards;

Agree / disagree.

o **note** that increasing operating allowances to $1.7 billion from Budget 2018 onwards, in addition to a tax and transfer package of $2.3 billion, with phasing, and higher Budget 2017 allowances would increase net debt to approximately 19.4 per cent of GDP in 2020/21;

p **note** that the higher operating allowances from Budget 2018 onwards would be reflected in The Treasury's final Budget forecasts;

q **note** that an increase in allowances for future Budgets would not be necessary if policy settings were adjusted in such a way that savings were found to offset future some future expense pressures;

r **note** that the package of measures recommended in this report would generate relatively more fiscal impulse in 2017/18 and 2018/19, which could place upward pressure on the OCR in the future;

s **note** that the package of measures recommended in this report is consistent with declining net debt and more specifically with the government's fiscal priorities and objectives and therefore does not place an excessive burden on future generations;

t **note** that the changes in recommendations k) and n) are consistent with the principles of responsible fiscal management set out in the Public Finance Act 1989;

u **note** that the Treasury will draft a Cabinet paper based on these decisions for Cabinet on Tuesday 18 April; and

v **note** that these decisions will inform the Treasury's final BEFU forecasts which will be finalised on 3 May 2017.

Renee Philip
Manager, Macroeconomic & Fiscal Policy

Steven Joyce
Minister of Finance

Economic and tax outlook

1. You have previously received advice on the Treasury's preliminary Budget economic and tax forecasts (T2017/381 refers). Table 1 outlines the main forecast economic indicators compared with the Treasury's HYEFU 2016 forecasts.

Table 1: Comparison of Key Economic Indicators between HYEFU 2016 and Preliminary BEFU 17 Forecasts

June years		2016 Actual	2017 Forecast	2018 Forecast	2019 Forecast	2020 Forecast	2021 Forecast
Economic growth[1]	HYEFU16	2.8	3.6	3.5	2.9	2.4	2.3
	BEFU17	**2.7 (R)**	**3.7**	**4.1**	**3.5**	**2.4**	**2.0**
Unemployment rate[2]	HYEFU16	5.0	4.8	4.6	4.2	4.3	4.3
	BEFU17	**5.0**	**5.1**	**4.9**	**4.4**	**4.3**	**4.3**
CPI inflation[3]	HYEFU16	0.4	1.5	2.0	2.1	2.0	2.1
	BEFU17	**0.4**	**1.7**	**1.5**	**2.1**	**2.2**	**2.1**
Current account balance[4]	HYEFU16	-2.9	-3.0	-3.8	-4.1	-4.4	-4.4
	BEFU17	**-2.9 (R)**	**-2.6**	**-3.0**	**-3.4**	**-3.8**	**-3.9**
Nominal GDP[5]	HYEFU16	4.2	5.2	5.6	5.0	4.1	3.9
	BEFU17	**4.2 (R)**	**6.0**	**5.5**	**5.5**	**4.4**	**3.6**
Nominal GDP ($billions)	HYEFU16	251.8	264.8	279.5	293.4	305.5	317.4
	BEFU17	**253.1 (R)**	**268.2**	**282.9**	**298.5**	**311.8**	**323.0**
	change	1.3	3.4	3.4	5.1	6.3	5.6
Tax revenue ($billions)	HYEFU16	70.4	74.2	78.0	82.0	85.8	89.9
	BEFU17	**70.4**	**74.8**	**78.6**	**83.3**	**87.4**	**91.2**
	change	0.0	0.6	0.6	1.3	1.6	1.3

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

2. These forecasts show a more positive outlook for the New Zealand economy than expected at HYEFU 2016, chiefly owing to faster population growth. Growth continues to be supported by high levels of inward migration, construction activity, exports (particularly tourism) and low interest rates. Real GDP growth is forecast to be around 3.5 per cent per annum in the March 2017 quarter and to accelerate to around 4.0 per cent over 2018.

3. While the growth outlook in New Zealand's key trading partners remains broadly similar to the HYEFU forecast, uncertainties around the outlook have increased. Growth has slowed in Australia but this has been offset by faster growth in other advanced economies, notably in the US where we have followed the International Monetary Fund and *Consensus* and revised growth forecasts higher reflecting expected fiscal stimulus. Risks remain around the precise details of Brexit, the continued imbalances in the Chinese economy and future US economic, trade and fiscal policy. The extent of the potential impacts from these uncertainties and the precise channels through which they might impact on New Zealand are difficult to ascertain. Consequently we treat these as risks to the central forecast and caution that the domestic economic and tax outlook could significantly alter should these risks materialise.

4. Migration is providing a significant boost to aggregate growth, with real GDP per capita growth broadly similar to HYEFU across the forecast period. Net migration flows have continued to strengthen, and this strength is assumed to persist through 2017.

5. Population growth is adding to the supply side of the economy. Compared to the HYEFU, which assumed migration declining from the end of 2016, this assumption lifts the working age population by 1.4 per cent.

6. There remains a degree of slack in the labour market. The unemployment rate is expected to return to its long-run rate of 4¼ per cent at a slower pace than forecast in the HYEFU owing to more rapid population growth and higher labour force participation rates.

7. Momentum in residential investment is expected to slow in 2017, owing to the recent easing in building consents issuance. Similarly, house price growth has also slowed. We expect these to both be temporary slowdowns reflecting the impact of tighter loan-to-value ratios and uncertainty related to the Auckland Unitary Plan. Sustained demand for housing is forecast to support residential investment at high levels for the remainder of the forecast period.

8. Consumer price inflation is expected to pick up over the forecast period as spare capacity is used up, stabilising at an annual rate of 2% a little later than forecast at HYEFU. However, it is likely that inflation may ease in a year's time before sustained increases occur as the impact of recent petrol and food price rises drop out of the annual calculation.

