2014
BUDGET

Fiscal Strategy Report

Hon Bill English, Minister of Finance

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New Zealand Government

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Fiscal Strategy Report

Summary

The Crown's books continue to improve as the New Zealand economy grows and the Government maintains its careful and responsible management of public spending.

Led by the private sector, the economy is growing steadily and growth of between 2 and 4 per cent is forecast over the next four years. The Government's focus has therefore moved to managing a growing economy rather than recovering from a recession.

Sound fiscal policy is essential for sustaining economic growth over the medium term. It is also essential for New Zealand's long-term fiscal sustainability.

The Government is on track to meet its key fiscal objectives, as:

- Budget forecasts show a total Crown operating balance before gains and losses (OBEGAL) in surplus of $372 million in 2014/15, and
- fiscal projections show net core Crown debt dropping to 20 per cent of gross domestic product (GDP) by 2020.

The fiscal outlook has improved markedly over the past five years. However, ongoing fiscal responsibility is required to ensure that the improvements shown in the forecasts actually occur.

After net debt has gone below 20 per cent of GDP we intend to maintain it within a range of 10 per cent to 20 per cent of GDP over the economic cycle, while also making contributions to the New Zealand Superannuation Fund (NZS Fund).

Budget 2014 has an operating allowance of $1 billion per annum. An improving fiscal outlook means there is some scope to increase operating allowances in future Budgets.

The allowance for Budget 2015 has therefore been lifted to $1.5 billion, growing after that at 2 per cent each Budget. This is a moderate increase that will provide the Government with future options around investment in public services and/or modest tax reductions, but not materially affect interest rates.

Allowances averaging around $1.5 billion per Budget remain well below those adopted in the mid-2000s and core Crown expenses will continue to fall each year as a proportion of GDP.

This *Fiscal Strategy Report* (FSR) shows the Government's ongoing commitment to careful management of spending. In recent years we have demonstrated that a focus on the real drivers of poor social outcomes delivers results without wasteful increases in spending.

The Government will continue to use its resources to strengthen families and communities and support business and enterprise, while also meeting its fiscal objectives.

Past Fiscal Performance

The New Zealand economy went into recession in early 2008 and was later hit by the global financial crisis. Large spending increases in the mid-2000s proved to be unaffordable when revenue fell. Projections done as part of Budget 2009, for example, showed that if the Government maintained the spending and revenue tracks it inherited then it would face never-ending deficits and net debt would exceed 60 per cent of GDP by the early 2020s.

Subsequently, New Zealand experienced a major natural disaster – the Canterbury earthquakes – and the global recovery was slow. Each of these events had a further significant impact on the Crown's financial position.

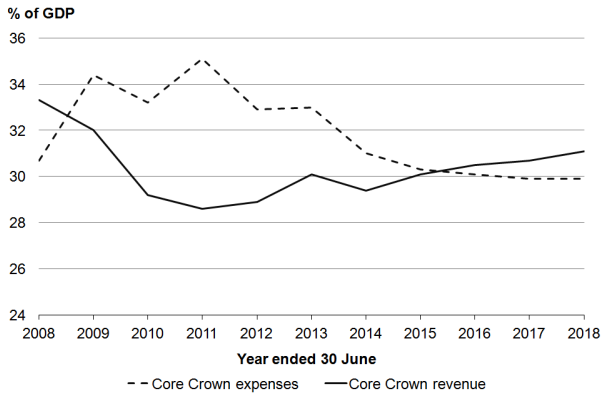
The Government's plan throughout this time was to support the economy in the short term by allowing operating deficits, but then to reduce these deficits by slowing growth in government spending as the economy recovered.

This approach cushioned New Zealanders and their families from the worst effects of the recession and did so within a clear framework that would return the operating balance to surplus and reduce debt back to more prudent levels over time.

In 2010/11, the operating deficit reached a peak of $18.4 billion, or 9.2 per cent of GDP, although around half of this reflected the one-off effects of the Canterbury earthquakes. Net debt increased from 5.5 per cent of GDP in 2007/08 to around 26 per cent in the current year.

The fiscal outlook has improved markedly over the past five years. Tax revenue has increased as the economy has recovered (Figure 1). But the biggest contribution to the fiscal turnaround has been considered expenditure restraint that rigorously tests spending for value and results.

Figure 1 – Core Crown revenue and expenses



Source: The Treasury

Fiscal restraint has been achieved in a number of ways, including: reprioritising spending from lower-value to higher-value activities; reducing Budget operating allowances; reducing the cost escalations built into existing policies; and driving better results from the public sector.

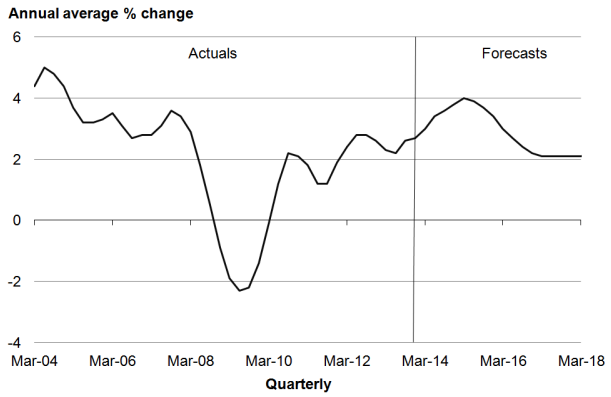
We have learned how much more can be achieved, particularly for the most vulnerable and the most dependent, by spending taxpayers' money more carefully and deliberately.

