



2013
BUDGET

Fiscal Strategy Report

Hon Bill English, Minister of Finance

16 May 2013

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New Zealand Government

Fiscal Strategy Report

Summary

Choosing sound fiscal and economic policies, and being disciplined in adhering to them, means the Government's books are in good shape. The fiscal outlook has improved markedly over the past few years, but a lot of work is needed to make the forecasts a reality, particularly when it comes to reducing debt.

This *Fiscal Strategy Report* confirms the Government's commitment to return the operating balance to surplus in 2014/15 and get net debt down to more prudent levels.

Budget forecasts show a total Crown operating surplus before gains and losses of \$75 million in 2014/15. Longer-term Budget projections show net core Crown debt dropping to 17.6 per cent of gross domestic product (GDP) in 2020/21, in line with the Government's target.

The Government has used its balance sheet to support the economy, and support New Zealanders, through the worst of the recession, the global financial crisis and the Canterbury earthquakes.

That has been the appropriate response to those challenges. But, as households around the country know, carrying substantial debt is neither comfortable nor financially prudent. So the build-up in debt has to be reversed, and the Government is committed to running cash surpluses and paying off debt. That requires an ongoing commitment to restrain spending into the future, as the economy continues its recovery.

At the same time, the Government is advancing its programme to build a more productive and competitive economy, deliver better public services and support the rebuilding of Christchurch.

Three key changes have been made to the fiscal parameters, compared to what was outlined in the most recent *Budget Policy Statement* (BPS).

First, the operating allowances for new spending have been slightly adjusted. Operating allowances are now \$900 million in Budget 2013, \$1 billion in Budget 2014, and thereafter grow at 2 per cent per Budget. This change to future allowances will mean less spending, bigger surpluses and a greater ability to pay down debt.

Second, the Government intends to delay contributions to the New Zealand Superannuation Fund (NZS Fund) until the long-term debt target is reached – that is, until

net debt is no higher than 20 per cent of GDP. This means that NZS Fund contributions are expected to resume in 2020/21 – two years later than was projected in the most recent *Half Year Economic and Fiscal Update*.

Third, the Government is now satisfied there is scope for significant reductions in Accident Compensation Corporation (ACC) levies. Levy reductions will reduce total Crown revenue, and this reduction is built into the Budget forecasts.

Economic Context

The New Zealand economy continued to expand in 2012, growing by 3 per cent over the year to December. This growth rate, while moderate, was still one of the higher growth rates of countries in the Organisation for Economic Co-operation and Development (OECD).

Real wages are increasing and interest rates are at 50-year lows. There are 50,000 more jobs in the economy than two years ago, although unemployment remains too high and attracting new investment that creates jobs is a particular focus for the Government.

The expansion in economic activity has been achieved in the face, once more, of a turbulent world economic environment, and a high New Zealand dollar.

Looking ahead, Budget forecasts show annual growth of between 2 and 3 per cent over the next four years. Contributing to this growth are low interest rates, increased activity resulting from the Canterbury rebuild and strong commodity export prices. Business and consumer confidence have improved.

Trade and investment relationships with Asia, the fastest-growing region in the world, are increasing. Australia, New Zealand's largest trading partner, remains one of the stronger-performing developed economies.

The New Zealand economy is expected to grow more strongly over the next two years than many other developed countries, including the United States, Canada, the United Kingdom, Japan, and the Euro area.

The current account deficit is forecast to rise gradually to over 6 per cent of GDP in the next few years, driven by stronger investment by businesses and households, including investment in the Canterbury rebuild. If investment in the rebuild is excluded, the current account deficit remains below 5 per cent of GDP.

New Zealand's offshore net liabilities will also worsen slightly as insurance pay-outs for Canterbury continue. However, national saving is expected to rise, led by the Government getting its finances in order. Household saving rates are expected to retain the gains made over recent years, following the large dissaving over much of the 2000s.

In summary, New Zealand is well placed, although a number of risks and challenges remain. The recent drought, for example, may have a more persistent effect than expected. Rapid house price growth, if sustained, could spill over into increased spending and borrowing, placing unwanted pressure on the domestic economy.

Internationally, some of the more extreme downside risks for the global economy have receded and the situation overall is more balanced now than it has been for some time, although international conditions continue to place upward pressure on the New Zealand dollar.

Fiscal Strategy

The Government has four priorities, which are to: responsibly manage the Government's finances; build a more productive and competitive economy; deliver better public services; and support the rebuilding of Christchurch.

Decisions presented in Budget 2013 contribute to meeting all of these priorities.

The Government's fiscal strategy is largely directed at the first priority – responsibly managing the Government's finances – but also impacts on the other three. For example, good fiscal management, which limits growth in government spending, frees up room for the private sector to grow without putting pressure on inflation and, therefore, interest rates. And better management of public assets helps the Government improve the quality of public services.

The fiscal strategy involves:

- maintaining strong fiscal discipline, with key objectives being to return to surplus in 2014/15 and reduce net debt to no higher than 20 per cent of GDP by 2020
- effectively managing the size and composition of the Crown's balance sheet
- ensuring that the way Crown revenue is raised is efficient, stable and provides the right incentives within the economy, and
- introducing appropriate institutional arrangements to manage public spending into the future, while achieving results for New Zealanders.

This strategy, including its short-term intentions and long-term objectives, is consistent with the principles of responsible fiscal management as set out in the Public Finance Act (listed here in Annex 2).

Each of the four parts of the fiscal strategy is important, and is self-reinforcing. But the cornerstone of the Government's fiscal strategy is to get the books in order so it is consistently running surpluses and paying back debt.

Taking on more debt has been appropriate to support the economy and cushion New Zealanders and their families from a number of major shocks including the recession, the global financial crisis and the Canterbury earthquakes.

But, as households around the country know, carrying substantial debt is neither comfortable nor financially prudent.

Annual interest payments on our debt will, this financial year, be similar to spending on the Police, early childhood education and the Unemployment Benefit combined. A sizeable debt also risks keeping interest rates and the exchange rate higher than they would otherwise be, and in turn crowding out the internationally-competitive sectors of the economy.

Getting on top of government debt reduces New Zealand's total indebtedness, which helps to maintain credibility with international lenders and therefore keeps borrowing costs down for businesses and households as well as the Government.

And lower government debt puts New Zealand in a much better position to cope with the next economic shock, or the next natural disaster, to come along. This point has been graphically illustrated by countries that went into the global financial crisis with already high levels of government debt, and are now having to implement harsh austerity measures in an attempt to get their finances back under control.

