Office of the Minister of Finance

Chair
CABINET

SETTING A FISCAL STRATEGY

Proposal

1. This paper seeks approval for high level options regarding future budgets and fiscal parameters to address the deteriorating fiscal situation.

Executive Summary

2. The 2009 Budget has three main parts:

- helping New Zealanders through the current crisis;
- putting in place longer-term initiatives to lift productivity, improve competitiveness and sharpen New Zealand's future economic performance; and
- making the first steps towards fiscal consolidation (i.e., changes to tax and spending plans) and implementing changes in policy to ensure that the growth in Government debt is minimised.

3. The emphasis to date has been on softening the immediate impact of the global downturn. Fiscal stimulus is large and will help sustain the economy for a period.

4. The Government is facing a deteriorating fiscal position with forecasts of persistent operating deficits and rising debt-to-GDP. These forecasts are unacceptable given rising debt servicing costs, the need to prepare for future fiscal pressures, and the inequity of placing a higher debt burden on future generations without a corresponding increase in productive assets.

5. This paper sets out a fiscal plan that strikes a balance between supporting economic activity in the short-term while ensuring a prudent fiscal position over the medium-term.

6. Starting on a measured path of fiscal consolidation will involve some reduction in fiscal stimulus and GDP. However, the alternative is to let debt-to-GDP rise to levels that result in negative impacts on the economy. This is because New Zealand is reliant on foreign capital inflows. A loss of confidence in our ability to restore a prudent level of public debt could see a loss of investor confidence with an increase in the cost of borrowing and reduced access to external financing. This could impose sharp and painful reductions in GDP.

7. Ahead of the event it is difficult to identify the exact triggers for a credit downgrade or what constitutes a sufficient fiscal policy response. Nonetheless, credit rating agencies and international investors will look at the extent to which New Zealand's fiscal position is out of line with other economies, both now and into the future. They will also look at our ability to make decisions to remedy the fiscal position. We have already made decisions for Budget 2009 regarding savings and a lower operating allowance. The fiscal response set out in this paper further demonstrates a commitment to make hard decisions.

8. Waiting and seeing is not an option. Treasury has prepared alternative economic and fiscal scenarios to gauge the size of the policy challenges and the robustness of policy response across different economic environments. One scenario has a less pronounced recession with a faster rebound. Under this favourable, but less probable economic scenario, a wait-and-see policy approach has gross debt around 54% of GDP toward the end of the projection horizon.

9. The recommended fiscal policy response comprises: delaying the second and third tranches of tax cuts; suspending required capital contributions to the New Zealand Superannuation Fund until we return to operating surpluses (but making a contribution to the Fund in 2009/10 of $250 million, with future amounts subject to annual review); a permanent change in the budget operating allowance from $1.75 billion to $1.10 billion from Budget 2010.

10. The proposed fiscal response, under current preliminary Budget forecasts, "bends back" the path of debt-to-GDP so that it peaks at around 45% in the medium term and falls toward 35% by the end of the projection period. The final form and path of the long-term fiscal objectives, including that for debt, will be specified in the 2009 Fiscal Strategy Report.

11. Treasury will finalise its fiscal forecasts in early May and so the projections of debt-to-GDP presented here are subject to revision. The fiscal parameters in the policy response have been selected to provide some buffer to downward revisions (i.e., debt-to-GDP increasing as a result of changes in economic forecasts).

12. Faced with high levels of uncertainty, we may need to respond further if the world situation worsens and the New Zealand fiscal position deteriorates further.

13. The complete fiscal strategy, including revised long-term fiscal objectives, an increased focus on the balance sheet and risks, and long-term fiscal projections, will be presented in the 2009 Fiscal Strategy Report to be published at the time of the Budget.

The 2009 Budget Policy Statement and the Budget 2009

14. The New Zealand economy has recently posted its fourth consecutive quarter of falling Gross Domestic Product (GDP). The drought of 2007/2008 and the adjustment of the housing sector meant the economy was already in recession before the current global financial and economic downturn began to unfold. Although New Zealand has avoided the direct financial turmoil seen in other countries in the form of banking sector difficulties, we are being detrimentally affected by the worldwide recession. Treasury's December 2008 Forecasts indicated that the recession was going to have a significant impact on the fiscal position.