Deficits have been funded by higher debt. The Crown's net debt will rise from $10.3 billion in 2007/08 to an expected $65.5 billion in 2016/17. As a percentage of GDP, net debt is well below the Organisation for Economic Co-operation and Development (OECD) average. But it is still a sizeable level of debt and it reduces the Government's ability to borrow in future if New Zealand were to experience another economic shock or natural disaster, particularly given New Zealand's relatively high net external liability position. The Government is therefore committed to reducing this debt to more prudent levels.

Short-term Fiscal Intentions

The economy is growing steadily and growth of between 2 and 4 per cent is forecast over the next four years (Figure 2).

Figure 2 – Real GDP growth



Sources: Statistics New Zealand, The Treasury

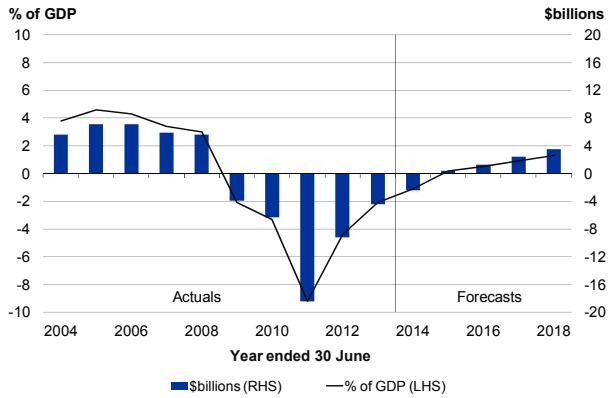
Growth was initially driven by low interest rates, an elevated terms of trade and the Christchurch rebuild. However, that has turned into a broader-based recovery supported by strong consumer and business confidence, new investment and higher productivity. Growth is already delivering more jobs, and wages that are rising faster than inflation.

In this context, the Government will operate fiscal policy with two goals in mind.

The first is to return the Crown's operating balance to surplus in 2014/15, and to increase surpluses thereafter. Consistent and growing surpluses will enable the Government to meet its net capital requirements and begin reducing debt towards our long-term debt objective (described in the next section).

Budget forecasts show we are on track to meet our surplus target, with an operating surplus in 2014/15 of $372 million, growing to a surplus of $3.5 billion in 2017/18 (Figure 3).

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



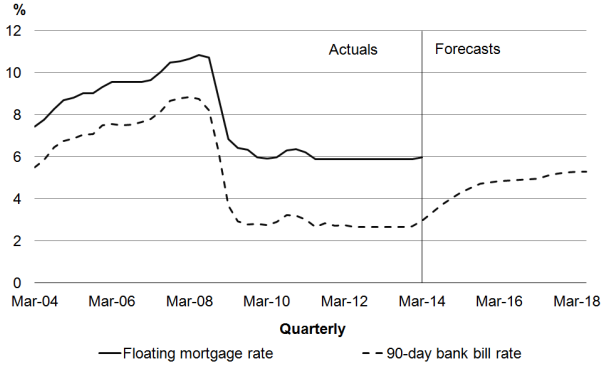
Source: The Treasury

Future surpluses will give us choices, including paying for new capital investments, reducing debt, increasing spending and/or reducing taxes.

But the use of these surpluses has to be sustainable – recognising that surpluses rise and fall with the economic cycle – and also has to avoid putting pressure on monetary policy.

All else being equal, a significant increase in government spending, or a significant reduction in taxes, during an economic upswing would lead to interest rates being higher than they otherwise would be (Box 1). This relationship can be seen in the mid-2000s when government spending increased markedly alongside a booming housing market, and interest rates were forced to such high levels that in 2008 homeowners were paying over 10 per cent interest on a floating mortgage (Figure 4).

Figure 4 – Interest rates



Sources: Reserve Bank of New Zealand, The Treasury

The Government's second short-term goal is therefore to carefully manage its spending and revenue so that any changes in fiscal policy settings – and in particular changes to Budget allowances – do not have a material adverse impact on interest rates. This will help to keep interest rates over the course of this economic cycle lower than they would otherwise have to be. Tight fiscal policy over this period will help to restrain domestic demand pressure, making room, amongst other things, for necessary construction activity in Canterbury and Auckland.

Box 1: Interaction Between Fiscal Policy and Interest Rates

The Government's fiscal policy decisions, including initiatives relating to spending, taxes and borrowing, generally impact on monetary policy and interest rates.

An increase in government spending (or reduction in taxes) increases aggregate demand in the economy.

