Budget Policy Statement

Hon Bill English, Minister of Finance

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Budget Policy Statement

Executive Summary

The economy continues to strengthen under the Government's programme of consistent economic and fiscal management, and this is driving more jobs and higher wages for New Zealanders.

The 2016 *Half Year Economic and Fiscal Update* (*Half Year Update)* shows economic growth is expected to average around 3 per cent over the next five years. By 2020/21, the Treasury expects unemployment to drop to 4.3 per cent, another 150,000 jobs to be created, and the average wage to increase a further $7,500 to $66,000.

While the recent Kaikōura earthquakes have had a major impact on affected families and businesses, they are not expected to disrupt the overall momentum of the economy. However, they do highlight the importance of the Government's fiscal strategy – paying down debt in the good times so New Zealanders can be supported through challenging times.

The *Half Year Update* forecasts include an initial assumption of $1 billion of net costs to the Government as a result of the earthquakes.

The operating balance before gains and losses (OBEGAL) is expected to be $473 million in surplus this year – including the provision for the earthquake costs – before rising significantly over the forecast period.

Despite rising surpluses, the Government remains focused on keeping tight control of spending so that it can pay down debt and support New Zealanders in the event of a future economic shock or natural disaster.

Net debt is expected to fall to 18.8 per cent of GDP in 2020/21, in line with the Government's target.

The *Budget Policy Statement* confirms that operating allowances remain at $1.5 billion per year in each of the next four Budgets.

The capital allowance has been increased from $900 million to $3 billion in Budget 2017 and to $2 billion in future Budgets to provide for a number of high quality infrastructure and investment projects.

Economic and Fiscal Outlook

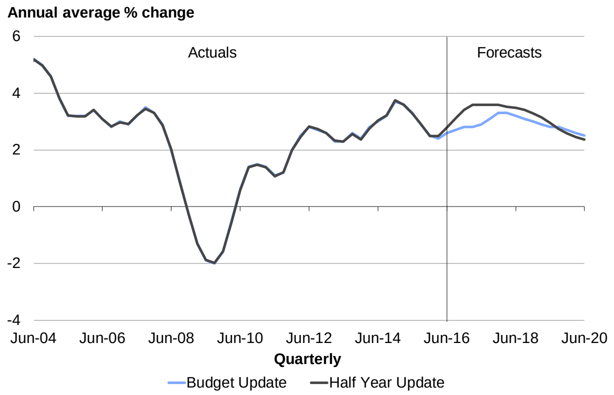
The outlook for the economy continues to improve

New Zealand continues to make good economic progress at a time when many other countries are grappling with low growth, fiscal deficits and a range of other risks and challenges.

The economy is expanding at a solid rate and the outlook is for sustained economic growth into the future. This is supported by high levels of construction activity, exports (particularly tourism), a growing population and low interest rates.

The Kaikōura earthquakes last month caused significant damage and will affect economic activity in the region. However, this is not expected to disrupt the overall momentum of the national economy.

Figure 1 – Real GDP growth



Sources: The Treasury, Statistics New Zealand

The Treasury's latest economic forecasts in the 2016 *Half Year Update* show an even more positive outlook than those in Budget 2016 (Table 1).

Real GDP growth is expected to average around 3.5 per cent over the next two years, and 3 per cent over the five year forecast period. In total, the Treasury expects nominal GDP to be $23.7 billion higher cumulatively across the four years to June 2020, compared with Budget 2016 forecasts.

Table 1 – Comparison of the Treasury's growth forecasts between *Half Year Update* and *Budget Update*

June years	**2016 Actual**	**2017 Forecast**	**2018 Forecast**	**2019 Forecast**	**2020 Forecast**	**2021 Forecast**
Real GDP (annual average % change)						
Half Year Update	2.8	3.6	3.5	2.9	2.4	2.3
Budget Update		2.9	3.2	2.8	2.5	
Change		**0.7**	**0.3**	**0.1**	**-0.1**	
Nominal GDP ($ billions)						
Half Year Update	251.8	264.8	279.5	293.4	305.5	317.4
Budget Update		259.2	273.6	287.4	299.2	
Change		**5.6**	**5.9**	**5.9**	**6.3**	

Sources: The Treasury, Statistics New Zealand

This stronger growth is expected to support an additional 150,000 jobs by 2021, on top of the 250,000 jobs created in the past three years. Unemployment is forecast to fall to 4.3 per cent over the next three years, and the average annual wage is expected to continue to rise faster than inflation – up to $66,000 by 2020/21.

