The Treasury

Budget 2018 Information Release

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Treasury Report: Fiscal Strategy for Budget 2018

Date:	19 March 2018	**Report No:**	T2018/309
		File Number:	MC-1-5-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Provide** feedback on Budget allowance settings ahead of the Budget Ministers 3 meeting, and to feed into final economic forecasts.	We have a meeting with you on Monday 19 March to discuss this report. We will reflect your feedback in the slides for the Budget Ministers 3 meeting, which we will provide you on Friday 23 March.

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Katy Simpson	Senior Analyst, Macroeconomic and Fiscal Policy	[39] (wk)	N/A (mob)	✓
Neil Kidd	Acting Manager, Macroeconomic and Fiscal Policy	[39] (wk)	N/A (mob)	

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

Return the signed report to the Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Executive Summary

This report provides you with the Treasury's fiscal strategy advice ahead of Budget 2018. The Treasury recommends maintaining a buffer against the Government's net debt rule of 20% of GDP. We recommend limiting increases to the Budget 2018 capital allowance, managing operating expenses within the Budget 2018 operating allowance, and increasing future operating and capital allowances to reflect future intentions and fiscal pressures.

The Treasury's preliminary Budget 2018 economic forecasts show that the economic outlook remains positive and is broadly similar to the *Half Year Update* (HYEFU). Growth is expected to remain around current levels before accelerating over 2019 and 2020 and the unemployment rate is expected to fall to around 4%. There remains a range of risks to the economic outlook including whether the construction sector has sufficient capacity to absorb the forecast pick-up in investment, household spending and saving behaviour, and whether the profile of net migration continues to evolve as we have assumed.

There has been an overall improvement in the fiscal position compared to the HYEFU forecasts. The preliminary tax revenue forecast is higher by $4.0 billion across the forecast period compared to the HYEFU, owing to a strong recent outturn and slightly higher forecast nominal GDP driven by an increase in the long-run assumption for net migration. Preliminary Budget forecasts show core Crown net debt at 18.0% of GDP in 2021/22 and operating balance before gains and losses (OBEGAL) surpluses across the forecast period, in line with the Budget Responsibility Rules (BRRs).

There are a number of risks which it would be prudent to provision for by maintaining a small buffer against your net debt rule. Relatively small changes in the judgements underpinning the economic forecasts can have a significant impact. The Treasury's forecasts for economic growth are slightly more positive than most domestic forecasters. If economic forecasts were in line with the average of external forecasts, we estimate net debt would increase by 1.3% of GDP in 2021/22 compared with our preliminary forecasts, removing the majority of the fiscal headroom against the net debt rule.

In addition, the preliminary fiscal forecasts have improved, in part, as a result of a higher migration assumption. However, the fiscal forecasts do not fully capture the impact of higher migration on operating and capital expenses, largely because these pressures are assumed to be managed within allowances. We estimate the cumulative impact on operating expenses, and net debt, from this higher migration assumption would be 0.2% to 0.3% of GDP by 2021/22. This is likely to be a conservative estimate of the overall net debt impact as we have not factored in an impact on capital investment e.g. schools, hospitals and infrastructure.

These estimates come with a large number of caveats and there are a range of other risks, both on the upside and the downside. The impact of higher migration will mostly be increased pressure against allowances, which would result in a deterioration in net debt only if allowances were increased. Estimates of these impacts are discussed in more detail in the report.

	Per cent of GDP
Net core Crown debt in 2021/22 (preliminary BEFU forecast)	**18.0**
Increase in operating expense due to higher migration if assumed on top of allowances	+0.2 to +0.3
Impact of scenario where GDP is in line with average of external forecasts	+1.3
Adjusted net core Crown debt in 2021/22	**19.5-19.6**

There continues to be value in maintaining focus on the BRRs as a framework for sound fiscal management and to build fiscal credibility. We do not recommend any changes to the Government's existing fiscal strategy and rules.

Of the BRRs, the net debt rule is likely to be the most binding constraint over the next few years. Preliminary fiscal forecasts show there is expected to be $7.1 billion headroom against the net debt rule of 20% of GDP in 2021/22, if spending is kept in line with the Budget allowances set in the *Budget Policy Statement* (BPS). If a net debt buffer of 0.7% of GDP were maintained, as in HYEFU forecasts, this would reduce the available headroom to $4.6 billion.

While there are significant pressures against the 2018 Budget allowances, particularly for capital investment, we recommend that you limit any increase to capital allowances and stay within the operating allowance set out in the 2018 BPS, in order to reserve some headroom for economic and fiscal risks and to increase future allowances. There is also likely to be capacity constraints in the ability to deliver significant increases in some types of capital investment. Invariably, this will require some difficult trade-offs and scaling options, and should be accompanied by a focus on cost drivers to avoid just deferring pressures to future budgets.

