THE TREASURY
Kaitohutohu Kaupapa Rawa

25 MAY 2017

BEFU BASICS

Our Budget Economic and Fiscal Update (BEFU) gives us context for Budget 2017 and over the next four years (our forecast period)

http://www.treasury.govt.nz/budget/forecasts/befubasics

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New Zealand Government

TREASURY BASICS –
Making sense of New Zealand's economic and fiscal landscape

Our Economic and Fiscal Updates

The Treasury is New Zealand's economics and finance ministry. We advise on the direction of New Zealand's economic policy with the aim of achieving a strong and sustainable economy, and raising New Zealand living standards. This includes reporting on the revenue and expenditure of government (fiscal outlook), and assisting to ensure spending is fit for purpose and can improve outcomes for New Zealanders.

Sharing what we do

The Treasury is responsible for economic and fiscal forecasts. We release these every six months. We have an annual **Half-Year Economic and Fiscal Update** (HYEFU), and this is a summary of the annual **Budget Economic and Fiscal Update** (BEFU).

This particular update forms part of Budget 2017 and provides economic context for Budget decisions. It primarily outlines what the Treasury observes in our current economic and fiscal climate, what we might see in the future, and what risks we may face over the next four years. This gives an indication of what the economy is most-likely to do to inform decision making.

Making it New Zealander-centric

Our advice is not just based on facts and figures. Improving outcomes means we need to understand which outcomes to improve, and what is important to New Zealanders. We use the **Treasury's Living Standards Framework** to recognise the different aspects of New Zealanders' living standards and well-being.

We took this approach further and last year presented a living standards perspective that stretches over the next 40 years. **He Tirohanga Mokopuna: 2016 Statement on the Long-term Fiscal Position**, shares our take on long-term fiscal issues facing New Zealand. We know that sustainable government finances are a requirement to improving long-term living standards, and vice versa.

Understanding what we do

Along with *delivering* first-rate economic and financial advice, we are *committed* to providing it in a way that New Zealanders can understand how we work to achieve our goals. This plain English version of our economic outlook and fiscal overview is a contribution to the **Open Budget** initiative.

BEFU Basics

This overview is split into two parts – economic and fiscal.

The **Economic outlook** is how our country is expected to do economically. It is the **big picture** that helps us position ourselves as a country to earn, grow, spend wisely, and pay off debt.

Economic Outlook

We use some key indicators to tell us what's happening in the economy:

- **Gross Domestic Product (GDP)** is one way we keep track of how an economy is doing. It measures the value of goods and services produced in an economy in a period of time. When GDP increases the economy is growing. If GDP falls for two quarters in a row we call it a recession.
- **Net Migration** is the number of people coming to New Zealand for more than a year, less the number of people who leave New Zealand for other countries for more than a year. More people here increases demand for goods, services and infrastructure, and the amount of tax paid. Generally an increase in the workforce means that production can increase and therefore the economy grows.
- **Unemployment** is the number of people actively looking for work who are not currently in jobs.
- **Household Spending**: Households choose to spend most of their income on goods and services (including housing). Households also save. When demand in the economy is greater than business ability to provide the goods and services, prices can increase (inflation).
- **Housing investment** is about 90% house building and 10% the transactions involved with house buying and selling

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The **Fiscal outlook** is about the health of our **public purse**. It looks at the government's income (largely from tax), and how the government is spending and managing its debt

Fiscal

We use some key indicators to tell us what's happening with government's revenue and expenditure trends

- **Tax revenue** is the income the government receives from taxpayers (e.g. income tax, GST, companies tax)

- **Core Crown Expenses** are the day-to-day spending of the government to provide services to New Zealanders (e.g. health and education), as well as run the agencies that provide those services and interest costs from borrowing money. (It excludes crown entities and SOEs.)

- **OBEGAL** stands for Operating Balance before Gains and Losses and is what's left after expenses are deducted from revenue. It includes profits/losses from Government controlled entities such as ACC and New Zealand Post, as well as the tax revenue and core Crown expenses discussed above

- **Net Debt** is what the Central government has borrowed less what it owns (assets) that can be used to pay off debt if required (referred to as financial assets). Examples of financial assets are cash and share investments.

GDP

Gross Domestic Product (GDP) is a measure of the size of the economy. There are two ways we look at GDP – nominal and real.