So the Government is firmly focused on capping, then reducing, its debt.

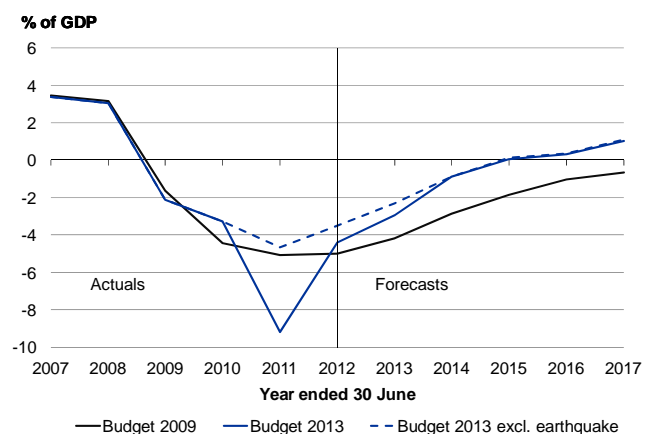
Past Fiscal Performance

When the National-led Government presented its first Budget in 2009, it did so against the backdrop of a sharp recession that had started in early 2008, and the impact of the worst global financial crisis since the 1930s. In the absence of policy change, the outlook was for never-ending deficits and exploding levels of government debt. On top of this, New Zealand subsequently experienced the Canterbury earthquakes, a slower-than-expected global recovery and the impact of the Retail Deposit Guarantee Scheme (RDGS), each of which had a significant effect on the Crown's financial position.

The Government's plan throughout this time was to support the economy in the short term by running operating deficits (reflecting lower tax revenue and higher spending on items such as benefits), but then to reduce these deficits by slowing growth in government expenditure as the economy recovered.

This approach provided support to the economy when it was most needed, and cushioned New Zealanders and their families from the effects of the recession. However, it did so within a clear framework which would deliver a prudent fiscal position with operating surpluses and net debt around 20 per cent of GDP in the medium term.

Figure 1 – Total Crown operating balance before gains and losses



Source: The Treasury

In 2010/11, the operating deficit reached a peak of \$18.4 billion, or 9.2 per cent of GDP (Figure 1), with around half of this deficit reflecting the one-off effects of the Canterbury earthquakes and the RDGS. That deficit halved the following year, is expected to reduce to \$6.3 billion in 2012/13 and is forecast to return to surplus in 2014/15.

Part of the improvement reflects the unwinding of many of the one-off expenses. But it also reflects a slowing of the growth rate of expenses relative to tax revenue and GDP.

The Government's operating surplus (or deficit) is equivalent to a business's underlying profit (or loss) – it is the Crown's revenue minus its expenses. Similar to businesses, the Government also records cash flows as a result of its operating and capital activities.

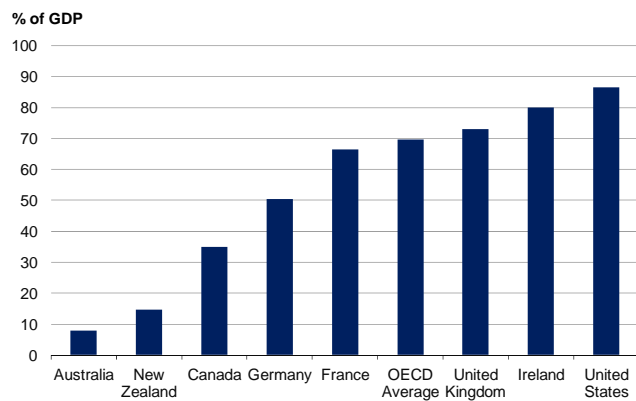
This is important because cash deficits need to be funded by borrowing, while cash surpluses are available to pay back debt. The Crown has posted cash deficits since 2008/09, and these peaked at \$13.3 billion in 2010/11.

As a result, the Crown’s net debt has risen from \$17.1 billion in 2008/09 to an expected \$58 billion in the current year, 2012/13, and is still rising. As a percentage of New Zealand’s GDP, net debt is still well below the OECD average, and below most of the countries it is typically compared with (Figure 2). But it is still a sizeable level of debt, and is currently rising by around \$130 million a week, on average over the next financial year.

Running deficits and building up debt has been the appropriate response to the challenges the economy has faced over the past five years. But this build-up in debt has to be reversed and the Government is committed to reducing net debt to more prudent levels. This will require running persistent cash surpluses to pay off debt.

While the Government has been running deficits, it has also been very active in restraining spending, and in particular addressing some of the long-term drivers of this spending. Over five Budgets, the Government’s new spending and revenue initiatives in the final year of the forecast period have totalled less than \$1.7 billion, or an average of around \$330 million per Budget. The equivalent over the last five Budgets of the previous government was a total of \$19 billion, or an average of \$3.8 billion per Budget.

Figure 2 – General government net financial liabilities, 2012



Source: OECD Economic Outlook No 92 December 2012

Spending restraint has been achieved in a number of ways, including: reprioritising spending from lower-value to higher-value activities; reducing Budget operating allowances (including two net-zero Budgets in 2011 and 2012); reducing the cost escalations built into existing policies; and driving better efficiency and better results from the public sector.

Note: The OECD data for New Zealand differs from the Treasury’s net core Crown debt data owing to differences in methodology and coverage.

At the same time, the Government has continued to invest in the productive capacity of the economy and in major infrastructure projects.

As a result of the Government’s responsible financial management, the fiscal outlook has improved markedly over only a few years. Early decisions the Government took to improve the fiscal position have had a large impact on the projections for future years because of the compounding effects of lower interest costs and lower debt levels, and the compounding effects of lower operating allowances.

Short-term Fiscal Intentions

The Government’s focus in the short term – that is, over the forecast period to 2016/17 – is on returning the total Crown operating balance before gains and losses to a surplus no later than 2014/15. The Government is also focused on returning to cash surpluses so it can begin to pay off debt. Meeting these targets requires continued spending restraint.