We recommend an increase in operating and capital allowances for Budget 2019 and beyond and that increased allowances are signalled in the Budget 2018 *Fiscal Strategy Report* and the Treasury's final forecasts. This would help to reflect future Government intentions and fiscal pressures. New spending allowances for Budget 2019 and beyond are set at a lower level than for Budget 2018, and there are still significant Government expenditure and investment intentions or requests for funding from agencies in future Budgets.

Previous experience suggests that agency cost pressures are around 60-80% of the operating allowance and, on the basis of agency Four Year Plans, this is likely to continue: there is uncertainty but perhaps as much as $1.5 billion of the operating allowance might be taken up by price and volume growth. The data that the Treasury collects on future agency capital intentions suggests that there is still a significant level of requests that will need to be accommodated within future capital allowances. There are also outstanding manifesto commitments, significant fiscal risks (for example, from pay equity claims) and the Government may want to progress other high priority initiatives (for example, related to the wellbeing budget or the Welfare Expert Advisory Group recommendations).

Given uncertainty about the future mix and timing of fiscal pressures between operating and capital, and the relative value of them, we recommend increasing both operating and capital allowances across the forecast period from Budget 2019 onwards while still maintaining some net debt headroom. This report provides scenarios showing the impact on net debt from increasing allowances, including in Budget 2018. We can work with you to finalise allowances.

The fiscal stance is currently forecast to be expansionary in the near term, with a moderate contraction later in the forecast period. From a macroeconomic perspective, a moderate fiscal expansion in the short term is broadly appropriate in the context of population-driven growth, low interest rates and subdued wage and price pressures. Material changes in spending allowances would impact on demand pressures in the economy, which will be considered by the Reserve Bank in setting the OCR. A greater fiscal expansion would place pressure on interest rates and exchange rates at the margin. This could bring forward OCR increases (currently forecast to take place from mid-2019) and put upward pressure on the exchange rate, weighing on the competitiveness of the export sector. However, macro stability risks from higher interest rates are less concerning in an environment of historically low interest rates, subdued inflation and rising global interest rates. Indeed, there may be some financial stability benefits in supporting aggregate demand so that interest rates return to normal levels, as very low interest rates can fuel asset price inflation.

Recommended Action

a **note** preliminary 2018 BEFU economic forecasts continue to show a positive economic outlook, with GDP growth of around 3 percent on average over the next five years and the unemployment rate falling to around 4 percent in 2020/21;

b **note** preliminary 2018 BEFU fiscal forecasts show OBEGAL surpluses rising to around $10 billion and net debt reducing to 18.0% of GDP in 2021/22 in line with the Government's Budget Responsibility Rules;

c **note** there is value in maintaining focus on the Budget Responsibility Rules as a framework for sound fiscal management and to build fiscal credibility;

d **note** these preliminary forecasts show there is around $7.1 billion of headroom against the Budget Responsibility Rule of reducing net core Crown debt to 20% of GDP within five years of taking office, and that there are a number of competing options for the use of any fiscal headroom;

e **note** that we recommend maintaining a buffer against your net debt rule to manage risks to these forecasts, particularly that our forecasts are more positive than other independent forecasters and that higher migration is not fully reflected in fiscal forecasts;

f **note** that Budget 2018 allowances are heavily oversubscribed, particularly for capital, and we expect this overall trend to continue in future budgets;

g **note** the Treasury recommends limiting any increase to Budget 2018 capital allowances and maintaining operating expenses within the existing Budget 2018 operating allowance as set out in the 2018 Budget Policy Statement so as to leave net debt headroom for future spending pressures and risks;

h **note** we recommend increasing operating and capital allowances in Budget 2019 and beyond to reflect future intentions and risks;

i **agree** to increase future operating and capital allowances and to signal these in the Budget 2018 *Fiscal Strategy Report* and the Treasury's final forecasts;

Agree / Disagree

j **note** that there is a high degree of uncertainty as to the relative value between operating and capital expenditure in future budgets, and the timing of commitments, but that allowance levels can be adjusted at future fiscal events;

k **note** we have provided a range of scenarios for allowance settings, which illustrate alternative allowance levels for your consideration, including increases to Budget 2018 allowances, and we can work with you to finalise these allowances;

l provide the Treasury with feedback on allowance settings so that a draft package can be developed for the Budget Ministers 3 meeting on 26 March and that allowances can be reflected in the Treasury's final forecasts;

Neil Kidd
Acting Manager, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Treasury Report: Fiscal Strategy for Budget 2018

Purpose of Report

1. This report provides you with the Treasury's advice on fiscal strategy on the basis of the preliminary 2018 *Budget Economic and Fiscal Update* (BEFU) forecasts.

2. This provides an opportunity to ensure that you are comfortable with your allowance settings and progress towards delivering your fiscal strategy or, if not, to adjust policy settings before the economic forecasts are finalised on 10 April.

3. Your feedback on allowance settings will be used to develop further draft budget packages and slides which will be provided to you on Friday 23 March ahead of the Budget Ministers 3 meeting on Monday 26 March.