NOMINAL vs REAL

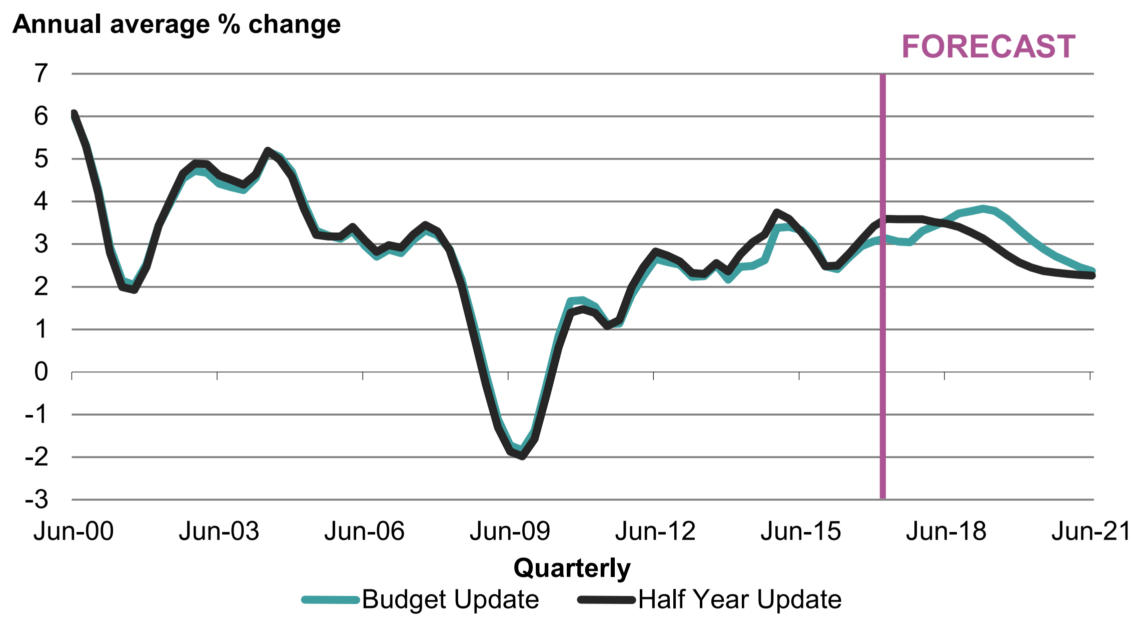
Nominal GDP is estimated at *current* prices and is a good indicator for how much tax will be generated by all the individuals and businesses in the economy.

Real GDP is estimated at *constant* prices so it takes account of inflation. How real GDP changes over time is a good measure for how fast the economy is growing.

What the Treasury says

Overall our economy is growing steadily. Annual real GDP growth is expected to rise to a peak of 3.8% in 2019, from about 3% at the moment. High net inward migration, construction including the Kaikōura rebuild, exports including tourism, and low interest rates are supporting this growth. The Family Incomes package will also contribute by increasing household incomes, allowing them to spend more.

The longer term forecast sees real GDP growth slow to 2.4% in 2021 as interest rates rise and spare capacity in the economy is used up. This is when all resources in the economy are fully employed.



Migration

Net migration moves in cycles over time. It is an important economic indicator, and one that is monitored quite frequently.

