The Treasury and
Office of the Minister of Finance

Budget 2019 Information Release
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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Fiscal Strategy for 2019 Wellbeing Budget

Date:	20 March 2019	**Report No:**	T2019/628
		File Number:	BM-2-9-5-2019

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Provide** feedback on Budget allowance settings to inform materials for the Budget Ministers 2 meeting and the final economic forecasts.	We have a meeting with you on **Thursday 21 March** to discuss this report.

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Ben Gaukrodger	Senior Analyst, Macroeconomic and Fiscal Policy	[39]	N/A (mob)	✓
Renee Philip	Manager, Macroeconomic and Fiscal Policy	[39]	[23]	

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Fiscal Strategy for 2019 Wellbeing Budget

Executive Summary

This report provides you with the Treasury's fiscal strategy advice ahead of the 2019 Wellbeing Budget. The advice is based on preliminary Budget Economic and Fiscal Update 2019 forecasts and is intended to help you take decisions on Budget allowances.

Preliminary fiscal forecasts show the Government is on track to meet the Budget Responsibility Rules (BRRs). However, there is less forecast headroom against the net debt rule than at the *Half Year Economic and Fiscal Update* (HYEFU), and little room to increase allowances while still meeting this rule.

Funding sought and recommended by the Treasury's Vote teams greatly exceeds the allowances assumed in the HYEFU. This means there are hard choices around how much to spend in Budget 2019 as well as the approach to managing Budget 2020 and meeting the BRRs. You face a trade-off between maintaining a buffer against the BRRs and investing now in wellbeing-enhancing initiatives and addressing significant cost pressures.

We recommend a moderate increase in the Budget 2019 operating allowance to enable spending that is aligned with Wellbeing Budget priorities. We also recommend that a significant proportion of the multi-year capital allowance (MYCA) be used in Budget 2019, and that the overall MYCA be increased moderately to support investment in future Budgets. This will help to build a pipeline of capital initiatives, which in turn should support the readiness of the private sector to help deliver these initiatives.

Without an increase in allowances, and given the large number of pre-commitments, the predominant focus of the Budget would be on high-risk cost pressures and spending necessary to meet legislative commitments, rather than enabling a wider wellbeing focus.

Our recommendation to moderately increase allowances to progress measures aligned to Wellbeing Budget priorities is consistent with maintaining a sustainable fiscal outlook and macroeconomic stability. However, increased spending in Budget 2019 will reduce headroom for spending in Budget 2020. Increasing spending at Budget 2019 will also make it challenging to achieve the BRR to reduce net debt to 20 percent of GDP within five years of taking office. Forecasts have yet to be finalised, but it is likely that a moderate increase in allowances will show net debt slightly above 20 percent of GDP in 2021/22 and slightly below 20 percent in 2022/23. There is a wide margin of uncertainty around such forecasts.

It is important to have a fiscal anchor that ensures public debt is maintained at prudent levels. We recommend focusing on maintaining a sustainable trajectory for public debt over the medium term, but consider it undesirable to focus on managing net debt to a precise figure in one particular year as doing so can lead to sub-optimal investment choices. Maintaining net debt *around* 20 percent of GDP provides a prudent buffer against future shocks and, as long as there is a credible and sustainable fiscal trajectory, small fluctuations in the level of net debt relative to the 20 percent target are not economically significant. Consequently, small fluctuations are also unlikely to generate any adverse response from investors and credit rating agencies.

Capacity pressures are placing constraints on the pace of spending across the public sector, particularly for construction projects. Although there is uncertainty about the capacity constraints, we judge that a moderate increase in spending allowances can likely be accommodated without unduly risking delays or significantly exacerbating cost pressures. Sequencing projects would also help to build a pipeline of projects that provides greater planning certainty to the private sector. The capital package recommended by the Treasury is forecast to be spent over ten years, reflecting planning times and expected sector capacity.

Increasing government spending will add to aggregate demand in the economy and place upward pressure on interest and exchange rates. However with interest rates very low and core inflation contained, the Reserve Bank has indicated that the Official Cash Rate will remain at an expansionary level for some time. Therefore, a fiscal impulse from greater government spending would be broadly supportive of monetary policy in maintaining macroeconomic stability, although increased government spending also risks crowding out private investment.

