The Treasury

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[40]	Not in scope	

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Treasury Report: Fiscal Policy Scenarios to 2030

Date:	17 October 2016	**Report No:**	T2016/1821
		File Number:	MC-1-5-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** the contents of this report.	None
Associate Minister of Finance (Hon Steven Joyce)	**Note** the contents of this report.	None
Associate Minister of Finance (Hon Paula Bennett)	**Note** the contents of this report.	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[34]	[34]	[39]	[23]	✓
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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 Policy Scenarios to 2030

Executive Summary

This report provides you with fiscal projections over the next fifteen years based on three different fiscal policy scenarios.

The first scenario is based on the Government's current Budget allowances as indicated in the Fiscal Strategy Report published at Budget 2016. This would imply a relatively large reduction in the level of Government expenditure relative to the size of the economy, particularly for expenses other than NZ Superannuation. A reduction of this magnitude may not be desirable in the absence of ongoing policy reform.

The second scenario is an illustration of the potential fiscal headroom for the Government to increase allowances while still remaining consistent with its current fiscal strategy which focuses on debt reduction. The Treasury will provide more advice on this in early-November, to inform the Government's policy decisions ahead of the publication of the Budget Policy Statement in early December.

The third scenario is an initial attempt to build an aggregate fiscal scenario based on 'bottom-up' analysis of cost drivers across different sectors. This scenario is an attempt to illustrate the potential future impacts of current policy settings, but the techniques would need to be developed further before this could be used reliably.

Overall, these scenarios demonstrate that there is likely to be fiscal headroom to increase Budget allowances without changing the Government's current fiscal strategy. However, this headroom is unlikely to be sufficient to fully fund current cost pressures.

Recommended Action

We recommend that you:

a. **note** that the current level of operating allowances imply a relatively large reduction in the level of Government expenditure as share of GDP over the next 15 years, except for NZ Superannuation, which may not be desirable in the absence of ongoing policy reform

b. **note** that projections of the Government's fiscal strategy for at least ten years are required to be published in the Fiscal Strategy Report and it is important that these are credible as the trajectory of net debt is seen as a key indicator of New Zealand's fiscal sustainability

c. **note** that it is likely that the forecast in the Half Year Economic and Fiscal Update (HYEFU) will show that there is some fiscal headroom to increase allowances while remaining consistent with the broad parameters of the Government's current fiscal strategy, which focuses on reducing net debt gradually

d. **note** that the Treasury will provide more detailed advice on fiscal strategy in the context of HYEFU forecasts in the upcoming ‘Roadcheck Report’, to inform the Government’s decisions in November in advance of the publication of Budget Policy Statement in early December

e. **note** that the aggregate impact of ‘bottom-up’ cost drivers would exceed the levels of operating and capital allowances that are consistent with meeting the Government’s fiscal strategy, based on a scenario that draws on analysis of key expenditure pressures, and

f. **note** that the Treasury intends to strengthen the quality of the information and processes used to generate this ‘bottom-up’ scenario, so it could serve as a useful tool to assist decision-making in conjunction with other information like the collection of 15-year economic and fiscal impacts of new Budget initiatives.

Renee Philip
Manager, Macroeconomic and Fiscal Policy

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Paula Bennett
Associate Minister of Finance

Treasury Report: Fiscal Policy Scenarios to 2030

Purpose of Report

1. We have recently provided you with initial advice on whether the current budget allowances could be increased over the next four years (T2016/1683 refers). This report extends that analysis, by providing you fiscal policy scenarios over a longer time horizon to 2030. This analysis reflects your desire for the Treasury to more actively take the potential future impact of current policy into account when providing you with fiscal strategy advice.

Approach to Developing Scenarios

2. We have produced three scenarios for this report, using the Treasury's Fiscal Strategy Model (FSM). Primarily, we focus on the impact of these assumptions on the projections for Core Crown Net Debt and Total Crown OBEGAL. We also draw out other key projections where they are relevant in understanding the impact of particular fiscal allowances.