4. In addition, you are meeting Budget Ministers on Monday 19 March at 6.15pm to discuss draft 2018 Budget packages and it is possible that allowance settings will be discussed.

The economic and fiscal outlook - and what it means for the Budget Responsibility Rules

Preliminary economic forecasts are for slightly higher growth than at the Half Year Update

5. The Treasury's preliminary 2018 BEFU economic forecasts show that the economic outlook remains positive and is broadly similar to the 2017 *Half Year Economic and Fiscal Update* (HYEFU) forecasts. The main differences, including recent revisions to historical GDP levels, are outlined in detail in TR2018/364 and summarised in Table 1 below. Growth is expected to remain around current levels before accelerating over 2019 and 2020, supported by low interest rates, high population growth, government spending, a high terms of trade and momentum in the global economy. Overall, once GDP revisions are accounted for, nominal GDP is a cumulative $0.9 billion higher across the forecast period. In part, this change is due to an assumption of higher net migration towards the end of the forecast period.

6. Underlying inflationary pressures are expected to remain muted in the near-term following recent weakness in tradeables inflation and with some policy changes expected to contribute to downwards pressure on prices (including the Fees-free tertiary education package). The Treasury and the Reserve Bank share the same central expectation for capacity pressures to build over the forecast period placing pressure on non-tradeables inflation. Both institutions forecast OCR increases starting from 2019. There are substantial upside and downside risks to this forward OCR path, with the link between reduced slack and inflation being less certain in recent years.

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

June years		2017 Actual	2018 Forecast	2019 Forecast	2020 Forecast	2021 Forecast	2022 Forecast	5-year total
Economic growth[1]	**Prelim BEFU**	**3.3**	**2.9**	**3.3**	**3.5**	**2.8**	**2.3**	
	HYEFU	2.7	2.9	3.6	3.0	2.6	2.1	
Economic growth per capita[1]	**Prelim BEFU**	**1.2**	**0.9**	**1.3**	**1.9**	**1.4**	**1.1**	
	HYEFU	0.6	0.9	1.7	1.4	1.4	1.1	
Unemployment rate[2]	**Prelim BEFU**	**4.8**	**4.6**	**4.3**	**4.1**	**4.0**	**4.1**	
	HYEFU	4.8	4.6	4.4	4.2	4.0	4.1	
CPI inflation[3]	**Prelim BEFU**	**1.7**	**1.6**	**1.6**	**2.0**	**2.1**	**2.2**	
	HYEFU	1.7	2.0	1.9	2.1	2.2	2.2	
Current account balance[4]	**Prelim BEFU**	**-2.8**	**-2.6**	**-3.0**	**-2.8**	**-3.0**	**-3.0**	
	HYEFU	-2.9	-2.1	-2.3	-2.7	-3.3	-3.9	
Nominal GDP[5]	**Prelim BEFU**	**6.2**	**5.4**	**4.6**	**5.5**	**4.9**	**4.5**	
	HYEFU	5.8	5.0	5.3	5.0	4.8	4.2	
Nominal GDP ($billions)	**Prelim BEFU**	**273.8**	**288.5**	**301.7**	**318.2**	**333.6**	**348.6**	
	HYEFU	268.0	281.4	296.2	311.0	325.9	339.6	
	change	**5.8**	**7.1**	**5.5**	**7.2**	**7.8**	**8.9**	**36.4**
	adj. change[6]		**0.0**	**-1.6**	**0.1**	**0.6**	**1.8**	**0.9**
Tax revenue ($billions)	**Prelim BEFU**	**75.6**	**79.6**	**83.2**	**88.1**	**93.6**	**99.1**	
	HYEFU	75.6	78.2	82.8	87.8	93.0	97.8	
	change	0.0	1.4	0.4	0.3	0.6	1.3	4.0

1. Production GDP, annual average % change 2. June quarter 3. Annual % change 4. Annual as % of GDP
5. Expenditure measure 6. change adjusted for starting point revisions to historical GDP data

7. Since the finalisation of these forecasts new economic data and information regarding Government policies has been received. GDP data for the December quarter has been released, showing that the economy expanded 2.9% on an annual average basis to December 2017. While annual average growth was in line with our expectations, the quarterly growth outturn was a little weaker, with the adverse agricultural impact anticipated for early 2018 coming through sooner than expected. On the other hand, nominal GDP growth was stronger and there were further upward revisions to recent quarters. We will need to assess how much of this higher nominal GDP starting point will flow into tax forecasts.

8. The preliminary economic forecasts assumed that the profile of spending for KiwiBuild was the same as at HYEFU. This has been updated in the preliminary fiscal forecasts as the majority of spending is now expected to occur later in the forecast period. This will likely have a negative impact on near term growth and residential investment when the final economic forecasts are produced.