9. Higher levels of economic activity and higher terms of trade support nominal GDP, which is cumulatively $24 billion higher across the five years to June 2021. Some of this increase reflects historical revisions to GDP; allowing for this the net change compared to the Half Year Update is closer to $17 billion. The net change is the main driver of revisions to the tax forecasts.

10. Higher than expected revenue outturns in the current year combined with the stronger outlook for nominal GDP flows directly through to a higher forecast tax take, with tax revenue forecast to be $5.4 billion higher over the five years to 2021 compared to HYEFU 2016. In particular, business profits from a faster growing economy leads to higher corporate and other persons tax, while stronger employment flows through into higher forecast revenue from PAYE tax. Higher actual and projected deposit rates lift the forecasts of interest Resident Withholding Tax, and higher consumption and residential investment increase the GST base.

Update on economic forecasts after preliminary forecast finalisation

11. The preliminary forecasts do not include economic data received after the economic forecasts were finalised on 24 February 2017. This includes the December quarter GDP outturn, which was weaker than expected (0.4 per cent real GDP growth in the quarter compared to 0.9 per cent expected).

12. Some of the relative weakness in December quarter GDP is expected to be temporary. However, overall, real GDP growth in the December 2016 quarter combined with downward revisions to the September quarter signals less momentum in activity than previously anticipated, with recent developments in building consents data pointing to weaker growth in residential investment.

13. Price developments provided some offset, and supported December quarter nominal GDP (nominal GDP was around $600m higher than we incorporated in our preliminary Budget forecasts in the December quarter). Some of this increase likely reflects timing issues associated with terms of trade movements. The preliminary forecasts anticipated a large boost to nominal GDP from the terms of trade in the March 2017 quarter, but it appears some of this may have been captured in the December 2016 quarter.

14. We would always expect some changes to economic and tax forecasts before they are finalised. Overall, developments suggest some modest retracement in activity, nominal GDP and tax revenue relative to the preliminary forecasts. Over the five years of the forecast period, this suggests around $2-3 billion less nominal GDP than in the preliminary forecasts and approximately $1 billion less tax revenue. However, the majority of the strength relative to HYEFU is expected to remain and the economic forecasts will be boosted further from the stimulus associated with any tax package.

15. The key drivers of growth in the final BEFU forecasts are likely to remain similar to those in the preliminary forecasts, namely inward migration, construction activity, exports (particularly tourism) and low interest rates. We expect growth in housing construction to accelerate after a temporary period of recent weakness. However, if this period of weakness were to persist then there would be downside risks to the overall growth outlook.

16. The economic forecasts, to be finalised on 18 April, will incorporate this economic data and other information, including Budget decisions. The final BEFU forecasts will be accompanied by two scenarios, which demonstrate how the economic outlook may vary if some of the key judgements in the forecast differ. The first scenario will show how a stronger migration profile may impact the economic outlook. The second scenario will examine the impact of a more cautious attitude towards debt on household consumption and saving.

Fiscal outlook

17. The fiscal outlook remains positive. The preliminary fiscal forecasts [T2017/766 refers] show operating surpluses rising, core Crown expenses falling as a share of GDP and net debt falling below 20% of GDP by 2020.

18. The preliminary BEFU fiscal forecasts incorporate the preliminary economic and tax forecasts, updated forecasts of spending from departments and allowances as set at HYEFU i.e. operating allowances of $1.5 billion per Budget and capital allowances of $3 billion in Budget 2017 and $2 billion thereafter.

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

Table 2: Comparison of Key Fiscal Indicators between HYEFU 2016 and Preliminary BEFU 2017 Forecasts

	Actual			***Forecast***		
$ billion, June years	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
OBEGAL - 2017 Prelim BEFU	1.8	1.6	4.1	7.3	8.7	10.0
OBEGAL - 2016 HYEFU		0.5	3.3	5.4	6.8	8.5
Total Change		1.1	0.8	1.9	1.9	1.5
Residual Cash - 2017 Prelim BEFU	(1.3)	(0.6)	(1.5)	2.1	2.9	5.2
Residual Cash - 2016 HYEFU		(2.2)	(2.1)	1.4	3.0	2.6
Total Change		1.6	0.6	0.7	(0.1)	2.6
Net Worth - 2017 Prelim BEFU	89.4	100.2	107.2	117.5	129.7	143.5
Net Worth - 2016 HYEFU		93.0	99.1	107.4	117.3	129.3
Total Change		7.2	8.1	10.1	12.4	14.2
Net Debt - 2017 Prelim BEFU	61.9	62.9	64.4	62.4	59.7	54.6
Net Debt - 2016 HYEFU		64.4	66.4	65.0	62.1	59.6
Total Change		1.5	2.0	2.6	2.4	5.0
% of GDP, June years						
Net Debt - 2017 Prelim BEFU	24.5	23.5	22.8	20.9	19.1	16.9
Net Debt - 2016 HYEFU		24.3	23.8	22.2	20.3	18.8
Core Crown Expenses – 2017 prelim BEFU	29.2	28.9	28.3	27.6	27.3	27.1
Core Crown Expenses– 2016 HYEFU		29.6	28.7	28.1	27.9	27.7
Core Crown Revenue – 2017 prelim BEFU	30.1	30.2	30.0	30.1	30.2	30.4
Core Crown Revenue – 2016 HYEFU		30.4	30.1	30.1	30.3	30.6

20. The operating balance before gains and losses (OBEGAL) is forecast to rise strongly from 2016/17 with surpluses reaching $10.0 billion (over 3 per cent of GDP) by the end of the forecast period. OBEGAL surpluses are forecast to be higher than in HYEFU 2016 across the forecast period.

21. Core crown expenses as a share of GDP are on a downward trajectory, forecast to fall from approximately 29 per cent of GDP in 2015/16 to just over 27 per cent of GDP by the end of the forecast period.