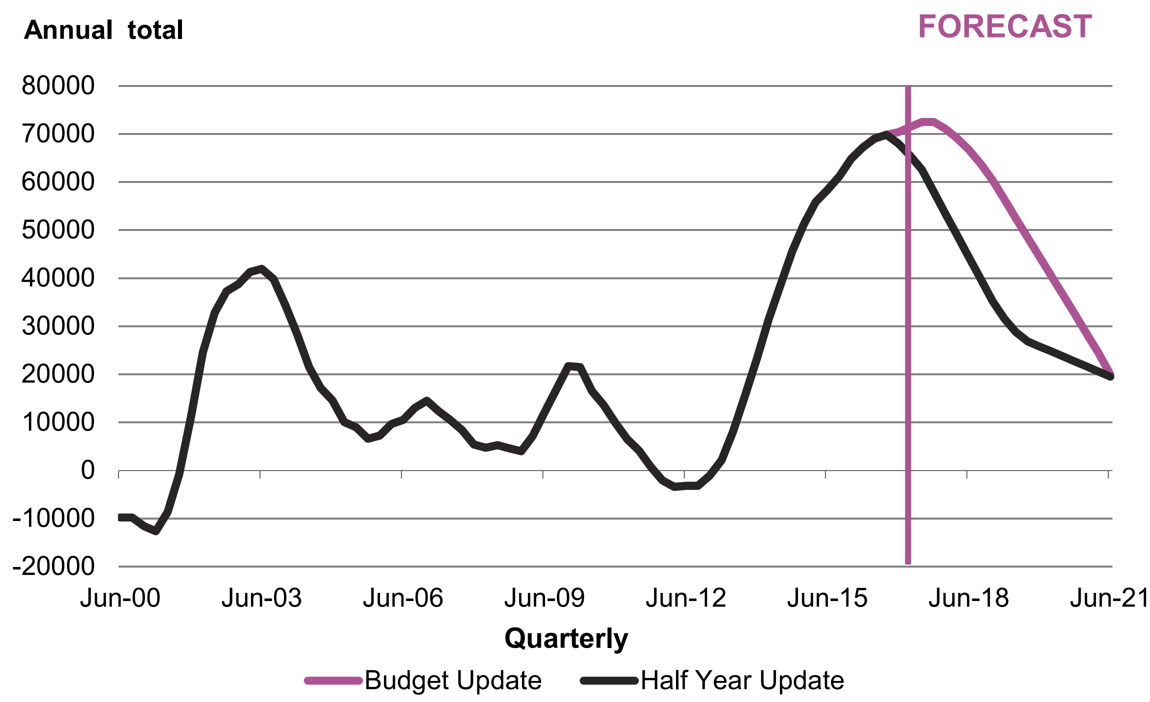
New Zealand vs Australia

Historically more Kiwis leave New Zealand, mostly for Australia, than come back to New Zealand. Recently more Kiwis than usual have come home and fewer have left. Over time we assume the normal pattern to resume.

What the Treasury says

The number of people coming to New Zealand relative to those leaving continues to be at record levels, and higher than we had expected. Over the next four and a half years we assume migration will add 212,000 people to the population. After the end of our forecast period, Stats NZ assumes net migration will reduce to 15,000 per year by 2022.

More people also adds to the amount of goods and services people want. To meet this demand businesses may need to hire more people. But it also means more demand for items like housing and meeting extra housing demand in a short amount of time is difficult. We assume flows of migrants into New Zealand will return to the Stats NZ assumption in 2022.



Employment

We measure the health of our employment situation by measuring unemployment.

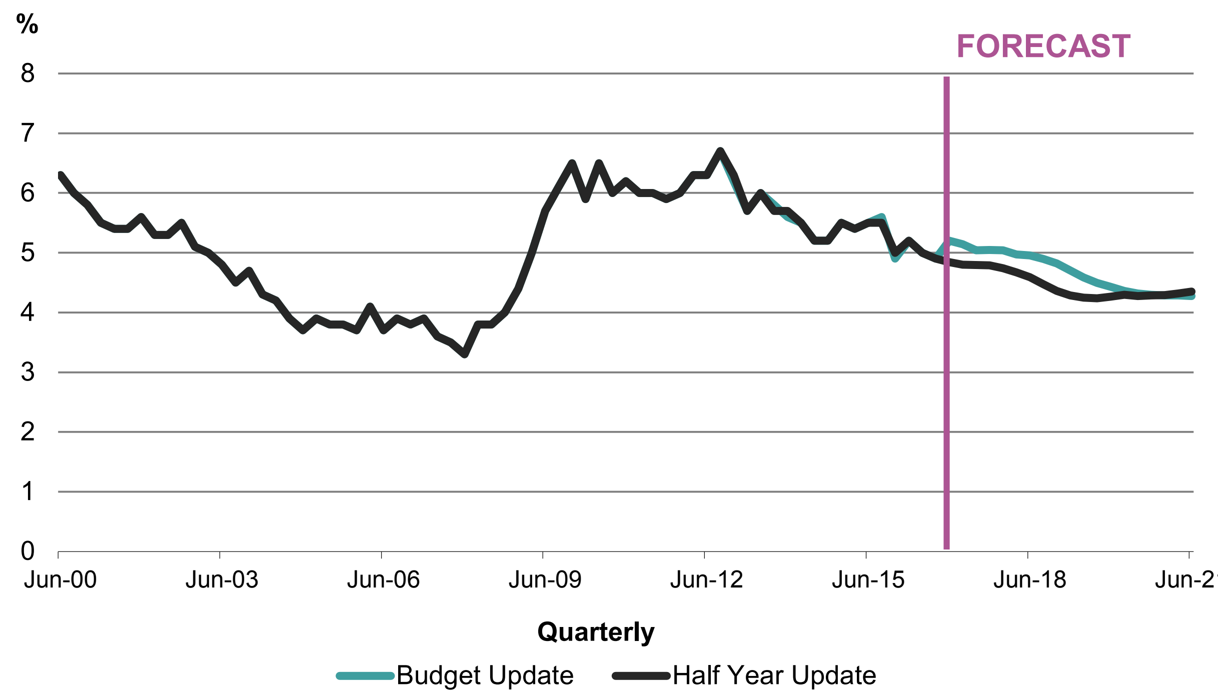
Unemployment and wages

When the unemployment rate is relatively high there is less pressure on businesses to raise wages. Because of that prices for goods and services don't go up as fast either.