The Treasury's forecasts show that, in the coming years of the cycle, the economy is likely to be operating at or above its potential. Therefore, higher aggregate demand cannot be fully met by increased output, and so will lead to inflation pressures and higher prices.

As the economic expansion is gathering momentum and growth is becoming more broad-based, the Reserve Bank has now begun to raise interest rates. An increase in government spending that put additional pressure on demand and inflation would likely result in the Reserve Bank increasing interest rates further in order to combat that inflation.

Since 2012, fiscal consolidation has been removing demand pressure from the economy, which is one reason why interest rates have been able to remain at historically low levels. On average over the next four years fiscal policy is expected to continue to exert a mild tightening effect on the economy. The Treasury's advice is that relative to a neutral stance the Government's fiscal stance is expected to remove inflationary pressure over the next four years, such that the Official Cash Rate (OCR) will be around 50 basis points lower than otherwise by 2018.

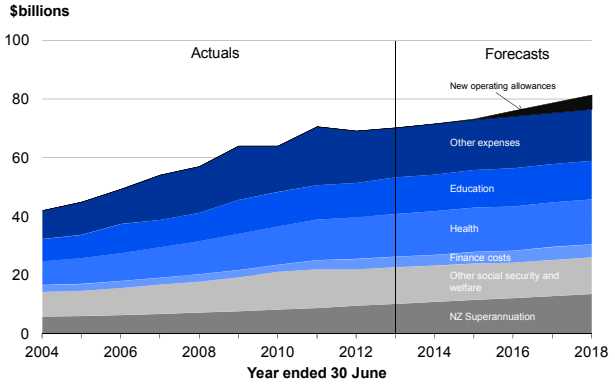
Operating fiscal policy in support of monetary policy and allowing interest rates to be lower than they would otherwise be will help to sustain the recovery, create better conditions for investment and productivity growth and reduce the pressure on households with mortgages. It will also reduce pressure on the exchange rate, taking pressure off the tradable sector and help tilt the economy towards savings, investment and exports.

Both the OBEGAL surplus and interest rate goals require ongoing spending restraint. In particular, they require sticking to a modest operating allowance each year for new spending and/or revenue reductions (see section on operating allowances).

Core Crown expenses are forecast to rise in dollar terms (Figure 5) but fall as a share of GDP. Core Crown expenses have fallen from 34.4 per cent of GDP in 2008/09 to a forecast 30.3 per cent in 2014/15 and are soon expected to fall below 30 per cent of GDP.

In the next four years, the Government will continue to focus on achieving better results as the main way of restraining future government expenditure.

Figure 5 – Core Crown expenses



Source: The Treasury

The Government has set 10 challenging results for the public sector to achieve over the next few years, in areas such as reducing long-term welfare dependency, supporting vulnerable children, boosting skills and employment, and reducing crime.

The Government is willing and able to spend more now to reduce the long-term social and economic costs of dysfunction. What is good for families and communities is also good for the Government's books.

To implement this investment approach, government agencies must prepare comprehensive four-year plans incorporating data analysis and modelling of future costs. These new ways of thinking have allowed the Government to maintain a track to surplus while delivering better public services.

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

Long-term Fiscal Objectives

The Government's key longer-term objective remains to reduce net core Crown debt to 20 per cent of GDP by 2020. The Government will run surpluses consistent with this debt objective, while also meeting the Government's net capital requirements.

Carrying substantial debt is neither comfortable nor financially prudent. Using surpluses to reduce government debt puts New Zealand in a better position to cope with the next economic shock or natural disaster.

Contributions to the NZS Fund are not available to meet future deficits in these situations. Therefore, our priority is to repay debt until net debt reaches 20 per cent of GDP, before resuming contributions to the NZS Fund. Repaying debt also helps to raise national savings, maintain credibility with international lenders, reduce finance costs and allow the internationally competitive sectors of the economy to grow.

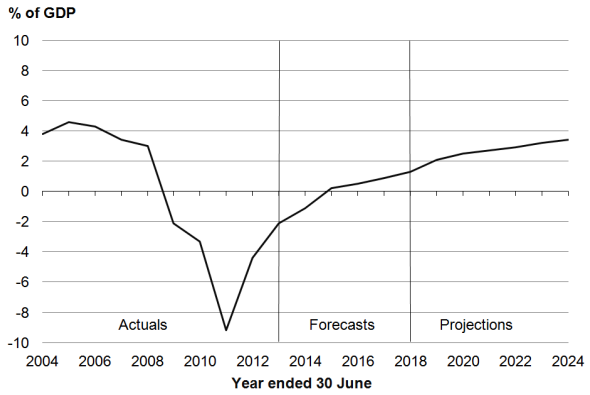
Beyond 2014/15, operating surpluses are expected to increase each year (Figure 6). Cash surpluses are expected from 2017/18 onwards (Figure 7), at which point net debt will start to reduce in dollar terms. As a percentage of GDP, net debt is expected to start reducing after peaking (on an annual basis) at 26.4 per cent of GDP in 2014/15 (Figure 8). Gross sovereign-issued debt peaked at 40.1 per cent of GDP in 2012.