To aid your consideration, the report sets out three scenarios illustrating different ways in which you may choose to increase allowances. We consider each of the scenarios, set out in Table 1 below, to be fiscally sustainable.

Table 1: Allowances in different scenarios (direct impacts only)

Scenario	Net debt in 2021/22 (% of GDP)	Net debt in 2022/23 (% of GDP)
Base scenario: operating and capital allowances as at the BPS, with $2.2 billion of the $8.9 billion remaining in the MYCA allocated in Budget 2019	19.6%	18.0%
Scenario 1: Budget 2019 operating allowance increases by $0.9 billion. Capital allocation of $6.3billion in Budget 2019.	20.2%	18.7%
Scenario 2: Budget 2019 operating allowance increases by $0.9 billion and MYCA increases by $1.7 billion. Capital allocation of $6.3 billion in Budget 2019.	20.4%	19.1%
Scenario 3: Budget 2019 and Budget 2020 operating allowances increase by $0.9 billion and MYCA increases by $1.7 billion. Capital allocation of $6.3 billion in Budget 2019.	20.9%	19.8%

The 2019 *Budget Policy Statement* signalled that the Government will provide more detail about its post-2021/22 fiscal strategy at Budget 2019. Despite the limited fiscal headroom in the near term, there is considerable fiscal headroom projected beyond 2021/22. A credible commitment to maintain debt within a prudent range in the medium term could help to manage risks with meeting the current debt rule. The Treasury will provide advice on future fiscal rules before the Budget.

Recommended Action

We recommend that you:

a **note** preliminary 2019 BEFU economic forecasts continue to show a stable economic outlook, but that tax revenue is expected to be lower than forecast at HYEFU;

b **note** that a Budget package delivered within existing allowances will include a limited number of initiatives that progress your Budget priorities, and that your current draft Budget package exceeds existing allowances;

c **note** that you will need to manage significant cost pressures in subsequent Budgets, and that decisions on initiatives for Budget 2019 should be considered with those pressures in mind;

d **note** that we recommend a moderate increase in the operating allowance for Budget 2019 to enable spending aligned with your priorities for the Wellbeing Budget;

e **note** that we recommend a significant proportion of the multi-year capital allowance be used in Budget 2019 to help build a pipeline of capital initiatives, and that the overall multi-year capital allowance be increased moderately;

f **note** that there is scope for a moderate increase to Budget allowances while maintaining fiscal sustainability given that there is already a prudent buffer against future shocks and operating surpluses put debt on a downward trajectory;

g **note** that increasing allowances comes with some delivery risk given capacity constraints, but these can be managed by keeping allowance increases modest and sequencing and prioritising projects;

h **note** that the extent to which you can increase allowances will depend on choices about how much buffer to retain against the net debt rule;

i **note** that we have provided three scenarios for allowance settings, which illustrate alternative allowance levels for your consideration, and we can work with you to finalise these allowances;

j **discuss** allowance settings with the Treasury at the Budget Matters meeting on 21 March, to inform materials for the Budget Ministers meeting on 25 March; and

k **note** that the Treasury will report to you before Budget with advice about the fiscal strategy post-2021/22.

Renee Philip
Manager, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal Strategy for 2019 Wellbeing Budget

Purpose of Report

1. This report sets out the Treasury's fiscal strategy advice for Budget 2019, the Wellbeing Budget. The advice is intended to help you take decisions on Budget allowances.

2. The advice is based on the preliminary *Budget Economic and Fiscal Update* 2019 (BEFU) forecasts, and takes into account progress against your fiscal strategy and opportunities to progress your Budget priorities.

The Fiscal Context for Decisions in the 2019 Wellbeing Budget

3. When deciding budget allowances, key considerations include the affordability of increased spending, the value of spending opportunities, the feasibility of departments delivering increased spending, whether increased spending is fiscally sustainable, and whether increased spending supports macroeconomic stability. The affordability of increased spending depends on the tax revenue the Government expects to receive which is largely driven by the outlook for nominal GDP.