3. Scenario 1 models the impact of the Government's current fiscal allowances, as signalled in its 2016 Fiscal Strategy Report (FSR). Scenario 2 models the impact of higher fiscal allowances that still result in net debt reducing to 10% of GDP by 2030.

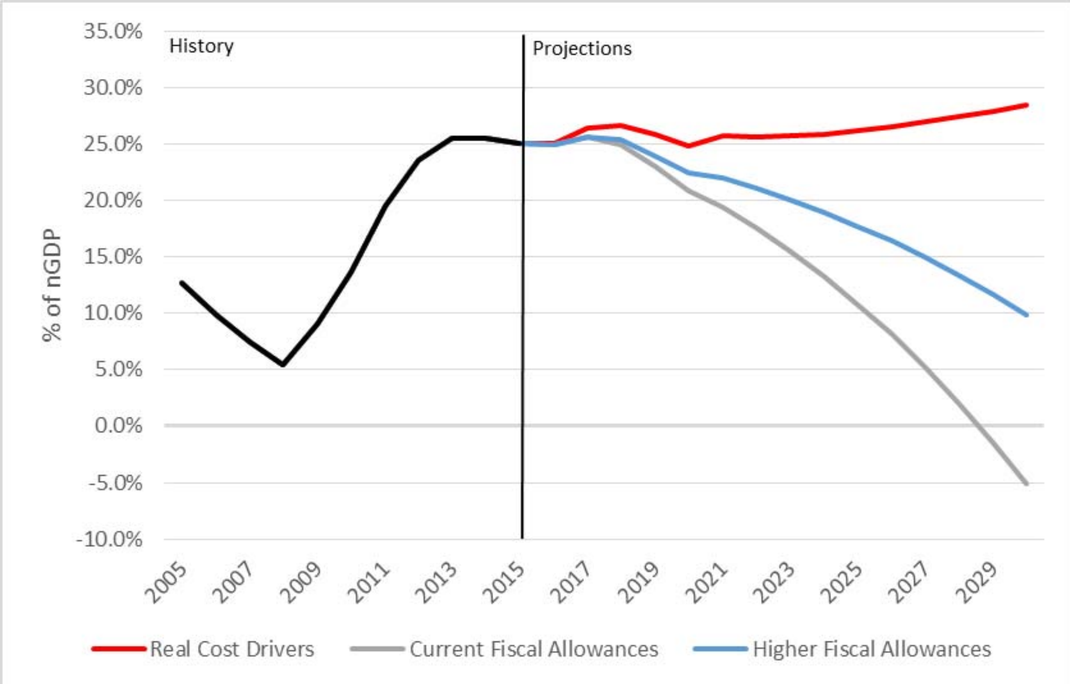
4. The purpose of these two scenarios is to provide an illustration of the range of fiscal policy choices the Government can make in Budget 2017, and how they would relate to the current fiscal strategy, which places a priority on debt reduction. These two scenarios are based on 'top-down' assumptions, and so are similar to the type of fiscal strategy analysis you have recently received (T2016/1683 refers).

5. The Government will have an opportunity to consider the current level of Budget allowances in early November, in light of the Preliminary HYEFU forecasts. These decisions will inform the 2017 Budget Policy Statement, to be published in early-December alongside the HYEFU.

6. Scenario 3 in this report uses the FSM to model the impact of known cost drivers across the next fifteen years on the future fiscal position. The purpose of this scenario is to help assess whether the size of operating and capital allowances included in the first two scenarios are likely to be sufficient to meet known cost pressures.

7. The specific assumptions and analysis that feed into Scenario 3 have not been developed in a completely consistent fashion, so this exercise should be understood as a broad brush view of the aggregate implications of the cost pressure outlook.

Figure 1: Projections of Core Crown Net Debt in Three Scenarios



8. All of these scenarios use the economic and fiscal forecasts from BEFU 2016 as a base. In addition, all three scenarios assume that tax rates are adjusted in the period from 2020 to 2030 to compensate for the effect of fiscal drag, which is the assumption made in the projections that are published in the Government's annual FSR.