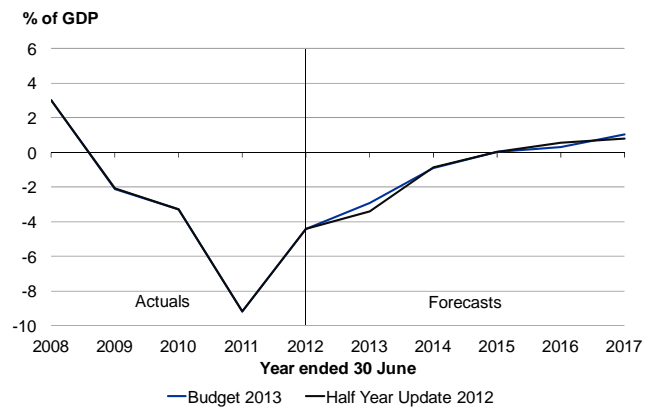
Budget forecasts show the Government meeting its key short-term target, with an operating surplus in 2014/15 of \$75 million (Figure 3).

Core Crown residual cash is forecast to remain in deficit throughout the forecast period, which means the level of net core Crown debt will continue to rise. However, as a share of GDP, net debt is forecast to peak at 28.7 per cent in 2014/15, and decline thereafter (Figure 4).

While core Crown expenses continue to rise in dollar terms (Figure 5), they are falling as a share of GDP. Core Crown expenses are forecast to drop below 31 per cent of GDP in 2014/15 – down from 35 per cent just two years ago – and then remain well under that level.

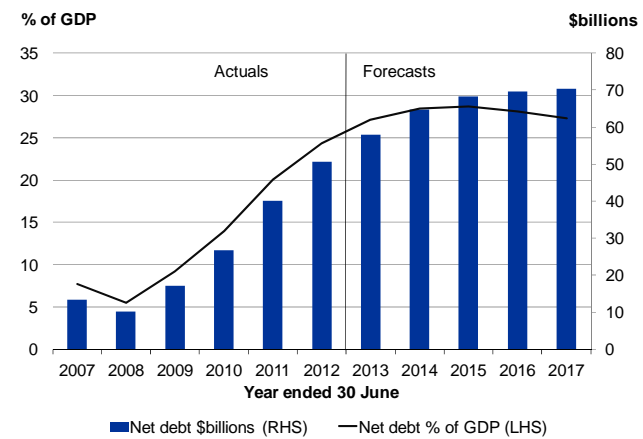
The priority given to managing the Government’s finances means that there is, and will continue to be, limited new operating spending each year. Operating allowances have been revised to \$900 million in Budget 2013, \$1 billion in Budget 2014 and growing thereafter at 2 per cent per Budget. The change to future allowances will mean less spending, bigger surpluses and more ability to pay down debt (Box 1).

Figure 3 – Total Crown operating balance (before gains and losses)



Source: The Treasury

Figure 4 – Net core Crown debt



Source: The Treasury

In addition, there will continue to be no new money set aside for capital spending over this and the following three Budgets. New capital spending will be funded from the Crown's balance sheet, and in particular from the proceeds of the Government's share offers, which are expected to free up \$5 billion to \$7 billion for new investment in public assets.

The Government's return to operating surplus is not dependent on the Mighty River Power share sale. The share offer programme effectively swaps one type of asset for another – electricity company shares for cash – so its primary effect is on the mix of assets and debt that the Government owns, rather than on the operating balance. Changes in the Crown's balance sheet over the short term are outlined in the section below on Managing the Crown's Balance Sheet.

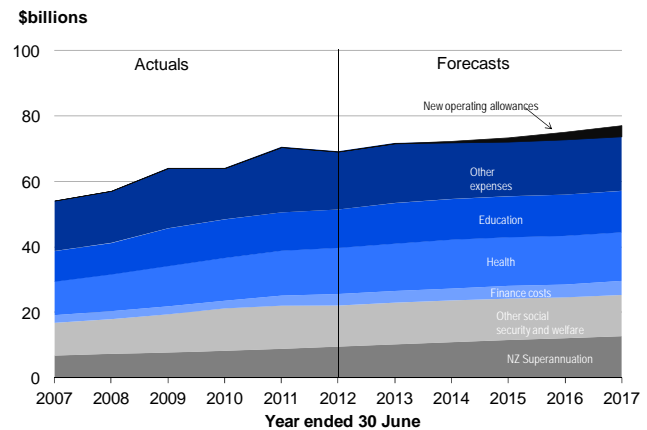
Having been stimulatory during the recession, fiscal policy is expected to exert a mildly contractionary effect on the economy throughout the forecast period. This is illustrated in Figure 6, which shows the "fiscal impulse" – an estimate of the impact on demand of the change in fiscal position from year to year. As a result, fiscal policy will operate in support of monetary policy and allow interest rates to be lower than they would otherwise be.

Ongoing spending restraint is a major part of the Government's fiscal strategy. But spending restraint is not a handbrake on providing better public services. In fact, big increases in spending have often been a measure of failure, rather than a measure of success. Government spending increased 50 per cent over just five years in the mid-2000s with little, in the end, to show for it.

This Government, in contrast, is focused on driving innovation and results in the public sector. And, in turn, better results from public services will create downward pressure on government spending in the future, through results such as lower reoffending rates and better health outcomes.

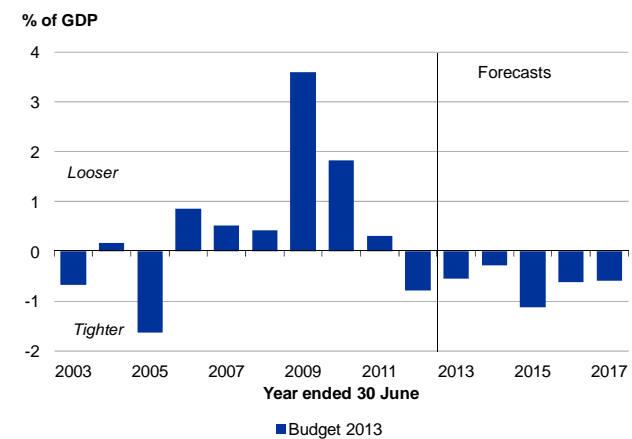
The Government's short-term fiscal intentions are set out formally in Annex 1.

Figure 5 – Core Crown expenses



Source: The Treasury

Figure 6 – Fiscal impulse



Source: The Treasury

Box 1 – Operating Allowances

The operating allowance is the amount the Government sets aside for new discretionary spending and revenue initiatives in the current and future Budgets.

The operating allowance for Budget 2013 has been set at \$900 million, increasing to \$1 billion in Budget 2014 and growing thereafter at 2 per cent per Budget. This represents a slight increase in the allowance for this Budget, but a decrease for all future Budgets, compared to what was signalled in the 2013 BPS (Table 1).