Economic growth remains solid but the outlook has deteriorated slightly since the Half Year Update

4. We recently reported to you on the Treasury's preliminary BEFU 2019 economic forecasts [T2019/381 refers]. As highlighted in Table 2 below, those preliminary forecasts show **that the economic outlook remains stable**. The economy continues to expand at a pace that is close to trend, supported by population growth, government spending, accommodative monetary policy and solid growth abroad.

5. However, **nominal GDP is expected to be a cumulative $6 billion lower over the forecast period than at HYEFU**, after adjusting for historical revisions. As a result, preliminary tax forecasts are lower than at HYEFU. This change reflects mixed economic data since the HYEFU forecasts were finalised that point to a slightly softer near-term domestic growth outlook. Nominal GDP growth is supported by a rising terms of trade and inflation around 2 percent.

Table 2: Comparison of Key Economic Indicators between HYEFU and Preliminary BEFU Forecasts

June years		2018 Actual	2019 Forecast	2020 Forecast	2021 Forecast	2022 Forecast	2023 Forecast	5-year total
Economic growth[1]	**Prelim BEFU**	**3.1**	**2.5**	**2.9**	**2.7**	**2.5**	**2.4**	
	HYEFU	2.7	2.9	3.1	2.7	2.5	2.3	
Economic growth per capita[1]	**Prelim BEFU**	**1.1**	**0.8**	**1.4**	**1.4**	**1.3**	**1.2**	
	HYEFU	0.7	1.1	1.5	1.4	1.2	1.2	
Unemployment rate[2]	**Prelim BEFU**	**4.4**	**4.2**	**4.2**	**4.2**	**4.3**	**4.3**	
	HYEFU	4.4	4.1	3.9	4.0	4.1	4.1	
CPI inflation[3]	**Prelim BEFU**	**1.5**	**1.9**	**2.0**	**2.0**	**2.0**	**2.0**	
	HYEFU	1.5	2.0	2.0	2.0	2.0	2.0	
Current account balance[4]	**Prelim BEFU**	**-3.4**	**-3.6**	**-3.4**	**-3.3**	**-3.3**	**-3.5**	
	HYEFU	-3.4	-3.5	-3.6	-3.6	-3.6	-3.7	
Nominal GDP[5]	**Prelim BEFU**	**5.5**	**4.1**	**5.4**	**5.2**	**4.8**	**4.6**	
	HYEFU	5.5	4.3	5.6	5.1	4.7	4.5	
Nominal GDP[5] ($billions)	**Prelim BEFU**	**288.4**	**300.1**	**316.5**	**332.9**	**348.8**	**364.8**	
	HYEFU	289.3	301.8	318.6	334.9	350.6	366.3	
	change	**-0.9**	**-1.7**	**-2.1**	**-2.1**	**-1.8**	**-1.5**	**-9.1**
	adj. change[6]	**-**	**-1.1**	**-1.5**	**-1.5**	**-1.2**	**-0.9**	**-6.2**

1. Production GDP, annual average % change 2. June quarter 3. Annual % change 4. Annual as % of GDP
5. Expenditure measure 6. Change adjusted for starting point revisions to historical GDP data

Preliminary fiscal forecasts are in line with economic and tax forecasts…

6. We recently reported to you on the Treasury's preliminary 2019 BEFU fiscal forecasts [T2019/741 refers]. As highlighted in Table 3 below, these preliminary forecasts show that the Government remains on track to meet its Budget Responsibility Rules (BRRs). The operating balance before gains and losses (OBEGAL) remains in surplus over the forecast period growing to $7.9 billion by 2022/23 (2.2 percent of GDP). Net core Crown debt is forecast to fall below 20 percent of GDP by 2021/22 (19.6 percent of GDP) and to 18.0 percent by 2022/23.

... while you are on track to meet your fiscal rules, fiscal headroom is limited …

7. Compared with HYEFU, the forecast OBEGAL and net debt positions are slightly weaker across the forecast period. This primarily reflects the slightly weaker economic forecasts discussed above, which have lowered forecast tax revenue by a cumulative $1.5 billion over the forecast period.

