The Treasury

Budget 2017 Information Release

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Fiscal Policy Scenarios to 2030

Date:	15 March 2017	**Report No:**	T2017/596
		File Number:	MC-1-5-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	Note.	22 March 2017

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Neil Kidd	Senior Analyst	[39]	[23]	✓
Oscar Parkyn	Principal Advisor	[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 Policy Scenarios to 2030

Executive Summary

In light of updated economic forecasts, this report provides you with a preliminary assessment of how much fiscal headroom there is with respect to the Government's fiscal targets (as set out in the Fiscal Strategy Report 2016). There is still significant uncertainty in these scenarios, in part because preliminary fiscal forecasts have not yet been completed.

As well as fiscal objectives for maintaining rising operating surpluses in the forecast period and to have core Crown expenses below 30 percent of GDP, the key fiscal targets are:

- reducing net debt to around 20 per cent of GDP by 2020; and
- reducing net debt to within a range of 0 to 20 per cent of GDP over the next 10 years.

The Treasury recommends that the target of reducing net debt to around 20 per cent of GDP by 2020 should remain a fiscal anchor for decisions in Budget 2017. The flexibility provided by "around" 20 per cent of GDP should not be used for discretionary policy changes but should be reserved to provide a buffer against economic shocks.

The updated preliminary economic forecasts indicate there is significant net debt headroom based on the Budget allowances indicated in the December *Budget Policy Statement*. The improvement in the forecast outlook largely stems from an upward revision to forecast population growth feeding through to higher forecast nominal GDP and tax revenue.

This fiscal headroom could be used to either increase expenditure in Budget 2017, increase expenditure in future Budgets and/or to allow for tax reductions.

We present several scenarios that illustrate the path of net debt following increased allowances and/or tax reductions to illustrate the size of potential packages, whilst living within the net debt targets. In calculating the amount of headroom available for expenditure or tax priorities, the scenarios assume net debt is no higher than 20 per cent of GDP in 2020/21.

Based on the current and future pressures against allowances, a tax package of around $2 billion per annum starting in April 2018 would be consistent with the net debt targets. This would allow headroom for modest increases to spending allowances. The Treasury will provide more detailed advice on fiscal settings in the context of preliminary Budget economic and fiscal forecasts on 31 March.

Recommended Action

We recommend that you:

a. **agree** that reducing net debt to around 20 per cent of GDP by 2020 should remain a fiscal anchor for decisions in Budget 2017.

b. **note** the scenarios assume that net debt must be no higher than 20 per cent of GDP in 2020/21 in calculating the amount of headroom available for expenditure or tax priorities.

c. **note** that there is significant net debt headroom that could be used to increase allowances or to enact tax policy changes.

d. **note** that there is still significant uncertainty in these scenarios, in part because preliminary fiscal forecasts have not been completed yet.

e. **note** that based on current information, a tax package of $2 billion per annum starting in April 2018 would allow headroom for increased allowances, either now or in future budgets, whilst maintaining net debt below 20 per cent of GDP.

f. **note** that the Treasury will provide more detailed advice on fiscal settings in the context of preliminary budget economic and fiscal forecasts on 31 March.

Felicity Barker
Acting Manager, Macroeconomic and Fiscal Policy

Steven Joyce
Minister of Finance

Treasury Report: Fiscal Policy Scenarios to 2030

Purpose of Report

1. We have recently provided you with advice on the Treasury's preliminary economic and tax forecasts. This report uses this information to produce a preliminary assessment of the impact this will have on our net debt forecasts. We will provide more detailed advice on the fiscal settings in the context of preliminary Budget economic and fiscal forecasts on 31 March.

Fiscal Scenarios

2. We have estimated the impact that the preliminary economic forecasts will have on the main fiscal aggregates through to 2030/31. This involves updates to the tax and benefit forecasts however, it is not a full preliminary fiscal forecast. More information on the modelling assumptions is in the annex.

3. We provide five fiscal scenarios with the results summarised in Table 1 (further detail in Table 2). The scenarios show the impact on net debt of increasing allowances in Budget 2017 and beyond, and the resulting headroom for a tax package given the fiscal targets.

4. Scenario 1 illustrates the current Government policy, as stated in the December *Budget Policy Statement* (BPS):

   - Operating allowances of $1.5 billion per Budget until Budget 2020, growing at 2 per cent thereafter;
   - Capital allowances of $3 billion in Budget 2017 and $2 billion in Budgets 2018 to 2020, growing at 2 per cent thereafter.