22. Core Crown net debt is lower across the forecast period than at HYEFU and is forecast to decline to 16.9 per cent of GDP in 2020/21. The stronger fiscal outlook reflects higher tax receipts and lower benefit payments which more than offset increased capital spending and the commencement of NZSF contributions a year earlier than HYEFU (resulting from the lower net debt).[1]

23. There is always significant risk to the fiscal outlook. There is considerable economic uncertainty, both domestic and global, which create risks for the revenue outlook. These risks include the net migration outlook, the pace and timing of residential investment activity, the degree of spare capacity in the economy and the terms of trade. There are some lower probability-high impact downside risks to the global economic outlook, including fragilities in China and disruptions to global trade. There are fiscal risks to operating and capital expenditure, including from the impact of the Kaikoura earthquake and higher population growth. Nevertheless, we are more confident than in December that net debt is on a trajectory to below 20 per cent of GDP, absent a significant shock. In the event of a significant shock, the fiscal strategy is appropriately focussed on rebuilding fiscal buffers.

[1] NZSF contributions are assumed to resume when net debt falls below 20% of GDP, in line with current policy. In the preliminary fiscal forecasts, this occurs in 2019/20.

Fiscal Strategy

24. The fiscal outlook remains consistent with the Government's fiscal strategy. Preliminary economic and fiscal forecasts, accompanied by medium-term projections to 2030/31, show the Government is on track to meet its long-term objectives and the short-term intentions of maintaining rising OBEGAL surpluses and reducing net debt to around 20 per cent of GDP by 2020.

25. The Government's long-term fiscal objectives are to reduce net government debt to between 0 and 20 per cent of GDP, keep core Crown expenses below 30 per cent of GDP and ensure operating balances are sufficient to meet net capital requirements, including New Zealand Superannuation Fund (NZSF) contributions.

26. Consistent with the long-term objectives, the Government's shorter-term fiscal priorities are:

    - maintaining rising OBEGAL surpluses over the forecast period so that cash surpluses are generated and net debt begins to reduce in dollar terms
    - reducing net debt to around 20 per cent of GDP in 2020
    - if economic and fiscal conditions allow, beginning to reduce income taxes, and
    - using any further fiscal headroom - including from positive revenue surprises - to reduce net debt faster.

27. The most binding fiscal target at present is the intention to reduce net debt to around 20 per cent of GDP by 2020. This remains a prudent fiscal anchor for decisions at Budget 2017. We recommend that decisions are taken so that net debt stays at or below 20 per cent of GDP in 2020/21. The flexibility for net debt to rise above 20 per cent of GDP in 2020/21, provided for by the change in wording to "around" 20 per cent, should be reserved to provide a buffer against economic shocks.

28. Beyond 2020, we recommend a strengthened focus on ensuring that decisions are taken that will keep net debt on a downward trajectory to well within the 0 to 20 per cent of GDP range set by the long-term debt objective. Fiscal projections imply significant headroom within this objective, even if there were moderate increases in allowances and a tax package in Budget 2017.

Fiscal headroom

29. With a stronger outlook for tax revenue, there is some headroom to consider higher spending or tax reductions while remaining on track to achieve the fiscal targets.

30. Preliminary fiscal forecasts show net debt of 16.9 per cent of GDP in 2020/21. However, this includes over $2 billion of contributions to the New Zealand Superannuation Fund (NZSF) in 2019/20. If allowance increases and a tax package push net debt over 20 per cent in 2019/20, then this contribution will not be made in 2019/20, increasing the amount of headroom available. If NZSF contributions were delayed until 2020/21 (the same time as HYEFU), net debt in 2020/21 would be forecast to be 16.2 per cent of GDP.

31. This is equivalent to just over $12 billion of net debt headroom in 2020/21 or alternatively an increase in expenditure of almost $3 billion per annum starting in 2017/18 or a tax package of $3.5 billion starting in April 2018. Some of this headroom could be used to address capital and operating pressures against Budget 2017, increase future budget allowances and/or to provide for a package of tax measures.

32. The increase in tax revenues are likely to be structural as they largely driven by increased population: we forecast that core Crown revenue will stay at around 30 per cent of GDP across the forecast period. Therefore, a modest increase in expenses or a reduction in revenue is likely to be sustainable. To the extent that increased expenditure is focussed on the consequences of the recent earthquake, we expect it to be temporary and so will not affect the sustainability of public finances.

Macroeconomic considerations

33. The fiscal stance in the preliminary fiscal forecasts is mildly stimulatory in 2016/17 and 2017/18, largely reflecting elevated capital and earthquake-related spending. A tighter fiscal stance is forecast from 2018/19. We consider a somewhat expansionary fiscal stance in the short term is broadly appropriate in the context of high population growth and a response to a natural disaster.

34. Underlying inflationary pressures are expected to remain muted in the near term with the pick-up in headline inflation initially driven by temporary factors such as petrol and food, which will drop out of the annual calculation. Spare capacity in the economy is expected to be gradually absorbed as the economy continues to grow. Reflecting this, the economic forecasts assume that the Reserve Bank's Official Cash Rate will remain on hold over the next two years, although a faster pick-up in inflation and greater capacity pressures could lead to an earlier rise in interest rates.

35. The New Zealand dollar exchange rate remains relatively elevated on a trade-weighted basis by historical standards, although is well down from its mid-2014 peak against the US dollar.

Budget packages

36. Remaining within the Budget allowances set at HYEFU would require some difficult choices and trade-offs. A Budget package within the allowances would primarily reflect funding for non-discretionary cost pressures with very little room for high value expenditure and social investment initiatives.

37. [33]

38. The emerging operating package funds volume pressures in key sectors and other commitments, includes funding for high evidence social investment initiatives (Track 1), and funds ministerial priorities around tourism, trade and regional economic development under the Business Growth Agenda. Reducing the operating package significantly below $1.8 billion would involve some difficult trade-offs across key sectors given a major component of the package addresses volume and wage cost pressures.