8. The net debt rule is the most binding of your BRRs over the next few years – there is less headroom against the debt rule than at HYEFU, and little room to increase allowances while still meeting the debt rule. Paragraphs 46-51 discuss scenarios with higher allowance levels and their impact on forecast net core Crown debt.

Table 3: Key Fiscal Indicators in Preliminary BEFU Forecasts

June Years	2018/19	2019/20	2020/21	2021/22	2022/23
% of GDP					
Net core Crown debt	20.6	20.7	20.5	19.6	18.0
Total Crown OBEGAL	0.6	0.7	1.1	1.8	2.2
Core Crown expenses	29.4	28.9	28.8	28.3	28.2

9. The preliminary BEFU fiscal forecasts incorporate the preliminary economic and tax forecasts and updated forecasts of spending from departments, and include the operating and capital allowances as set in your 2019 *Budget Policy Statement* (BPS).

10. The BEFU 2019 economic and fiscal forecasts will likely change between now and finalisation to account for changing risks, new data and policy decisions. In particular, GDP data for the December 2018 quarter will be released on 21 March. The economic forecasts will be finalised on 11 April, and the fiscal forecasts will be finalised on 8 May. New economic data received since the preliminary forecasts were finalised suggests

that economic growth for 2018 will turn out modestly weaker than anticipated in our preliminary forecasts.

… and there are risks to the forecasts

11. Economic forecasts are inherently uncertain and faster or slower growth could have a material impact on the fiscal position. There are wide margins of uncertainty around forecasts 5 years ahead. While the Treasury's forecasts represent our best judgements given the information available and are, on average, near the midpoint of external economic forecasts, it is important to acknowledge that future forecasts and actual outturns are likely to differ from our current forecasts.

12. Alongside general forecast uncertainty there are also a range of specific risks to our economic and tax forecasts [T2019/381 refers], including:

    - **increasing global trade tensions** resulting in lower global demand for New Zealand exports;
    - **major adjustments in global financial and equity markets** hitting wealth levels, access to credit, and heightened investment uncertainty;
    - **capacity constraints:** the Treasury (and Reserve Bank) residential investment forecasts are at the top end of market forecasters, chiefly because we assume that urban development reforms and other policies will unlock capacity in the construction sector. Should this not occur or occur at a slower rate than assumed, this could lead to reduced economic activity and lower tax revenue;
    - **higher-than-forecast nominal wages** as a result of government policies targeted at low paid workers and wage settlements in the public sector, particularly if there is greater spill over to the private sector, and greater-than-expected capacity pressures in the labour market; and
    - **stronger (weaker) aggregate demand** due to net migration being higher (lower) than currently anticipated, particularly given uncertainty surrounding Stats NZ's new official measure of net migration.

13. If the above risks were to eventuate, real economic growth could be higher (lower) than forecast and result in higher (lower) tax revenue. To illustrate the potential magnitude of risks, the following scenarios demonstrate the forecasts' sensitivity to alternative scenarios for capacity and migration:

    - If capacity constraints in the economy are more binding than assumed in the central forecasts, the Government would have less fiscal space. A scenario with more binding capacity constraints (similar to the level of capacity constraints in 2004-2006) is estimated to reduce real GDP growth and lower nominal GDP across the forecast period. This would reduce tax revenue by around $1.4 billion over the forecast period.

    - If net migration is higher than assumed in the central forecasts, the Government would have higher tax revenue, although also greater expenditure pressures. A scenario with the total population growing by 33 000 more across the forecast period, compared with the central forecast, would lead to stronger real GDP growth, higher inflation, and higher nominal GDP across the forecast period by about $7 billion. This would increase tax revenue by about $2.9 billion over the forecast period. Expenditure pressures from higher migration are difficult to quantify.

14. Budget 2019 policy decisions and any potential tax reforms can also be expected to impact the economic forecasts. The nature of the economic impact will depend on the size, composition and timing of any policy changes, and will be incorporated in the final economic and tax forecasts.