Budget projections show that net debt is projected to reach 20 per cent of GDP in 2019/20, in line with the Government's debt objective. This includes the impact of resuming full contributions to the NZS Fund in 2019/20.

Fiscal projections show that if the Government maintains operating allowances at levels set out in this FSR throughout the projection period, net debt would drop significantly below 20 per cent of GDP in the years beyond 2020 (Figure 8). However, these long-term projections do not incorporate the possibility of future natural disasters or economic fluctuations.

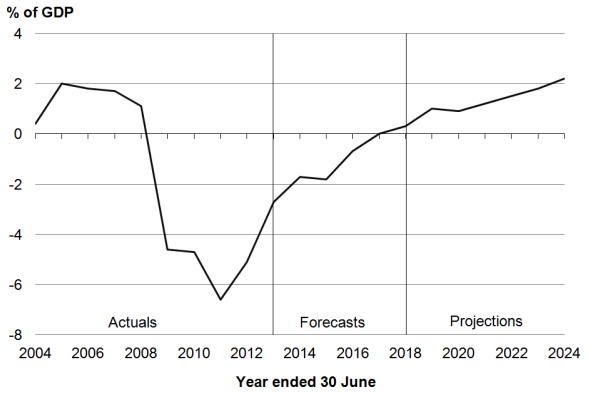
Beyond 2020, the Government intends to maintain net debt within a range of around 10 per cent to 20 per cent of GDP. This reflects the fact that debt provides a buffer for economic shocks, so it will fluctuate over the economic cycle. The long-term debt objective has been amended to reflect this (Annex 1).

Figure 6 – Total Crown operating balance (before gains and losses)



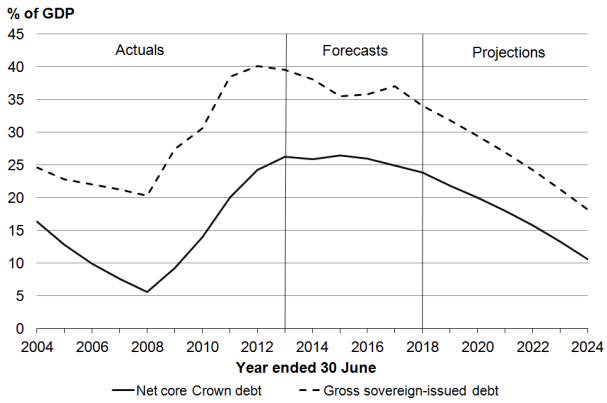
Source: The Treasury

Figure 7 – Core Crown residual cash



Source: The Treasury

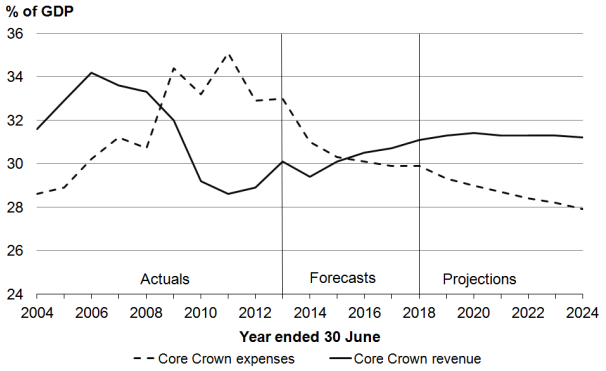
Figure 8 – Government debt



Source: The Treasury

To run consistent operating surpluses, revenue has to exceed expenses. The Government will restrain its spending so that, over time, core Crown expenses are reduced to below 30 per cent of GDP and remain under that level (Figure 9).

Figure 9 – Core Crown revenues and expenses



Source: The Treasury

These longer-term projections show a remarkable turnaround in the Government's books, compared with what was expected only a few years ago. While the fiscal outlook has improved markedly over the past five years, there is a lot of work to be done to make the forecasts and projections a reality.

The Government's long-term fiscal objectives are set out formally in Annex 1. The fiscal projections presented in this FSR assume a continuation of the Government's current expenditure policy settings, including maintaining operating and capital allowances. They show the central projection based on the assumptions outlined in Annex 3.

Looking even further into the future, the fiscal challenges associated with population ageing and cost growth are outlined in the Treasury's *Long-term Fiscal Statement.* The Statement stresses that good fiscal policy in the short to medium term – controlling government spending and getting debt down – is crucial in preparing for an ageing population. Reducing net debt to no higher than 20 per cent of GDP, resuming NZS Fund contributions as planned and delivering further improvements in public-sector performance will have a significant effect on long-term projections of the Government's fiscal position and reduce the burden on future generations.

Allowances for Future Budgets

The operating allowance for new spending and revenue initiatives was previously set at $1 billion per annum for Budget 2014, growing after that at 2 per cent each Budget. The Government is sticking to this allowance for Budget 2014, but the improving fiscal outlook means there is some room to increase future allowances.

Advice from the Treasury is that increasing allowances to $1.5 billion per annum is around the upper limit for increased spending (or revenue initiatives) before they begin to materially affect interest rates or impact on the Government's objective of reducing net debt to 20 per cent of GDP by 2020.