15. In the 2009 Budget Policy Statement (BPS) we argued that the appropriate response, for a time, is to allow the fiscal position to bear its share of the burden of the downturn, rather than immediately raising taxes and/or cutting expenditure in response. The tendency for tax revenue to fall, and unemployment spending to increase during a recession helps to buffer the economy. Gauging the size of these stabilising effects is problematic in such an uncertain environment although Treasury considers that they are operating now and in the near-term.

16. In addition, discretionary fiscal policy changes in the form of reduced tax rates and Government infrastructure spending are providing fiscal stimulus. Treasury estimates at the time of the December forecasts indicated that fiscal impulse would be around 3.5% of GDP in the year ending June 2009 and around 1.6% of GDP in the year ending June 2010. Cuts of 5.25% in the Official Cash Rate (OCR) in a little over six months have provided significant monetary policy stimulus.

17. Nonetheless, our judgment in the BPS was that the projections of debt-to-GDP rising to over 50% were outside the range considered prudent in light of rising debt servicing costs and preparation for the future fiscal pressures associated with rising superannuation and health expenditure. Accumulating debt places a burden on future generations and this is inequitable when not matched by an equivalent increase in productive assets.

18. The BPS stated that the Government would take steps to ensure debt and net worth did not deteriorate to the extent projected. Our initial steps to deal with these challenges were to:

- Establish the true nature of the fiscal risks that exist.

- Where possible, drop unfunded commitments made by the previous Government.

- Establish a Budget process for 2009 that is limited to the immediate priorities of the incoming Government and any emergency pressures.

- Halt the growth in the number of people employed in back office government administration.

19. We have completed these steps but now need to do more. The BPS indicated an operating allowance of $1.75 billion for Budget 2009 and an increase in the capital allowance from $900 million to $1.45 billion. The phasing of that capital spending has been adjusted to bring forward infrastructure priorities. Budgets 2010 to 2012 were to have the same capital allowance and Budget 2013 would increase the capital allowance to $1.65 billion.

20. The Cabinet Strategy Committee Paper, *2009 Budget Package*, proposes a revised operating allowance of $1.45 billion per annum (including a contingency) for the 2009 Budget. This still allows for new spending close to $2 billion because we have made sufficient savings. This change in the net operating allowance is relatively small in terms of affecting aggregate demand in the economy, but will represent a first step in establishing a credible fiscal response.

Preliminary Treasury Forecasts for Budget 2009

21. The Treasury has recently completed preliminary forecasts for Budget 2009. Given the high degree of uncertainty regarding the path of the economy and the implications of this for setting fiscal strategy, Treasury has developed two alternative economic scenarios to help with decision making.

Table 1 - Economic variables: Preliminary Budget Update and alternative scenarios

	Faster rebound	Preliminary Budget Update	Protracted downturn
Level of real GDP relative to December main forecast (in 2013)	-3%	**-4.6%**	-7%
Cumulative difference in nominal GDP relative to December main forecast (over the years 2009 to 2013)	-$13b	**-$54b**	-$98b
Quarters of recession (where December 2007 was peak)	5	**7**	8
First quarter of GDP growth	June 2009	**December 2009**	March 2010
Quarters to return to December 2007 real GDP	9	**14**	16
Unemployment rate (peak quarter)	6.3%	**8.0%**	9.6%

22. From the income perspective, nominal GDP largely comprises wages, salaries, and the profits of firms. These aggregates, together with consumption expenditure, represent the major components of the tax base and so tax revenues (i.e., PAYE, company tax, GST). Therefore, changes in nominal GDP directly influence tax revenues and the operating balance. Over the 2009 to 2013 March years, the preliminary Budget forecasts have nominal GDP a cumulative $54 billion below the December Forecast main scenario ($28 billion below the December Forecast downside scenario).