Table 1 – Operating allowances

\$millions	Budget 2013	Budget 2014	Budget 2015	Budget 2016
Revised operating allowance	900	1,000	1,020	1,040
Previous operating allowance as signalled in the BPS	800	1,190	1,214	1,238
Reduction/ (increase) in spending	(100)	190	194	198

Less spending will mean bigger surpluses and more ability to pay down debt. By the end of the forecast period, in 2016/17, the operating balance and the residual cash balance will be almost \$500 million bigger than they otherwise would have been, as the result of reducing allowances (Table 2).

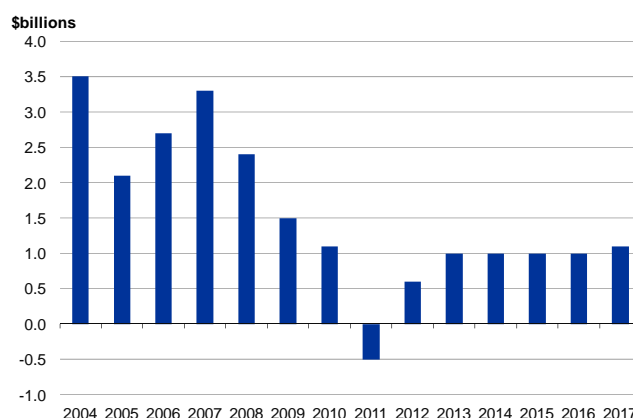
Table 2 – Impact on key fiscal indicators from change in operating allowances

\$millions	2013/14	2014/15	2015/16	2016/17
Budget 2013	(100)	(100)	(100)	(100)
Budget 2014		190	190	190
Budget 2015			194	194
Budget 2016				198
Increase/ (reduction) in the operating balance and residual cash	(100)	90	284	482

The revised operating allowances show the Government's ongoing spending restraint, particularly when compared to operating spending earlier in the 2000s (Figure 7).

Keeping to these operating allowances will require continuing reprioritisation of spending from lower-priority into higher-priority areas, and require government departments to keep finding efficiencies as part of their Four-year Plans.

Figure 7 – New operating spend per Budget



Source: The Treasury

Note: Excludes revenue initiatives.

Long-term Fiscal Objectives

The Government's long-term fiscal objectives remain unchanged. The focus is to bring net core Crown debt back to a level no higher than 20 per cent of GDP by 2020. The Government will run operating surpluses and cash surpluses consistent with this debt objective, while also meeting the Government's net capital requirements.

There is, of course, a wide band of uncertainty around medium- and long-term projections, and the Government does not intend to be a slave to the 20 per cent debt target in every Budget.

However, the *Half Year Economic and Fiscal Update* showed the Government was some way off meeting this long-term debt target, with net debt projected to be almost 25 per cent of GDP in 2020/21. The Government has therefore decided to delay resuming contributions to the NZS Fund until net debt falls below 20 per cent of GDP (Box 2).

As a result of this change, net debt is now projected to reach 17.6 per cent of GDP in 2020/21, in line with the Government's long-term objective. NZS Fund contributions are therefore also projected to resume in 2020/21 – two years later than was projected in the *Half Year Economic and Fiscal Update*.

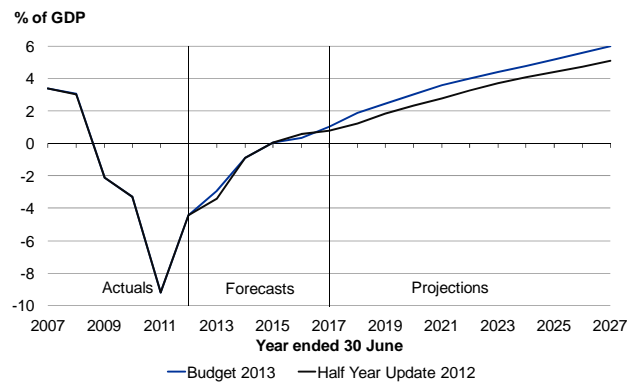
Past 2014/15, operating surpluses are expected to increase each year (Figure 8). Cash surpluses are expected from 2017/18 onwards (Figure 9), at which point net debt will start to reduce in dollar terms.

As a percentage of GDP, net debt is expected to stay under 30 per cent of GDP and start reducing after 2014/15 (Figure 10).

A broader measure of the strength of the balance sheet – total Crown net worth – is expected to start consistently increasing as a percentage of GDP from 2014/15 (Figure 11). Most of the ongoing balance sheet strengthening reflects debt reduction.

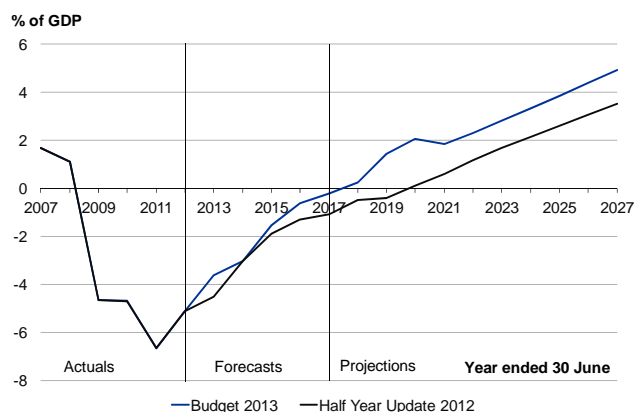
Net worth is projected to have recovered to pre-crisis levels by the mid-2020s.

Figure 8 – Total Crown operating balance (before gains and losses)



Source: The Treasury

Figure 9 – Core Crown residual cash



Source: The Treasury

Operating surpluses require revenues to exceed expenses. Figure 12 shows the projected paths for core Crown revenue and expenses. Revenue is projected to increase as a proportion of GDP until 2020/21, after which it is assumed to remain broadly stable.

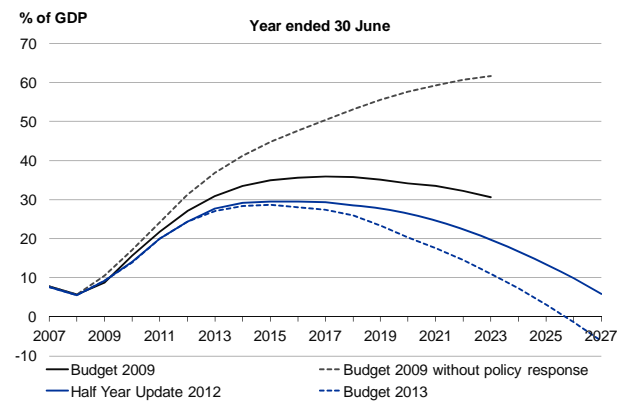
Ongoing expenditure restraint is essential for New Zealand’s long-term fiscal sustainability and to put the country back on a sustainable growth path, with economic growth led by the private sector. The Government will restrain its spending so that, over time, core Crown expenses are reduced to below 30 per cent of GDP and remain well under that level. Core Crown expenses are expected to remain well below the level of the spending limit outlined in Budget 2012, for the next decade.