What the Treasury says

The unemployment rate is expected to decline gradually over the next year. It hovers around 5% because even though there are more people looking for jobs, there are also more jobs. Employment growth is forecast to be stronger than what we previously thought it would be.

Further out, we expect the number of people with a job will grow faster than the number of people looking for employment. This will lower the unemployment rate to about 4.25%. As this happens, businesses will find that competition for job openings decreases and they will need to raise wages to attract people.



Housing

The demand for houses will continue to increase.

Housing/Debt/GDP

The growth in the housing market has seen household debt increase. At the end of last year, household debt reached 168% of household disposable income.

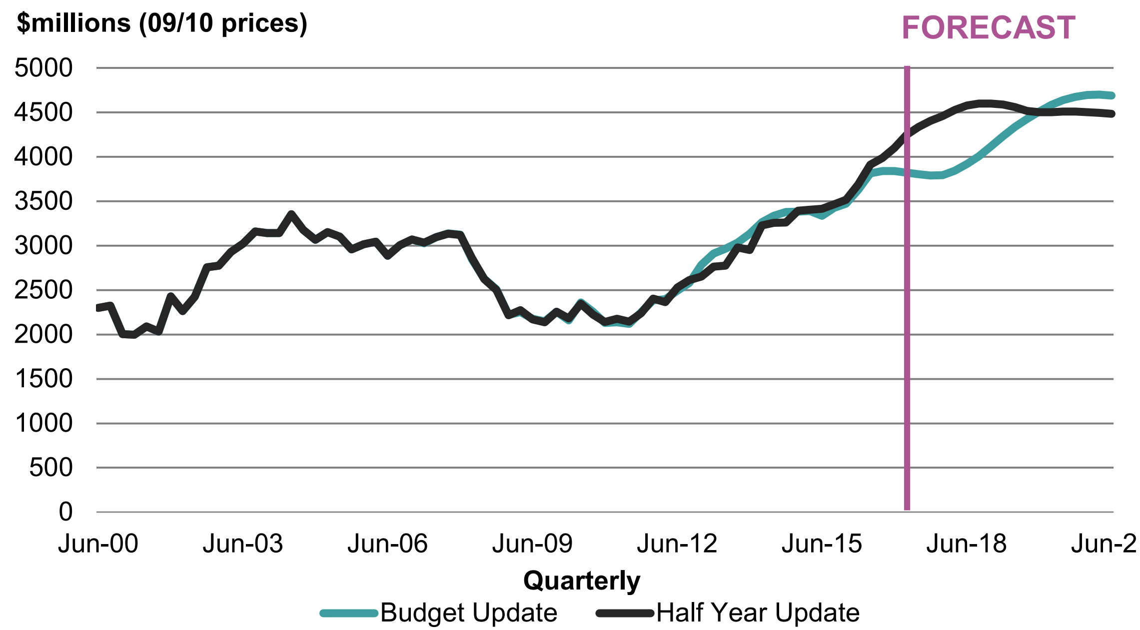
If incomes don't rise or interest rates rise sharply then paying off mortgages could be difficult for some. If this happens then people may spend less, or buy or build fewer houses, reducing GDP.

What the Treasury says

Demand for housing is growing due to high population growth and low interest rates (making it cheaper to service a mortgage).

We don't expect housing investment to increase as quickly as we did in our last Half year Update. In fact we think it will level out for a while. This is because there are tighter restrictions on banks lending for housing, there is uncertainty around the Auckland Unitary Plan, there is a shortage of skilled labour to build houses, and property developers are finding it more difficult to borrow money. But we think most of these factors will be just temporary – and further on we expect the built-up demand for housing will encourage an increase in house building.

House prices will continue to rise but not as quickly, as more houses are built to meet some of the demand.



Household spending

How households choose to spend their income makes a big difference to an economy.

