The Treasury

Budget 2024 Information Release

September 2024

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: BEFU 2024 Medium-Term Fiscal Projections - Assumptions and Alternative Scenarios

Date:	3 May 2024	**Report No:**	T2024/1251
		File Number:	MC-1-0-M105056

Action sought

	Action sought	Deadline
Hon Nicola Willis **Minister of Finance**	**Decide** your preferred projections assumptions around operating expenditure, capital expenditure, and tax revenue. **Agree** to publish alternative projections scenarios in the Fiscal Strategy Report. **Agree** to publish the Fiscal Strategy Model (FSM) online on Budget Day.	Thursday 9 May 2024

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Kurt Hawkins	Graduate Analyst, Macroeconomic and Fiscal Policy	[39]	[35]	✓
Ben Gaukrodger	Manager, Macroeconomic and Fiscal Policy			

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: BEFU 2024 Fiscal Projections - Assumptions and Alternative Scenarios

Executive summary

This report outlines draft medium-term fiscal projections and recommends key assumptions we think you should adopt to underpin those projections.

The projections are required content for the Fiscal Strategy Report. The projections are set by the Minister of Finance, and cover estimates of the key fiscal variables for 10 years, starting from the end of the forecast period. The purpose is to show likely future progress towards the Long-Term Objectives set out in your fiscal strategy.

Our recommendations for the three assumptions that will most influence your projections are as follows:

- **Operating expenditure:** We recommend new operating expenditure in the first year of the projections is the same as the final forecast year, $2.4 billion, and that operating expenditure grows at 2 percent per annum.

- **Capital expenditure:** We recommend aligning capital expenditure with the National Party Fiscal Plan at $7 billion per annum, growing at 2 percent per annum. This is consistent with the approach used in the PREFU projections.

- **Tax revenue:** We recommend keeping tax revenue at its end-of-forecast level in the early years of the projection period until net core Crown debt falls below 40 percent of GDP, after which revenue begins to taper down to its long-term average. This would align the projections with both your LTO's and revenue strategy which stresses the importance of reducing net core Crown debt.

The deterioration in the fiscal forecasts, which are yet to be finalised, creates a worse starting point for the projections since the last set of projections published at the Pre-Election Economic and Fiscal Update 2023 (PREFU). Despite this, indicative final projections using either the assumptions adopted at PREFU or our recommended assumptions show the Government achieving its LTO's. Primarily this reflects changes to the operating allowances.

The Treasury is also seeking your feedback on how to communicate risks to the medium-term outlook using the projections. We recommend illustrating risks to the central projections in your Fiscal Strategy Report by showing alternative scenarios, including one where operating allowances are slightly higher, and one where productivity growth is lower.

We can work with you and/or your office to explore alternative options for any assumptions and/or scenarios ahead of Budget as directed.

Treasury Report: BEFU 2024 Fiscal Projections – Assumptions and Alternative Scenarios

Purpose of Report

1. This report:

   i Outlines draft projections that show the medium-term trajectory for the main fiscal aggregates.

   ii Seeks your direction on the operating allowance, capital allowance and tax revenue assumptions to be applied over the projection period (2028/29-2037/38).

   iii Seeks your agreement to publish certain alternative scenarios in the Fiscal Strategy Report (FSR) to illustrate risks to the medium-term fiscal outlook. Alternatively, these scenarios could be included in the Economic and Fiscal Update (EFU)

   iv Seeks your agreement to publish an updated version of the Fiscal Strategy Model (FSM) online together with explanatory material. Subject to your agreement, this material will be published alongside Budget 2024, consistent with standard practice.

Background

2. The fiscal projections are decade-long estimates of key fiscal variables covering the 10-year period after the fiscal forecasts, which are produced using Treasury's Fiscal Strategy Model (FSM). The projections belong to the Minister of Finance, and you decide on the key assumptions which underpin them, making them an important tool for communicating your fiscal strategy. The projections published at Budget 2024 will be the first set of projections published since the Pre-Election Economic and Fiscal Update 2023 (PREFU) and the first published by this Government.