5. Based on this preliminary assessment, there is headroom to increase expenditure or reduce taxes while also reducing net debt to around 20 per cent of GDP by 2020. Net debt is estimated to be 16.1 per cent of GDP by 2020/21 under current settings, which would provide headroom to increase expenses by approximately $3 billion per annum starting in 2017/18 or a tax package of approximately $3.5 billion per annum starting in April 2018.

6. There are pressures against allowances in Budget 2017 and there are likely to be further pressures in future Budgets. We consider that it would be prudent to increase allowances in Budget 2017 and either increase future allowances or leave some headroom remaining in order to increase allowances in the future.

7. Scenario 2 increases the operating allowance to $1.7 billion per annum for Budget 2017 only, which would allow some funding for higher-value discretionary initiatives e.g. ECE, and disability and primary care, funding for some initiatives in Vote Health and Vote Social Development, and Ministerial priorities in the BGA. There is no specific allowance made for EQC or Southern Response pressures: these would need to be managed through allowances.

8. In addition to the assumptions in scenario 2, scenario 3 includes a Budget 2017 capital allowance of $4.5 billion, [33]

9. In addition to the assumptions in scenario 3, scenario 4 also includes higher future operating allowances of $1.7 billion from Budget 2018 to Budget 2020, growing at 2% thereafter. This reflects some allowance for future cost pressures signalled through four year plans and/or the possibility that higher population growth will place upward pressure on expenses beyond what is included in the forecasts.

10. In addition to the assumptions in scenario 4, scenario 5 increases the capital allowance by $500 million from Budget 2018 to 2020 to $2.5 billion, growing at 2% thereafter to reflect the possible impact of higher migration on infrastructure. This also allows additional headroom for some expensive items in the capital pipeline, [33]
[33]

11. Net debt remains well below 20% of GDP in 2020/21 in all scenarios which provides headroom for a potential tax and transfer package. We show the equivalent annual cost of a tax package that would result in net debt equal to 20% of GDP in 2020/21.

12. Given the current information and aforementioned pressures, we consider that a tax and transfer package of around $2 billion per annum would be prudent. This would allow for higher future Budget allowances that could be signalled now or maintained as a buffer as pressures materialise in future Budgets.

Table 1 – Summary of fiscal scenarios

Scenario	Net debt in 2020/21 (% of GDP)	Potential size of tax package consistent with net debt at 20% of GDP in 2020/21 ($ billions per annum)
1. Baseline	16.1	3.6
2. Higher (+0.2b) operating allowance in B17	16.4	3.3
3. Higher (+$1.5b) capital allowance in B17	16.9	2.8
4. Higher (+0.2b) ongoing operating allowances	17.3	2.5
5. Higher (+$0.5 b) ongoing capital allowance from B18	17.8	2.0

Source: The Treasury
Note: The scenarios are cumulative i.e. Scenario 5 includes the policy changes assumed in scenarios 1 to 4.

Medium-term fiscal strategy

13. The Public Finance Act requires the Government to state its fiscal objectives for a period of at least 10 years. The Government's fiscal strategy includes an objective to reduce net debt to within a range of 0 to 20% of GDP over the next 10 years.

14. The range (0-20% of GDP) recognises that debt should be allowed to fluctuate over the economic cycle. We consider it prudent in the long term to aim to have headroom within this range such that a moderate shock would not lead to net debt considerably exceeding 20% of GDP. Further, aiming for a more specific target would provide a clearer anchor. For example, a net debt target of around 10% of GDP would provide a buffer against shocks, consistent with the current range, and also a stronger fiscal anchor.

15. The specification of the range objective recognises that medium-term debt projections do vary considerably between forecast rounds and debt can rise significantly in response to shocks. Historically, net debt has risen by an average of 10 percentage points of GDP following recessions in New Zealand.

16. Current projections show net debt falling to 10% of GDP in 2022/23 and turning negative around 2025/26. Under scenario 1, OBEGAL surpluses are projected to rise to nearly 7% of GDP by 2030/31 and net debt is projected to fall to -25% of GDP (that is, a net asset position) by 2030/31.

17. 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 2014/15 to 24% of GDP in 2030/31 reflecting the assumed tracks for operating and capital allowances.

18. There will be a need to reset the fiscal strategy for the post-2020 period given current settings imply an indefinite rise in surpluses and a significant reduction in the level of Government expenditure as a share of GDP. Net debt is projected to fall to 10% of GDP by 2024/25 even with an increase in operating allowances to $1.7 billion per annum, [33] and a tax package of $2 billion per annum. This headroom in the long-term debt target will give future Government's choices to increase spending or reduce taxes.