The New Zealand economy is expected to grow more strongly over the next few years than many other developed economies, including the Euro area, the US, Australia, the UK, Japan and Canada.

One source of risk to this outlook is the global economy. Global growth is still low and there are further risks going forward. These risks include the impact of Brexit on the UK and European Union; ongoing imbalances in the Chinese economy; the impact of Australia's transition from mining investment; and future developments around global trade integration.

Table 2 – Summary of the Treasury's economic forecasts

June years	2016 Actual	2017 Forecast	2018 Forecast	2019 Forecast	2020 Forecast	2021 Forecast
Real GDP (annual average % change)	2.8	3.6	3.5	2.9	2.4	2.3
Consumers Price Index (annual % change)	0.4	1.5	2.0	2.1	2.0	2.1
Employment growth (annual average % change)	2.3	4.8	1.6	1.5	1.1	0.9
Unemployment rate (June Quarter)	5.0	4.8	4.6	4.2	4.3	4.3
Wage growth (annual % change)	2.1	1.6	2.2	2.8	3.1	3.0
Current account (% of GDP)	-2.9	-3.0	-3.8	-4.1	-4.4	-4.4

Sources: The Treasury, Statistics New Zealand

The Government's books have turned around markedly

Before the 2009 Budget, the Treasury projected that if the Government had maintained the fiscal track it inherited net debt would exceed 60 per cent of GDP by the early 2020s. Following the Canterbury earthquakes, the Government's annual deficit peaked at $18.4 billion in 2010/11 – around half of which was directly attributable to the earthquakes.

This was unsustainable, so the Government focused on improving public sector productivity and getting better results from existing spending. Substantial improvements in public services have been achieved, in part because of, rather than in spite of, tight financial constraints.

By carefully managing the public finances and addressing the underlying drivers of demand for public services, the Government delivered on its plan to get back to surplus in 2014/15 and remain there, achieving a $1.8 billion surplus in 2015/16.

The Treasury's latest forecast for stronger nominal GDP flows through to a higher tax take over the forecast period, with tax revenue expected to be $7.7 billion higher over the four years to 2020 compared with Budget 2016.

A number of factors broadly offset the increase in tax revenue, including higher social assistance expenses, higher new spending allowances for capital, weaker than expected ACC results, higher net finance costs and the $1 billion initial estimate of net fiscal costs from the Kaikōura earthquakes.

Figure 2 – Operating balance (before gains and losses)

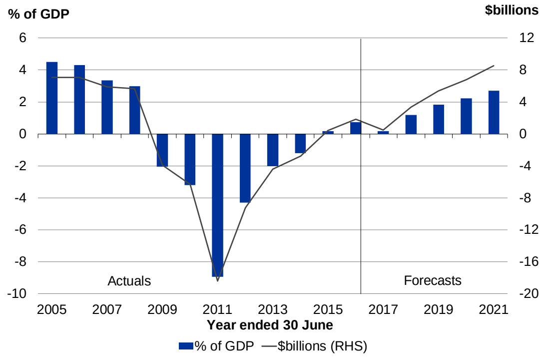
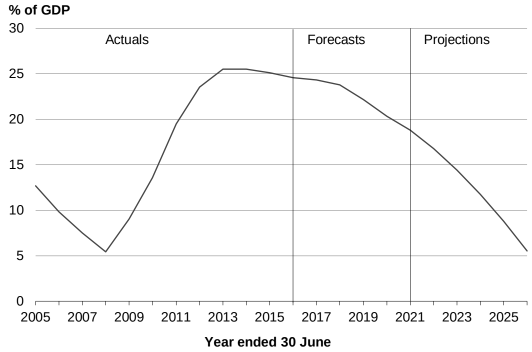


Figure 3 – Net core Crown debt



Source: The Treasury

After accounting for the $1 billion cost of the recent earthquakes, the Treasury forecasts a $473 million OBEGAL surplus in 2016/17, rising to $8.5 billion in 2020/21 (Figure 2).