23. The first alternative economic scenario features a less pronounced recession with a faster rebound, but still with lower levels of real and nominal GDP relative to the December Forecasts. This scenario is closer the Reserve Bank's March Monetary Policy Statement. The second alternative scenario features a more protracted downturn with substantive losses in real and

nominal GDP. The opening up of large output gaps between actual GDP and trend GDP is a theme of the IMFs current forecasts for advanced economies.

International Fiscal Policy Responses

24. Around the world governments have announced packages of tax cuts and spending increases to support their domestic economies. These discretionary measures, in combination with the effects of the recession on government revenues and transfer spending have had substantial impacts on fiscal deficits and debt ratios.

25. In its yet-to-be published World Economic Outlook (WEO), the IMF is forecasting public debt ratios over the next few years to increase by around 30% of GDP in large countries that have been significantly affected by the financial sector crisis (e.g., US, UK and Japan) and by around 15% of GDP across the smaller Euro countries.

26. The temporary nature of fiscal stimulus packages and stated (or assumed) fiscal plans means that in some countries debt-to-GDP is forecast to stabilise and start to decline over the medium-term. In some cases the rapid and marked deterioration in fiscal balances is placing a limit on the scope for further fiscal stimulus (e.g., UK) or inducing fiscal consolidation (e.g., Ireland). Ireland has experienced banking sector difficulties and a sharp contraction of GDP. Supplementary budgets are aiming to keep the fiscal deficit under 10% of GDP. The cost of borrowing has risen and Standard and Poor's have recently downgraded Ireland's credit rating from AAA to AA+ (negative outlook).

27. The persistent deficits and sustained increase in debt-to-GDP projected for New Zealand reflect the structural nature of past increases in spending and the permanent change in tax cuts going ahead. The downside scenario in the December Forecasts showed debt increasing by over 50% of GDP by the end of the projection period (2022/23).

New Zealand's Fiscal Policy Response

28. Fiscal stimulus is in train to help sustain the economy for a period. Based on OECD information, fiscal easing in New Zealand is at the more expansionary end of what is being carried out internationally. The extent of discretionary fiscal stimulus, particularly in the year ending June 2009, represents an appropriate response to the circumstances facing New Zealand. This assessment is based on a view that there is still further scope for monetary policy to play a role and the specific factors facing New Zealand.

29. My statements in the BPS that the projected path of debt-to-GDP is outside the range the Government considers prudent means that over the next three to five years fiscal policy needs to change. Fiscal stabilisers will continue to play a supporting role. However, the structural fiscal deficit needs to decline to ensure a stable debt ratio over the medium term. Supporting the economy in the short-term while working towards a stable debt ratio will help maintain access to external financing and provide a greater degree of certainty about future tax and spending levels for households and firms.

30. Three considerations have been used in developing an appropriate fiscal response: external financing issues; the effect of fiscal policy on aggregate demand; and the need to maintain a degree of fiscal flexibility in the face of considerable uncertainty.

External Financing Issues

31. In January, Standard and Poor's revised their outlook on New Zealand's sovereign AA+ rating from stable to negative, and highlighted the need for this year's Budget to present a credible fiscal consolidation plan. That warning was based on a much better fiscal outlook than we face today. Moody's, in a recent visit, conveyed a similar message.

32. New Zealand is reliant on foreign capital inflows and the funding structure of our banks is on a relatively short term basis. Almost 40 per cent of bank funding is from abroad, and around 70 per cent of government bonds are held abroad (and the majority of new buyers are likely to be foreign).

33. Continued disruptions in global financial markets might hamper access to external financing. But the Government's own actions can play a role. A loss in confidence that New Zealand fiscal policy will move back to a prudent debt path could see a loss of investor confidence in banks or the government. This could lead to an increase in the cost of borrowing and/or reduced availability of external financing. This in turn would require a sharper and more painful economic adjustment. This argues for the need to maintain fiscal sustainability and a strong sovereign credit rating.