Not all households are the same

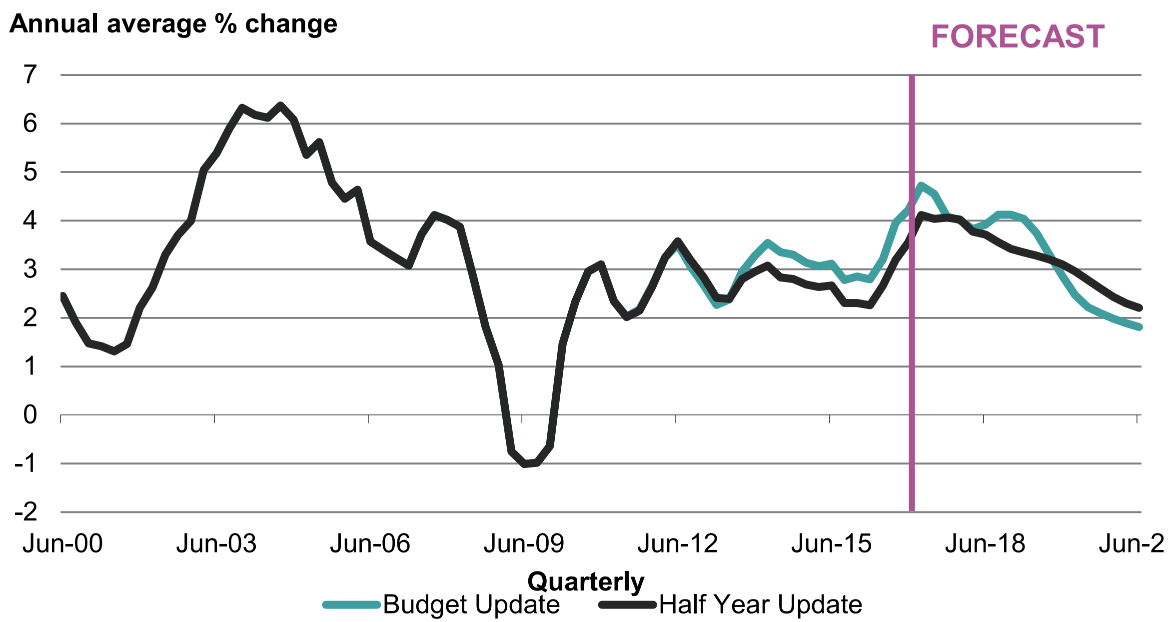
In these forecasts we assume households will increase the amount they spend at about the same rate their income increases.

But we also understand that we all have our own particular preferences and these change when economic conditions change.

What the Treasury says

We expect growth in household spending will stay high over the next few years. High population growth, low interest rates so people can borrow and spend more, and rising farm incomes all help boost spending. The government has also introduced in Budget 2017 a Family Incomes Package, which will increase incomes from 2018 onwards. We expect the majority of people will spend this rather than save.

From 2019 household spending growth slows. The reasons? We forecast interest rates to rise, people to start saving more, growth in house prices to ease, and population growth to slow down with less people migrating to our shores.



Tax revenue

Core Crown tax revenue is earned by the Government from various sources (e.g. income tax, GST, motor vehicle fees)

Tax expenditure

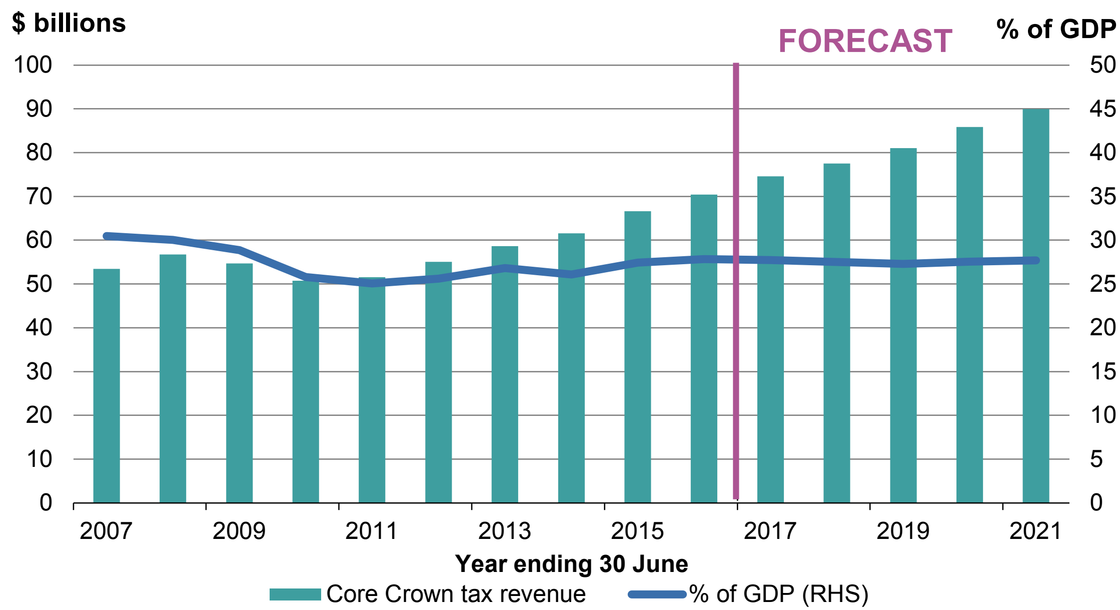
As well as forecasting tax revenue the Treasury also calculates the impact tax deductions and tax credits have on reducing tax revenue (referred to as tax expenditure). You can see the calculations here.