39. If the package were reduced this would likely involve a decrease in discretionary (but high value) expenditure and further scaling of departmental and service cost pressures. In the Social Sector, some of the more marginal calls include further scaling price adjustments for schools, reducing high value expenditure on pharmaceuticals, scaling departmental cost pressures and requiring agencies to absorb the balance within baselines, and reducing the amount of discretionary expenditure associated with the new Ministry of Vulnerable Children. There are a number of risks associated with these options and any further reductions in the Social Sector are likely to create funding gaps and general pressures which will come back for funding in future Budgets.

40. For BGA and the "Other" package, the main marginal calls are around discretionary expenditure that could be scaled, deferred or funded through baselines. [33]
[33]

[33] The key risk associated with these options is future funding calls through the between-Budget contingency or Budget 2018.

41. [33]

Any additional funding that was required for the reinstatement of the Southern Corridor would be a cost against Budget 2018. [33]
[33]

42. For the Capital package, further funding could be deferred, however this will compound the pressures against future Budgets and would not align with the Government's priority of investing in infrastructure for a growing economy. [33]

[33]

Tax and transfer package

43. You have received advice on a range of tax and transfer packages that have been formulated to be consistent with your objective to improve work incentives with consideration for helping those on low incomes or in financial hardship.

44. The Treasury supports a tax and transfer package costing around $2 to 2.5 billion per annum. A package of this fiscal cost is consistent with progress toward the Government's fiscal targets while providing some buffer to accommodate spending pressures in future Budgets and risks to the economic outlook. A larger package could be considered but would provide less buffer with respect to these risks.

45. A package of around $2 to 2.5 billion per annum would be sufficient to:

    a increase personal income tax thresholds: increasing the $14,000 threshold to $22,000 and increasing the $48,000 threshold to $52,000;

    b increase Accommodation Supplement payments: update the maxima to reflect 2016 median rents, while re-allocating areas to reflect rental costs;

    c Family Tax Credit (FTC): align the FTC rates to the eldest child rates, and increase the abatement rate and reduce the abatement threshold at the same time; and

    d Removing the Independent Earner Tax Credit (IETC).

46. It is economically costly to raise revenue from income taxes, therefore it is appropriate to ensure taxes are no higher than necessary to fund expenditure priorities and ensure that the fiscal outlook is sustainable.

47. There are trade-offs between tax reductions and other expenditure priorities. We do not consider there to be other spending initiatives in the order of $2 billion per annum that would have greater value than a tax and transfer package.

48. There are trade-offs within the tax and transfer package. While we consider the elements all have merit, we have a preference to prioritise AS changes over increasing FTC rates if a smaller fiscal cost is preferred. AS is better targeted at households in financial hardship and FTC has relatively limited simplification benefits and targets a wider range of income groups. However, we note that the impact on labour supply of AS is less clear.

49. The Treasury has advised you on the distributional implications of potential tax and transfer packages. Broadly, the proposed packages provide after-tax and transfer income gains to a large number of families across the income distribution with more significant gains to many families on low to middle incomes.

Personal income tax changes

50. Personal tax threshold adjustments will partially compensate for fiscal drag that has occurred since 2010, improve work incentives at the margin and lift after-tax incomes of many individuals and families.

51. Personal tax thresholds have not been adjusted since 2010. While there is not fiscal headroom to adjust all thresholds for fiscal drag since 2010 and to include changes to transfer settings, we consider that lifting the $14,000 and $48,000 thresholds improves the tax system.

52. Increases in tax thresholds generally improve work incentives. In particular, increases at the $14,000 threshold are likely to improve work incentives for those on benefits as these individuals typically enter work at lower incomes. Increases at the $48,000 threshold are likely to improve individuals' incentives to work longer hours in aggregate.

53. The labour supply responses of these tax and transfer packages (excluding the impact of AS changes) indicate that the long-run impact on GDP is likely to be positive but small (less than 0.3%). For final Budget forecasts, the macroeconomic effects of a tax and transfer package will be taken into account.

Accommodation Supplement

54. The proposed changes to Accommodation Supplement will address financial hardship for those in housing stress.

55. Residual incomes have been increasing for New Zealanders across the income scale since the mid-1990s. However, a smaller group of individuals have not shared in this general lift in residual incomes largely owing to housing stress. In particular, the residual (after housing costs) incomes of AS recipients (excluding those receiving New Zealand Superannuation or Veterans Pension, and non-beneficiaries) have declined by 8% on average since 2006. Some groups face significantly higher declines in residual incomes, particularly singles or couples without children (T2017/403 refers). The AS changes presented will result in average residual incomes for AS recipients being 5% higher on average than in 2006 and significantly reduce the number of households in severe housing stress (defined by MSD as a residual income of less than $180 per week).

56. There will be a risk of landlord capture with any mechanism used to increase the income of low-income households, including increases to the AS or FTC payment rate. The risk of landlord capture needs to be balanced against the risk of continually declining after-housing costs incomes of the lowest-income households. There is considerable uncertainty about the degree of landlord capture and increasing housing supply responsiveness should dampen the likelihood of landlord capture.

57. However, should the degree of landlord capture be relatively high, the negative labour supply impacts from increasing AS or FTC are likely to be more muted.

Independent Earner Tax Credit (IETC)

58. The Treasury supports the removal of the IETC as it is poorly targeted, administratively complex and increases effective marginal tax rates when it is abated (T2017/164 refers). The fiscal savings (up to $260 per annum) can be used to reduce the net cost of the tax and transfer package and would mitigate distributional impacts at the same time.

59. We note that better targeting of this tax credit could still improve work incentives for certain individuals, but would require more complex administration.

Family Tax Credit (FTC)

60. Changes to FTC are a targeted way to lift incomes of families to raise their children. The proposed alignment of child rates will help to simplify the system.

61. We consider the changes to FTC compared with the changes to AS are less targeted to assisting people in financial hardship and have limited simplification benefits.

62. The Treasury has also provided options on the abatement schedule and phasing of the FTC, which could help to manage the fiscal cost.