These longer-term projections show a remarkable turnaround in the Government’s books, compared to what was expected only a few years ago. Projections done as part of Budget 2009, for example, showed that if the Government had maintained the spending track it inherited, and hadn’t made policy changes, net debt would exceed 60 per cent of GDP by the early 2020s (Figure 10).

But it is crucially important when looking at long-term projections, and even when looking at short-term projections, to recognise that these are simply assumptions in a spreadsheet, or inputs to a model, until actual decisions are made in the real world. While the fiscal outlook has improved markedly over the past few years, there is a lot of work to be done to make the forecasts a reality. At its peak, in 2016/17, net debt is expected to reach \$70 billion, or around \$15,000 for each and every New Zealander.

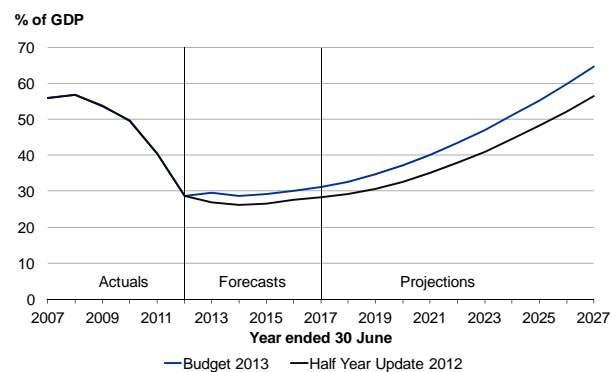
The Government, on behalf of all New Zealanders, has to be focused on reducing this debt. History is littered with examples of countries that were prepared to take on debt during bad economic times, but were not prepared to pay back that debt when their economic fortunes improved.

Figure 10 – Net core Crown debt



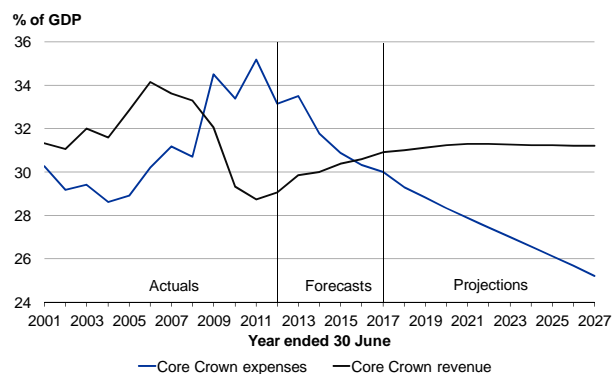
Source: The Treasury

Figure 11 – Total Crown net worth



Source: The Treasury

Figure 12 – Core Crown revenues and expenses



Source: The Treasury

The Government's long-term fiscal objectives are set out formally in Annex 1. The fiscal projections in Figures 8 to 12 assume a continuation of current government policy settings, including operating and capital spending, until the end of the projection period. They show the central projection based on the assumptions outlined in Annex 3.

Box 2 – Contributions to the New Zealand Superannuation Fund

The Government has decided to delay resuming contributions to the NZS Fund until net core Crown debt falls below 20 per cent of GDP.

Cash surpluses are expected from 2017/18 onwards. The choice at that point is whether to use these cash surpluses to reduce debt to more prudent levels or whether to put money into world share markets while holding higher debt. The Government considers that the first option is clearly more responsible, given the importance – outlined elsewhere in this *Fiscal Strategy Report* – of paying back debt. It is also the lower-risk option given the volatility and risk of investing in international stock markets.

Once net debt gets below 20 per cent of GDP, the Government is comfortable with building up the NZS Fund, which currently holds over \$21 billion of financial assets.

As a result of this change, NZS Fund contributions are projected to resume in 2020/21 – two years later than was projected in the *Half Year Economic and Fiscal Update* and, in fact, the same time as was expected when the Government initially suspended contributions to the NZS Fund in Budget 2009.

It is important to stress that this short delay in resuming contributions to the NZS Fund will not in any way affect New Zealanders' entitlement to New Zealand Superannuation, either now or in the future. The Government has been very clear that it has no intention of changing the age of eligibility of New Zealand Superannuation, the way that payments are calculated, or the link to 66 per cent of the average wage for a couple. Delaying contributions to the NZS Fund will not change the Government's ability to make these payments, because low debt is equally as important as NZS Fund assets in meeting some of the future fiscal pressures from population ageing.

Managing the Crown's Balance Sheet

The Government has moved to more consistent and deliberate management of the Crown's balance sheet – that is, what it owns and what it owes.

Since the global financial crisis, nominal government spending on capital has risen to around 18 per cent of total fixed capital formation in the economy, as private investment has fallen. This increase, up from around 13 per cent prior to the crisis, means that the Government is playing a bigger role in total investment activity within the New Zealand economy. The Government now owns a total of \$240 billion of assets (as at June 2012). Government debt has also risen significantly over recent years.

The Government's balance sheet strategy involves:

- rebuilding the Crown's balance sheet buffer against future risks and adverse events, in the first instance by reducing debt as a share of GDP

- encouraging asset ownership only when it is necessary to deliver core public services and only after other arrangements have been explored
- looking to dispose of assets that are surplus to requirements or no longer fit for purpose
- prioritising capital to its highest value use, including establishing the Future Investment Fund to reinvest the proceeds of the Government's share offers in higher-priority public assets
- introducing private sector capital and disciplines where appropriate; for example, with the development of partnership schools or the use of public-private partnerships for the Hobsonville schools and Wiri prison
- more active monitoring of Crown-owned entities such as State-owned Enterprises and Crown Financial Institutions (CFIs), with a view to raising performance, reducing risks, and ensuring the efficient use of capital, and
- better monitoring of actual investment performance against expectations.