15. Finally, alongside general forecast uncertainty there are known risks to the fiscal forecasts [T2019/741 refers].

The Outlook for the 2019 Wellbeing Budget

The funding sought in Budget 2019 greatly exceeds allowances…

16. We reported to you in February with an initial assessment of how funding sought during Budget 2019 compared with allowances [T2019/359 refers]. In summary, Ministers submitted Budget initiatives seeking $7.5 billion in operating funding per annum, and $14.5 billion of capital funding. In addition, Ministers identified savings opportunities through prioritisation initiatives of $567 million operating funding per annum. There have been minor changes to these amounts since then as the Budget package has evolved.

17. The current draft package being considered by Ministers totals $3.3 billion of operating expenditure per annum including pre-commitments ($2.5 billion excluding pre-commitments) and $6.3 billion of capital expenditure (excluding pre-commitments). Savings identified through prioritisation of $128 million in operating expenditure per annum are also included in this package.

Table 4: Allowances as per the 2019 Budget Policy Statement, before and after pre-commitments

$ billion	Budget 2019	Budget 2020	Budget 2021	Budget 2022
BPS operating allowance	2.4	2.4	2.4	2.4
Operating allowance after pre-commitments	1.6	2.25	2.4	2.4
Multi-year capital allowance	← 13.1 before pre-commitments 8.9 after pre-commitments →			

… but cost pressures will absorb most of the available allowances …

18. Based on our assessment of initiatives, cost pressures and non-discretionary initiatives (such as those addressing health and safety legislative requirements) would absorb almost all of the unallocated operating allowance if it remains unchanged. This reflects that a number of cost pressures have been deferred over multiple Budgets. If the Budget 2019 operating allowance remains unchanged, a number of cost pressures would need to be deferred to Budget 2020 and there would be a range of significant risks to service delivery.

19. We recommend that a significant proportion of the multi-year capital allowance (MYCA) be used to help build a pipeline of capital initiatives. Consistent with the intent of the MYCA, some departments (particularly Health and Education) have sought multiple years' worth of funding in Budget 2019. While a large amount of capital pressures are for cost pressures necessary to fund critical infrastructure and services, not all of this funding is required from Budget 2019.

20. You therefore face choices over how much of the MYCA to commit in this Budget, how much room is left for future Budgets, and whether to increase the overall MYCA to provide greater headroom for future Budgets. Decisions taken this Budget involve trade-offs between encouraging long-term forward planning (by committing more of the MYCA than is necessary to manage immediate pressures) and ensuring sufficient funding for future Budgets.

... which means that a Budget within current allowances will not include initiatives aligned with wellbeing priorities

21. Given pre-commitments and cost pressures, there is minimal scope for discretionary initiatives within current allowances. Accordingly, without changes to allowances it is highly unlikely that meaningful progress will be made against the Government's priorities for the Wellbeing Budget.

[33]

… and increased spending will drive further pressures over time

27. Increased spending will also drive cost pressures higher in future as the baseline grows. Accordingly, to maintain a sustainable fiscal position it will be necessary to manage pressures effectively by encouraging reprioritisation and changes to service delivery to ensure it is as efficient and effective as possible.

We recommend that you increase allowances for Budget 2019 to enable spending aligned with Wellbeing Budget priorities…

28. The Wellbeing Budget is focused on five Budget priorities, which were informed by evidence from the Treasury's Living Standards Framework (LSF) about where substantive opportunities exist to make a difference to wellbeing. Throughout the Budget process, significant emphasis has been placed on Ministers (and their agencies) working together to produce initiatives that are focused on the outcomes contained in the Budget priorities.

29. Components of the LSF have also been used to assess the impact that each initiative could have on wellbeing, and the timeframes when the impact of the initiative will begin to be visible. Most cost pressure initiatives will contribute to maintaining current levels of wellbeing, while other initiatives aim to increase levels of wellbeing.

30. Increasing allowances for Budget 2019 will enable you to manage cost pressures and progress investment opportunities that enhance wellbeing by delivering on the Government's Budget priorities. Based on our assessment of Budget bids [T2019/359 refers], increasing Budget allowances will have a positive effect on living standards, and this should outweigh the costs of marginally higher spending and debt.