34. Adjustments to credit ratings, credit access and credit cost are likely to occur in steps as new information comes to hand, policy responses are adjusted, and investors reassess the situation. Ahead of the event it is difficult to identify the exact triggers for a downgrade or the thresholds for what constitutes a sufficient policy response. But there are some pointers:

- The extent to which New Zealand's fiscal position looks out of line with other economies. New Zealand has the benefit of starting from a relatively low level of public debt-to-GDP. As noted above, countries that have been badly affected by financial sector turmoil are facing large increases in public debt ratios. However, in contrast to the temporary nature of fiscal deteriorations overseas, New Zealand's deficits are more persistent and debt-to-GDP does tend to stabilise.

- The extent to which we demonstrate the ability to make decisions to remedy the fiscal position. We have already made decisions for Budget 2009 regarding savings and a lower operating allowance. The fiscal response set out below further demonstrates a commitment to make hard decisions.

Effects on Aggregate Demand and GDP

35. Speed, timing and composition, will, together with the state of the economy, market perceptions and interest rates, determine the GDP effects of fiscal consolidation. Expansionary effects of a fiscal consolidation might occur if avoidance of a significant fiscal deterioration had favourable effects on confidence, investor sentiment and interest rates. However, at least in the short-term we would expect some contractionary effects on aggregate demand and GDP.

Ability to Adjust Fiscal Policy

36. The uncertainty surrounding the economic outlook argues for a fiscal policy response that reacts to new information while at the same time recognising the possibility that if the economic outlook is worse fiscal plans need to be changed.

37. New Zealand's low level of government debt and fiscal adjustments in the past afford us some up-front credibility. Working against this is the size of the projected fiscal deterioration, external financing issues and the longer-term fiscal challenges.

Recommended Option

38. I am proposing an option that balances the need to improve the medium-term fiscal position, steer the economy through the recession, position New Zealand for recovery and deliver on Government priorities and commitments over time. The main features of this option are as follows:

- The intent of the New Zealand Superannuation Fund, reflected in the current long-term objective for the operating balance, was that contributions be met from operating surpluses across the economic cycle. Consistent with this I propose suspending the required capital contributions until we return to operating surpluses. This option also reduces the risk that additional investment brings to the Government's finances, especially when this investment is debt funded. The funding arrangement means that capital contributions will be higher than otherwise when contributions restart. Suspending contributions to the New Zealand Superannuation Fund reduces the borrowing requirement (and so gross debt) and has little impact on aggregate demand. However, the lower path of gross debt is associated with a reduced path of financial assets so that "net debt" is unchanged.[1] This means the benefits from this action are in reducing borrowing.

- When the New Zealand Superannuation Fund was established the then government noted its intention to make contributions to the Fund from available surpluses. It also noted that where these were insufficient for making the required contribution a reduced contribution could be made. The economy is now facing a long period of persistent deficits. Nonetheless I propose making a contribution to the New Zealand Superannuation Fund in 2009/10 of $250 million, with the aim of this being directed into New Zealand based investments. We will consider whether we make any further contributions on an annual basis.

- In order to achieve this objective, we will need to accept that investing this $250 million within New Zealand would be a high-level intention that the Super Fund Guardians would need to have regard to, rather than a firm direction about how this contribution is used. Ultimately it will be up to the Guardians how much action they take in reaction to the direction. However, any firmer direction than this may require legislative change.

- Notwithstanding the Government's goal of reducing taxes over time, the second (2010) and third (2011) tranches of the planned tax cuts be delayed until such time as economic and fiscal conditions allow a reconsideration.

- Consistent with the delay of tax cuts, the fiscal projections include the effects of not changing the tax system in response to rising wages (i.e., where rising incomes shift people into higher tax brackets – so-called "fiscal drag"). As a result, "fiscal drag" will see a rise in tax-to-GDP until we make decisions to further progress our tax strategy.

- A permanent change in the budget operating allowance from $1.75 billion to $1.10 billion from 2010/11, growing with inflation. The operating allowance is a net concept so that we can progress a larger quantum of government priorities if savings are made elsewhere. Our ongoing commitment to carefully examining all Government spending is likely to generate opportunities for this sort of reallocation.