3. The projections use historical averages and trends of economic, fiscal, and demographic variables to indicate the likely path key fiscal variables will take in the 10-year period after the forecasts have ended. This contrasts with the fiscal forecasts which rely on the specific judgements of forecasters to predict the government's financial position over a 5-year period. Despite using a different methodology, the projections are built on top of the fiscal forecasts and begin from the end of them, which means changes in the forecasts can have a large impact on the projections. The economic and fiscal forecasts (explained in more detail in T2024/1137) have deteriorated significantly since the projections were last published at PREFU.

4. The projections are published in the FSR released alongside Budget 2024. Under the Public Finance Act, your published projections must illustrate the likely future progress towards your Long-Term Objectives. Your Long-Term Objectives (LTO's) for your fiscal strategy, announced at the 2024 Budget Policy Statement, are to:

   a Reduce net core Crown debt to below 40 percent of GDP and maintain debt between 20 percent and 40 percent of GDP thereafter.

   b Deliver sufficient operating surpluses to achieve the debt objective.

   c Reduce core Crown expenses to 30 percent of GDP in the long-term.

   d Ensure the level of operating revenues is consistent with the operating balance objective.

   e Ensure net worth remains at a level sufficient to buffer economic shocks.

Key assumptions underpinning the projections

5. Outlined below are the three key assumptions in the indicative final BEFU 2024 projections, options for changing them, and our recommended approach for each.

Key assumption 1: Operating expenditure in the projection period

6. The assumption around the size and rate of growth of operating expenditure in the projection period has a large impact on total Crown OBEGAL and net core Crown debt. The most recent projections from PREFU 2023 assumed annual new operating expenditure was set in line with the allowance set for the final forecast year, which was $3 billion at the time.

7. **Our recommendation is to follow the same convention of projecting operating expenditure using the final forecast year operating allowance.** This means new operating expenditure would be set at $2.4 billion in the first projection year, and grow by 2 percent per year to adjust for inflation. This approach would ensure consistency with the forecast period around the level of operating allowances.

8. Although the recommended operating expenditure projection is credible, it will likely become increasingly challenging to adhere to given cost pressures associated with an ageing population and the ambitious path for capital expenditure over the projections (discussed below). The updated projection for core Crown expenses, based on the forecast allowances, also suggests that your LTOs could be achieved with a somewhat higher allowance assumption.

9. Accordingly, we also recommend that you illustrate the impact of higher operating allowances through an alternative projection scenario (discussed later in this report).

10. If you wish to amend the operating expenditure projection, we propose adopting either or both of the following alternative assumptions:

    a Operating expenditure could be assumed to grow in line with GDP growth rather than inflation. This would reflect the likelihood that cost pressures will grow at a faster rate than generalised inflation in the projection years, due to increase demand for government services as the population grows and ages.

    b The size of the initial operating allowances in the projection period could be set at a higher level. For example, you could use higher operating allowance (e.g. allowances of $3 billion) considered in your fiscal strategy advice, in light of the potential for increased cost pressures during the projection years.

Key assumption 2: Capital expenditure in the projection period

11. The assumption around the size and rate of growth in capital expenditure in the projection period primarily affects the projection for net core Crown debt and has limited impact on the projection for OBEGAL.[1] The PREFU 2023 projections assumed new capital expenditure equivalent to $7 billion per annum and growing by 2 percent per year in line with inflation. This led to new capital expenditure equalling $8.4 billion in the final year of the projections.

12. **Our recommendation is that you maintain the PREFU assumption of annual new capital expenditure of $7 billion in the first year of the projection period, growing by 2 percent per year.** This assumption is consistent with the National Party's fiscal plan and the conventions adopted in recent iterations of the fiscal projections.

