The Treasury and Office of the Minister of Finance

Budget 2019 Information Release
August 2019

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[1]	prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand	6(a)
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[23]	damage seriously the economy of New Zealand by disclosing prematurely decisions to change or continue government economic or financial policies relating to the entering into of overseas trade agreements.	6(e)(vi)

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[37]	to enable a Minister of the Crown or any department or organisation holding the information to carry out, without prejudice or disadvantage, negotiations (including commercial or industrial negotiations)	9(2)(i)
[38]	to enable a Minister of the Crown or any department or organisation holding the information to carry on, without prejudice or disadvantage, negotiations (including commercial or industrial negotiations)	9(2)(j)
[39]	to prevent the disclosure or use of official information for improper gain or improper advantage	9(2)(k)

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Options for the fiscal strategy beyond 2021/22

Date:	8 April 2019	**Report No:**	T2019/661
		File Number:	MC-1-5-3

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Discuss** with officials. **Indicate** your preferred approach to the post-2021/22 fiscal strategy.	4:30pm on 17 April.

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Anna Hamer-Adams	Analyst - Macroeconomic and Fiscal Policy	[39]	N/A	✓
Renee Philip	Manager - Macroeconomic and Fiscal Policy	[23]	[23]	

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

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Options for the fiscal strategy beyond 2021/22

Executive Summary

The Public Finance Act 1989 requires the Fiscal Strategy Report to state the Government's long-term objectives for fiscal policy, consistent with the principles of responsible fiscal management. The 2019 Budget Policy Statement signalled the Government would provide more detail on its post-2021/22 fiscal strategy at Budget 2019.

This report provides the Treasury's initial thinking on designing future Budget Responsibility Rules (BRRs) and options for the approach to take in Budget 2019.

There are choices around the post-2021/22 fiscal strategy, including the choice of fiscal rules and how to manage any change in the fiscal strategy.

Options for Budget 2019

There are three broad options for change at Budget 2019:

- the 2019 Fiscal Strategy Report could provide broad direction about the post-2021/22 fiscal objectives without announcing any significant change to the existing BRRs. For example, indicating that the Government's objective is to reduce net debt to 20 percent of GDP within five years of taking office, and then maintain net debt around 20 percent of GDP thereafter,
- specify new post-2021/22 rules in detail (eg, augmenting the current BRRs with new BRRs for the post-2021/22 period), or
- announce new BRRs to replace the current BRRs in Budget 2019.

Given the limited time to take decisions before Budget, we recommend retaining the current BRRs and limiting the Budget announcement on the post-2021/22 fiscal strategy to broad directional statements. If you wish to make a more significant change to the BRRs at Budget 2019, officials could provide further detailed advice on the specification of new rules.

Future Budget Responsibility Rules

The BRRs underpin the Government's fiscal strategy and provide guidance for Budget decisions. This report sets out the Treasury's initial thinking on the key considerations for potential future BRRs, including what is required to comply with the Public Finance Act 1989.

The ultimate objective of fiscal rules is to support intergenerational wellbeing. Sustainable debt is necessary to avoid debt crises or sharp fiscal consolidation and the accompanying severe adverse wellbeing consequences. Sufficient fiscal buffers are needed to enable fiscal policy to support financial/physical and human capital following major negative shocks without jeopardising fiscal sustainability (eg, spending to support recovery after a natural disaster or recession). At the same time, there should be consideration of borrowing for high-value public investment with intergenerational benefits, conditional on not exceeding a prudent level of debt.

As with the current BRRs, the Treasury recommends that the long-term fiscal strategy includes a debt anchor and an operating balance rule. [33]
[33] . In particular,

- maintaining net debt within a range (rather than targeting a point in a particular year), subject to any significant shocks; and

- [33]

A debt anchor specified as a range will support fiscal sustainability (if the range is within prudent levels), economic stability (by allowing debt to fluctuate over the economic cycle) and could accommodate high-value investments with intergenerational benefits.