9. The economic forecasts will be finalised on 10 April.

Preliminary tax forecasts are $4.0 billion higher than HYEFU

10. Tax revenue is expected to be a cumulative $4.0 billion higher by the end of the forecast period than at HYEFU. This is driven by the recent strong outturns in tax revenue that are expected to continue in the near term, and the small improvement in the nominal GDP forecast. For the seven months to January 2018, core Crown tax revenue was $0.9 billion (2.1%) above the *Half Year Update* forecast.

11. Tax revenue as percent of GDP is expected to rise over the forecast period, as tax thresholds are not increasing in line with wage growth.

Preliminary fiscal forecasts show a strong outlook

12. Consistent with the positive economic outlook, the fiscal outlook remains strong. Slightly higher nominal GDP and higher tax revenue result in lower net debt than forecast at HYEFU. Net debt is forecast to peak at 21.5% of GDP in 2018/19 and fall to

18.0% of GDP in 2021/22 – down from 19.3% at HYEFU. Operating balance before gains and losses (OBEGAL) surpluses rise to around $10 billion by 2021/22.

13. Core Crown expenses are higher in nominal terms but smaller as a share of GDP than at HYEFU. They are declining as a share of GDP over the forecast period and average around 28% of GDP. The residual cash deficits in the next two years are driven by elevated capital spending, although they are now forecast to be smaller than at HYEFU.

14. The preliminary BEFU fiscal forecasts incorporate the preliminary economic and tax forecasts, updated forecasts of spending from departments and include the operating and capital allowances as set in your 2018 *Budget Policy Statement* (BPS).

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

Year ending 30 June	2017 Actual	2018 Forecast	2019 Forecast	2020 Forecast	2021 Forecast	2022 Forecast
$billions						
OBEGAL - 2018 Prelim BEFU	4.1	2.6	2.7	5.2	7.0	9.9
OBEGAL - 2017 HYEFU		2.5	2.8	5.0	6.5	8.8
Total Change		**0.1**	**(0.1)**	**0.2**	**0.5**	**1.1**
Core Crown expenses- 2018 Prelim BEFU	76.3	82.3	86.5	89.2	92.8	95.4
Core Crown expenses - 2017 HYEFU		81.7	86.3	89.2	92.7	95.3
Total Change		**0.6**	**0.2**	**0.0**	**0.1**	**0.1**
Residual cash - 2018 Prelim BEFU	2.6	(2.2)	(3.7)	(1.7)	0.1	3.7
Residual cash - HYEFU 2017		(2.6)	(4.7)	(2.6)	0.3	2.3
Total Change		**0.4**	**1.0**	**0.9**	**(0.2)**	**1.4**
Net Debt - 2018 Prelim BEFU	59.5	61.2	64.9	66.5	66.3	62.6
Net Debt - 2017 HYEFU		62.1	66.8	69.4	69.0	66.8
Total Change		**(0.9)**	**(1.9)**	**(2.9)**	**(2.7)**	**(4.2)**
Net worth attributable to the Crown - 2018 Prelim BEFU	110.5	117.4	123.4	132.3	143.4	158.0
Net worth attributable to the Crown - 2017 HYEFU		116.6	122.5	131.1	141.5	154.6
Total Change		**0.8**	**0.9**	**1.2**	**1.9**	**3.4**
% of GDP						
Core Crown expenses- 2018 Prelim BEFU	27.9	28.5	28.7	28.0	27.8	27.4
Core Crown expenses - 2017 HYEFU		28.5	28.6	28.2	28.0	27.6
Total Change		**0.0**	**0.1**	**(0.2)**	**(0.2)**	**(0.2)**
Net Debt - 2018 Prelim BEFU	21.7	21.2	21.5	20.9	19.9	18.0
Net Debt - 2017 HYEFU		21.7	22.2	21.9	20.8	19.3
Total Change		**(0.5)**	**(0.7)**	**(1.0)**	**(0.9)**	**(1.3)**

Note: some numbers may not sum due to rounding

Fiscal forecasts are in line with the Budget Responsibility Rules

15. We think there is value in maintaining a focus on the Government's BRRs in order to build fiscal credibility and as a mechanism to prioritise investment and expenditure. The net debt rule is the most binding constraint over the next few years and provides a fiscal anchor. This helps to ensure a strong fiscal position for New Zealand, which provides a buffer so fiscal policy can respond to any future negative shock. In addition, maintaining the fiscal strategy would help to mitigate any uncertainty for investors that might arise from the Government's review of the Reserve Bank Act.

16. Operating and capital allowances were announced in the BPS in December 2017 that are consistent with these rules. These allowances are set out in Table 3 below, and have been used as the basis of the preliminary 2018 BEFU forecasts

Table 3: 2018 BPS allowances

$billions	Budget 2018	Budget 2019	Budget 2020	Budget 2021
Operating allowance (per year)	2.600	1.875	1.875	1.875
Capital allowance (total)	3.400	3.400	3.100	2.700
Capital allowance (net of pre-commitments)	2.498	2.672	2.672	2.700

17. The Treasury's preliminary forecasts show there is $7.1 billion of nominal headroom against the net debt rule if spending is in line with BPS allowances. This means that net debt could be higher by $7.1 billion in 2021/22 than currently forecast so that net debt would be forecast to be 20% of GDP.