The Government has therefore decided to lift the operating allowance for Budget 2015 to $1.5 billion per annum, growing after that at 2 per cent each Budget (Table 1).

This is a moderate increase that will provide the Government with future options around investment in public services and/or modest tax reductions, but not materially affect interest rates.

There is room to move some of the allowance between Budgets, provided they average around $1.5 billion and economic conditions permit.

Allowances averaging around $1.5 billion per Budget remain well below those adopted in the mid-2000s (see Figure 10), and core Crown expenses will continue to fall each year as a proportion of GDP.

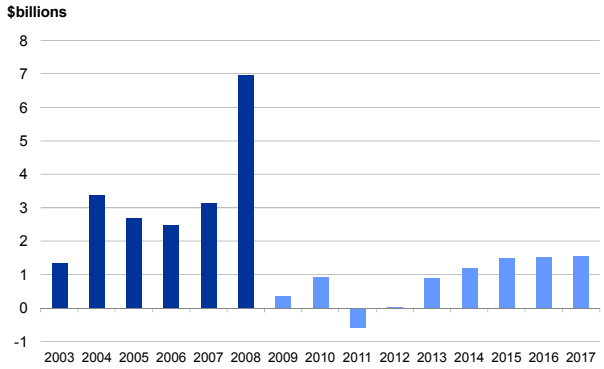
Table 1 – Operating allowances

$millions	**Budget 2014**	**Budget 2015**	**Budget 2016**	**Budget 2017**
Revised operating allowance	1,000	1,500	1,530	1,561
Previous operating allowance as per the 2013 FSR	1,000	1,020	1,040	1,061
Increase in operating allowance	-	480	490	500

This change to allowances is built in to all the forecasts and projections presented here and in the *Budget Economic and Fiscal Update* (BEFU).

If tax revenue comes in well ahead of forecast, the Government's main priority will be debt repayment until the core Crown net debt objective is met. A further increase in operating allowances in this situation would likely push up interest rates when the economy was on an even stronger upswing than was expected – again, this was the experience of the mid-2000s.

Figure 10 – New operating allowances in each Budget (final year impact)



Source: The Treasury

In regard to Budget capital allowances, the Government will continue to focus on using its balance sheet effectively. For Budget 2014, and the following two Budgets, new capital spending will be funded from reprioritisation, in particular by drawing on proceeds from the Government's share offers through the Future Investment Fund.

Managing the Crown's Balance Sheet

The Crown's balance sheet – what it owns and what it owes – is discussed in detail in the Treasury's *Investment Statement*, published in March 2014.

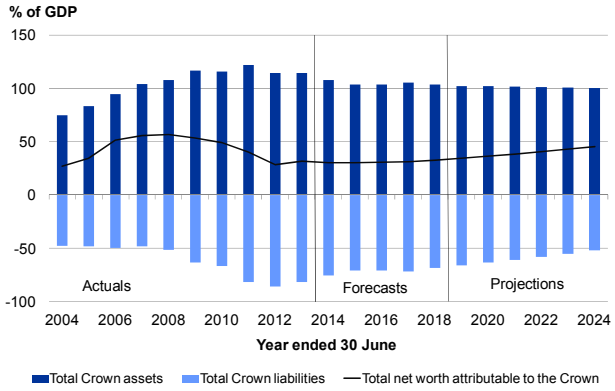
Budget forecasts show that the Crown currently owns around $249 billion of assets and has around $174 billion of liabilities. The Crown owns assets, in the main, to deliver public services and achieve its social objectives.

Over the past five years, the Crown's assets have grown by 14 per cent. Over the same period, its liabilities grew 48 per cent as a result of increased borrowing and greater insurance liabilities.

The Crown's net worth has dropped over recent years, but is expected to start consistently increasing as a percentage of GDP from 2014/15 (Figure 11).

Most of the forecast balance sheet strengthening reflects debt reduction. On the asset side of the balance sheet, most of the increase comes from an increase in financial assets.

Figure 11 – Net worth attributable to the Crown



Source: The Treasury

This Government has moved to more consistent and deliberate management of the Crown's balance sheet. Strong balance sheet management delivers better value for money for taxpayers, supports the provision of public services, helps manage the effect of shocks on the economy and shares benefits, costs and risks across current and future generations.

The Government's balance sheet strategy involves:

- rebuilding the Crown's balance sheet buffer against future risks and adverse events by reducing debt as a share of GDP, resuming NZS Fund contributions and then rebuilding other parts of the Crown's balance sheet
- encouraging asset ownership only when it is necessary to deliver core public services
- looking to dispose of assets that are surplus to requirements or no longer fit for purpose
- prioritising capital to its highest-value use, including using 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 use of public-private partnerships for the Hobsonville schools and Wiri prison, and the development of a market for social housing
- more active monitoring of Crown-owned entities such as State-owned Enterprises and Crown Financial Institutions, 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 coming year, the Government intends to develop performance targets to better support the management of the Crown's balance sheet.