13. The recommended level of capital expenditure can be maintained alongside a fall in net core Crown debt. However, the scale of the capital expenditure is high relative to the operating allowances, given that roughly 1 dollar of operating expenditure is required for 3 dollars of capital expenditure. This implies significant reprioritisation of existing spending beyond what will be required to manage cost pressures and deliver new initiatives. This provides a further motivation to increase the projected operating allowances, as described above.

14. An alternative option is to project a linear transition from the $2.5 billion capital expenditure in the final year of the forecast period to the $7 billion assumption in the later years of the projection period. This approach would be more consistent with the smaller operating allowances at the start of the projection period. This would also improve your net core Crown debt track and the consistency between how the projections treat operating and capital expenditure. However, there is a risk that this track for capital expenditure does not fully communicate your intention to increase capital investment in the coming years to the market.

Key assumption 3: Tax revenue in the projection period

15. The assumption around whether tax revenue relative to the size of the economy increases, decreases, or stays the same relative to the end of the forecast period has a large impact on both OBEGAL and net core Crown debt in the projection period.

[1] It should also be noted that, unlike the forecasts, the projections do not adopt the Multi-Year Capital Allowance (MYCA) due to modelling constraints. You have previously indicated you wish to receive further advice on the MYCA in the context of your capital investment choices. We will provide you with further advice on this post-Budget.

16. The PREFU projections assume that revenue as a percent of GDP returns to its long-run historical average. As tax revenue as a percent of GDP is above its long-run average at the end of the forecast period, maintaining those assumptions would see revenue fall slightly across the entire projection period.

17. We recommend you alter the path tax revenue takes in the projection period to better align with your intended medium-term fiscal strategy. Specifically, we recommend that tax revenue as a percent of GDP stays at its end-of-forecast level until net core Crown debt falls below 40 percent of GDP. Once net core Crown debt falls below this level, we recommend tax revenue as a percent of GDP would start to fall to its long-term average.

18. This approach would see a faster decline in net core Crown debt in the projections and would better align with the Government's revenue strategy. This states that revenue will need to exceed expenses for a period to bring net core Crown debt below 40 percent of GDP over the medium-term.

19. Keeping tax revenue to GDP constant implicitly assumes that tax brackets are adjusted in line with wage inflation, while a falling tax revenue to GDP ratio implies tax reductions beyond wage inflation. Our recommended approach would imply that tax brackets are adjusted more slowly than PREFU in the early part of the projection period. This could be justified given that tax brackets will be adjusted in Budget 2024.

20. Alternatively, the current assumption that tax revenue falls slightly over the forecast period could be retained. This assumption would show a moderately less favourable path for net core Crown debt and would mean that the fiscal projections could become inconsistent with the revenue strategy if there is a substantial deterioration in the medium-term outlook. Another alternative is for tax revenue as a percentage of GDP to trend back to the 2024/25 level rather than the long-term average. This would be appropriate if you consider the tax changes in this year's Budget to set a new baseline assumption.

Impact of assumptions on projections

21. The indicative final BEFU 2024 projections are outlined below. These projections are based on the indicative final fiscal forecasts (T2024/1137 refers), with operating allowances of $2.4 billion per annum in Budgets 2025, 2026 and 2027. Two options for the projections are shown. One with the Treasury's recommended assumptions as set out above, and another with assumptions unchanged from PREFU. The projections from PREFU 2023 are included for comparison.