Fiscal scenarios with higher Budget 2017 allowances and a tax and transfer package

63. Both the increase in allowances and a tax package are affordable within the net debt target of around 20 per cent of GDP by 2020/21. The following scenarios assume an operating allowance of $1.8 billion and a capital allowance of $3.5 billion in Budget 2017 and show the impact on net debt in 2020/21 from the various tax packages.

Tax package	*Net debt in 2020/21 (% of GDP)*	*Maximum increase in operating allowances from Budget 2018 onwards such that net debt = 20% GDP in 2020/21 ($ millions)*
Package 4	18.8	620
Package 5a	19.7	100
Package 6a	19.2	410
Package 6a Mild	19.1	480
Package 6a Medium	19.0	490
Package 6a Extreme	19.0	520

64. There would be moderate headroom to increase future allowances from Budget 2018 onwards under all scenarios except tax and transfer package 5a. An increase in operating allowances of $100 million in Budget 2018 onwards, or an increase in capital allowances of $200 million per budget, increases net debt to GDP by approximately 0.2% in 2020/21.

65. Under all of these scenarios, a residual cash surplus would be achieved one year later, in 2019/20, than forecast at HYEFU.

Future allowances – operating expenses

66. We recommend that there is an increase to future allowances given recent experience of pressures and the likelihood of additional pressures in future. The limited information we have to date suggests there is likely to be pressure against future operating allowances such that it is difficult to limit gross new operating expenditure to $1.5 billion per budget. A greater focus on baseline expenditure could help with the reprioritisation of funding towards higher priority and more effective services and allow net allowances to be maintained at $1.5 billion. However, given the Budget 2017 experience so far of limited savings initiatives to offset gross new expenditure, we do not think it would be prudent to rely on this.

67. Gross new operating expenditure has been increasing over the last several budgets. Gross new operating expenditure increased steadily from just under $1 billion in Budget 2011 to a little over $1.5 billion in Budget 2015, with a sharper increase to approximately $2.1 billion in Budget 2016. Savings initiatives have offset gross expenditure resulting in a significantly lower net operating allowance e.g. revenue and savings items averaged nearly $500 million per annum in Budget 2016. We do not yet have the evidence to say with certainty that this trend will continue but it does show that without a decrease in gross spending in future budgets back to at least the Budget 2015 level, or an adjustment of policy settings, it would be difficult to live within an allowance of $1.5 billion.

68. The aggregation of departmental Four Year Plans further suggests that limiting new operating expenditure in future budgets to $1.5 billion could be difficult. [33]

69. The Treasury has assessed these cost pressures according to the quality of the strategic response identified: no response identified; no viable response identified, significant risk and uncertainty to the option identified or high level of confidence the response can be implemented. [33]

There is time to identify a strategic response for cost pressures, especially in later years, [33]

70. High levels of net migration are one of the main drivers of the improved fiscal position. However, whilst our forecasts reflect the higher taxation resulting from higher population, many expenditure items are forecast assuming fixed nominal baselines with new expenditure provided for through allowances. To illustrate possible risks to expenses arising from the higher population, we have considered the level of allowances that would be required in order to maintain real per capita expenditure (excluding those items that already contain a forecasted uplift for population growth such as social services and welfare spending).

71. To maintain constant real per capita expenditure for core Crown expenses minus social services and welfare spending (as these already have population growth included in their forecasts) and finance costs (which would not change with population), operating allowances would need to be set at between $1.7 billion and $2 billion per Budget over the next four budgets.

72. There are categories of expenditure that would not need to increase with population growth, at least in the short term, for example defence or environmental protection. Excluding expenditure on such items, the allowance needed to keep real terms expenditure per capita constant would be $1.5 billion to $1.7 billion per budget.[2]

73. There are several caveats to these calculations: we might expect to see falling unit costs in some areas as the population grows and it is worth noting that all of these calculations are not specific to the sector i.e. we do not use sector specific population and inflation. Four Year Plans are therefore a better measure of cost pressures facing individual departments.

74. This analysis suggests that allowances of $1.5 billion may be too small to deal with rising cost pressures, including those resulting from population growth, as well as accommodate any new high value-for-money expenditure, unless significant savings or revenue raising items can be identified. Significant new policy initiatives, such as the child hardship package in Budget 2015, would be difficult to manage.

75. This suggests allowances should increase but does not provide a strong evidence base to allow for a recommendation as to what they should be increased to. In the absence of a better measure, if the Budget 2017 allowance is increased to $1.8 billion, then it may be prudent to increase future allowances to a similar level i.e. by around $200 to 300 million per annum.

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[2] This includes only expenditure on health, education, law and order, transport and housing and community development. It excludes expenditure on social security and welfare, core government services, defence, economic and industrial, heritage, primary, environmental, other (e.g. treaty settlements), and finance costs.

76. The Budget allowances represent a small proportion of the approximately $70 billion of existing Government expenditure. It is likely that not all of this expenditure is effective and generating expected outcomes. Significant areas of expenditure are primarily driven by existing policy settings, which if reviewed may provide the opportunity for considering other ways of investing for better outcomes. The Treasury acknowledges that further work is required to determine how we can ensure greater transparency around baseline spending and use existing processes (such as Four Year Plans and Track 1) to determine areas of low value expenditure that should be reprioritised.

Future allowances – Capital expenses

77. Capital allowances from Budget 2018 to Budget 2020 are set at $2 billion per budget. However, expenditure on the City Rail Loop is a pre-commitment against them, which reduces these allowances to $1.564 billion per budget. Some uncertainty will remain around the Housing Infrastructure Fund, as proposals from councils are assessed in the coming months, particularly around the amount of the concessionary charge and timing of repayments. This could have implications for net debt in 2020/21 or the size of future capital allowances.