Scenario 1: Current Fiscal Allowances

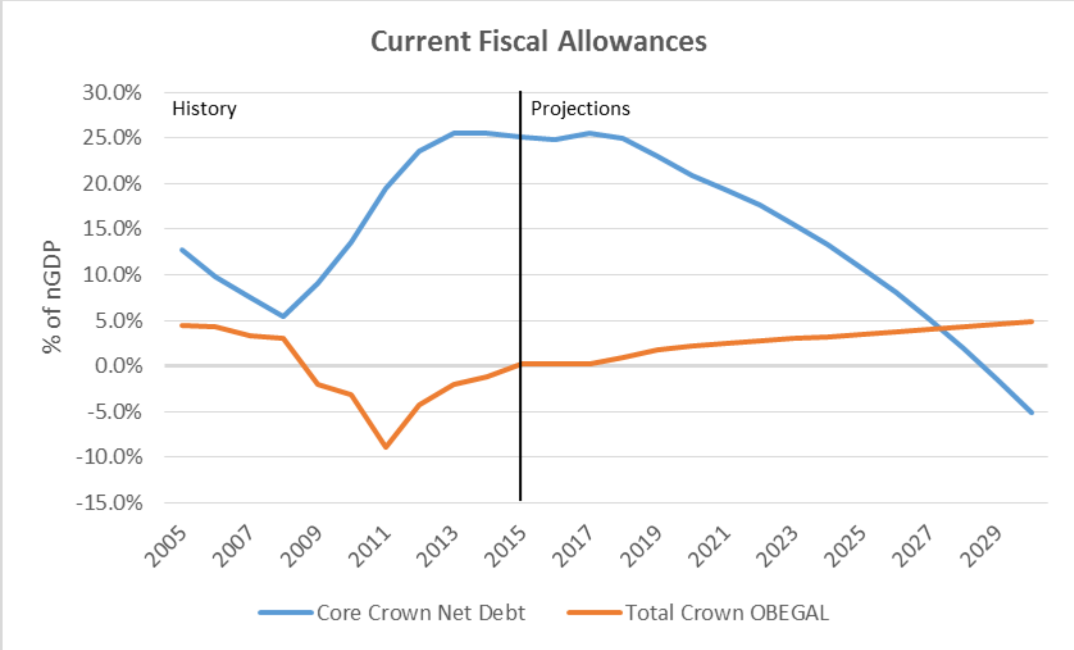
9. Figure 2 below shows the fiscal outlook to 2030 based on the fiscal allowances that are current Government policy, as stated in the 2016 FSR. These are:

- Operating allowances of $1.5 billion per Budget until Budget 2020, growing at 2% thereafter;

- Capital allowances of $0.9 billion per Budget until Budget 2020, growing at 2% thereafter.

10. This scenario is identical to the projections that were included in the 2016 FSR. The Public Finance Act requires the annual publication of fiscal projections that extend out at least ten years in the Fiscal Strategy Report and it is important that these projections communicate a future path for fiscal policy that is credible.

Figure 2: Projected Impact of Current Fiscal Allowances on Net Debt and Operating Balance



<u>What does this scenario illustrate?</u>

11. These projections show that by 2020, key fiscal indicators will be in line with the Government's short-term fiscal intentions. For example, by 2020/21 core crown expenses are at 28.0% of GDP, OBEGAL surplus rises to 2.5% of GDP and net debt falls to 19.4% of GDP.