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, including a reduction in all personal tax rates, a reduction in the company tax rate, stricter rules around property and an increase in goods and services tax (GST).

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.

Any future tax reductions would need to be funded from operating allowances, and be consistent with the Government's fiscal strategy as set out in this FSR.

Accident Compensation Corporation (ACC) annual levies for households and businesses have fallen by close to $1 billion since 2011/12, and additional levy reductions in 2015/16 were incorporated in Budget 2013 forecasts.

ACC is on track to provide these further levy reductions of around $480 million in 2015/16. Final decisions on the levies will be made by Cabinet after public consultation by ACC.

Depending on the outcome of this consultation, the average levy for a private motor vehicle could fall by around $130 a year from 1 July 2015.

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 Budget Policy Statement. There are minor changes reflecting the revisions to the fiscal forecasts and change to operating allowances (see Table A1.1). These revised fiscal intentions are consistent with the Government's long-term fiscal objectives (see Table A1.2) and the BEFU.

Table A1.1 – Short-term fiscal intentions

Fiscal Strategy Report 2014 (May 2014)	*Budget Policy Statement 2014 (Dec 2013)*
Debt Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 34.0% of GDP in 2017/18. Net core Crown debt (excluding NZS Fund and advances) is forecast to be 23.8% in 2017/18 and to be 20.0% of GDP in 2019/20.	***Debt*** Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 33.2% of GDP in 2017/18. Net core Crown debt (excluding NZS Fund and advances) is forecast to be 22.3% in 2017/18.
Operating balance 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. The operating balance (before gains and losses) is forecast to be -1.1% of GDP in 2013/14. The operating balance (before gains and losses) is forecast to be 0.2% of GDP in 2014/15. This is consistent with the long-term objective for the operating balance. The operating balance is forecast to be 1.3% of GDP in 2014/15.	***Operating balance*** 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. Based on the operating allowance for the 2014 Budget, the operating balance (before gains and losses) is forecast to be -1.0% of GDP in 2013/14. The operating balance (before gains and losses) is forecast to be 0.0% of GDP in 2014/15. This is consistent with the long-term objective for the operating balance. The operating balance is forecast to be 1.3% of GDP in 2014/15.
Expenses 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% of GDP by 2015/16. Core Crown expenses are forecast to be 29.9% of GDP in 2017/18. Total Crown expenses are forecast to be 38.8% of GDP in 2017/18. This assumes a new operating allowance of $1.5 billion per annum from Budgets 2015, growing at 2 per cent in each Budget thereafter (GST exclusive).	***Expenses*** 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% of GDP by 2015/16. Core Crown expenses are forecast to be 29.2% of GDP in 2017/18. Total Crown expenses are forecast to be 38.7% of GDP in 2017/18. This assumes a new operating allowance of $1 billion for Budget 2014, growing at 2 per cent for Budgets thereafter (GST exclusive).

Fiscal Strategy Report 2014 (May 2014)	*Budget Policy Statement 2014 (Dec 2013)*
Revenues Total Crown revenues are forecast to be 40.3% of GDP in 2017/18. Core Crown revenues are forecast to be 31.1% of GDP in 2017/18. Core Crown tax revenues are forecast to be 28.5% of GDP in 2017/18.	***Revenues*** Total Crown revenues are forecast to be 40.8% of GDP in 2017/18. Core Crown revenues are forecast to be 31.4% of GDP in 2017/18. Core Crown tax revenues are forecast to be 28.8% of GDP in 2017/18.
Net worth Total Crown net worth is forecast to be 34.9% of GDP in 2017/18. Total net worth attributable to the Crown is forecast to be 32.8% of GDP in 2017/18.	***Net worth attributable to the Crown*** Total net worth attributable to the Crown is forecast to be 34.2% of GDP in 2017/18. Core Crown net worth is forecast to be 17% of GDP in 2017/18.

The Government's long-term objectives relate to the next 10 years. The Government's long-term fiscal objective for debt has been amended since the 2013 FSR to be more explicit about the path of debt beyond 2020. The rest of the long-term objectives are unchanged from the 2013 FSR.

Table A1.2 – Long-term fiscal objectives

Fiscal Strategy Report 2014
Debt Manage total debt at prudent levels. We will reduce net debt to a level no higher than 20 per cent of GDP by 2020. We will work towards achieving this earlier as conditions permit. Beyond 2020, we intend to maintain net debt within a range of around 10 per cent to 20 per cent of GDP over the economic cycle.
Operating balance Return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the NZS 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.

These 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 (listed here in Annex 2).

Contributions to the New Zealand Superannuation Fund

The Government will resume contributions to the NZS Fund once net core Crown debt is no higher than 20 per cent of GDP. The delay in contributions reflects the Government's view that it is more prudent to reduce debt than to put money into world share markets while debt is still too high.

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.

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 2014 forecast horizon, are provided in Table A1.3.