What the Treasury says

Core Crown tax revenue is forecast to rise in every year for the next four years. As you can see below, by 2020/21 it's expected to reach $89.9 billion, $19.5 billion higher than in 2015/16.

The increase is mainly due to the growth in the economy (see nominal GDP slide).

Offsetting some of this increase is the Family Incomes Package. While personal income tax reduces by just over $6 billion across the four years some other taxes increase as people are expected to spend this increase rather than save, and it will have a direct increase on GST revenue, company tax through increased profits, and income tax as there is more demand for workers. Overall the Package decreases tax revenue by $4.8 billion by 2020/21.



Core Crown expenses

Core Crown expenses are day-to-day government spending such as **maintaining government services like health, benefit payments,** public servants' salaries, and paying interest on debt.

On the rise

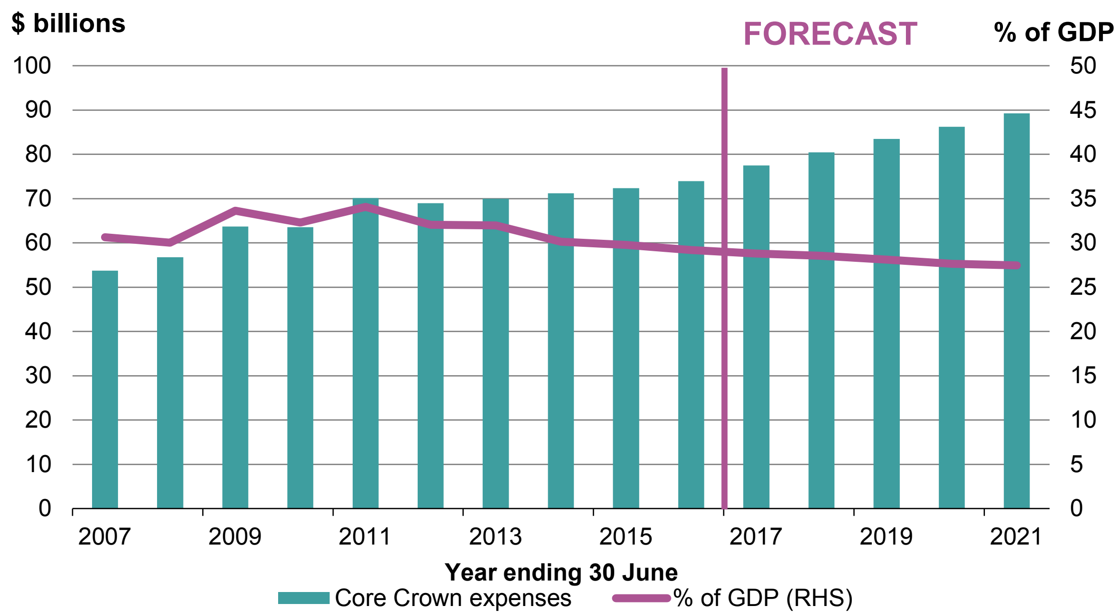
In 2011/12 core Crown expenses were around $15,640 per capita. By 2020/21 we expect that to have risen to $17,478 per capita

What the Treasury says

Core Crown spending is increasing across the next four years. A lot of this increase is due to Budget 2017 operating decisions and new spending set aside by the Government for future Budgets. New operating expenditure in Budget 2017 averages around $1.8 billion per year over the forecast period – up from the $1.5 billion per year we expected in our last forecast.