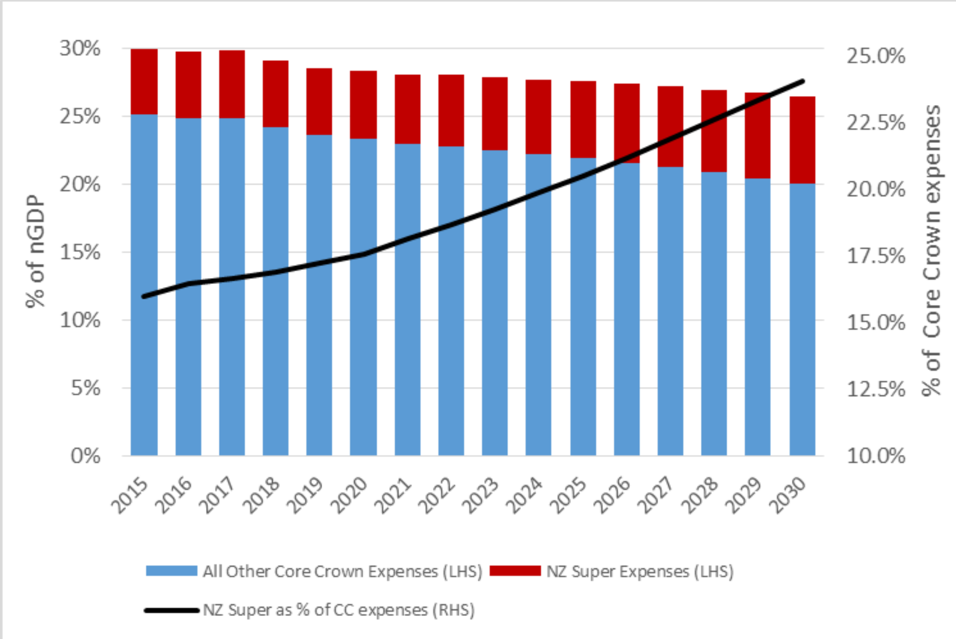
12. However after that these projections assume the same allowances are pursued for another ten years from 2020. As a result of that, by 2030 OBEGAL surpluses are projected to rise to 5% of GDP and net debt is projected to fall to -5.1% (that is, a net asset position).

13. Rising surpluses are a result of a widening gap between revenue and expenses. Core crown revenue is assumed to remain constant as a share of GDP at around 30-31% across the projection period. By comparison, Core Crown expenses decline from 30% of GDP in 2015 to 26% in 2030.

14. This implies a significant contraction in government expenditure. This contraction is made even more severe for some expenditure categories given that NZ Superannuation (NZS) expenses continue to rise as a share of GDP in this projection, as they are not constrained by operating allowances and grow in line with an ageing population and wage growth.

15. Figure 3 shows that from 2015 to 2030, NZS expenses are projected to grow from 16% to 24% of all core crown expenditure. Across the same period, all other areas of core crown expenditure are projected to decline from 25% of GDP to 20% of GDP.

Figure 3: Projected Levels of Core Crown Expenses and NZS Expenses



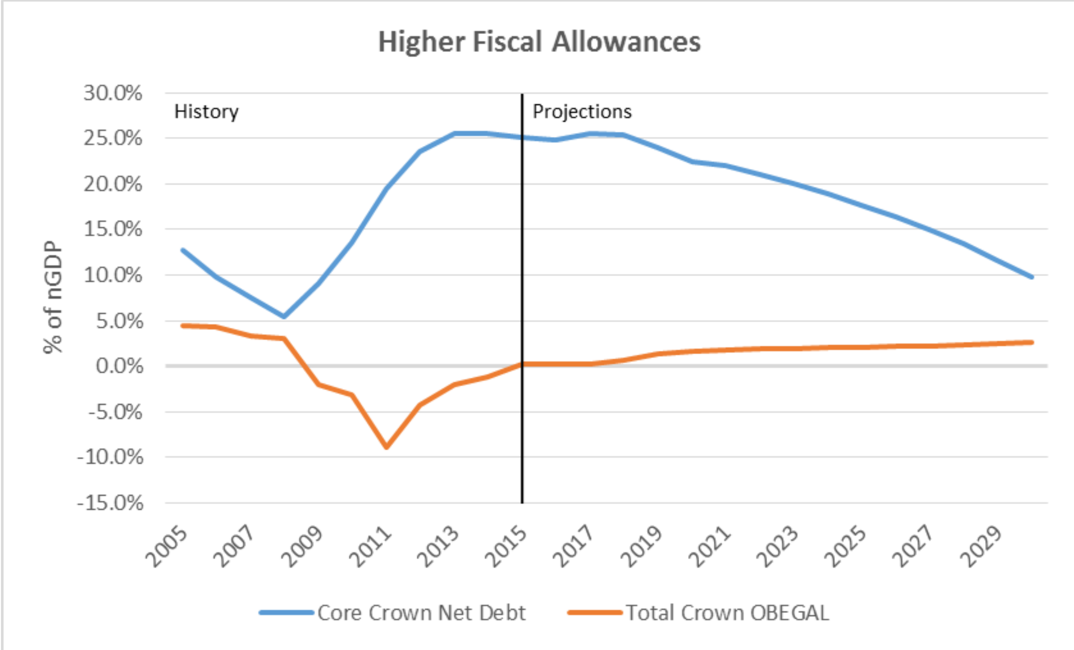
16. The Treasury's view is that this fiscal strategy may not be desirable, because it implies a significant contraction in the level of Government expenditure in proportion to the size of the economy. A reduction of this magnitude may not be credible in the absence of an ongoing commitment to implementing policy reform.