...while maintaining a sustainable fiscal outlook

31. Our view remains that fiscal sustainability is a pre-requisite for wellbeing. It is important to have a fiscal anchor that ensures public debt is maintained at prudent levels. We recommend the focus be on maintaining a sustainable trajectory for public debt over the medium term. Maintaining net debt around 20 percent of GDP provides a prudent buffer against future shocks.

32. Forecasts have yet to be finalised, but it is likely that a moderate increase in allowances will lead to net debt being slightly higher than 20 percent of GDP in 2021/22 and then decrease in 2022/23. There is a wide margin of uncertainty around such forecasts.

33. We consider that keeping net debt *around* 20 percent of GDP is appropriate, especially while forecast operating surpluses and economic growth ensure that net debt as a percentage of GDP remains on a stable or downward trajectory. However it is undesirable to focus on managing net debt to a precise figure in one particular year. Small fluctuations in net debt are not economically significant, but they can have disproportionate influence on long-term investment decisions where there is a fixed-date point target for net debt. This is especially true if the target date is close.

34. Credit rating agencies and investors are unlikely to consider a small, temporary increase to net debt to materially impact on New Zealand's creditworthiness. This would, however, be conditional on increases to allowances being allocated to high-value initiatives, a clear ongoing commitment to a medium-term fiscal anchor, and effective communication of the change.

35. Accordingly, **there is scope to increase Budget allowances, and consequently net core Crown debt, while maintaining fiscal sustainability**. As set out in Table 3 above, net core Crown debt is forecast to be 19.6 percent of GDP in 2021/22 and 18.0 percent of GDP in 2022/23. This is in line with the BRRs, which include targeting a reduction in the level of net core Crown debt to 20 percent of GDP within five years of the Government taking office.

36. As such, the key choices for the Government are around how much buffer should be built in against the net debt rule and how strictly to interpret the BRRs.

37. The following section of this report sets out options for allowances that are fiscally sustainable and broadly consistent with the net debt BRR. However, if your priority is to ensure net core Crown debt is *below* 20 percent of GDP within five years of taking office, then it may be prudent to retain a buffer against changes in the forecasts. If this is your preference, we can provide more advice on your options for maintaining such a buffer. Such advice could consider various options including: lowering allowances; increasing savings from prioritisation within baselines; and other policy settings with fiscal impacts.

While the economy is stretched, there is capacity to deliver on additional government spending, albeit with some risks

38. We judge that a moderate increase in spending allowances can likely be accommodated without unduly risking delays or exacerbating capacity constraints. However, there is a risk of future spending by agencies being lower than forecast if this additional spending cannot be delivered.

39. Capacity pressures are placing constraints on the pace of spending across the economy, particularly for construction projects. It is more likely that initiatives will be achieved if projects are sequenced and priority is given to initiatives in sectors or regions where there is capacity. Sequencing projects would also help to build a pipeline of projects that provides greater planning certainty to the private sector. Policy measures that help to ease capacity constraints and improve productivity would also help to sustain growth and macroeconomic stability, as would measures that enhance the public sector's investment capacity and capability.

40. Consistent with this, the $6.3 billion of capital included in the current Budget package is forecast to be spent over ten years, reflecting planning times and sector capacity. Despite our recommendation to allocate a significant proportion of the MYCA in Budget 2019, the ten-year horizon means that the spending profile for capital is only slightly different to what was forecast at HYEFU. Table 5 shows the difference.

Table 5: Forecast profile for multi-year capital allowance – HYEFU 2018 and Budget 2019

$ million	18/19	19/20	20/21	21/22	22/23	23/24	24/25	25/26	26/27	27/28	Total
HYEFU **2018 forecast**	476	2,190	2,992	2,937	2,240	1,427	564	114	-	-	13,100
Prelim BEFU **2019 forecast**[1]	488	2,522	2,626	2,350	2,068	1,425	835	366	210	210	13,100
Difference	12	332	(306)	(587)	(332)	(2)	271	252	210	210	-

1. Assumes the $6.3 billion capital package for Budget 2019, as considered at the Budget Ministers 1 meeting. Does not include the effects of an increase in the MYCA as recommended in scenarios 2 and 3 below. In scenarios 2 and 3, which include a $1.7 billion increase in the MYCA, there is total additional capital expenditure of $250 million in the five years to 2022/23, relative to HYEFU 2018 forecasts.