There are risks to these forecasts…

18. There are a range of risks that could result in either faster or slower growth and therefore could have a material impact on the fiscal position. Economic forecasts are inherently uncertain and while the Treasury's forecasts represent our best judgements, it is important to acknowledge that future forecasts and actual outturns will be different.

19. When considering risks, we draw a distinction between significant shocks (eg, natural disaster or global crisis), which would likely require changes to your fiscal strategy, and smaller changes to our judgements about how the economy is evolving. The latter may still have material impacts on the fiscal position but are less likely to be a credible reason to move away from your fiscal strategy and BRRs.

20. The set of forecasts presented earlier describe a view of the outlook that is more positive than the average of other forecasters of the New Zealand economy. To demonstrate the impact of a different economic outlook on the fiscal position we have produced a scenario that approximately replicates the average of other forecasters' views of the economic outlook. In this scenario, growth peaks at 3.3%, and unemployment remains around current levels. Overall, this reduces nominal GDP by a cumulative $9.7 billion, flowing through to tax revenue that is $3.4 billion lower across the forecast period. This results in a materially weaker fiscal position with net debt that is 1.3% of GDP higher by 2021/22. In this scenario the Government would have limited headroom to increase allowances from current levels and still meet the net debt rule.

21. Alongside these general risks there are a range of specific risks to our forecasts, including:

    a Net migration being higher than forecast (upside).

    b High household debt posing a risk to consumption if financial conditions tighten (downside).

    c Capacity constraints in the broader economy being more binding than assumed leading to a faster increase in interest rates (downside).

    d The sustainability of the global economic expansion could be jeopardised by geopolitical risks (for example, a trade war) and fragility in emerging economies (downside).

22. A risk to the fiscal forecast is spending pressure from population growth. The Treasury's population forecasts are provided to agencies as an input into their fiscal forecasts, which in turn are inputs to the Treasury's fiscal forecasts. However, agencies will often use their own population assumptions if they have different data requirements

e.g. the Treasury's population forecast is not sufficiently disaggregated to use in education forecasts. Therefore, there has been some divergence between the Treasury's population forecast assumptions, largely driven by migration, and the forecast assumptions underpinning the fiscal forecasts. The Treasury population forecasts are cumulatively around 30,000 to 35,000 higher by 2022 than that incorporated into the Ministry of Education, the Ministry of Health and the Ministry of Social Development forecasts. The result is that we may be capturing the economic growth and tax revenue that migrants generate but less so the fiscal costs, particularly in the later years of the forecast period. However, even if captured in agency forecasts, the majority of these expenses would show up in the Treasury's fiscal forecasts as pressure against allowances as opposed to an impact on net debt.

23. Our initial estimates suggest that incorporating the Treasury's migration forecasts into the Ministry of Education's early childhood education (ECE) and school roll forecasts, the Ministry of Health's population based funding forecasts and the Ministry of Social Development's benefit forecasts, might add around an extra $0.7 billion to $1 billion to operating expenses, largely as future pressures that will need to be managed within the operating allowances. This is equivalent to a 0.2% to 0.3% increase in net debt in 2021/22. There is a large degree of uncertainty in these estimates, in particular we assume that the cost of providing public services increases one-for-one with an increase in population, which might not be true if migrants are low users of public services or if there are productivity gains in providing public services as the population increases.

24. We have less information on the impact that higher migration will have on capital pressures, as it would depend on geographic distribution and the demographic make-up of the migrants. We are already seeing the impact of higher migration on schools, hospitals and infrastructure and we would expect this to continue if higher levels of migration last for longer.

Given there are risks, there are good reasons to maintain some net debt headroom

25. Maintaining headroom would help to ensure BRRs are still met if the economic or fiscal forecast deteriorates. Maintaining some headroom against your net debt rule would help to guard against facing a trade-off between missing the fiscal rules or reducing allowances in the future if risks materialise. As an illustration, keeping net debt at 19.3% of GDP in 2021/22 (as at the HYEFU*)* implies spending $4.6 billion of the $7.1 billion headroom.

26. The key trade off with the remaining headroom is how much to use in Budget 2018 (discussed in the next section) and how much to hold back for future Budgets (discussed in the subsequent section).

The outlook for Budget 2018

27. This section is based on the draft package set out in Budget Ministers 2 slides which you received on 15 March.

Operating allowances are oversubscribed

28. You received an average of $5.6 billion per annum of operating spending budget bids, well above the BPS operating allowance of $2.6 billion. The draft operating package for Budget 2018 at $2.673 billion fits broadly within the BPS allowance of $2.6 billion. This is made up of approximately $3 billion of gross spending (including precommitments) and $315 million of reprioritisation and savings.

29. Around 70-80% of the draft package funds volume, price and personnel cost pressures. The high proportion of cost pressures is consistent with previous Budgets and likely to continue in the future.