Table A1.3 – New Zealand Superannuation Fund calculations ($billions)

Year ended 30 June	2015	2016	2017	2018
Calculations of annual contributions if they were to resume in 2014/15	2.3	2.3	2.3	2.2
Forecast contributions	0	0	0	0

Annex 2

Principles of Responsible Fiscal Management

The Public Finance Act 1989 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

(e) when formulating revenue strategy, having regard to efficiency and fairness, including the predictability and stability of tax rates

(f) when formulating fiscal strategy, having regard to the interaction between fiscal policy and monetary policy

(g) when formulating fiscal strategy, having 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 2027/28

The economic and fiscal forecasts from 2013/14 to 2017/18 are detailed in the 2014 BEFU. The projection period begins in 2018/19 and extends out to 2027/28. 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 projections[1]

Year ending 30 June	2014	2015	2016	2017	2018	2019	2020	2021	2022	...	2028
	Forecast					Projections					
Labour force	2.4	2.1	1.2	0.9	0.8	1.1	1.0	1.0	0.9	...	0.7
Unemployment rate[2]	6.0	5.5	5.2	4.8	4.5	4.5	4.5	4.5	4.5	...	4.5
Employment	3.1	2.7	1.6	1.3	1.2	1.1	1.0	1.0	0.9	...	0.7
Labour productivity growth[3]	1.4	1.4	1.5	1.1	1.1	1.5	1.5	1.5	1.5	...	1.5
Real GDP	3.4	3.9	2.6	2.1	2.2	2.3	2.4	2.5	2.4	...	2.2
Consumers Price Index (CPI) (annual percentage change)	1.8	1.9	2.6	2.2	2.0	2.0	2.0	2.0	2.0	...	2.0
Government 5-year bonds (average percentage rate)	4.1	4.5	4.9	5.1	5.2	5.3	5.5	5.5	5.5	...	5.5
Nominal average hourly wage	2.9	2.8	3.1	3.5	3.5	3.5	3.5	3.5	3.5	...	3.5

Notes:

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

Forecasts are an attempt to predict future outcomes, using wide-ranging resources, comprehensive modelling and expert opinion and knowledge. Projections, which arise from, and are heavily influenced by, their forecast base are potential paths. These paths are based on trend or long-run averages for growth rates or levels of key economic, fiscal and demographic variables, and generally assume no policy changes beyond those built into their forecast base. They also normally involve no behavioural or other responses to outcomes or trend movements, be they positive or adverse.

Under normal domestic and global economic conditions, to the extent that such a state exists, the five-year forecast horizon might be expected to be long enough for most variables to reach or be near their long-run averages by its end. However, events such as the global financial crisis and the Canterbury earthquakes have had lingering impacts, meaning that even five years is not long enough for all effects to have worked their way through the economy. As a consequence, for some economic variables, such as the average hours worked or the government 5-year bond rate, a degree of transition is still required between the end of the forecast and the projected year by which they attain their assumed long-run trend growth rate or level. For each variable the annual convergence rate used is based on recent actual and forecast performance.

With each passing year the post-forecast transition periods are diminishing, as more time has elapsed since these major events first impacted upon the economy. For example, at Budget 2011, some economic variables were not assumed to stabilise in that Budget's projections until 2019/20, which was five years beyond the final forecast year. While 2019/20 is still the year by which all variables have stabilised in the Budget 2014 projection, it is now only two years beyond the end of the forecast base.

Furthermore, whereas in past Budget projections nearly all major economic variables have required a few years of transition to reach long-run growth rates or levels, in the Budget 2014 projection only the average hours worked, the average hours paid and the government 5-year bond rate are not at their long-run assumed value by 2018/19, the first projected year. These three variables attain their stable levels one year later.

Projected real GDP grows from its forecast base as a product of the growth of the employed labour force and the average hours they work, as well as their productivity growth. Beyond 2019/20, when both the average hours worked and the unemployment rate are assumed to have reached long-run stable levels, real GDP growth is driven by the growth of the labour force, based on projections by Statistics New Zealand, and a long-run annual labour productivity growth assumption of 1.5 per cent. Adding projected real GDP growth and CPI-based inflation, which is assumed to match the middle of the Policy Targets Agreement band at 2 per cent per year, gives the projected growth of nominal GDP. This economic variable is used in the projection of many fiscal variables, most notably tax revenue, and serves as the denominator for most major fiscal indicators, such as core Crown net debt to GDP.

