TE TAI ŌHANGA
THE TREASURY

Economic and Tax Outlook – BPS 2024

27 March 2024

https://www.treasury.govt.nz/publications/economic-and-tax-outlook-bps-2024-27-march-2024

The Government has published its Budget Policy Statement 2024 (BPS), which sets out the goals and objectives that will guide its decisions in the forthcoming Budget, as well as its fiscal strategy. To support the BPS, the Treasury has produced a scenario of how the economy may evolve under certain assumptions. This document provides additional detail on that scenario.

The Treasury's scenario presents our view of the outlook for the economy and tax revenue under the following specific assumptions:

- Economic data up to 15 March 2024 were taken into account. A wide range of data has pointed to a further deterioration in the economic outlook since the Half Year Economic and Fiscal Update (*Half Year Update)* was published in December 2023.
- The most recent GDP results for the December 2023 quarter were released after the BPS finalisation and are therefore not incorporated in this scenario.
- A higher multi-year capital allowance (MYCA) is incorporated. This reflects the Government's decisions to top up the MYCA as described in the BPS (relative to the MYCA assumed in the *Half Year Update*).
- Apart from the change above, no announced or proposed Government policy change made since the *Half Year Update* is incorporated in the scenario as information on changes will be presented alongside the Budget on 30 May 2024.

The scenario does not present updated fiscal forecasts. Complete fiscal forecasts depend on information yet to be collected from a range of government entities, and on Budget 2024 decisions yet to be made. A full set of updated economic and fiscal forecasts and projections will be presented alongside the Budget on 30 May 2024.

The economic outlook has deteriorated

The Treasury has been forecasting a slowdown in growth as high inflation – and the restrictive interest rates necessary to address it – reduce spending in the economy. Since finalising the *Half Year Update*, economic activity has been weaker than previously thought and inflation has eased more quickly. There is also increasing evidence that labour productivity growth, which plays an important role in the potential capacity of the economy, is lower than previously thought. As a result, we are expecting a weaker economic and tax outlook over the next five years.

Table 1 – Key economic and tax variables

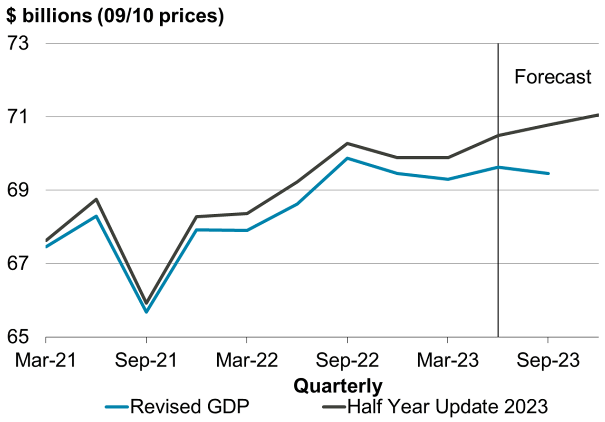
June years	2023 Actual	2024 Forecast	2025 Forecast	2026 Forecast	2027 Forecast	2028 Forecast
Real production GDP (annual average % change)						
Budget Policy Statement	3.0	0.1	2.1	3.1	2.8	2.5
Half Year Update 2023	3.2	1.5	1.5	2.8	3.0	2.7
Unemployment rate (June quarter)						
Budget Policy Statement	3.6	4.6	4.9	4.5	4.4	4.4
Half Year Update 2023	3.6	4.5	5.2	4.8	4.6	4.4
CPI inflation (annual % change)						
Budget Policy Statement	6.0	3.3	2.2	2.1	2.0	2.0
Half Year Update 2023	6.0	4.1	2.5	2.2	2.0	2.0
Nominal GDP ($ billion)						
Budget Policy Statement	395.5	414.6	432.6	455.6	478.4	500.9
change from Half Year Update	-0.5	-5.4	-7.1	-8.0	-10.2	-12.1
Core Crown tax revenue ($ billion)						
Budget Policy Statement	112.4	120.8	127.1	135.5	143.0	149.8
change from Half Year Update	0.0	-1.2	-2.6	-2.6	-3.2	-4.2

Sources: Stats NZ, the Treasury

The economy is weaker than expected…

The anticipated slowdown in activity came sooner than expected. The September 2023 quarter release of GDP data was weaker than anticipated and showed a downward revision in several previous quarters (see Figure 1). Sentiment, card spending, and housing data through late 2023 and early 2024 showed ongoing weakness (confirmed as a further decline in December quarter GDP, released after this scenario was finalised). On the other hand, labour conditions eased less than expected in December 2023, and wage growth remains high.

Figure 1 – Real GDP revisions



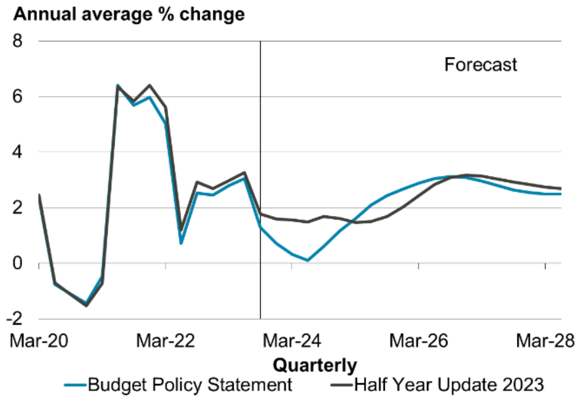
Sources: Stats NZ, The Treasury

Inflationary pressure has also eased more than expected. Headline CPI inflation slowed to 4.7 per cent in the December 2023 quarter, weaker than expected due to sustained falls in petrol and food prices, but still some distance from the inflation target. Core inflation has slowed significantly, with the sectoral measure from the Reserve Bank of New Zealand (the Reserve Bank) easing to 4.5 per cent and Stats NZ's trimmed mean to 5 per cent. These developments have led us to conclude that aggregate demand in the economy is now broadly in line with the economy's capacity to supply goods and services.