Figure 1: OBEGAL as a percent of GDP

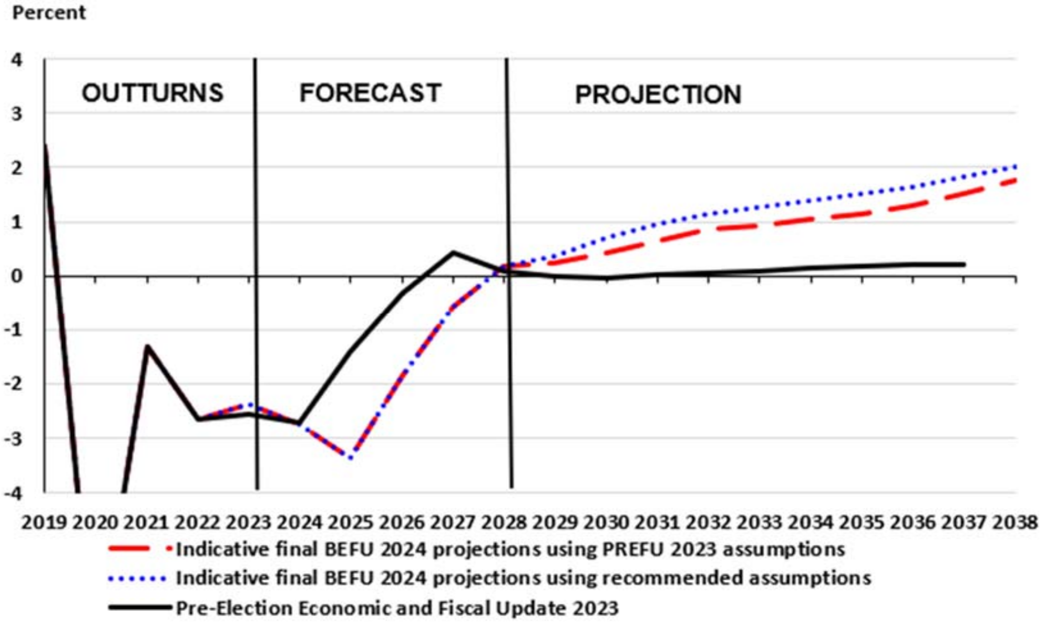


Figure 2: Net core Crown debt as a percent of GDP

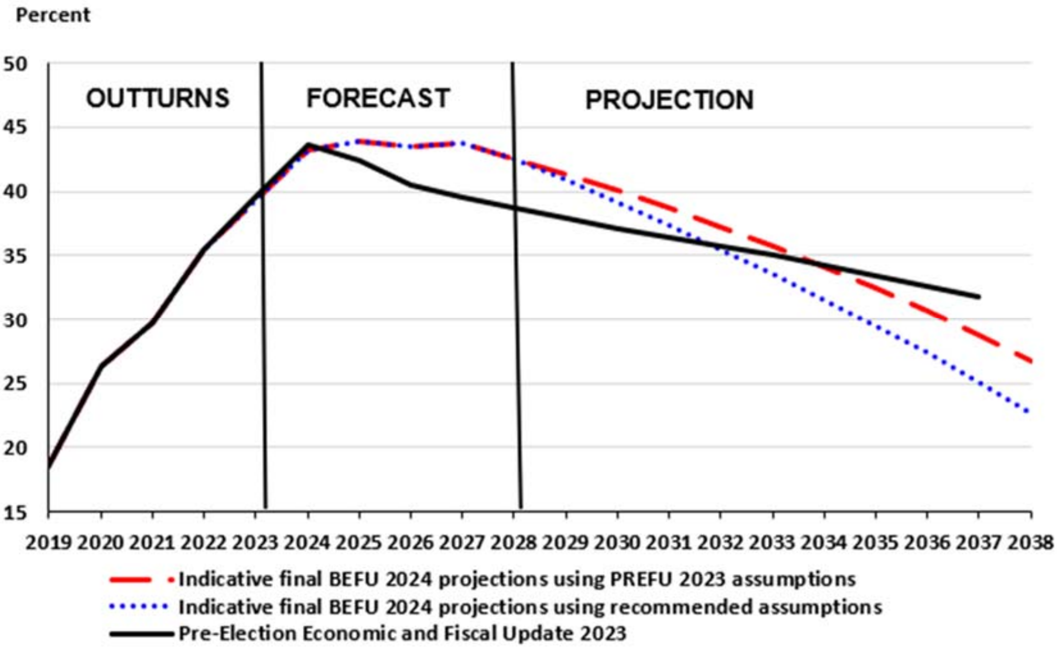