Fiscal projections and assumptions

Table A3.2 – Summary of fiscal projections, as percentages of nominal GDP

Year ending 30 June	2014	2015	2016	2017	2018	2019	2020	2021	2022	...	2028
	Forecast					Projections					
Core Crown revenue	29.4	30.1	30.5	30.7	31.1	31.3	31.4	31.3	31.3	...	31.2
Core Crown expenses	31.0	30.3	30.1	29.9	29.9	29.3	29.0	28.7	28.4	...	26.8
Total Crown revenue	39.0	39.6	39.8	39.9	40.3	40.5	40.6	40.5	40.5	...	40.4
Total Crown expenses	40.0	39.3	39.1	38.9	38.8	38.2	37.9	37.6	37.4	...	35.9
Total Crown OBEGAL[1]	-1.1	0.2	0.5	0.9	1.3	2.1	2.5	2.7	2.9	...	4.4
Total Crown operating balance	1.3	1.3	1.6	2.0	2.5	3.1	3.6	3.8	4.1	...	5.8
Core Crown GSID[2]	38.1	35.5	35.8	37.0	34.0	31.8	29.4	26.9	24.2	...	10.0
Core Crown net debt[3]	25.8	26.4	25.9	24.9	23.8	21.8	20.0	18.0	15.7	...	-2.8
Total Crown net worth	32.7	32.6	32.8	33.6	34.9	36.6	38.6	40.8	43.1	...	61.1
Net worth attributable to the Crown[4]	30.4	30.3	30.6	31.5	32.8	34.4	36.3	38.3	40.5	...	57.4

Notes

1 Operating balance before gains/(losses)

2 Gross sovereign-issued debt

3 Excludes financial assets of the NZS Fund and core Crown advances

4 Excludes assets and liabilities belonging to minority interests

Source: The Treasury

Fiscal projections have changed from those in the 2013 FSR, largely reflecting changes in economic and fiscal forecasts and the change to operating allowances.

Table A3.3 – 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, multiplied by a fiscal drag elasticity of 1.35, at the beginning of the projection period. From 2020/21 onwards, source deductions remain at a long-term stable value of 11.2 per cent of GDP. The four other major tax categories – Corporate tax, GST, hypothecated Transport taxes 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 4.1 per cent for Corporate tax, 7.6 per cent for GST, 1.3 per cent for hypothecated Transport taxes and 4.5 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 there in later projected years.
New Zealand Superannuation (NZS)	Demographically adjusted and linked to net wage growth, via the "wage floor". The latter refers to the net (after-tax) weekly NZS rate for a couple being constrained in legislation to lie between 65 per cent and 72.5 per cent of net average weekly earnings. As tax on average weekly earnings increases owing to fiscal drag, the net average weekly earnings do not grow as quickly as the gross earnings in the years where fiscal drag is applied in modelling source deductions.
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	$1.592 billion in 2018/19, based on 2 per cent growth from a $1.5 billion value in Budget 2015. Operating Allowances continue to grow at 2 per cent per annum from this value in later projected years.
Capital Allowance	$0.955 billion in 2018/19, based on 2 per cent growth from a $0.9 billion value in Budget 2015. Capital Allowances continue to grow at 2 per cent per annum from this value in later projected years.
NZS Fund	Contributions to the Fund suspended until 2018/19. Contributions begin again in 2019/20, at a level consistent with the New Zealand Superannuation and Retirement Income Act 2001.

Guide to the Budget Documents

A number of documents are released on Budget day. The purpose of these documents is to provide information about the Government's spending intentions for the year ahead and the wider fiscal and economic picture. The Budget documents are as follows:

Executive Summary

The *Executive Summary* is the overview of all the Budget information and contains the main points for the media and public. This summarises the Government's spending decisions and key issues raised in the *Budget Speech*, the *Fiscal Strategy Report*, and the *Budget Economic and Fiscal Update*.

Budget Speech

The *Budget Speech* is the Minister of Finance's speech delivering the Budget Statement at the start of Parliament's Budget debate. The Budget Statement generally focuses on the overall fiscal and economic position, the Government's policy priorities and how those priorities will be funded.

Fiscal Strategy Report

The *Fiscal Strategy Report* sets out the Government's fiscal strategy in areas such as the balance between operating revenues and expenses, and its debt objectives. The report includes fiscal trends covering at least the next 10 years and the Government's long term fiscal objectives.

The Government must explain changes in, and/or inconsistencies between, the *Fiscal Strategy Report*, the *Budget Policy Statement* and the previous year's *Fiscal Strategy Report*.

Budget Economic and Fiscal Update

The *Update* includes Treasury's overall economic forecasts and the forecast financial statements of the Government, along with the implications of Government financial decisions and other information relevant to the fiscal and economic position.

The Estimates of Appropriations

The *Estimates* outlines for the financial year about to start (the Budget year) expenses and capital expenditure the Government plans to incur on specified areas within each Vote, and capital injections it plans to make to individual departments. The *Estimates* is organised on the basis of 10 sector volumes, with each Vote allocated to one sector. Supporting information in the *Estimates* summarises the new policy initiatives and trend information for each Vote and provides information on what is intended to be achieved with each appropriation in a Vote and how performance against each appropriation will be assessed and reported on after the end of the Budget year.

The Supplementary Estimates of Appropriations and Supporting Information

The *Supplementary Estimates* outlines the additional expenses and capital expenditure required for the financial year about to end. The *Supporting Information* provides reasons for the changes to appropriations during the year, related changes in performance information and certain additional performance information for new appropriations.

NZ Budget App

Smartphone and tablet users can also access the Budget documents through the NZ Budget App. The App is available on the Apple Store for iOS devices and the Google Play store for Android devices or see www.treasury.govt.nz/budget/app

Websites

These documents are available at www.treasury.govt.nz and www.budget.govt.nz