78. The forward view of pressures in the capital pipeline gives some information on whether these allowances are likely to be enough to cover the pressures identified. Over $10 billion of capital requests was received as part of Budget 2017. To a large extent, whether future allowances are manageable depends on whether these requests are likely to be resubmitted and represent high value investment for the Government in future budgets. Achieving a package of around $3.5 billion in Budget 2017 required the deferral of a number of significant initiatives which could total up to approximately $7 billion, which are likely to be requested in Budget 2018 and outyears, [33]

79. [33]

80. In addition to current known pressures, we might expect an increasing pressure from population growth on infrastructure, as seen with the need for a Government contribution to the CRL and the creation of the Housing Infrastructure Fund. Allowances of $1.5 billion would not allow any new significant initiatives in this area, after dealing with known pressures.

Recommended allowances

81. The Treasury recommends Budget 2017 packages with a cost of approximately $1.8 billion per annum on average of operating expenses and $3.5 billion of capital expenses. There are limited options to further restrict expenditure in Budget 2017 beyond these levels.

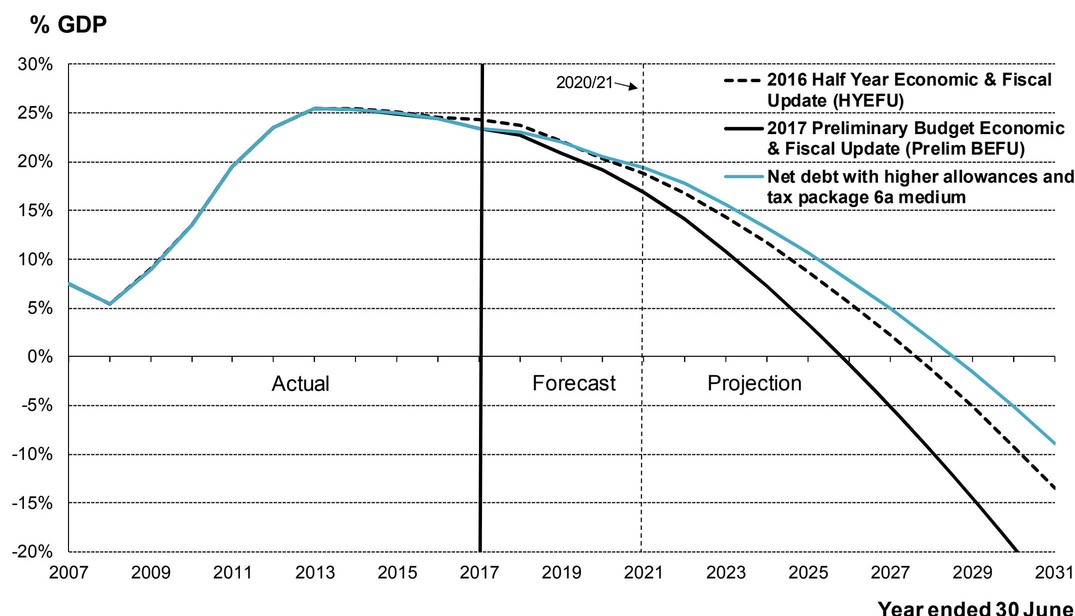
82. We recommend a tax package of around $2 to $2.5 billion per annum. A tax package of $2.3 billion, with phasing, e.g. option 6a medium, would allow operating allowances to increase by $200 million per budget from Budget 2018 onwards. At this stage, we do not recommend increasing capital allowances from Budget 2018 onwards. These were increased from $900 million to $2 billion in the Budget Policy Statement 2017. However, there is likely to be pressure against the capital allowance: it would therefore be prudent to maintain some headroom within the fiscal target so that the capital allowance could be reassessed in the future.

83. In total this would take net debt to 19.4 per cent of GDP in 2020/21, with NZSF contributions restarting in that year, based upon preliminary forecasts. The impact of these allowance changes on net debt is shown in Figure 1. The impact on the main fiscal aggregates to 2030/31 is shown in the Annex, along with the impact of other possible tax packages.

84. There are risks to these forecasts. As discussed above, the December 2016 quarter GDP release suggests that final economic and tax forecasts may come in slightly weaker than the preliminary forecasts. If tax revenue forecasts were reduced by $1 billion cumulatively over the forecast period, all else equal, net debt would increase by 0.3 percentage points of GDP. There are also some specific risks to the fiscal forecasts, in particular there is a risk that the negotiation envelope for Terranova could increase, possibly by $290 million [33]

If they materialised, these two fiscal risks would increase net debt to GDP by approximately 0.2 percentage points in 2020/21.