Although OBEGAL surpluses continue, in dollar terms net debt is still forecast to increase by a further $4.5 billion over the next two years, owing to the Government's capital investment programme.

The forecasts show net debt as a proportion of GDP has peaked and is forecast to fall to 18.8 per cent of GDP in 2020/21. Crown net worth is forecast to continue to increase in line with the reduction in net debt.

Table 3 – Summary of the Treasury's fiscal forecasts

Year ending 30 June $billions	**2016 Actual**	**2017 Forecast**	**2018 Forecast**	**2019 Forecast**	**2020 Forecast**	**2021 Forecast**
OBEGAL						
Half Year Update	1.8	0.5	3.3	5.4	6.8	8.5
Budget Update		0.7	2.5	5.0	6.7	
Change		**(0.2)**	**0.8**	**0.4**	**0.1**	
Residual cash						
Half Year Update	(1.3)	(2.2)	(2.1)	1.4	3.0	2.6
Budget Update		(4.2)	(2.1)	2.0	3.9	
Change		**2.0**	**0.0**	**(0.6)**	**(0.9)**	
Net worth attributable to the Crown						
Half Year Update	89.4	93.0	99.1	107.4	117.3	129.3
Budget Update		86.6	91.6	99.2	108.9	
Change		**6.4**	**7.5**	**8.2**	**8.4**	
Net debt						
Half Year Update	61.9	64.4	66.4	65.0	62.1	59.6
Budget Update		66.3	68.3	66.3	62.3	
Change		**(1.9)**	**(1.9)**	**(1.3)**	**(0.2)**	
Net debt (% of GDP)						
Half Year Update	24.6	24.3	23.8	22.2	20.3	18.8
Budget Update		25.6	25.0	23.1	20.8	
Change		**(1.3)**	**(1.2)**	**(0.9)**	**(0.5)**	

Source: The Treasury

Fiscal Strategy

The Kaikōura earthquakes last month highlighted the importance of delivering on the Government's fiscal strategy, which remains unchanged.

Keeping on top of spending and paying down debt in the good times ensures we are in a good position to cope with economic shocks and natural disasters, and allows the Government to support New Zealand communities through challenging times.

While the recent earthquakes are significant both in terms of their impact on communities in and around Kaikōura and their fiscal cost, the strength of the Government's books means we are able to respond as needed.

The *Half Year Update* forecasts show the Government is delivering on its overall fiscal strategy: keeping a tight rein on spending, focusing on getting better results from public services, and starting to pay down debt.

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

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

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

The improving fiscal situation gives the Government choices around progressing these objectives while also investing in priority public services and infrastructure.

When it is affordable, and when economic conditions permit, the Government would like to lower income taxes, with a focus on helping lower and middle income earners obtain a greater return from their own hard work. However, responding to the earthquakes and reducing debt are currently of higher priority.

The *Half Year Update* does not make an explicit provision for tax reductions, but the Government will continue to consider options for lowering tax rates or thresholds – either in Budget 2017 or after – as the fiscal situation continues to improve.

Contributions to the NZ Superannuation Fund are forecast to start in 2020/21, in line with the current policy to resume contributions once net debt falls below 20 per cent of GDP.