19. The short-term and long-term fiscal targets will need to be reassessed in the next Parliamentary term to ensure they continue to provide a sound anchor for the public finances, particularly for the post-2020 period. It is important that any changes to fiscal targets are well-communicated and well-understood by relevant stakeholders such as financial markets, rating agencies, public sector chief executives, media and the public.

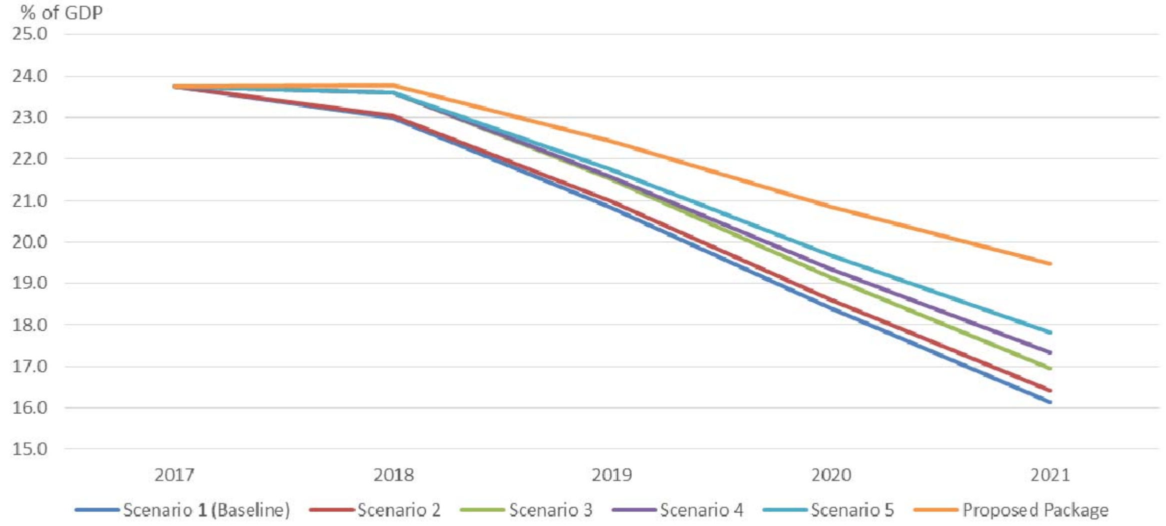
20. We will provide initial thinking on the post-2020 fiscal targets in advice on 31 March. Options for fiscal targets could include a stronger focus on the mid-point of the long-term net debt objective (i.e. 10% of GDP), supplemented with a medium-term view of the appropriate level for operating surpluses (e.g. around 1-3% of GDP).

Table 2 – Net debt, operating balance and fiscal headroom

Scenarios	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	Net debt headroom remaining in 2020/21 ($ billions)	Equivalent to annual tax package ($ billions)
	Net debt (% of GDP)																
1. Baseline	23.7	23.0	20.8	18.4	16.1	13.4	10.1	6.6	2.8	-1.3	-5.6	-10.1	-14.9	-19.9	-25.1	12.4	3.6
2. Higher (+0.2b) operating allowance in B17 only	23.7	23.0	21.0	18.6	16.4	13.7	10.5	7.1	3.3	-0.7	-4.9	-9.4	-14.2	-19.2	-24.3	11.6	3.3
3. Higher (+$1.5b) capital allowance in B17	23.7	23.6	21.5	19.1	16.9	14.2	11.1	7.6	3.8	-0.2	-4.4	-8.9	-13.6	-18.6	-23.8	9.9	2.8
4. Higher (+0.2b) ongoing operating allowances	23.7	23.6	21.6	19.3	17.3	14.9	12.0	8.9	5.5	1.9	-1.8	-5.8	-10.0	-14.3	-18.8	8.6	2.5
5. Higher (+$0.5 b) ongoing capital allowance from B18	23.7	23.6	21.7	19.7	17.8	15.4	12.6	9.6	6.4	2.9	-0.7	-4.5	-8.5	-12.7	-17.1	7.0	2.0
Tax package ($2b tax package)	23.7	23.8	22.4	20.9	19.5	17.6	15.3	12.8	10.0	6.9	3.7	0.3	-3.4	-7.2	-11.2	-	N/A