We recommend maintaining net debt within a range that is wide enough to allow for a degree of forecast uncertainty and is centred around current levels. For example, the fiscal strategy could specify a range for net debt of 15 to 25 percent of GDP, subject to any significant shocks. There is already significant fiscal headroom in capital allowances for higher capital investment while keeping net debt around 20 percent of GDP over the projection period. Delivering a larger or earlier increase in capital expenditure would be challenging given capacity constraints in the economy over the forecast period.

If in the future a materially greater scale of high-value public investment is identified and capacity constraints ease, there would be a case for increasing the target range up to a maximum of 30 percent of GDP while still remaining at a level that could be considered prudent. We would not recommend increasing the target range up to 30 percent of GDP at the current time because doing so would increase the risk of exacerbating capacity constraints and/or funding low-value investments, which would limit the ability to fund high-value investments in the future.

The fiscal strategy should be set with regard to the wider Crown balance sheet. The current debt anchor uses the net core Crown debt indicator. There are trade-offs between targeting more comprehensive measures (eg, total Crown net worth), which are useful for broader sustainability analysis, and narrower measures (e.g. net core Crown debt), which may provide better guidance to Budget decisions and the Crown's financial resilience to shocks.
[33]

[33]

Next steps

Officials are scheduled to meet with you on Wednesday 17 April to discuss this report. We seek your feedback on:

- the approach you would like to take in Budget 2019;
- what further advice is required; and
- how you wish to engage with Budget Ministers and Cabinet.

Recommended Action

We recommend that you:

a **note** that the 2019 Budget Policy Statement signalled the Government would provide more detail on its post-2021/22 fiscal strategy at Budget 2019.

b **note** that there are options for how any transition to post-2021/22 Budget Responsibility Rules is managed in Budget 2019.

c **note** the Treasury recommends the long-term fiscal strategy include a debt anchor (specified as a range) and an operating balance rule.

d **note** that the Treasury will provide advice on the medium-term fiscal projections following the finalisation of economic and fiscal forecasts.

e **indicate** your preferred approach to the Budget Responsibility Rules (BRRs) at Budget 2019:

a. *Minimal option* – maintain the current BRRs, but provide a broad directional signal to maintain net debt around current levels in the 2019 Fiscal Strategy Report.

Yes / No

OR

b. *Indicate new post-2021/22 BRRs*

Yes / No

OR

c. *Replace the current BRRs in Budget 2019* – announce that the existing BRRs will be replaced with new rules.

Yes / No

f **discuss** with officials at 4:30 pm on 17 April to provide feedback on:

- the approach you would like to take in Budget 2019;
- what further advice is required; and
- how you wish to engage with Budget Ministers and Cabinet.

Renee Philip
Manager

Hon Grant Robertson
Minister of Finance

Treasury Report: Options for the fiscal strategy beyond 2021/22

Purpose of Report

1. The 2019 Budget Policy Statement signalled the Government will 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.

2. This report provides the Treasury's initial views on designing future Budget Responsibility Rules (BRRs) and options for change at Budget 2019.

3. This report is structured as follows:

   - Background – Public Finance Act 1989 (PFA) requirements and the current BRRs
   - Objectives of fiscal rules
   - Strategic context – factors influencing fiscal management going forward
   - Managing the transition to post-2021/22 fiscal rules
   - Options for the debt anchor
   - Options for the operating balance rule
   - Next steps

Background

The PFA requires the fiscal strategy to specify long-term fiscal objectives…

4. The PFA requires the Government to set out long-term objectives ('long-term' defined as a period of no shorter than 10 consecutive financial years) and short-term intentions ('short-term' defined as a period of no shorter than the next two financial years) for debt, operating balance, operating revenues, operating expenses, and net worth.

5. The short-term intentions and long-term objectives must be consistent with the principles of responsible fiscal management in the PFA (Annex 1). These principles include reducing and maintaining debt to prudent levels and running operating surpluses once those levels have been reached, managing fiscal risks, having regard for the impact on present and future generations and ensuring that the Crown's resources are managed effectively and efficiently.