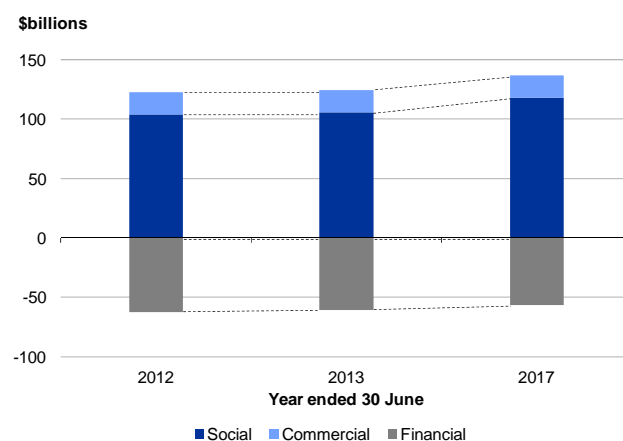
Over the forecast period, new capital spending will be funded from the Crown's balance sheet, including from the proceeds of the Government's share offer programme. This will lead to some changes in the composition of the Crown balance sheet (Figure 13).¹

The Government's social net asset portfolio is expected to grow the most in value, by \$13.9 billion over the next five years. The Government intends to manage the social portfolio in a manner consistent with delivering value-for-money public services, as well as concentrating new investments in areas where ownership risks cannot cost-effectively be carried by the private or not-for-profit sectors.

The Government's commercial portfolio is expected to grow marginally by \$0.5 billion over the next five years.²

The government's financial portfolio is expected to grow by \$5.9 billion, reflecting growth in CFIs.

Figure 13 – Crown's net assets by portfolio



Source: The Treasury

¹ The Crown's balance sheet broadly consists of three portfolios. The "Social Portfolio" consists of the assets and liabilities held primarily to provide public services or to protect assets for future generations; the "Financial Portfolio" reflects assets and liabilities held by the Crown to finance or pre-fund government expenditure; while the Crown's "Commercial Portfolio" consists of the portfolio of companies held with purely commercial objectives. For more details, see the Investment Statement of the Government of New Zealand 2010 on the Treasury website (www.treasury.govt.nz).

² Accounting standards require that the full value of the assets in the companies involved in the Government's partial share sales remain on the Crown's balance sheet after the sale. The ownership of those assets does change, and this is reflected in the increase in minority interests. Further discussion on the Government's sale programme is included in the Treasury's *Budget Economic and Fiscal Update*.

Crown Revenue

The Government supports a broad-base, low-rate tax system that minimises economic distortions, rewards effort, has low compliance and administrative costs, and minimises opportunities for tax avoidance and evasion.

A comprehensive review of New Zealand's tax system was undertaken in 2009 by the Tax Working Group. As a result of this review, major tax reforms were announced in Budget 2010. These reforms were broadly fiscally neutral and involved, amongst other things:

- reducing all personal tax rates, including a new lower top tax rate of 33 per cent, and reducing the company tax rate to 28 per cent
- increasing goods and services tax (GST) to 15 per cent, to encourage savings rather than consumption
- tightening up the tax treatment of investment property, and
- bringing in stricter tax rules for foreign multinationals to reduce their ability to minimise tax payments in New Zealand.

The Government considered, and rejected, other potential tax changes such as a land tax and a capital gains tax. The Government is comfortable with the broad structure of the tax system and has no plans for further major reforms in the near term.

In the wider system of Crown revenue, the Government is now satisfied there is scope for significant and sustainable reductions in ACC levies.

The Government has therefore made an allowance for levy reductions of around \$300 million in 2014/15. Final figures will be determined after ACC consults on levies later this year.

ACC's improved performance, and an on-going review of its funding policy, mean the Government has also allowed for a levy reduction of around \$1 billion in 2015/16.

When combined with the \$630 million reduction in levies in 2012/13, these proposed changes would amount to around 40 per cent lower ACC levy rates for households and businesses, with the impact varying over the different accounts.³

³ The fiscal impact of reducing levies will be higher than the actual reduction to levy payers. This is because the consequential impacts on investment revenue and insurance expenses also need to be accounted for. The impact on the operating balance before gains and losses is expected to be approximately \$400 million in 2014/15, \$1.5 billion in 2015/16 and \$1.1 billion in 2016/17. These impacts are built into the Budget forecasts.

Thinking About Future Generations

A future challenge will be the ageing of the New Zealand population which, incrementally over a number of years, will place significant upward pressure on government spending. There is no “quick fix” that addresses this. Rather, the change to the structure of the population will require governments to make a whole series of policy and spending decisions over a long period of time.

The Government’s fiscal strategy is mindful of the longer term. Decisions to restrict the growth in Crown expenses, and reduce the structural budget deficit, have had a significant effect on projections of the Government’s fiscal position into the future. And, in particular, the Government has recognised that changes to the institutional arrangements that drive future spending can have a profound effect over a long period of time.

This Budget is an example. The changes to operating allowances have a permanent and compounding effect across all future years. The Government is also making institutional changes with the aim of lessening future fiscal liabilities.

The investment approach to welfare, for example, looks to identify benefit recipients who are most likely to gain from being helped back into the workforce because they are at higher risk of remaining on a benefit in the long term. Once identified, those recipients would receive more support. This approach involves more spending up front, but it will mean that the Government will need to spend less on welfare in the future. It is an example of a policy change that will have long-term benefits for both welfare beneficiaries and the Government’s accounts.

These sorts of measures will help reduce spending as a share of GDP which is an essential building block towards dealing with the cost pressures that are likely to arise in the future. A lower expenditure base will allow governments a wider range of options for dealing with these pressures when they arise.

The Treasury is required under the Public Finance Act 1989 to publish a statement on the long-term fiscal position, at least every four years, which looks at least 40 years into the future. The Treasury expects to release the next *Long-term Fiscal Statement* in July 2013.

Annex 1

Short-term Fiscal Intentions and Long-term Fiscal Objectives

The Government's short-term fiscal intentions are substantially unchanged since those in the BPS; there are minor changes reflecting the revisions to the fiscal forecasts (see Table A1.1). These revised fiscal intentions are consistent with the Government's long-term fiscal objectives (see Table A1.2).