Capital allowances are more oversubscribed

30. The initial BPS Budget 2018 capital allowance is $3.4 billion. This compares to total Budget bids of $8.7 billion, of which $5.8 billion are cost pressures and $2.9 billion are manifesto commitments.

31. The draft capital package for Budget 2018 is currently at $3.640 billion, including $0.9 billion of precommitments and $3 million of reprioritisation. This exceeds the available allowance by $240 million.

But there are benefits of delivering your Budget within or close to announced allowances

32. There is value in aiming to manage operating expenses within the operating allowance and to limit any increase in the capital allowance in Budget 2018 as signalled in the BPS. This would help to maintain credibility in the fiscal strategy, manage pressures in future Budgets and provide a buffer for economic risks.

33. Limiting increases to the capital allowance in particular will be a challenge and will involve significant trade-offs and scaling. Phasing helps, especially given industry capacity, but risks pushing out costs rather than reducing them. Cost drivers will need to be considered to help manage down future pressures.

34. The proposal for Housing NZ to increase its borrowing limit to fund capital expenditure is an additional consideration. Housing NZ borrowing would not affect the core Crown net debt indicator. However, the proposal could undermine the credibility of the core Crown net debt indicator as a binding fiscal target, particularly if it sets a precedent for other similar proposals (or is seen to). The Treasury's preferred approach of managing Housing NZ's funding through the Budget process would put further pressure on capital allowances.

Capacity constraints might limit the delivery of capital commitments

35. There is growing evidence that residential and commercial construction sectors are facing capacity constraints that limit the ability to deliver infrastructure and construction projects. This poses two risks. First, if capacity constraints are more binding than expected then investment growth could be lower than currently forecast. Second, capacity constraints could lead to significant delays in the delivery of projects and/or substantial increases in costs.

36. High level indicators show that growth in construction costs has been trending upwards over recent years. Although recent outturns have suggested some softening, construction cost growth remains high relative to recent history. Higher cost inflation is consistent with reports of increased difficulty in finding skilled and unskilled labour in the construction sector.

37. Fletcher Building has recently announced that it will not be bidding for large scale construction projects, this leaves only one Tier One contracting firm left in New Zealand (CPB Contractors).

38. The forecast Crown accounts provide additional insights into capacity pressures. The fiscal forecast regularly applies 'top-down' adjustments to reflect that not all capital projects will be delivered on time and to give a more accurate cash profile of capital spending. Recently the adjustments made have increased from $800 million at HYEFU 2016 to $1235 million in the preliminary BEFU 2018 forecast. In addition, certain

projects have been unable to be progressed resulting in spending being pushed out into later years. Table 4 displays an example of what this means for KiwiBuild and Crown Infrastructure Partners.

Table 4: Examples of movements in forecast capital spending

$millions	2017/18	2018/19	2019/20	2020/21	2021/22	Post 2022	Total
Crown Infrastructure Partners							
HYEFU 2017	0	100	200	300	0	0	600
Current assumption	19	32	81	187	157	124	600
KiwiBuild							
HYEFU 2017	100	900	1000	0	0	0	2000
Current assumption	50	404	510	1036	0	0	2000

The outlook beyond Budget 2018

39. Provisions for new operating and capital spending beyond Budget 2018, while larger on average than we have seen in recent years,[1] are smaller than the Budget 2018 allowances and are likely to come under significant pressure from:

- increasing cost pressures from baseline spending, particularly through the cost drivers of population and prices;
- delivering on the Government's key manifesto policies and any other high priority investments you wish to progress, for example, recommendations arising from the Welfare Expert Advisory Group; and
- some other large possible sources of expenditure, for example, pay equity and collective negotiations.

40. We recommend that future allowances are increased in order to manage these pressures. Given uncertainty about the future mix and timing of fiscal pressures between operating and capital, and the relative value of them, we recommend increasing both operating and capital allowances across the forecast period from Budget 2019 onwards while still maintaining some net debt headroom. This could be adjusted at future fiscal events. The scenarios later in the report provide some examples.

There are future operating cost pressures, particularly from population and prices

41. Future operating allowances ($1.875 billion per annum) are set at a lower level than the Budget 2018 allowance ($2.6 billion per annum).

42. Over the previous four budgets, around 60 percent of new operating spending was provided to address cost pressures. The draft Budget 2018 package follows this general trend, albeit at a higher level with around 70-80% of the draft package relating primarily to dealing with cost pressures.

43. Agencies forecast information of cost pressures over the next four years show significant cost pressures of around $1.5 billion for 2019/20 and around $2.0 billion in 2020/21. The majority of these pressures are personnel-driven (ie, wages).

[1] Average operating allowances for Budgets 2015 to 2017 were $1.5 billion per annum; average capital allowances for Budgets 2015 to 2017 were $2.1 billion.