Figure 1 – Net core crown debt to GDP comparison



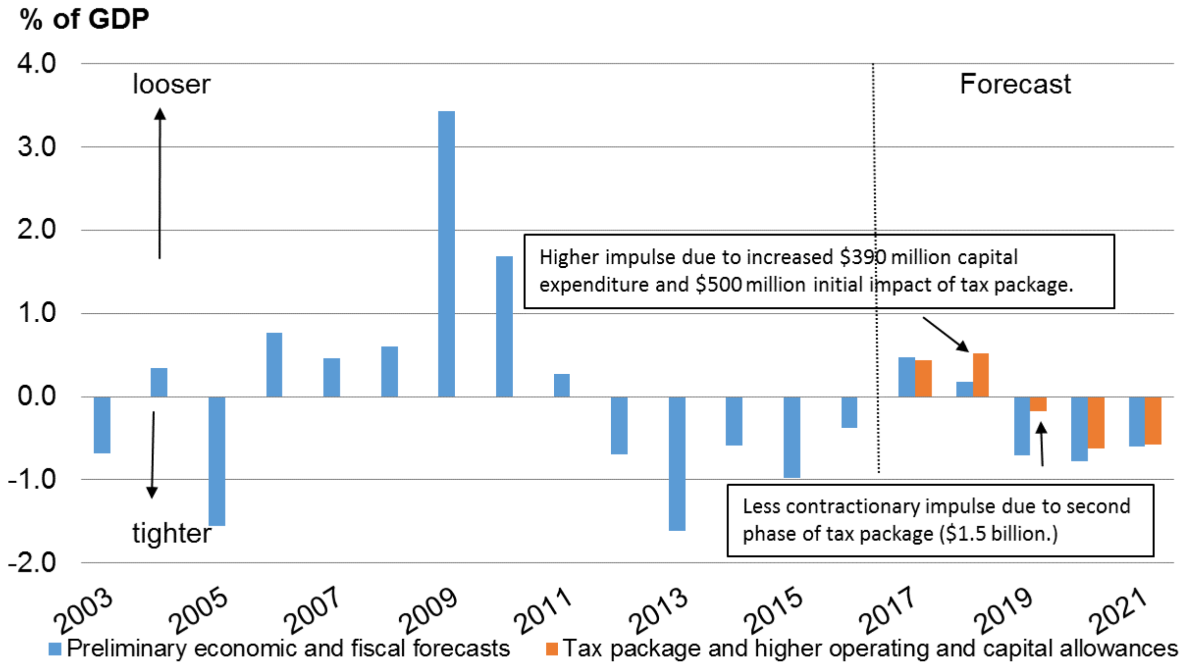
Macroeconomic implications

85. The PFA requires Government to consider the interaction between fiscal policy and monetary policy in its fiscal strategy.

86. Increases in Budget allowances and a tax and transfer package generates a more expansionary fiscal impulse than forecast at HYEFU. Tax cuts in 2018 would be expected to boost aggregate demand and will be incorporated into the final BEFU economic forecasts. Their macroeconomic effect will depend on households' spending/saving decisions and impact on labour supply.

87. The fiscal impulse indicator is an approximate estimate of the contribution of discretionary fiscal policy to aggregate demand. Figure 2 shows the indicator based on preliminary economic and fiscal forecasts (baseline) and with the recommended increases in allowances and tax and transfer package. The fiscal stance is expected to be slightly more expansionary in 2017/18 due to the initial impact of the tax and transfer package and higher operating and capital spending and less contractionary than the baseline in 2018/19 due to the tax package.

Figure 2 – Fiscal impulse



88. We have previously estimated that a fiscal stimulus of roughly 1 per cent of GDP would result in an increase in the OCR of roughly 30 basis points, compared with the counterfactual of no additional stimulus. However, any estimates are contingent on how the composition of tax and expenditure changes feed through into the economy and the cyclical position of the economy at the time that the impact is felt.

89. Whilst there would be times within the economic cycle when a fiscal stimulus of this magnitude would lead to a higher OCR within a short timeframe, this is less likely in the current juncture with some spare capacity in the economy and a low inflation environment. However, we would still expect the OCR would be higher than otherwise over time. That may not necessarily materialise as an increase in the OCR: it will

depend on a number of other factors that determine the monetary policy response. It could be that what would have been a lower OCR does not materialise.

Fiscal strategy considerations beyond 2020

90. The short-term fiscal intention to reduce net debt to around 20 per cent of GDP by 2020 is forecast to be met, and the 2020 year will fall within the next Parliamentary term. Beyond 2020, projections show net debt falling rapidly and surpluses growing, which is likely to make fiscal management challenging. We recommend providing greater clarity around your fiscal strategy beyond 2020 to continue to provide discipline on expenditure decisions in an environment of operating surpluses.

91. The current long-term fiscal objective is to maintain net debt within a range of 0-20 per cent of GDP over the next ten years.[3] A range target allows net debt to fluctuate over the economic cycle, acknowledging that net debt acts as a shock absorber, thereby supporting macroeconomic stability. However, the width of this range target does not support fiscal management as well as it could as it does not provide a clear fiscal anchor. This illustrates a trade-off between a target that provides a strong fiscal anchor (thereby supporting prudent fiscal management) and one that supports macroeconomic stability by avoiding pro-cyclical changes in fiscal settings (i.e. excessive cuts to spending in a cyclical downturn or conversely excessive increases in spending in a cyclical upturn, thereby exacerbating the economic cycle). At a minimum, fiscal targets should be sufficiently flexible to allow the automatic fiscal stabilisers to operate (e.g. tax revenues automatically rise in an upturn and fall in a downturn) in order to support macroeconomic stability. In general, a point target may better support fiscal management, while a range target may better support macroeconomic stability. One way to manage this trade-off would be to focus on a point within a wider range target.

92. In considering the appropriate level of the target, there is no clear evidence to suggest an "optimal" level of net debt. In the medium term the objective should be to stabilise net debt whilst allowing it to fluctuate in the short term in response to shocks. The Treasury plans to undertake new work following Budget 2017 in order to update our advice on appropriate fiscal buffers to inform new fiscal targets for the next Parliamentary term.

[3] The Public Finance Act requires all long-term objectives to be set for at least the next ten years.

93. You may wish to set a more specific fiscal target in the 2017 *Fiscal Strategy Report*. We have previously provided you with options to consider [T2017/708 refers]. The Treasury would recommend increasing the focus on the midpoint of the current range target, 10 per cent of GDP, whilst maintaining the range so that net debt could respond to economic shocks. A 10 per cent of GDP target within a range of 0 to 20 per cent would bring net debt closer to its pre-Global Financial Crisis level (around 5% of GDP). It would also mean that net debt is likely to stay below 20 per cent of GDP if New Zealand faced a typical recession, maximising the likelihood of staying within the target range. An example of how this target could be worded is:

> *'Reduce net debt to around 10 per cent of GDP. Maintain net debt within a range of 0 to 20 per cent of GDP, subject to shocks.'*

94. The exact wording of the target can be refined when drafting the *Fiscal Strategy Report* 2017.

Annex

The tables show the impact on fiscal aggregates of the 6 tax and transfer packages in this report. We assume Budget 2017 operating and capital packages of approximately $1.8 billion and $3.5 billion and future operating and capital allowances of $1.7 billion and $2 billion per Budget respectively.