…pointing to a weaker short-term economic outlook…

The falls in economic activity in 2023, together with expected modest quarterly growth over 2024 has led to sharply lower year-on-year growth in this scenario than previously forecast (Figure 2). We expect pressure on household budgets from the erosion in real wages over the past few years, and the decline in household wealth from past falls in house prices, to contribute to declines in real consumption spending until the second half of 2024. On a per capita basis, consumer spending has fallen rapidly, and this scenario envisages that continuing over 2024.

Figure 2 – Real GDP growth



Sources: Stats NZ, The Treasury

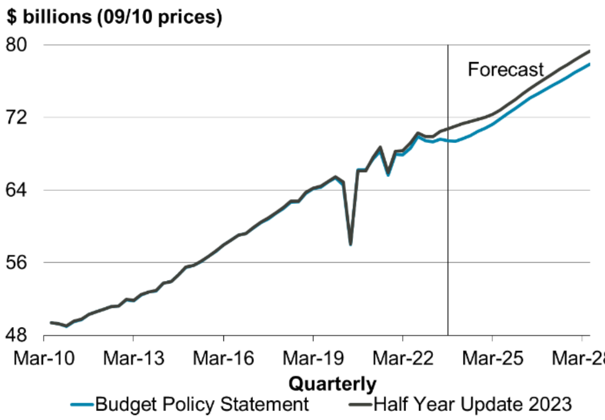
Economic growth is expected to remain subdued this year, despite strong population growth. These conditions are reflected in modest employment growth in the BPS scenario, and in rising unemployment and increasing spare capacity in the economy. Later this year, the increase in spare capacity, alongside continued progress in reducing inflation, is expected to provide scope for the Reserve Bank to begin reducing interest rates. Inflation is expected to return to the target range of 1 per cent to 3 per cent in the second half of 2024. As interest rates decline and growth in real wages picks up, GDP growth is expected to increase, rising to 2.1 per cent and 3.1 per cent in 2024/25 and 2025/26 respectively.

Thereafter, growth slows as spare capacity is absorbed and the economy settles at its potential or medium-term sustainable growth rate.

…while lower productivity growth leads to a subdued medium-term outlook

Productivity growth forecasts and the long-run trend in GDP growth are uncertain, and these are very important to the revenue outlook. Trend GDP growth in this scenario is lower compared with the *Half Year Update* because of lower expected productivity growth.

Figure 3 – Real GDP



Sources: Stats NZ, the Treasury

In the aftermath of the pandemic, GDP growth was strong relative to employment growth – implying a strong acceleration in productivity growth. This has reversed over the past year. The Treasury viewed the surge in productivity as temporary and assumed that productivity growth would slow gradually. However, recent data – including downward revisions to historical GDP (Figure 1 above) – have revealed that productivity growth actually slowed earlier and faster than previously forecast. With this additional evidence, we have made a downward adjustment to our productivity estimates over the coming years, with labour productivity levels around 2% lower than in the *Half Year Update*. Lower productivity contributes to a downward revision in real GDP over the next 5 years and, at the end of 2027/28, real GDP is 1.8 per cent lower than in the *Half Year Update* (see Figure 3).

The weaker cyclical state of the economy, combined with moderating price pressures and lower trend GDP growth flows through to weaker growth in nominal GDP. Compared to the *Half Year Update*, the cumulative level of nominal GDP over the 5 years to June 2028 is $42.8 billion lower.

…contributing to lower tax revenue

The now-weaker picture of GDP over 2023 and the somewhat faster decline in inflation are consistent with the slowing in tax revenue over the past couple of months, while the weaker growth outlook has implications across the period to June 2028. Overall, compared to the *Half Year Update*, tax revenue in this scenario is cumulatively $13.9 billion lower in the 5 years to 2027/28.

Weaker growth in nominal GDP drives the change in expected tax revenue. Source deductions revenue is expected to decrease – mainly owing to a weaker wage growth outlook in the scenario, which has follow-on implications for fiscal drag.[1] Stats NZ's recent downward revision to estimates of net operating surplus and slower growth in the scenario sees a reduction in business income tax. Meanwhile, weaker private consumption negatively impacts GST.

Uncertainty remains

The economic and tax outlook is inherently uncertain, with many, often unpredictable, domestic and global forces affecting economic conditions that ultimately influence tax revenue. Our recent analysis of forecast uncertainty highlights the significant disruption to economic relationships that occurred during the pandemic period and how this has contributed to greater deviations between forecast and actual outcomes. Although uncertainty has diminished as the effects of the pandemic and other shocks have receded, considerable uncertainty remains around the outlook for activity and inflation. With the economy nearing a turning point, there is elevated uncertainty about the economic and fiscal outlook, as illustrated by large revisions in recent updates.

There are several key uncertainties around the economic outlook. The path of non-tradables inflation remains a source of uncertainty for both the international and domestic outlooks. The impacts of past policy tightening on household spending are a further source of uncertainty, as illustrated by September's unexpectedly sharp slowdown. Other sources of uncertainty include the outlook for and economic impact of net migration, as well as prospects for productivity growth.

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1 Fiscal drag occurs when wage growth moves more taxpayers into higher tax brackets, thereby increasing income tax as a share of income across the economy.