Scenario 2: Higher Fiscal Allowances

17. Figure 4 below shows the fiscal outlook to 2030 based on a scenario that assumes higher fiscal allowances that are still consistent with the Government's current fiscal strategy. This is an extension of a scenario we recently constructed for you in advice relating to the Budget 2017 Strategy Cabinet Paper (T2016/1683 refers). The assumptions in this scenario are:

- Operating allowances of $2 billion per Budget until Budget 2020, growing at 2% thereafter;
- Capital allowances of $1.4 billion per Budget until Budget 2020, growing at 2% thereafter.

Figure 4: Projected Impact of Higher Fiscal Allowances on Net Debt and Operating Balance



<u>What does this scenario illustrate?</u>

18. Like Scenario 1, these projections show that by 2020, key fiscal indicators will be in line with the Government's short-term fiscal intentions. Net debt would be at 22% of GDP in 2020/21, and surpluses would be rising.

19. This analysis is based on the forecasts from BEFU 2016, and it is likely that the fiscal outlook in HYEFU 2016 will be more positive and there will be a degree of fiscal headroom consistent with the Government's fiscal objectives. Having said that, it is notable that in both Scenario 1 and 2, net debt is not projected to fall materially until 2019.

20. Beyond 2021, the higher allowances in this scenario mean that net debt does not decline as quickly, and reaches 9.8% of GDP by 2030. Surpluses also do not grow as quickly, reaching around 2.6% of GDP by the end of the projection.

21. Both of these projections are consistent with the Government's current long-term fiscal objectives to deliver surpluses sufficient to meet the objective of having net debt between 0 and 20% of GDP.

22. Core crown revenue is assumed (as in Scenario One) to remain constant as a share of GDP at around 30-31% across the projection period. Total core crown expenses decline more slowly, as a result of the higher allowances, from 30% of GDP in 2015 to 29% in 2030. Across the same period core crown expenses excluding NZS decline less sharply than in Scenario 1, from 25% of GDP to 23% of GDP.

<u>How does this scenario relate to upcoming decisions?</u>

23. Delivering this scenario would still require some expenditure constraint, based on the extent to which known cost pressures exceed the current Budget allowances. It shows that while there may be some fiscal headroom consistent with the current fiscal strategy, this is limited and further increases to allowances would likely require the Government to revisit the parameters of its current fiscal strategy.

24. Raising operating allowances from $1.5 billion to $2 billion would allow some additional cost pressures to be addressed, but would still require trade-offs across the

Government's priorities, for instance between expenditure increases and revenue reduction. In addition, increasing capital allowances from $0.9 billion to $1.4 billion may not be sufficient to meet all currently signalled and committed capital initiatives.

25. In early November, the Treasury will be providing you with more detailed analysis about trade-offs between the Government's fiscal strategy and its priorities for Budget 2017. This will take into account the preliminary HYEFU 2016 forecasts. Before that in late October the Treasury Investment Management and Asset Performance (IMAP) team will be providing you with some further information on pressures against the current capital allowances.