Figure 3: Core Crown revenue as a percent of GDP

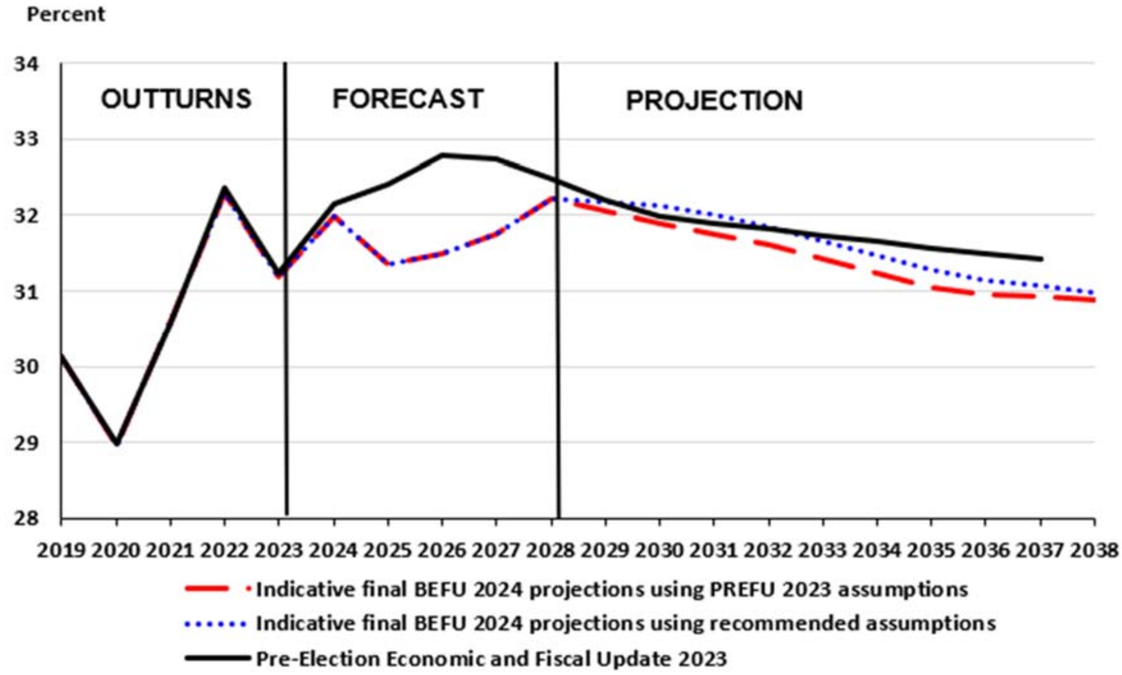
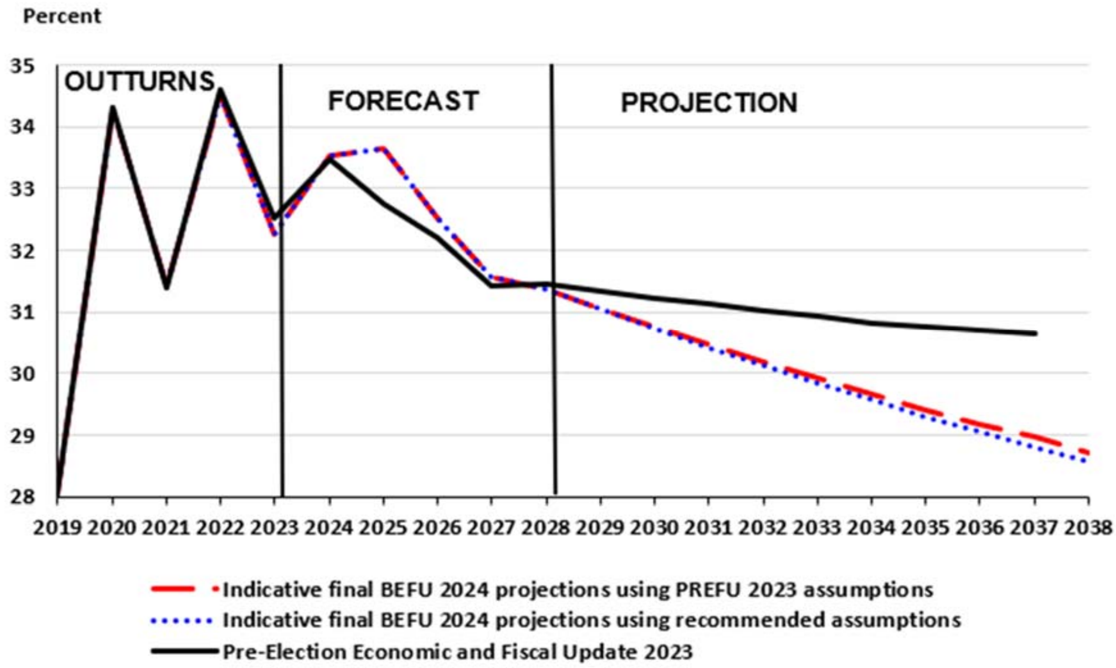