Table A1.1 – Short-term fiscal intentions

<i>Fiscal Strategy Report 2013</i>	<i>Budget Policy Statement 2013</i>
<p>Debt</p> <p>Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 38.8 per cent of GDP in 2016/17.</p> <p>Net core Crown debt (excluding NZS Fund and advances) is forecast to be 27.3 per cent of GDP in 2016/17.</p>	<p>Debt</p> <p>Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 39.1 per cent of GDP in 2016/17.</p> <p>Net core Crown debt (excluding NZS Fund and advances) is forecast to be 29.3 per cent in 2016/17.</p>
<p>Operating balance</p> <p>Our intention is to return the operating balance (before gains and losses) to surplus as soon as practical and no later than 2014/15, subject to any significant shocks.</p> <p>Based on the operating allowance for the 2013 Budget, the operating balance (before gains and losses) is forecast to be -0.9 per cent of GDP in 2013/14. The operating balance (before gains and losses) is forecast to be 0.0 per cent of GDP in 2014/15. This is consistent with the long-term objective for the operating balance.</p> <p>The operating balance is forecast to be 0.2 per cent of GDP in 2013/14.</p>	<p>Operating balance</p> <p>Our intention is to return the operating balance (before gains and losses) to surplus as soon as practical and no later than 2014/15, subject to any significant shocks.</p> <p>Based on the operating allowance for the 2013 Budget, the operating balance (before gains and losses) is forecast to be -0.9 per cent of GDP in 2013/14. The operating balance (before gains and losses) is forecast to be 0.0 per cent of GDP in 2014/15. This is consistent with the long-term objective for the operating balance.</p> <p>The operating balance is forecast to be 0.0 per cent of GDP in 2013/14.</p>
<p>Expenses</p> <p>Our intention is to support a return to fiscal surplus by restraining the growth in core Crown expenses – so that they are reduced to around 30 per cent of GDP by 2015/16.</p> <p>Core Crown expenses are forecast to be 30.0 per cent of GDP in 2016/17.</p> <p>Total Crown expenses are forecast to be 39.5 per cent of GDP in 2016/17.</p> <p>This assumes a new operating allowance of \$1 billion in Budget 2014, growing at 2 per cent for Budgets thereafter (GST exclusive).</p>	<p>Expenses</p> <p>Our intention is to support a return to fiscal surplus by restraining the growth in core Crown expenses – so that they are reduced to around 30 per cent of GDP by 2015/16.</p> <p>Core Crown expenses are forecast to be 30.1 per cent of GDP in 2016/17.</p> <p>Total Crown expenses are forecast to be 39.1 per cent of GDP in 2016/17.</p> <p>This assumes a new operating allowance of \$800 million for Budget 2013, increasing to \$1.19 billion in Budget 2014 and growing at 2 per cent for Budgets thereafter (GST exclusive).</p>

<i>Fiscal Strategy Report 2013</i>	<i>Budget Policy Statement 2013</i>
<p>Revenues</p> <p>Total Crown revenues are forecast to be 40.6 per cent of GDP in 2016/17.</p> <p>Core Crown revenues are forecast to be 30.9 per cent of GDP in 2016/17.</p> <p>Core Crown tax revenues are forecast to be 28.3 per cent of GDP in 2016/17.</p>	<p>Revenues</p> <p>Total Crown revenues are forecast to be 40.1 per cent of GDP in 2016/17.</p> <p>Core Crown revenues are forecast to be 30.2 per cent of GDP in 2016/17.</p> <p>Core Crown tax revenues are forecast to be 27.7 per cent of GDP in 2016/17.</p>
<p>Net worth attributable to the Crown</p> <p>Total net worth attributable to the Crown is forecast to be 28.7 per cent of GDP in 2016/17.</p> <p>Core Crown net worth is forecast to be 12.1 per cent of GDP in 2016/17.</p>	<p>Net worth attributable to the Crown</p> <p>Total net worth attributable to the Crown is forecast to be 25.9 per cent of GDP in 2016/17.</p> <p>Core Crown net worth is forecast to be 9.2 per cent of GDP in 2016/17.</p>

The Government's long-term fiscal objectives are unchanged from those outlined in the BPS – as shown below in Table A1.2. The long-term objectives are consistent with the principles of responsible fiscal management, including the new principles of responsible fiscal management included in the Public Finance (Fiscal Responsibility) Amendment Bill.

Table A1.2 – Long-term fiscal objectives

Fiscal Strategy Report 2013

Debt

Manage total debt at prudent levels. Over the short to medium term, it is prudent to allow an increase in debt to deal with the current economic and fiscal shocks.

However, we need to ensure that this increase is eventually reversed and that we return to a level of debt that can act as a buffer against future shocks.

We will do this by ensuring that net debt remains consistently below 35 per cent of GDP, and is then brought back to a level no higher than 20 per cent of GDP by 2020. We will work towards achieving this earlier as conditions permit.

Operating balance

Return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the New Zealand Superannuation Fund, and ensure consistency with the debt objective.

Operating expenses

To meet the operating balance objective, the Government will control the growth in government spending so that, over time, core Crown expenses are reduced to below 30 per cent of GDP.

Operating revenues

Ensure sufficient operating revenue to meet the operating balance objective.

Net worth

Ensure net worth remains at a level sufficient to act as a buffer to economic shocks. Consistent with the debt and operating balance objectives, we will start building up net worth ahead of the full fiscal impact of the demographic change expected in the mid-2020s.

Contributions to the NZS Fund

Under the New Zealand Superannuation and Retirement Income Act 2001, the Government is required to indicate the annual capital contribution into the NZS Fund that would result from the calculation method described in section 43 of the Act, as well as the actual planned contribution. Both sets of capital contributions, for all years of the Budget 2013 forecast horizon, are provided in Table A1.3.

Table A1.3 – NZS Fund calculations (\$billions)

Year ended 30 June	2014	2015	2016	2017
Calculations of annual contributions if they were to resume in 2013/14	2.4	2.2	2.1	2.1
Forecast contributions	0	0	0	0

Annex 2

Principles of Responsible Fiscal Management

The Public Finance Act prescribes that the Government must pursue its policy objectives in accordance with the following principles:

- (a) reducing total debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total debt in the future by ensuring that, until those levels have been achieved, total operating expenses in each financial year are less than total operating revenues in the same financial year
- (b) once prudent levels of total debt have been achieved, maintaining those levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues
- (c) achieving and maintaining levels of total net worth that provide a buffer against factors that may impact adversely on total net worth in the future
- (d) managing prudently the fiscal risks facing the Government, and
- (e) pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

The Government is also progressing the Public Finance (Fiscal Responsibility) Amendment Bill, which is currently being considered by the Finance and Expenditure Committee. This Bill would replace principle (e) above with four new principles:

- (e) formulating revenue strategy with regard to efficiency and fairness, including the predictability and stability of tax rates
- (f) formulating fiscal strategy with regard to its interaction with monetary policy
- (g) formulating fiscal strategy with regard to its likely impact on present and future generations, and
- (h) ensuring that the Crown's resources are managed effectively and efficiently.