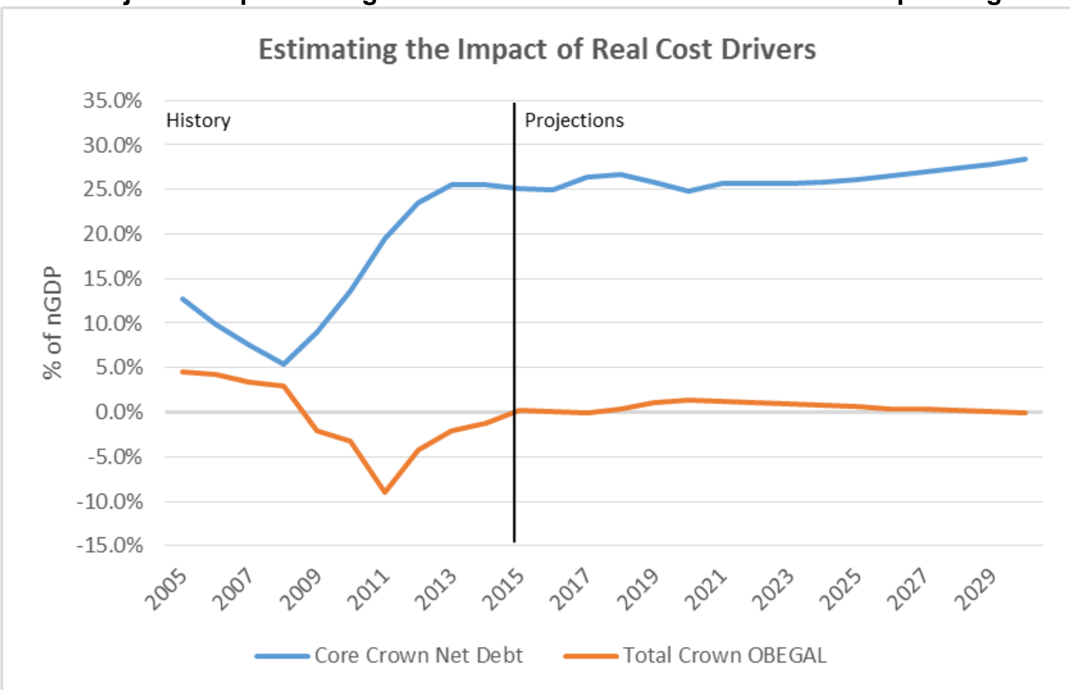
Scenario 3: Estimating the Impact of Real Cost Drivers

26. Figure 5 below shows the fiscal outlook to 2030 based on some analysis of cost drivers in key sectors of government expenditure. The assumptions that feed into this scenario are explained further, but on aggregate, the equivalent fiscal allowances this implies are roughly:

- Operating allowances that start at $1.8 billion in Budget 2017, and grow at 3.8% per Budget thereafter;

- Capital allowances that start at $2 billion in Budget 2017, and grow at 4.2% thereafter.

Figure 5: Projected Impact of Higher Fiscal Allowances on Net Debt and Operating Balance



What does this scenario illustrate?

27. The purpose of this scenario is to help assess whether the size of operating and capital allowances included in the first two scenarios are likely to be sufficient to meet cost pressures across the next fifteen years. We do this by proxying a fiscal strategy where restraint isn't applied by using fiscal allowances, but instead expenditure pressures are fully funded by Governments over that period.

28. To generate the assumptions for this scenario, we have collated 'bottom-up' information and analysis on cost drivers across the government. This is information that

was already held by Treasury teams, so it reflects assumptions that are more informed by what we know about the drivers of expenditure at a sector level.

29. For operating expenditure, a summary of the source of this analysis is set out in Table 1 below. We used this analysis to calculate an average annual growth rate of nominal expenditure, and applied that to the base expenditure in 2014/15. For areas of expenditure where we did not have sector-specific information to draw on, we grew the base expenditure at the rate of average nominal GDP growth to proxy future cost pressure.

30. Expenditure on NZS and welfare are not charged against operating allowances under the current conventions of the fiscal management approach. However, in this scenario both are modelled to grow over the next fifteen years on the basis of assumptions explained in Table 1.