Figure 4: Core Crown expenses as a percent of GDP



22. As outlined in the figures above, indicative final BEFU 2024 projections using either the unchanged or recommended set of assumptions are consistent with your LTO's, including reducing net core Crown debt to below 40 percent of GDP, and reducing core Crown expenses to 30 percent of GDP.

23. The track for OBEGAL with either set of assumptions is notably stronger than it was in the PREFU 2023 projections, reflecting your lower final Budget allowances. This flows through to a faster reduction in net core Crown debt across the projection period. Even so, these projections illustrate that it may take an extended period, under current policy settings, to durably return debt to 20-40 percent of GDP.

24. The increased revenue collected under our recommended assumptions improves both the OBEGAL and net core Crown debt tracks, providing more of a buffer to shocks or another deterioration in the fiscal forecasts.

Alternative projections scenarios

25. Historically, alternative projection scenarios have been published either in the FSR or in the EFU. The purpose of these scenarios is to illustrate and communicate to the public how potential future changes and sources of uncertainty might affect the fiscal projections and overall fiscal sustainability. **We recommend publishing alternative projections scenarios in the FSR alongside the central projections** to outline future risks to the outlook.

26. If you do agree to publish alternative scenarios in the FSR, we have formulated the following two alternative scenarios:

    a Scenario One: New operating expenditure in the projection period grows at $3 billion in the first year of the projections, inflated by nominal GDP growth in later years.

    b Scenario Two: Labour productivity growth is lower than the current assumption of 1 percent growth per annum.

27. Scenario One would reflect the upside risks to projected operating expenditure, as discussed above. Under this alternative scenario, the OBEGAL surpluses over the projection would fall significantly (Figure 6), reducing the downward trajectory in net core Crown debt (Figure 7).

28. Scenario Two would be motivated by recent economic data suggesting downside risk to the long-run productivity assumption used in the FSM. While this assumption is going to be explored and analysed in more detail as later in the year, providing a scenario based around a lower rate of productivity growth would help signal the likely impact any downward revisions to productivity is likely to have. This scenario could illustrate the importance of improving economic growth for fiscal sustainability.

29. Scenario Two would take the 20-year average of labour productivity growth (the methodology used by the Australian Treasury in their projections) instead of the 30-year average currently used in the FSM. This would lead to an assumption of labour productivity growth of 0.7 percent per year compared to the current assumption of 1 percent. This would have a material impact on the projections, leading to a weaker track for both OBEGAL (Figure 5) and net core Crown debt (Figure 6).