44. While Ministers and departments have a number of options available to help manage these costs pressures (for example, through efficiencies, reprioritisations, or changes to existing policy settings), a significant portion will require new funding from future budget allowances. Based on this information, allowing for around $1.5 billion per annum in each future budget would be a prudent approach. With ongoing budget operating allowances of $1.875 billion per annum, there would be limited room for other priority spending initiatives.

There are still manifesto commitments to deliver

45. The Government has an ambitious programme to implement. The 100-Day Plan and the draft Budget 2018 package already go a significant way to achieving this. However, other manifesto initiatives will continue to be considered in future Budgets. Around $1.6 billion of operating and around $3.7 billion of capital manifesto initiatives submitted for Budget 2018 have not been supported in the draft package, so may need to be considered in future Budgets. This is because there are reviews underway which could help inform where to invest, the initiative is not implementation ready or further policy work is required to ensure expected outcomes can be achieved. For example, initiatives likely to be considered through Budget 2019 (if not funded in Budget 2018) and beyond include:

- [33]
-
-
- Christchurch Regeneration Acceleration Facility ($298 million capital); and
- [33]

Budget 2019 will be your first Wellbeing Budget

46. We have previously reported to you on how the various components of the Budget process can be used to help meet your objectives of delivering your first Wellbeing Budget (T2018/248 refers). While including a strong focus on wellbeing in Budget 2019 does not necessarily need to entail any additional new funding, you may wish to consider whether it should include new funding for priority initiatives. The Tax Working Group will also be reporting to the Government prior to Budget 2019.

47. We will provide you with advice, before Budget 2019 strategy discussions in June and July, on the choices you have for setting the Budget 2019 process to support the Government’s priorities. This will include options for managing cost pressures and delivering remaining manifesto commitments.

And there are other large possible expenditure items

Pay equity

48. Resolving pay equity claims will have significant fiscal implications. [38]

[38]

49. [38]

Depending on how the remaining pay equity claims are resolved, and any additional claims that are raised, there could be significant fiscal implications which will put pressure on managing within existing Budget allowances.

50. The State Services Commission is leading advice to Ministers on some alternative approaches to managing and assessing claims within the State Sector. This advice is expected to be provided to Ministers in late March or April 2018.

Collective negotiations

51. Most of the significant collectives are being considered as part of Budget 2018 (Nurses and Midwives, Primary and Secondary Teachers, Police, and MSD Service Delivery). In cases where the full cost of the collective is not funded through Budget 2018, this will have a fiscal risk for future Budgets.

Welfare Expert Advisory Group

52. As you are aware, the Minister for Social Development proposes to commission a Welfare Expert Advisory Group and its Terms of Reference are being developed. The Expert Advisory Group is likely to have a broad scope for recommending significant changes to the welfare system, consistent with the Confidence & Supply Agreement commitment to overhaul the welfare system and review Working for Families. At this stage, any fiscal implications for Budget 2019 or for Budget 2020 are unknown. The Treasury proposes that the Expert Advisory Group's Terms of Reference invite the Group to offer choices for scaling and phasing the implementation of proposed policy changes with significant fiscal implications. This will help to ensure that welfare policy changes are consistent with your fiscal strategy.

Mycoplasma bovis

53. Any fiscal implications of Mycoplasma bovis will add further pressures.

And there are high priority Government investments that will put pressure on future capital allowances

54. As you are aware, Budget 2018 is significantly oversubscribed in respect of capital investment initiatives. However, this is likely to continue. Major initiatives likely to be considered through Budget 2019 include:

- [33]
-
-

55. The Government will face difficult investment challenges in future years due to a number of factors:

- population growth is placing increased demand on government services;
- current policy settings for capital-intensive agencies;
- unfunded capital requests from previous budgets; and

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[38]

- market supply, and agency planning and delivery, may not be able to match demand.

56. Increasing the amount of investment in new capital initiatives alone is unlikely to be enough to address these factors. Given market and funding constraints, a focus on prioritising and phasing of any new capital investment is important. The Treasury will continue to provide ongoing advice on options and approaches for managing the investment pipeline in the long-term, including through the Government Investment Ministers' monthly meetings.

Allowance scenarios

57. We have put together some scenarios of allowance options based on preliminary forecasts. As a rule of thumb, increasing Budget 2018 operating allowances by $0.25 billion uses up around $1 billion of the $7.1 billion net debt headroom in 2021/22 (adding 0.3% to net debt as a share of GDP). And for every $0.1 billion increase in all of the Budget 2019, 2020 and 2021 operating allowances, there will be around a $0.6 billion reduction in net debt headroom (adding 0.1% to net debt as a share of GDP).

58. In scenario one, allowances are increased to fit within the draft Budget package presented in Budget Ministers 2 slides (eg, there is a $70m increase in the Budget 2018 operating allowance and a $240 million increase in the capital allowance). As an illustration, the scenario includes increases to Budget 2019, 2020 and 2021 operating allowances of $500 million and capital allowances of $250 million. In this scenario, net debt reaches 19.3% in 2021/22, maintaining the same amount of headroom against your net debt rule as in HYEFU.