Table 1: Summary of Assumptions Underpinning the Real Cost Driver Scenario

Expenditure Type	Modelled Annual Average Nominal Growth Rate	Main Driver of Expenditure Growth	Source of Analysis
Health	4.2%	Demographic growth of healthcare recipients and non-demographic growth in healthcare expenditure, offset by an efficiency assumption.	Treasury Health team calculations.
Education	3.5%	Changes in patterns of ECE participation, along with demographic increases and wage pressure.	Treasury Education team judgments, based on information from Draft Ministry of Education Strategic Financial Plan.
Justice	4.0%	Rising prison population, related pressure on justice sector pipeline, and policy and operational changes.	Treasury Justice team judgments, based on known expected cost pressures, adjusted for likely future unknown cost pressures.
Defence	4.7%	Acquisition and maintenance of the indicative military capability endorsed by Cabinet in the Defence White Paper (DWP) 2016.	Treasury analysis of DWP financial model.
Other Expenditure	4.2%	Growing in line with average nominal GDP growth	Assumption
NZ Super	6.1%	Growing in line with the demographic growth rate of the population aged 65 and over.	Modelled in the FSM, following current policy settings.
Welfare	3.1%	Main benefit categories growing with inflation. Supplementary benefits and Working for Families tax credits return to their historical ratio of expenditure to GDP.	Modelled in the FSM, based on techniques developed as part of the Long Term Fiscal Model.

31. It is important to note that this information was not collected specifically for this modelling exercise, but was generated and analysed as part of different processes for different purposes. For example:

- Projected expenditure for health is based on analysis that has been done by the Treasury health team as part of its role in assisting District Health Boards to produce long-term investment plans;

- Projected expenditure for education is based on draft information that the Treasury has received from the Ministry of Education, which it has prepared as part of its Strategic Financial Plan to inform a discussion at the SEC Cabinet Committee in November. The Treasury education team will provide you with a more detailed anlysis of this material in advance of that discussion;

- Projected expenditure increase for defence operating expenditure is based on the indicative funding track agreed by Cabinet in the context of the 2016 Defence White Paper.

32. For capital expenditure, our assumption is based on an aggregation of the future capital pipeline that IMAP collects as part of its portfolio monitoring role. [33]

This is to proxy the likelihood that actual capital pressure in the future will exceed the currently known pressures.

33. We would be cautious about putting too much weight on the specific projections generated by this scenario. We have used information that was available, even when we knew this was based on methods and judgement that were not necessarily consistent between sectors. In addition, this information is not necessarily the same as the sum of all Budget initiatives that agencies are likely to seek in upcoming Budgets.

How could a 'Cost Driver Scenario' be developed further?

34. This scenario illustrates is that it is possible to use 'bottom-up' information to generate an aggregate view of future fiscal pressure using the FSM. If a scenario like this could be made more reliable over time, it could provide a useful tool to help the Treasury more actively take the potential future impact of current policy into account when providing you with fiscal strategy advice.

35. In many ways this scenario is conceptually similar to work we have done this year to develop our Long-Term Fiscal Modelling to incoporate the potential impact of improved social outcomes. In both cases we are using 'bottom-up' analysis and judgements about the future of specifc government expenditure categories and then aggregating that into parameters that can be fed into the Treasury's 'top-down' fiscal models.

36. One purpose of including analysis of this scenario to you is to indicate the steps that the Treasury is taking towards better integrating the fiscal information it already has available. It is a first step, similar to the move towards collecting 15-year fiscal and economic forecast information on Budget Initiatives. For Budget 2017, this information will allow for greater transparency on the medium to long-term impacts of initiatives and will help inform decision-making.

37. More comprehensive processes would need to be designed to make a scenario like this reliable, as it would require the input of agencies across the system and a more consistent framework for understanding how to aggregate those sector-specific information. This is especially the case if we were to regularly report this information, either publicly or to Ministers for use in their Budget decision-making.

38. Furthermore, in the future we could use a scenario like this to start to understand how sensitive future cost pressure is to key variations in demographic, economic, or other assumptions. We have provided an initial example of this to you in our recent report which explored the impact of higher net migration on the fiscal position (T2016/1683 refers). However, making this more systematic is likely to require quite substantial changes to the way we collect and analyse fiscal information.

39. The Treasury is in the early stages of scoping what this reporting framework could look like, but this is likely to require some time to design and implement fully.