Figure 5: OBEGAL as a percent of GDP: Alternative scenarios

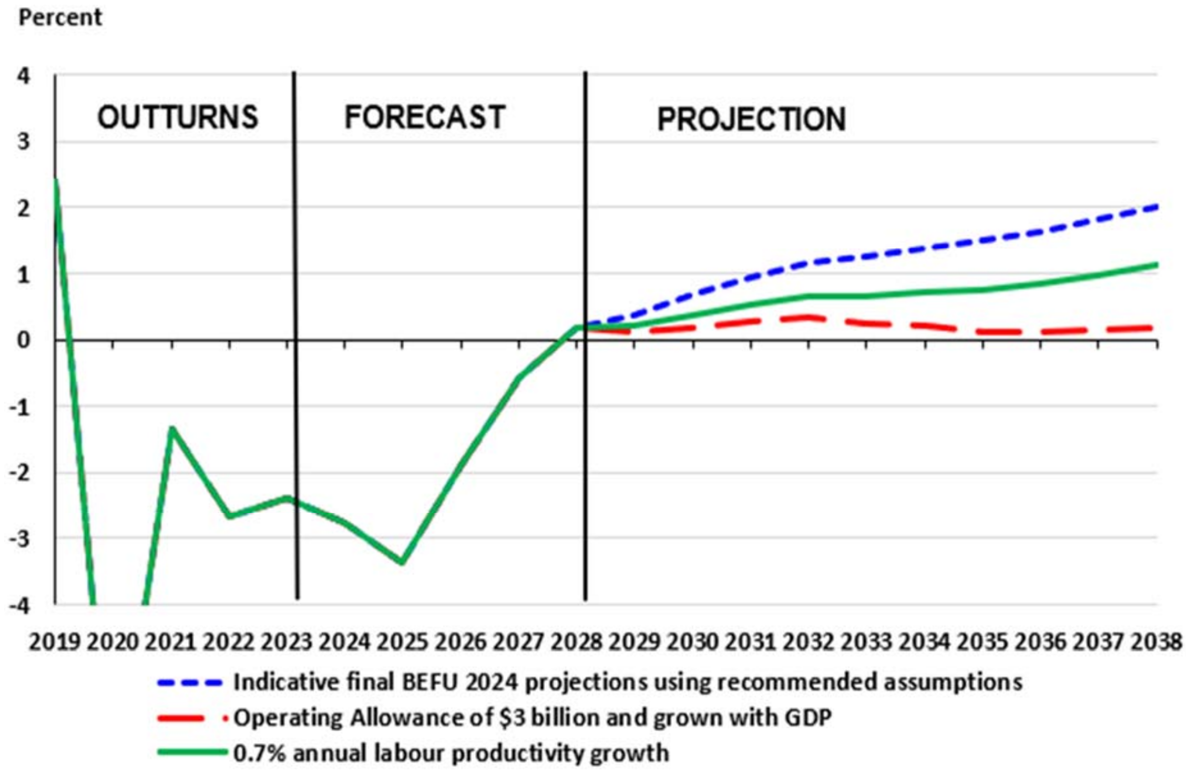
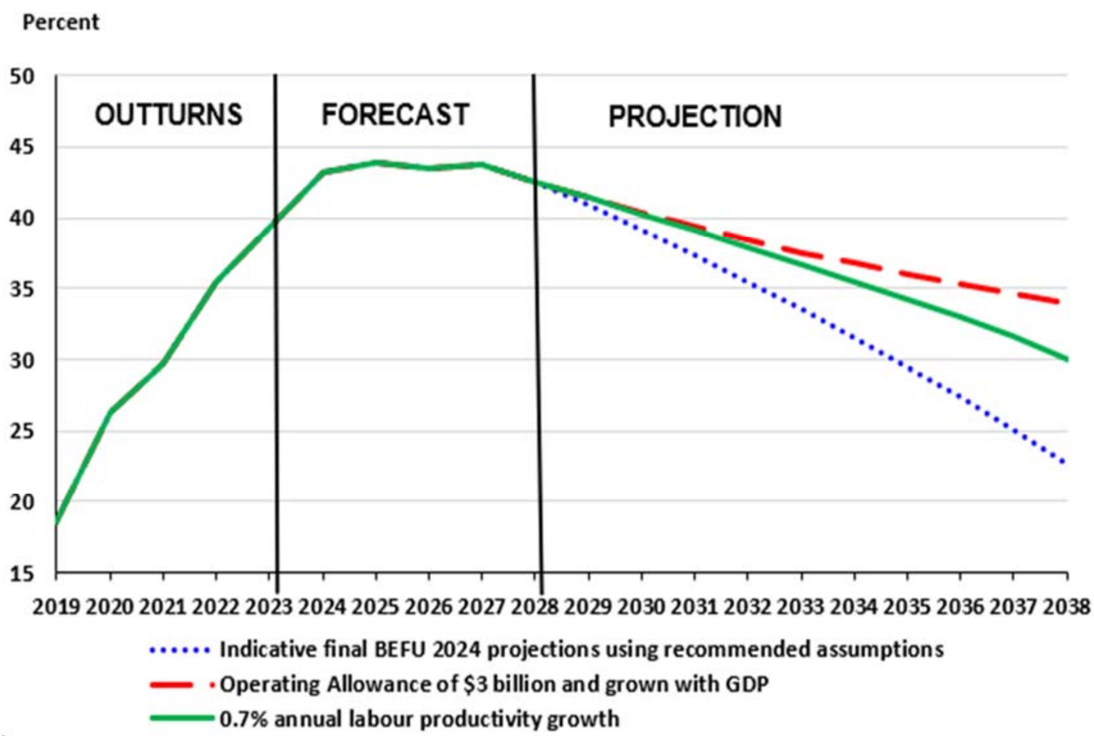