Package 4

% of GDP	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
OBEGAL	0.2	0.7	0.6	1.3	1.6	1.9	2.1	2.5	2.9	3.1	3.4	3.6	3.8	4.0	4.2	4.5	4.8
Core Crown revenue	29.7	30.1	30.2	29.8	29.4	29.6	29.8	30.0	30.2	30.3	30.4	30.4	30.4	30.4	30.4	30.4	30.4
Core Crown expenditure	29.8	29.2	28.9	28.3	27.7	27.5	27.5	27.3	27.1	27.0	26.8	26.6	26.4	26.2	26.0	25.7	25.4
Residual cash	-0.8	-0.5	-0.2	-0.8	-0.3	0.6	0.6	1.0	1.5	1.8	2.1	2.4	2.7	3.1	3.4	3.7	4.1
Net debt	25.0	24.5	23.4	23.0	22.0	20.5	19.2	17.4	15.1	12.7	10.0	7.1	4.0	0.8	-2.7	-6.3	-10.2

Package 5a

% of GDP	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
OBEGAL	0.2	0.7	0.6	1.2	1.3	1.6	1.8	2.2	2.5	2.8	3.0	3.2	3.4	3.5	3.8	4.1	4.4
Core Crown revenue	29.7	30.1	30.2	29.8	29.1	29.3	29.5	29.7	29.9	30.0	30.1	30.1	30.1	30.1	30.2	30.2	30.2
Core Crown expenditure	29.8	29.2	28.9	28.3	27.7	27.6	27.5	27.3	27.2	27.1	26.9	26.7	26.6	26.4	26.2	25.9	25.6
Residual cash	-0.8	-0.5	-0.2	-0.9	-0.6	0.3	0.3	0.6	1.1	1.4	1.8	2.1	2.3	2.6	2.9	3.3	3.6
Net debt	25.0	24.5	23.4	23.1	22.4	21.1	20.1	18.6	16.6	14.5	12.1	9.5	6.7	3.8	0.7	-2.7	-6.2

Package 6a

% of GDP	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
OBEGAL	0.2	0.7	0.6	1.3	1.5	1.8	2.0	2.4	2.7	3.0	3.2	3.4	3.6	3.8	4.0	4.3	4.6
Core Crown revenue	29.7	30.1	30.2	29.8	29.3	29.4	29.7	29.9	30.1	30.2	30.3	30.3	30.3	30.3	30.3	30.3	30.3
Core Crown expenditure	29.8	29.2	28.9	28.3	27.7	27.5	27.5	27.3	27.1	27.0	26.8	26.7	26.5	26.3	26.1	25.8	25.5
Residual cash	-0.8	-0.5	-0.2	-0.9	-0.4	0.5	0.5	0.8	1.3	1.6	2.0	2.3	2.6	2.9	3.2	3.5	3.9
Net debt	25.0	24.5	23.4	23.1	22.2	20.8	19.6	17.9	15.8	13.5	10.9	8.2	5.2	2.1	-1.2	-4.7	-8.5

Package 6a Mild																	
% of GDP	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
OBEGAL	0.2	0.7	0.6	1.3	1.6	1.8	2.0	2.4	2.7	3.0	3.2	3.4	3.6	3.8	4.1	4.3	4.6
Core Crown revenue	29.7	30.1	30.2	29.8	29.4	29.4	29.7	29.9	30.1	30.2	30.3	30.3	30.3	30.3	30.3	30.3	30.3
Core Crown expenditure	29.8	29.2	28.9	28.3	27.7	27.5	27.5	27.3	27.1	27.0	26.8	26.7	26.5	26.3	26.1	25.8	25.5
Residual cash	-0.8	-0.5	-0.2	-0.8	-0.3	0.5	0.5	0.8	1.4	1.6	2.0	2.3	2.6	2.9	3.2	3.6	3.9
Net debt	25.0	24.5	23.4	23.0	22.0	20.6	19.4	17.8	15.6	13.3	10.7	8.0	5.0	1.9	-1.4	-5.0	-8.7

Package 6a Medium																	
% of GDP	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
OBEGAL	0.2	0.7	0.6	1.3	1.6	1.8	2.0	2.4	2.7	3.0	3.2	3.4	3.6	3.8	4.1	4.4	4.7
Core Crown revenue	29.7	30.1	30.2	29.8	29.4	29.5	29.7	29.9	30.1	30.2	30.3	30.3	30.3	30.3	30.3	30.3	30.3
Core Crown expenditure	29.8	29.2	28.9	28.3	27.7	27.5	27.5	27.3	27.1	27.0	26.8	26.7	26.5	26.3	26.0	25.8	25.5
Residual cash	-0.8	-0.5	-0.2	-0.9	-0.3	0.5	0.5	0.8	1.4	1.7	2.0	2.3	2.6	2.9	3.2	3.6	3.9
Net debt	25.0	24.5	23.4	23.1	22.0	20.6	19.4	17.7	15.6	13.3	10.7	7.9	4.9	1.8	-1.6	-5.1	-8.9

Package 6a Extreme																	
% of GDP	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
OBEGAL	0.2	0.7	0.6	1.3	1.6	1.8	2.0	2.4	2.7	3.0	3.2	3.4	3.6	3.8	4.1	4.4	4.7
Core Crown revenue	29.7	30.1	30.2	29.8	29.4	29.5	29.7	29.9	30.1	30.2	30.3	30.3	30.3	30.3	30.3	30.3	30.3
Core Crown expenditure	29.8	29.2	28.9	28.3	27.7	27.5	27.5	27.3	27.1	27.0	26.8	26.7	26.5	26.3	26.0	25.8	25.5
Residual cash	-0.8	-0.5	-0.2	-0.8	-0.3	0.5	0.5	0.9	1.4	1.7	2.0	2.3	2.6	2.9	3.2	3.6	3.9
Net debt	25.0	24.5	23.4	23.0	22.0	20.6	19.4	17.7	15.5	13.2	10.6	7.8	4.8	1.7	-1.7	-5.2	-9.0