As well as this new spending, New Zealand superannuation costs are expected to increase, adding $3.7 billion by 2020/21. The Family Incomes package adds another $0.5 billion a year, mostly through increases to Working for Families payments and the Accommodation Supplement.

Overall core Crown expenses grow from $73.9 billion in 2015/16 to $89.2 billion in 2020/21 but they remain below 30% of GDP.



OBEGAL

OBEGAL is the difference between revenue the Government (and the entities it controls) earns and expenses it pays.

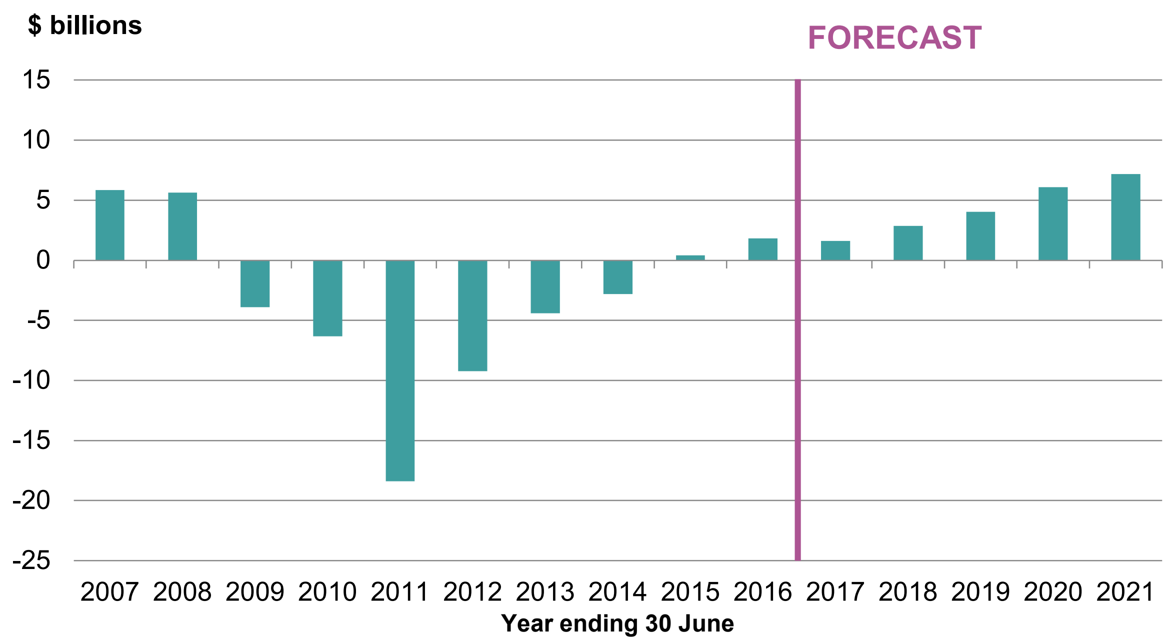
Operating vs capital

OBEGAL includes operating expenses of the Government but doesn't include spending on capital items such as building state highways or prisons.

What the Treasury says

The surpluses the Government has recorded in the last two years are expected to continue. The increase over time is mostly a reflection of the growing economy – as the economy grows people earn more and spend more, increasing the taxes they pay (and the government earns). By 2020/21 OBEGAL is expected to reach $7.2 billion.

OBEGAL also includes the results of Crown entities (such as ACC) and State-owned enterprises (such as New Zealand Post).



Net debt

The amount the Government owes to others less the assets it has on hand to pay off that debt.

Gross vs Net Debt

The **gross debt** is the total amount of money the government has borrowed.

Net debt is the amount borrowed less cash and investments the government holds.