Figure 6: Net core Crown debt as a percent of GDP: Alternative scenarios



Next steps

30. The Treasury can work with you and your office to set operating expenditure, capital expenditure, and tax revenue assumptions over the projection period, should you wish to specify different options to those provided in this report. If you agree to publish alternative projections scenarios in the FSR, we can also aid in the choice and design of scenarios.

31. Your decisions on fiscal assumptions will be built into the 2024 Budget version of the FSM, which will, with your permission, be published alongside the 2024 Budget and other material on the Treasury website on Budget Day. To enable Treasury to keep to the intended publication timeline for Budget, we seek decisions on fiscal assumptions and alternative scenarios by Thursday 9 May 2024.

32. The BEFU 2024 fiscal forecasts will be finalised on 9 May, and the BEFU 2024 projections soon after. We will provide your office with an updated set of projections, reflecting your decisions on assumptions, as soon as possible once the fiscal forecasts are finalised. We will work with your office to amend any assumptions at that point if the updated projections lead you to revisit the decisions you make in response to this report.

Recommended actions

We recommend that you:

a **agree** that projected new operating expenditure in the first projection year should be set at $2.4 billion in line with the operating allowances for Budgets 2025 to 2027, and grown at 2 percent per annum thereafter.

Agree / disagree

b **agree** to set annual new capital expenditure at $7 billion per annum in the first year of the projections, to be grown at 2 percent per annum thereafter.

Agree / disagree

c **agree** that tax revenue as a percentage of GDP should remain at its end-of-forecast level in the early part of projection period until net core Crown debt falls below 40 percent of GDP.

Yes / no

d **agree** to publish the Fiscal Strategy Model (FSM) and associated explanatory material online alongside the 2024 Budget Economic and Fiscal Update

Agree / disagree

e **agree** to the publication of alternative projections scenarios in the FSR

Yes / no

f **agree** (if scenarios will be published) to an alternative scenario concerning higher growth in operating allowances due to cost pressures

Yes / no

g **agree** (if scenarios will be published) to an alternative scenario concerning lower labour productivity growth

Yes / no

h **indicate** whether you would like to discuss options around projections assumptions and/or alternative scenarios with the Treasury

Yes / no

Ben Gaukrodger
Manager, Macroeconomic and Fiscal Policy

Hon Nicola Willis
Minister of Finance

_____/_____/_______