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[1] Net debt here is defined as including the New Zealand Superannuation Fund.

39. The table below sets out medium-term fiscal projections of this option compared to a Baseline case across the three economic scenarios. This comparison allows us to gauge the size of the policy challenges and the robustness of responses across different economic environments.

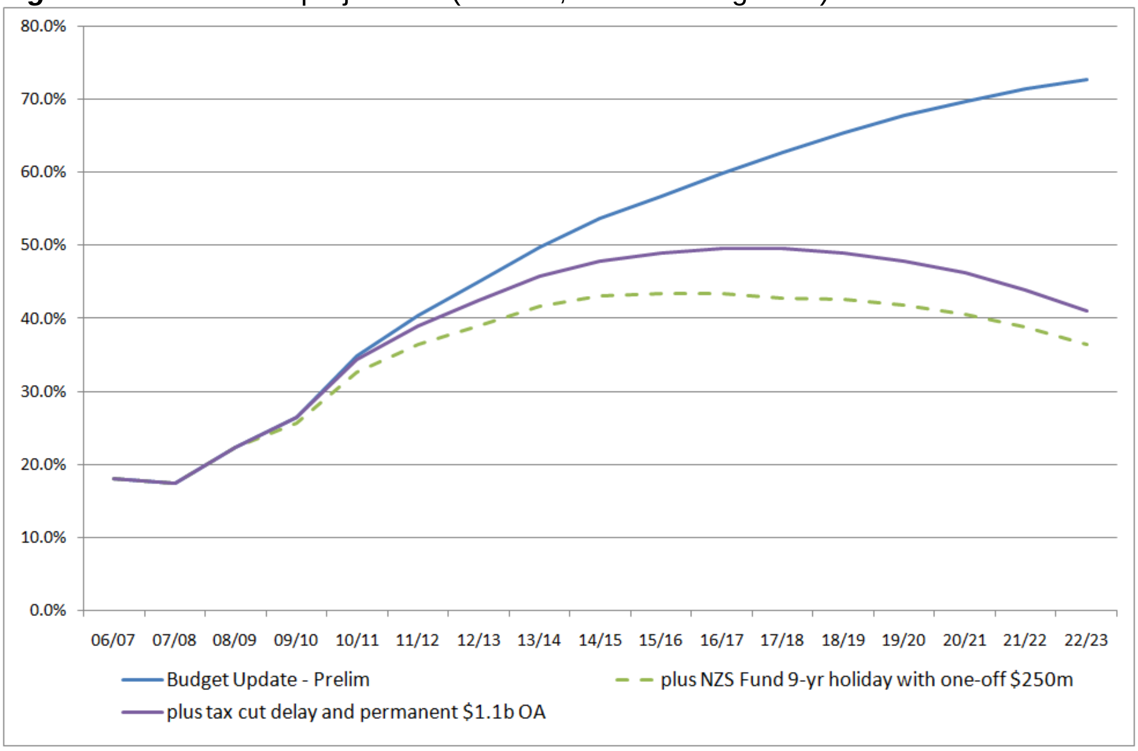
Table 2 – Projected fiscal indicators under alternative economic and fiscal scenarios*

	Economic scenario		
Fiscal response	**Faster rebound**	**Preliminary BEFU**	**Protracted downturn**
Baseline (Wait-and-see)	Gross debt at 54% and starting to stabilise. Persistent operating deficits.	Gross debt at 73% in 2023 and trending up. Persistent operating deficits.	Gross debt at 114% in 2023 and trending up. Persistent operating deficits.
Recommended option**	Gross debt peaks at around 30% and reaches 18% in 2023. Operating deficits for six years.	Gross debt peaks at around 44% and reaches 37% in 2023. Operating deficits for nine years.	Gross debt at 77% in 2023 and trending up. Persistent operating deficits.

* Gross debt as a % of GDP. Gross debt is defined as Gross Sovereign Issued Debt less Reserve Bank settlement cash (part of monetary policy) and Reserve Bank bills (part of liquidity policy).