6. The New Zealand approach relies on the commitment of each Government to its own rules, rather than the common international approach of legislated, numerical fiscal rules. This approach is a strength as it generally leads to stronger commitment by allowing fiscal rules to change through time reflecting changing circumstances and preferences.

…and the Government's current fiscal strategy focusses on the BRRs.

7. The Government has five BRRs. This advice focusses on the two BRRs that are currently most binding for fiscal management:

- The Government will reduce the level of net core Crown debt to 20 percent of GDP within five years of taking office, and
- The Government will deliver a sustainable operating surplus across an economic cycle.

8. The remaining BRRs signal the Government's policy intent with respect to expenditure, investment and the tax system. The Treasury has not reviewed these BRRs.

Objectives of fiscal rules

9. The ultimate objective of fiscal objectives (which we henceforth refer to as "rules") is to improve intergenerational wellbeing for all New Zealanders.

10. Fiscal rules contribute to intergenerational wellbeing by providing anchors for decision making that support the following:[1]

    - *Sustainability:* Compliance with the rule should ensure long-term debt sustainability (ie, stable debt-to-GDP and balanced revenue and expenses over the long term). Unsustainable debt can lead to severe adverse wellbeing consequences by causing a debt crisis or requiring sharp fiscal consolidation. Fiscal rules can support intergenerational equity by supporting fiscal sustainability without the need for significant policy changes in the future while enabling borrowing for high-value investment that benefits future generations (subject to not exceeding a prudent upper debt limit).
    - *Stabilisation:* Following the rule should not increase (and might even decrease) economic volatility. Fiscal rules promote economic stability when they are flexible enough to allow the budget balance to fluctuate over the economic cycle and let fiscal policy respond to major shocks (eg, spending to support recovery after a natural disaster or during a recession). Fiscal policy has a key role, alongside monetary policy, in supporting financial/physical and human capital by minimising unemployment and lost output during a downturn, natural disaster or other severe shock. This requires sufficient resilience such that debt can increase following a negative shock without jeopardising fiscal sustainability.
    - *Simplicity:* The rule should be easily understood by decision makers and the public.
    - *Operational guidance:* It should be possible to translate the rule into clear guidance in the annual Budget process. Budget aggregates targeted by the rule should be largely under the control of the policymaker.
    - *Credibility:* A rule should be in place for a sustained period to build credibility.
    - *Ease of monitoring:* Compliance with the rule should be easy to verify. The proposed functions of the Independent Fiscal Institution (IFI) include assessing compliance with the government's fiscal strategy, and so ideally any rule will be straightforward for the IFI to monitor.

[1] Fall, F. and J. Fournier (2015), "Macroeconomic uncertainties, prudent debt targets and fiscal rules", OECD Economics Department Working Papers, No. 1230, OECD Publishing, Paris.
Eyraud, L., X. Debrun, A. Hodge, V. Duarte Lledo, C. A. Pattillo (2018a). "Second-Generation Fiscal Rules; Balancing Simplicity, Flexibility, and Enforceability," IMF Staff Discussion Notes 18/04, International Monetary Fund.

The fiscal outlook creates choices for the long-term fiscal strategy

11. The fiscal outlook, as indicated by the preliminary Budget 2019 forecasts, is stable and broadly consistent with the BRRs. The fiscal outlook shows operating surpluses growing over time, driven by rising revenue and broadly stable expenses as a share of GDP (assuming future expenses are consistent with the assumed operating allowances). Beyond 2021/22, there are greater choices for the fiscal strategy around the size of operating surpluses and the path of debt, as well as the management of revenue, expenses and the wider Crown balance sheet.

12. The revenue outlook is driven by the economic outlook and policy measures. Tax revenue is forecast to rise as a share of GDP in the forecasts owing to fiscal drag and policy measures. The medium-term fiscal projections (beyond the forecast period) currently have a technical assumption that tax revenue will be stable as a percentage of GDP.