Annex 3

Projection Assumptions out to 2026/27

The economic and fiscal forecasts, from 2012/13 to 2016/17, are detailed in the *2013 Budget Economic and Fiscal Update*. The projection period begins in 2017/18 and ends in 2026/27. These post-forecast fiscal projections are based on the long-run technical and policy assumptions outlined below. The projection model can be found on the Treasury's website at www.treasury.govt.nz/government/fiscalstrategy/model.

Table A3.1 – Summary of economic and demographic assumptions¹

Year ending 30 June	2013	2014	2015	2016	2017	2018	2019	2020	2021	...	2027
	Forecast					Projections					
Labour force	-0.3	1.6	1.9	1.0	0.8	1.1	1.1	1.0	1.0	...	0.7
Unemployment rate ²	7.0	6.2	5.9	5.6	5.3	5.0	4.8	4.7	4.6	...	4.5
Employment	-0.8	2.5	2.2	1.3	1.2	1.4	1.2	1.1	1.1	...	0.7
Labour productivity growth ³	2.9	-0.4	1.1	1.4	1.1	1.1	1.3	1.5	1.5	...	1.5
Real GDP	2.5	2.5	2.9	2.5	2.2	2.4	2.5	2.6	2.6	...	2.3
Consumers Price Index (CPI) (annual percentage change)	1.0	1.9	1.8	2.2	2.2	2.0	2.0	2.0	2.0	...	2.0
Government 5-year bonds (average percentage rate)	2.9	3.3	4.1	4.8	5.0	5.1	5.2	5.3	5.4	...	5.5
Nominal average hourly wage	2.4	2.9	2.3	2.7	3.3	3.1	3.3	3.5	3.5	...	3.5

1 Annual average percentage change unless otherwise stated

2 Unemployment as a percentage of the labour force (annual average)

3 Hours worked measure

Sources: The Treasury, Statistics New Zealand

Transition of economic variables from the end of forecast

Given the difficulty in projecting cycles and shocks beyond the forecast horizon, the projections use trend or long-run averages for the growth rates or levels of key variables.

In previous forecast rounds the five-year forecast period was generally sufficient for the effects of current cycles and shocks to have worked their way through the economy. By the end of the forecast period, key variables such as unemployment, the terms of trade and labour force participation have usually returned to trend growth rates or levels.

In recent forecast rounds, shocks to the economy, either on the demand or supply side, have caused key variables to remain above or below trend at the end of the forecast period. For example, in Budget 2010, some of the key economic variables were not predicted to converge fully to their long-term values at the end of the forecast period, owing to the persistent effects of the recession. Those variables were adjusted from their end-of-forecast values to the long-term averages, using a relevant convergent rate for each variable.

In the Budget 2013 forecasts, the flow-on effect from the earthquake rebuild is assumed to continue into some early years of the projection period. Accordingly, real GDP growth for these years is assumed to grow above the trend rate until 2018/19. The unemployment rate, labour productivity growth and average weekly hours worked are adjusted to reflect the faster real GDP growth track. As well as this, age and gender group labour force participation rates and CPI inflation have also been adjusted from their end-of-forecast values. These all contribute to the projection of nominal GDP, which is both a driver of a number of important fiscal variables, such as tax revenue, and the denominator in key fiscal ratios (ie, debt-to-GDP).

From 2017/18 to 2018/19, labour productivity growth is calculated from real GDP growth and labour force. From 2019/20 onwards, labour productivity growth is assumed to return to the estimated long-term value of 1.5 per cent per annum.

For labour force participation rates, the adjustment technique involves using growth rates for participation rates from projections produced by Statistics New Zealand.

For the other three variables – CPI inflation, unemployment rate and average hours worked – a long-term average is determined, together with a convergence path. The long-term averages are based on historical data, making allowance for factors that could alter their future values, such as the Policy Targets Agreement with CPI inflation.

By 2022/23, all these variables have returned to their trend rates or levels.

Table A3.2 – Summary of fiscal assumptions

Tax revenue	Linked to growth in nominal GDP. Source deductions (mainly PAYE tax on salary and wages) is grown using employment growth and nominal average hourly wage growth for the first four years of the projection period. The latter is multiplied by a fiscal drag elasticity of 1.35. After the first four years of the projection period, source deductions are returned to a long-term stable value of 11.2 per cent of GDP. The four other major tax categories, Corporate tax, Hypothecated Transport taxes, GST and Other taxes, are gradually returned, from their end-of-forecast values, to long-term constant ratios to GDP. This transitional adjustment is to ensure that tax revenue projections are based on ratios to GDP that are neither higher nor lower than would be expected when the economy is performing at its potential. All tax categories change at a rate of 0.2 per cent of GDP per annum, with final ratios-to-GDP of 4.4 per cent for Corporate tax, 1.4 per cent for Hypothecated Transport taxes, 7.4 per cent for GST and 4.3 per cent for Other taxes. The long-term ratios are based on historical data, taking into account tax rate and policy changes that could affect these. Once the long-term ratios are reached the tax types remain at them in later projected years.
New Zealand Superannuation (NZS)	Demographically adjusted and linked to net wage growth, via the “66 per cent wage floor.” The latter refers to the net (after-tax) weekly NZS rate for a couple being constrained to lie between 66 per cent and 72.5 per cent of net average weekly earnings. As tax on average weekly earnings, being a part of overall PAYE, increases owing to fiscal drag, the net average weekly earnings do not grow as quickly as the gross earnings.
Other benefits	Demographically adjusted and linked to inflation.

Health and education	Held constant at the end-of-forecast values, because their growth is assumed to come from a share of the projected Operating Allowance annual increment.
Other expenditure	Held constant at the end-of-forecast values, because their growth is assumed to come from a share of the projected Operating Allowance annual increment.
Finance costs	A function of debt levels and interest rates.
Operating allowance	\$1.06 billion in 2017/18, based on 2 per cent growth from the end-of-forecast value. Operating Allowances for subsequent projected years grow at 2 per cent per annum from this value.
Capital allowance	\$0.936 billion in 2017/18. This is based on a track of \$0.9 billion in Budget 2016 as the starting point, grown at 2 per cent per annum.
NZS Fund	Contributions to the Fund suspended until 2019/20. Contributions begin again in 2020/21, and are consistent with the New Zealand Superannuation and Retirement Income Act 2001.