Budget Priorities

Budget 2017 will continue to progress the Government's programme and priorities, which have been updated in light of the recent earthquakes. The Government's broad strategic priorities and policy goals are to:

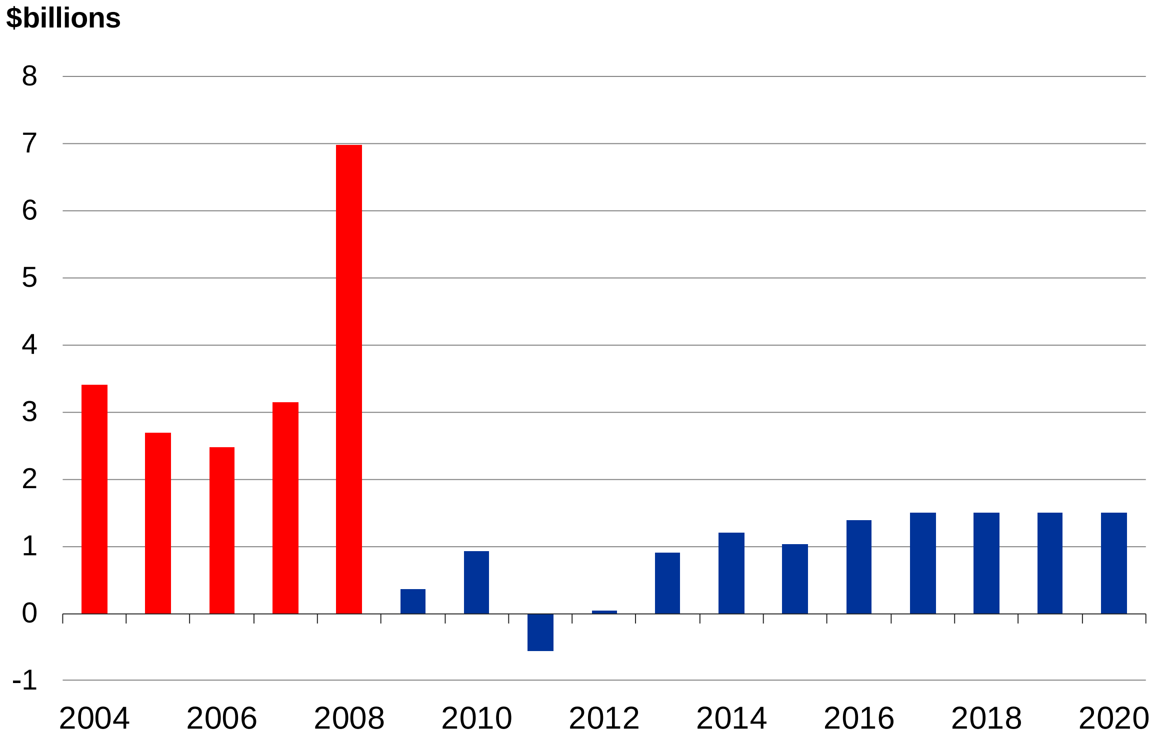
- responsibly manage the Government's finances
- build a more productive and competitive economy
- deliver better public services within tight financial constraints, and
- rebuild Christchurch and respond to the Kaikōura earthquakes.

Responsibly managing the Government's finances

The operating allowance for Budget 2017 remains $1.5 billion per year, slightly higher than those in Budgets 2009 to 2015 (Figure 4). This is in part to recognise that higher-than-expected population growth requires some extra investment in health, education, and other key public services.

Future operating allowances remain unchanged at $1.5 billion per year in each Budget through to 2020.

Figure 4 – New operating allowances in each Budget (final-year impact)



Source: The Treasury

To support continued solid economic growth and deliver better public services the Government has identified a number of high quality capital and infrastructure projects. The capital allowances have therefore been increased to $3 billion in Budget 2017 and to $2 billion per Budget from Budget 2018 onwards.

Table 4 – Capital allowances

$billions	**Budget 2017**	**Budget 2018**	**Budget 2019**	**Budget 2020**
Capital allowances *Half Year Update 2016*	3.0	2.0	2.0	2.0
Capital allowances *Budget Update 2016*	0.9	0.9	0.9	0.9

Source: The Treasury

The new capital allowances are broadly in line with the amount of new capital expenditure in Budget 2016, which included $2.6 billion of new capital and infrastructure projects. The fiscal forecasts in this document and the *Half Year Update* include these increases.

The Government remains committed to effectively and efficiently managing its large balance sheet, including using private sector capital and disciplines where appropriate, getting better performance from Crown-owned entities and reprioritising capital spending to higher-value uses.