13. Over the long term, there will be pressures for higher public spending that will need to be managed to maintain fiscal sustainability. In particular, New Zealand is in the midst of a demographic transition to an older population that will continue over the coming decades. This is expected to contribute to higher New Zealand Superannuation and healthcare expenditure in the absence of policy change.

The Crown balance sheet is strong, although not as strong as before the Global Financial Crisis and earthquakes…

14. The Crown balance sheet is relatively strong, indicated by low levels of public debt compared with other advanced economies and strong sovereign credit ratings.

15. The strength of the Crown balance sheet can also be compared with its position prior to the Global Financial Crisis and earthquakes that tested the Crown's fiscal buffers. Overall, the Crown's balance sheet remains weaker than in 2008. The Crown's net financial assets decreased by 13 percentage points of GDP between 2008 and 2018. This has been driven by higher net debt and the depletion of the Natural Disaster Fund, partially offset by more assets held by the New Zealand Superannuation Fund (NZSF) and ACC. Table 1 provides selected balance sheet indicators.

Table 1. Selected balance sheet indicators, 2008 and 2018 (% of GDP)

	2008	**2018**	**Change**
Net core Crown debt (excluding NZSF)	5	20	+15
Crown entity borrowing (third party)	1	1	0
Crown Financial Institutions' net assets			
New Zealand Superannuation Fund	7	13	+6
ACC	-5	-1	+4
Natural Disaster Fund (EQC)	3	0	-3
Government Superannuation Fund (GSF)	-4	-4	0
Total Crown net financial assets	-2	-15	-13
Total Crown non-financial assets	58	60	+2
Total Crown net worth	56	45	-11

Source: The Treasury

…and requires careful management

16. The Crown balance sheet is large and complex. While the current Budget Responsibility Rules focus on net core Crown debt, it is important to ensure that the entire balance sheet is well managed.

17. The Crown balance sheet includes a diverse range of entities with different governance models. The Crown's fiscal indicators are currently segmented into the core Crown, Crown entities and State-owned enterprises. The Budget process has traditionally focussed on the core Crown, as it includes departments that administer appropriations. However, the roles of different parts of the balance sheet are less delineated than they once were. For example, some Crown entities are becoming more involved in market activities and some entities have a mix of commercial and non-commercial mandates.

18. Fiscal management will increasingly need to consider a wider range of entities and financing instruments. For example, while it is appropriate to focus on net debt as an anchor for fiscal management, the net core Crown debt indicator is narrow and creates an incentive for alternative sources of financing. In particular, third-party borrowing by Crown entities is not captured by the core Crown indicator. While net core Crown debt is expected to fall as a percentage of GDP over the forecast period, third party borrowing by Crown entities is forecast to increase from 1 percent of GDP in 2017/18 to 2 percent of GDP by 2022/23. Borrowing by Crown entities through third parties is more expensive than borrowing through the core Crown. In Housing New Zealand's (HNZ) case, the borrowing cost is around 60 basis points higher than through New Zealand Government borrowing. Therefore, the current $1.3 billion of HNZ's external borrowing from third parties entails an additional cost of around $8 million per year, or $80 million over ten years.[2]

19. To enhance transparency around the wider Crown balance sheet, the Treasury's fiscal reporting will place increased emphasis on developments outside of the core Crown.

Debt can be used to finance high-value, intergenerational investments…

20. In general, it is appropriate that operating revenues and expenses are balanced over the economic cycle. This approach promotes fiscal sustainability by ensuring that recurring expenses are matched by revenues.[3] It also generally supports intergenerational equity to the extent that operating spending tends to benefit current generations, whereas capital investment tends to benefit future taxpayers.[4]

21. With a strong Crown balance sheet and historically low interest rates, there is an in-principle case for using debt to fund public investment that has intergenerational benefits. This supports intergenerational equity and enables tax rates to be smoothed over time. However, the Crown is not always the most effective funder or provider of infrastructure compared with the private sector or local government.