** Includes a one-off $250 million contribution to the New Zealand Superannuation Fund in 2009/10.

Figure 1 – Gross debt projections (% GDP, Years ending June)



40. Treasury will finalise its fiscal forecasts in early May and so the forecasts and projections of debt-to-GDP presented here are subject to revision. The fiscal parameters in the policy response have been selected to provide some buffer to downward revisions.

41. Looking across the fiscal responses and alternative scenarios indicates that:

- There is not a strong case for adopting a wait-and-see approach. Even under a more favourable, but less probable economic scenario, a wait-and-see approach has gross debt around 54% of GDP toward the end of the projection horizon.

- The balance of risks across the economic scenarios also argues against adopting a wait-and-see approach. There is a possibility that a modest fiscal consolidation may have to be adjusted upward through time. However, if we take no action and the economic situation deteriorates, then the ultimate response will be larger and more difficult to implement.

- The recommended option reflects the considerable uncertainty we face. It seeks to stabilise debt in line with the intent of the BPS. Nonetheless, the financing requirement is large. The debt path leaves a reduced buffer for future shocks and represents a reasonably large deviation from previous levels of prefunding (expressed in terms of net financial assets including those of the New Zealand Superannuation Fund).

- The permanent reduction in operating allowances is the main driver of changes against the Baseline. This is due to the cumulative effect of operating allowances. Maintaining $1.10 billion operating allowances will be challenging. This is especially the case during the recovery phase. In addition, while it may be possible to run low operating allowances for a period, a build-up of operating pressures (some related to new capital spending) might require future adjustments to the size of the allowance in-conjunction with baseline savings.

- There may be some contractionary effects on aggregate demand and GDP relative to previous forecasts. However, the fiscal stimulus is still likely to be substantial and sufficient in the near term when the economy is weakest. Although some contractionary effects are possible, monetary policy settings will (all else equal) be easier than otherwise.

- Any additional fiscal response will be conditional on monitoring the path of the economy (i.e., potential shifts between states of the world) and setting milestones for fiscal consolidation.

The 2009 Fiscal Strategy Report

42. The 2009 Fiscal Strategy Report, to be published with the 2009 Budget, will set out the complete fiscal strategy, including an increased focus on balance sheet issues, the drivers of past fiscal outcomes, together with the formal reporting requirements set out in the Public Finance Act 1989 (e.g., revised long-term fiscal objectives, potentially including net debt, and fiscal projections).

Financial Implications

43. This paper proposes a series of changes to Budget operating allowances and other fiscal parameters to address forecasts of a deteriorating fiscal situation and prevent an ever-rising rising debt-to-GDP ratio.

Other Implications

44. There are no Treaty of Waitangi, human rights, gender or disability implications. A Regulatory Impact Statement is not required.

Recommendations

45. The Minister of Finance recommends that Cabinet:

1 **note** the statements in the 2009 Budget Policy Statement regarding the unacceptability of persistent operating deficits and increasing gross debt-to-GDP.

2 **note** that setting fiscal plans involves balancing a range of factors, including an improvement in the medium-term fiscal position, steering the economy through the recession, positioning New Zealand for recovery and delivering on priorities and commitments over time.

3 **note** the need to agree to these fiscal plans now so they can be factored into Budget forecasts.

4 **agree** to the following changes to fiscal plans so that gross debt-to-GDP peaks at around 45% over the medium-term:

5 **revise** the operating allowance to a maximum of $1.1 billion from 2010/11, growing by the rate of inflation.

6 **suspend** contributions to the New Zealand Superannuation Fund for the period until the operating balance returns to surplus.

7 **make** a contribution to the New Zealand Superannuation Fund in 2009/10 of $250 million, with the aim being this is directed into New Zealand based investments. We will consider on an annual basis whether we make any further contributions.

8 **delay** the second and third tranches of the planned tax cuts in 2010 and 2011.

9 **note** that the complete fiscal strategy, including revised long-term fiscal objectives, an increased focus on the balance sheet and risks, and long-term fiscal projections, will be presented in the 2009 Fiscal Strategy Report to be published at the time of the Budget.

Hon Bill English
Minister of Finance