41. The impact of higher allowances needs to be considered in light of its impact on monetary policy and the wider macro-economy.[1] Material changes in spending allowances will impact on demand pressures in the economy, which will be considered by the Reserve Bank in setting the Official Cash Rate (OCR).

42. Higher allowances would place upward pressure on interest rates and exchange rates at the margin. This could bring forward OCR increases (currently forecast to take place from early 2020) or reduce the probability of OCR cuts, and put upward pressure on the exchange rate. The distributional effects of OCR increases favour savers and

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1 Section 26G(1)(f) of the Public Finance Act 1989 requires that the Government must, when formulating its fiscal strategy, have regard to the interaction between fiscal policy and monetary policy.

importers at the expense of those with high levels of debt and exporters. Higher government spending and interest rates also risk crowding out private investment.

43. Both the scale and composition of additional government spending is important. For additional investment to be welfare-enhancing, initiatives progressed through the Budget should significantly enhance the four capitals (natural, human, social, and financial and physical) that generate wellbeing now and into the future.

44. The nature of any monetary policy response will depend on the materiality of additional spending, and the amount of capacity in the economy. Recognising the Reserve Bank's employment objective, policies that affect the labour market could also have an impact on monetary policy. At present, there is an uncertain amount of slack in the economy, with the economy estimated to be at its potential level. Labour market indicators suggest the economy is operating above its potential level, particularly in the construction sector, although wage and price inflation have so far been subdued.

45. Macroeconomic stability risks from higher interest rates are less concerning in an environment of historically low interest rates and subdued inflation pressures. In this environment, a somewhat more expansionary fiscal stance than proposed by current allowances would be unlikely to create macroeconomic imbalances. Indeed, there may be some financial stability benefits in supporting aggregate demand as higher interest rates reduce the risk of facing the zero lower bound in the future.

Allowance Options

46. To help you take decisions on the Budget 2019 package, Table 6 outlines scenarios for allowances based on our preliminary forecast. These scenarios are fiscally sustainable and consistent with our recommended approach to the fiscal strategy as described in the section above. As a rule of thumb, increasing Budget 2019 operating allowances by $0.5 billion adds about 0.5 percent to net core Crown debt as a share of GDP in 2021/22 and 0.6 percent in 2022/23. A $1.0 billion increase in the MYCA increases net core Crown debt as a share of GDP by 0.2 percentage points in 2021/22 and 0.3 percentage points in 2022/23.

47. These allowance scenarios have been modelled based on preliminary fiscal forecasts. They do not incorporate any macroeconomic feedbacks from higher Budget allowances, which are likely to reduce the net core Crown debt figure at the margin. It is also important to note that the impact on net core Crown debt from the Budget 2019 package may differ once funding for initiatives are incorporated into agencies' baselines.

48. The operating allowance for Budget 2019 has been increased by $0.9 billion in each scenario. An increase of this magnitude is consistent with the package discussed at the Budget Ministers 1 meeting.

[33]

50. Each scenario provides for $6.3 billion of capital to be allocated in Budget 2019. Again, this is consistent with the package discussed at the Budget Ministers 1 meeting. This would leave $2.6 billion remaining in the MYCA for the next three Budgets, which is

likely to be too low given capital pressures.[2] As such, scenarios 2 and 3 provide for an increase in the MYCA of $1.3 billion.