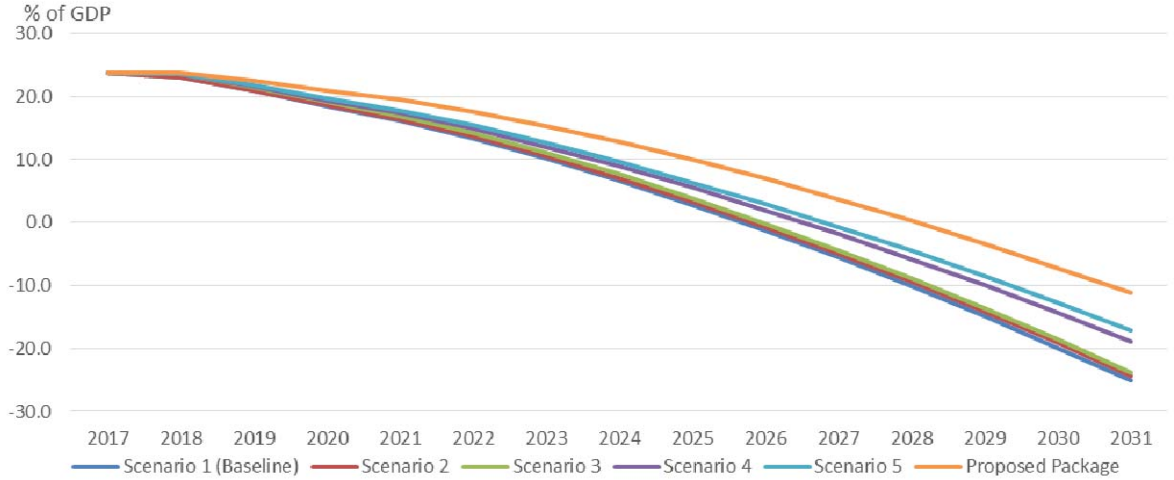
Scenarios	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
	Operating balance (OBEGAL, % of GDP)														
1. Baseline	0.5	1.4	2.3	2.8	3.2	3.7	4.1	4.4	4.7	5.0	5.3	5.7	6.0	6.4	6.7
2. Higher (+0.2b) operating allowance in B17 only	0.5	1.3	2.2	2.7	3.1	3.6	4.0	4.3	4.7	5.0	5.3	5.6	5.9	6.3	6.6
3. Higher (+$1.5b) capital allowance in B17	0.5	1.3	2.2	2.7	3.1	3.6	4.0	4.3	4.6	4.9	5.2	5.6	5.9	6.2	6.6
4. Higher (+0.2b) ongoing operating allowances	0.5	1.3	2.1	2.5	2.9	3.3	3.6	3.9	4.2	4.4	4.7	4.9	5.2	5.5	5.8
5. Higher (+$0.5 b) ongoing capital allowance from B18	0.5	1.3	2.1	2.5	2.9	3.3	3.6	3.9	4.2	4.4	4.6	4.9	5.2	5.4	5.7
Tax package ($2b tax package)	0.5	1.2	1.4	1.9	2.2	2.6	2.9	3.2	3.5	3.7	3.9	4.2	4.5	4.7	5.0

Figure 1 – Scenarios for net debt projections to 2020/21



Source: The Treasury

Figure 2 – Scenarios for net debt projections to 2030/31



Annex: Modelling assumptions for Scenarios

The Fiscal Strategy Model (FSM) projects forward most economic variables assuming a return to historic trends e.g. trend economic growth or based upon data sources e.g. Statistics New Zealand population projections. For expenses, it assumes fixed nominal baselines and adds on the Government's operating and capital allowances to forecast expenses. It assumes that tax rates are adjusted in the period from 2020 to 2030 to compensate for the effect of fiscal drag.

The future rise in the age of eligibility for New Zealand Super impacts on New Zealand Superannuation Fund (NZSF) contributions within the forecast and projection period. The FSM uses a lower rate of NZSF contribution as a result of this change. At HYEFU, we forecast NZSF contributions would be due to resume in 2020/21. If net debt falls below 20% in 2019/20, as it does in scenario 1, then NZSF contributions would restart in 2019/20. However, for the purposes of illustrating the remaining headroom, we have assumed a start date of 2020/21.

The fiscal forecasts have been updated only for tax forecasts and adjustments to benefit expenses based on updates to economic forecasts (i.e. CPI inflation). However, it does not include any other information about the fiscal outlook (e.g. departmental forecasts, changes to the expected timing of expenditure), which will be incorporated in the preliminary Budget fiscal forecasts.