59. In scenario two, allowances in Budget 2018 are increased further, with a $200m increase in the Budget 2018 operating allowance and a $540 million increase in the capital allowance. To keep net debt at the same level (19.3% of GDP) as scenario one in 2021/22, requires smaller increases in future budgets. Budget 2019, 2020 and 2021 operating allowances are increased by $400 million and capital allowances by $200 million.

60. Scenario three combines these two examples: the higher Budget 2018 allowances of scenario two and the higher allowances for later budgets of scenario one. This results in reduced headroom, with net debt in 2021/22 of 19.5%.

Table 5: Allowances in different scenarios

$billions		Budget 2018	Budget 2019	Budget 2020	Budget 2021	Net debt in 2021/22
BPS	Operating allowance (per year)	2.600	1.875	1.875	1.875	**18.0% of GDP**
	Capital allowance (total)	3.400	3.400	3.100	2.700	
Scenario One	Operating allowance (per year)	2.670	2.375	2.375	2.375	**19.3% of GDP**
	Capital allowance (total)	3.640	3.650	3.350	2.950	
Scenario Two	Operating allowance (per year)	2.800	2.275	2.275	2.275	**19.3% of GDP**
	Capital allowance (total)	3.940	3.600	3.300	2.900	
Scenario Three	Operating allowance (per year)	2.800	2.375	2.375	2.375	**19.5% of GDP**
	Capital allowance (total)	3.940	3.650	3.350	2.950	

61. On balance, we favour increasing future allowances whilst maintaining allowances for Budget 2018, or at least limiting increases (scenario one). This reflects our view that there is value in maintaining a buffer against your net debt rule and that there is the

potential for relatively more pressure against future allowances, depending on your fiscal intentions. Given uncertainty as to the relative value of increased operating expenditure and capital investment, it is difficult to recommend a precise split between them. Allowances could be reassessed at future fiscal events. We would welcome your feedback on whether you want any further allowance scenarios to be calculated.

Timing and communication of the use of headroom and changes to allowances

62. There are options about when you make announcements about future budget allowances. You could announce changes to future budget allowances at Budget 2018. This would clearly signal a response to future pressures and would explain why you have limited increases to allowances at Budget 2018. This is the Treasury's preferred option. Assuming you agree that future allowances should be increased, this option would increase transparency around fiscal intentions.

63. Another option is 'banking' the headroom in net debt, but clearly signalling in the *Fiscal Strategy Report* released alongside Budget 2018 that you plan to spend this in the future (if future fiscal and economic conditions permit). This has the benefit of reducing the risk that you have to cut allowances in the future, while also allowing you to explain why you have limited increases to Budget 2018 allowances.

The interaction of fiscal and monetary policy

64. The amount of slack in the real economy is decreasing and we expect this trend to continue, with the economy forecast to be operating above its potential level from 2019. This is consistent with a broad range of labour market capacity measures, although wage and price inflation have so far been subdued.

65. The fiscal stance is forecast to be expansionary in the near term, with a moderate contraction later in the forecast period. A moderate fiscal expansion in the short term is broadly appropriate in the context of population-driven growth and subdued wage and price pressures. A tighter fiscal stance later in the forecast period would help to ease pressures on interest and exchange rates when capacity pressures in the economy are expected to intensify.

66. Further fiscal expansion through higher allowances at this Budget, and future budgets, needs to be considered in light of its impact on monetary policy and the wider macro-economy. Material changes in spending allowances will impact on demand pressures in the economy, which will be considered by the Reserve Bank in setting the OCR. The Public Finance Act 1989 requires that the Government, when formulating fiscal policy, have regard to the interaction between fiscal policy and monetary policy. The advice in this report has been informed by discussions between senior officials from the Treasury and Reserve Bank about the coordination of fiscal and monetary policy.

67. Maintaining strong fiscal buffers are important to enable fiscal policy to play a stabilising role in any future downturn. While monetary policy plays the main role in supporting economic stability, conventional headroom to ease monetary policy is limited with the OCR at an historic low of 1.75 percent. During previous downturns, the Reserve Bank has cut the OCR by up to 5.75 percentage points. Downside risks for the economy include fragilities in the global economy, a fall in export commodity prices and risk stemming from elevated household debt and tighter financial conditions.

68. Further fiscal expansion would place pressure on interest rates and exchange rates at the margin. This could bring forward OCR increases (currently forecast to take place from mid-2019) and put upward pressure on the exchange rate, weighing on the

competitiveness of the export sector. However, macro stability risks from higher interest rates are less concerning in an environment of historically low interest rates and subdued inflation pressures. Indeed, there may be some financial stability benefits in supporting aggregate demand so that interest rates return to normal levels, as very low interest rates can fuel asset price inflation.

69. Policy measures that help to ease capacity constraints and improve productivity would help to sustain growth and macroeconomic stability.