Table 6: Allowances in different scenarios

$ billions		Budget 19	Budget 20	Budget 21	Budget 22	Net debt in 2021/22	Net debt in 2022/23
BPS	**BPS Operating and Capital Allowances, with HYEFU assumption of capital allocation of $2.2 billion in B19**						
	Operating allowance (per year)	2.4	2.4	2.4	2.4	19.6%	18.0%
	Operating allowance after pre-commitments	1.6	2.25	2.4	2.4		
	Capital allowance	13.1 (8.9 remaining before Budget 2019)					
	Capital allocation in B19	2.2	6.7 remaining after Budget 2019				
Scenario One	**B19 operating allowance increases by $0.9 billion; capital allocation of $6.3 billion in B19**						
	Operating allowance (per year)	3.3	2.4	2.4	2.4	20.2%	18.7%
	Operating allowance after pre-commitments	2.5	2.25	2.4	2.4		
	Capital allowance	13.1 (8.9 remaining before Budget 2019)					
	Capital allocation in B19	6.3	2.6 remaining after Budget 2019				
Scenario Two	**B19 operating allowance increases by $0.9 billion and MYCA by $1.7 billion; capital allocation of $6.3 billion in B19**						
	Operating allowance (per year)	3.3	2.4	2.4	2.4	20.4%	19.1%
	Operating allowance after pre-commitments	2.5	2.25	2.4	2.4		
	Capital allowance	14.8 (10.6 remaining before Budget 2019)					
	Capital allocation in B19	6.3	4.3 remaining after Budget 2019				
Scenario Three	**B19 and B20 operating allowances increase by $0.9 billion and MYCA by $1.7 billion; capital allocation of $6.3 billion in B19**						
	Operating allowance (per year)	3.3	3.3	2.4	2.4	20.9%	19.8%
	Operating allowance after pre-commitments	2.5	3.15	2.4	2.4		
	Capital allowance	14.8 (10.6 remaining before Budget 2019)					
	Capital allocation in B19	6.3	4.3 remaining after Budget 2019				

2 Note that of the $6.3 billion capital to be allocated in the three scenarios, roughly $1.6 billion is prefunding Health and Education costs that would have been met from future budgets if the MYCA had not been adopted. Accordingly, the amount remaining in the MYCA after Budget 2019 can be slightly lower than would otherwise be possible while still remaining plausible. T2019/749 provides more detail about the capital package.

51. The above scenarios do not assume any potential response to the recommendations of the Tax Working Group. Decisions regarding tax reform would need to be consistent with the fiscal strategy, including maintaining debt at prudent levels and achieving sustainable operating surpluses.

Fiscal strategy beyond 2021/22

We will provide advice around future fiscal rules before Budget

52. In the 2019 BPS you stated you would provide further detail on a post-2021/22 fiscal strategy at Budget 2019. This is consistent with the Public Finance Act 1989, which requires the *Fiscal Strategy Report* to state the Government's long-term objectives for fiscal policy.

53. The Treasury will provide advice on fiscal rules before the Budget. There is an opportunity to strengthen fiscal management by putting greater focus on the long term and managing debt within a prudent range as well as focussing on the efficiency and effectiveness of service delivery.

54. Despite the limited fiscal headroom in the near term, there is considerable fiscal headroom projected beyond 2021/22. A credible commitment to maintaining debt within a prudent range in the medium term could help to manage risks with meeting the current debt rule.

A further option would be to reconsider the BRRs in Budget 2019

55. A further option would be to change the BRRs in Budget 2019. If this included moving to targeting a range for net debt, there would be scope for increases in allowances beyond what is outlined in the scenarios in this report. This would enable you to fund more initiatives in the near term, and signal a greater commitment to capital investment, although capacity in the economy would likely set a natural constraint.

56. However, a substantive move would be likely to have credibility implications unless there is a strong commitment to a new set of BRRs that includes an effective fiscal anchor. Given the limited time to take decisions before Budget, and the complexity of that decision, we recommend retaining the current BRRs and limiting the Budget announcement on the fiscal strategy post-2021/22 to broad directional statements.

Next Steps

57. We can discuss this at Budget Matters on Thursday 21 March, if you would like to. An immediate decision will be to decide what you would like to take to Budget Ministers on Monday 25 March.

58. As noted above, the Treasury will provide advice on fiscal rules before the Budget. We can also provide further advice on any specific issues that you wish to consider further as a result of this advice.