Building a more productive and competitive economy

The Business Growth Agenda is the Government's programme of work to build a more productive, confident and competitive economy that will deliver higher incomes and higher living standards for New Zealand. It is focused on six key inputs for businesses: skilled and safe workplaces, export markets, infrastructure, innovation, natural resources, and investment.

Budget 2017 will continue to support and add to this programme of work to ensure there is a supportive business environment for firms to invest, grow and create jobs.

The Government's Comprehensive Housing Plan is increasing the supply of new housing – particularly in high-growth areas of New Zealand. This is delivering results, with around 30,000 residential building consents issued in the past year.

At the same time, the Government is investing in better quality social housing and emergency housing for those in need.

Delivering better public services

The Government has ensured departments and other agencies are focused squarely on getting better results for New Zealanders. As part of this, the Prime Minister has set 10 challenging results for the public service to achieve, including reducing crime, long-term welfare dependency and educational underachievement.

Budget 2017 will continue to support this focus on results, as well as the Government's programme of social investment which applies rigorous and evidence-based investment practices to social services.

This approach is ensuring the Government can invest early to address some of the chronic drivers of dysfunction in society and to support the most vulnerable into more independent lives.

A priority in the Budget will therefore be spending to achieve better outcomes for New Zealanders, and to meet demand and other pressures on social spending, most of which is health, education and income support transfers. There will also be a strong focus on driving the best value from existing spending.

Rebuilding Christchurch and responding to the Kaikōura earthquakes

The Government will do all that is required to support the recovery from the recent Kaikōura earthquakes.

It is too early to know the full extent of damage, and the likely fiscal cost remains very uncertain. The most significant impacts are likely to be increased infrastructure spending to repair roads and other utilities.

The Treasury's preliminary estimates are that the fiscal costs of the earthquakes could be around $2 to $3 billion. However, some of this is expected to be funded by insurance proceeds, existing resources or other funds. As a result the HYEFU forecasts include a net operating cost of $1 billion to the Crown in 2016/17, in addition to future new spending allowances.

The funding required to respond to the Kaikōura earthquakes will be reassessed in Budget 2017 as more information comes to light.

Budget 2016 committed the last major tranche of funding to support the rebuilding of Christchurch after the destructive earthquakes in 2010 and 2011. Going forward, the Government is focused on supporting the move from recovery to regeneration.

The Government's total contribution to the Christchurch rebuild is significant, at around $17.5 billion, including payments made by the Earthquake Commission (EQC), net of reinsurance proceeds.

Hon Bill English
Minister of Finance

8 December 2016

Annex

Long-term Fiscal Objectives and Short-term Fiscal Intentions

The Government's long-term objectives relate to the next 10 years. These long-term objectives have not been amended since the *Fiscal Strategy Report 2016* (FSR).

Table A1 – Long-term fiscal objectives

Budget Policy Statement 2017
Debt Manage total debt at prudent levels. Reduce net debt to within a range of 0 per cent to 20 per cent of GDP.
Operating balance Return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the NZ 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.

The Government's short-term fiscal intentions (in Table A2 below) include changes since the FSR 2016 reflecting revisions to the Treasury's fiscal forecasts. These forecasts include the impact of the Government's proposed budget allowances, including the increase in the capital allowances for Budgets 2017 to 2020.

The short-term intentions and long-term objectives are consistent with each other and with the principles of responsible fiscal management as set out in the Public Finance Act 1989. That is, they aim to:

- reduce total debt to prudent levels and achieve and maintain levels of total net worth so as to provide a buffer against adverse economic shocks
- ensure that on average total operating expenses do not exceed total operating revenues
- take into account the impact of fiscal policy on monetary policy
- prudently manage the fiscal risks facing government
- have regard for present and future generations, and
- ensure the Crown's resources are managed effectively and efficiently.