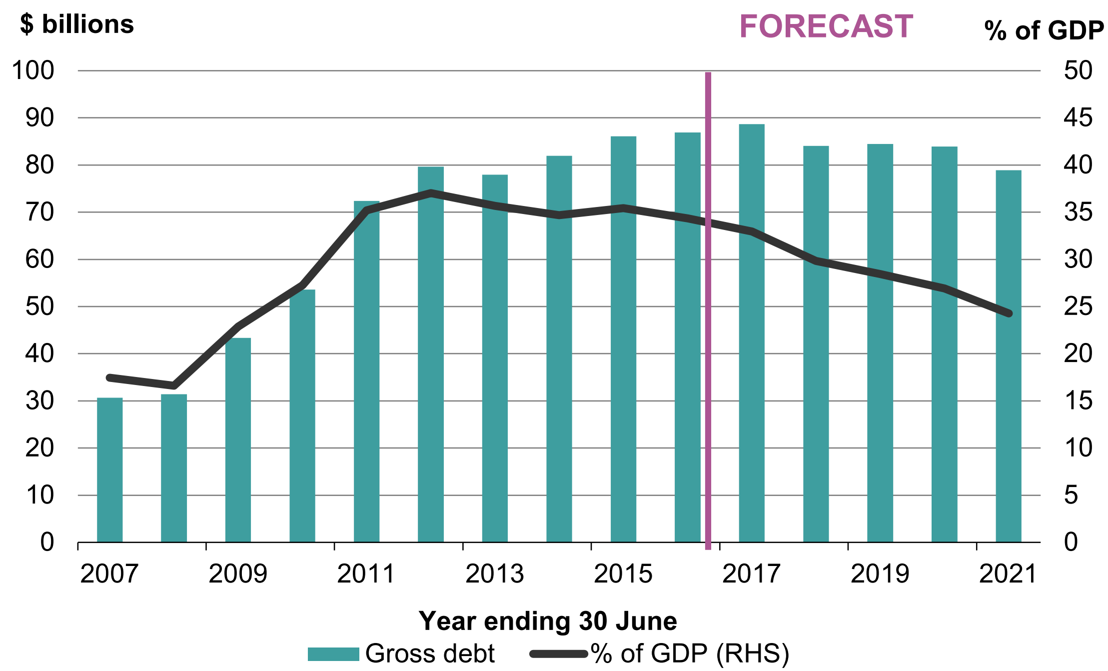
What the Treasury says

Over the forecast period the Government is expecting to receive more from tax and other sources than it pays out in operating expenses (a total net inflow of $25.5 billion over the next four years).

The Government is expected to spend this money investing in capital assets (such as roading and school property) and restarting contributions to the New Zealand Superannuation Fund (a total net outflow of $25.7 billion over the next four years).

Therefore net debt is expected to be only slightly higher by 2020/21 ($62.8 billion) in dollar terms, than it is at the end on 2016/17 ($62.3 billion).

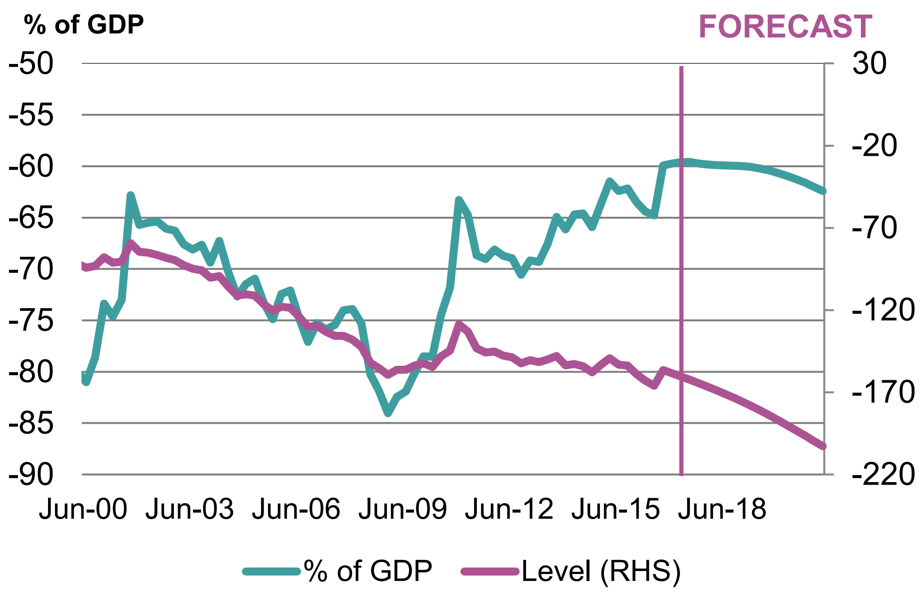
When you compare it to the size of the economy (which is expected to grow), net debt as a percentage of GDP is expected to fall to 19.3% by 2020/21.



Resources

ABOUT FORECASTING

Forecasting is a combination of understanding trends, applying our forecasting model and using assumptions. It is based on the realistic assumption that the economy itself is complicated. You can understand more about how we forecast here.



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Need to access our glossary?

Need to dive deeper?

You can access the different chapters of our full BEFU here:

1. Executive Summary
2. Economic Outlook
3. Fiscal Outlook
4. Risks and Scenarios
5. Specific Fiscal risks
6. Forecast Financial Statements
7. Core Crown Expense Tables