More detailed information about the principles of responsible fiscal management can be found at: www.treasury.govt.nz/publications/guidance/publicfinance/fiscalpolicyframework/

Table A2 – Short-term fiscal intentions

Budget Policy Statement 2017	***Fiscal Strategy Report 2016***
Debt	***Debt***
Our intention is to reduce net debt to around 20 per cent of GDP in 2020. Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 28.8 per cent of GDP in 2019/20. Net core Crown debt (excluding NZ Superannuation Fund and advances) is forecast to be 22.2 per cent of GDP in 2018/19, 20.3 per cent of GDP in 2019/20 and 18.8 per cent in 2020/21.	Our intention is to reduce net debt to around 20 per cent of GDP in 2020. Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 30.4 per cent of GDP in 2019/20. Net core Crown debt (excluding NZS Fund and advances) is forecast to be 23.1 per cent of GDP in 2018/19, 20.8 per cent of GDP in 2019/20 and is projected to be 19.3 per cent of GDP in 2020/21.
Operating balance	***Operating balance***
Our intention is to maintain rising operating surpluses (before gains and losses) so that net core Crown debt begins to reduce in dollar terms (subject to any significant shocks to the economy). The operating balance (before gains and losses) is forecast to be 0.2 per cent of GDP in 2016/17, rising to 1.2 per cent of GDP in 2017/18 and 2.7 per cent of GDP in 2020/21. This is consistent with the long-term objective for the operating balance. The operating balance is forecast to be 3.8 per cent of GDP in 2020/21.	Our intention is to maintain rising operating surpluses (before gains and losses) so that net core Crown debt begins to reduce in dollar terms (subject to any significant shocks to the economy). The operating balance (before gains and losses) is forecast to be 0.3 per cent of GDP in 2015/16. The operating balance (before gains and losses) is then forecast to be 0.3 per cent of GDP in 2016/17 and 2.2 per cent of GDP in 2019/20. This is consistent with the long-term objective for the operating balance. The operating balance is forecast to be 3.2 per cent of GDP in 2019/20.
Expenses	***Expenses***
Our intention is to support fiscal surpluses by restraining the growth in core Crown expenses and reducing these to below 30 per cent of GDP. Core Crown expenses are forecast to fall from 29.6 per cent of GDP in 2016/17 to 27.7 per cent of GDP in 2020/21. Total Crown expenses are forecast to be 35.5 per cent of GDP in 2020/21. This assumes new operating allowances of $1.5 billion per annum in Budgets 2017 to 2020.	Our intention is to support fiscal surpluses by restraining the growth in core Crown expenses and reducing these to below 30 per cent of GDP. Core Crown expenses are forecast to fall from 29.7 per cent of GDP in 2015/16 to 28.3 per cent of GDP in 2019/20. Total Crown expenses are forecast to be 36.4 per cent of GDP in 2019/20. This assumes a new operating allowance of $1.5 billion in Budget 2017 and for the remainder of the forecast period, growing at 2 per cent thereafter
Revenues	***Revenues***
Our intention is to support fiscal surpluses by growing revenue in dollar terms, although maintaining it at broadly the same proportion of GDP. Total Crown revenues are forecast to be 38.4 per cent of GDP in 2020/21. Core Crown revenues are forecast to be 30.6 per cent of GDP in 2020/21. Core Crown tax revenues are forecast to be 28.3 per cent of GDP in 2020/21.	Our intention is to support fiscal surpluses by growing revenue in dollar terms, although maintaining it at broadly the same proportion of GDP. Total Crown revenues are forecast to be 38.8 per cent of GDP in 2019/20. Core Crown revenues are forecast to be 30.6 per cent of GDP in 2019/20. Core Crown tax revenues are forecast to be 28.2 per cent of GDP in 2019/20.
Net worth	***Net worth***
Our intention is to strengthen the Crown's balance sheet as a buffer against future adverse shocks. Total net worth attributable to the Crown is forecast to be 40.7 per cent of GDP in 2020/21. Total Crown net worth is forecast to be 42.5 per cent of GDP in 2020/21.	Our intention is to strengthen the Crown's balance sheet as a buffer against future adverse shocks. Total net worth attributable to the Crown is forecast to be 36.4 per cent of GDP in 2019/20. Total Crown net worth is forecast to be 38.4 per cent of GDP in 2019/20.