22. The capital investment pipeline should depend on the investment opportunities available to the public sector and industry capacity to deliver projects. Over coming decades, there is likely to be significant demand for investment to replace and upgrade infrastructure, support a transition to a low emissions economy and adapt to climate change. A key challenge will be to ensure there is sufficient fiscal space preserved for future high-value investment and that fiscal space is not used up by lower value spending.

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2 Current market pricing shows the additional cost of borrowing through third parties is somewhere between 40-80 basis points over the New Zealand Government cost of funds, depending on the tenor of issuance.

3 Although balancing the operating balance is not a necessary or sufficient condition for fiscal sustainability, which requires primary cash balances sufficient to keep the debt-to-GDP stable in the long run.

4 Although there are some exceptions to this, as some operating spending has very long term benefits.

23. The Crown's currently low cost of borrowing does not automatically justify significantly greater Crown borrowing for investment. First, greater public borrowing would crowd out private investment and increase interest rates. Therefore, it is important that public investment has net benefits (meaning wider wellbeing benefits for society) that exceed the (risk-adjusted) cost of capital. As a rule of thumb, an increase in public debt of 1 percent of GDP is estimated to be associated with an increase in interest rates of around 3 basis points, although there is considerable uncertainty around such estimates. Second, delivery of infrastructure investment depends on the capacity of the economy to mobilise real resources (e.g. construction workers, building materials, etc.) and the capability of the public sector to deliver projects. In recent years, actual Crown capital spending has been below the level of budgeted expenditure, suggesting that capacity and capability constraints have been the main constraint on investment. The Treasury's Budget advice has therefore emphasised building a sequenced pipeline of capital projects.

...which needs to be balanced with ensuring resilience to shocks…

24. There is considerable uncertainty about the economic outlook, and the fiscal outlook is subject to a range of potential shocks. While New Zealand's public debt is low by international standards, experience has shown that public debt can increase rapidly after a shock and take a number of years to stabilise. It is prudent to ensure there are sufficient fiscal buffers to allow fiscal policy to respond to shocks without either a) jeopardising fiscal sustainability or b) prolonging the negative wellbeing effects of the shock (eg, having a longer or deeper recession due to a smaller-than-desirable fiscal response). Annex 2 summarises our analysis of what would be a prudent level of fiscal buffer for potential shocks.

25. The New Zealand economy is exposed to external shocks through trade, financial and commodity price channels. The global economy is fragile and there is limited monetary and fiscal flexibility in major advanced economies to manage major negative shocks. This increases the risk of external shocks affecting New Zealand.

26. Domestically, there are also a range of risks. A key macroeconomic vulnerability relates to high household debt, which exposes the economy to financial shocks (household debt as a percentage of disposable income is 166 percent, higher than its pre-GFC peak).[5] In addition, there are a range of other potential risks, such as natural disasters or risks to specific industries (such as biosecurity threats) that can have significant impacts on the public finances.

…especially with limited monetary policy space to respond to downside shocks

27. Monetary policy and a floating exchange rate are the primary macroeconomic stabilisation tools to support economic stability (ie, reducing the size of economic booms or recessions). Fiscal policy can also support macroeconomic stabilisation through the "automatic stabilisers" (ie, allowing taxes and some welfare spending to automatically fluctuate over the economic cycle) or discretionary policy stimulus.

28. In general, it is appropriate that the Reserve Bank has the primary responsibility for macroeconomic stabilisation through its inflation and employment mandate. However, monetary flexibility to respond to a future downside shock is limited with the Official Cash Rate at already very low levels. And currency depreciation may not be sufficiently stimulatory in a synchronised global downturn.

29. Therefore, fiscal policy should be prepared to play an active role in stabilisation in a future severe shock [T2018/3106 refers]. The appropriate fiscal policy response to a

5 The Treasury (2018), "Household balance sheet developments", Monthly Economic Indicators Special Topic, https://treasury.govt.nz/publications/research-and-commentary/rangitaki-blog/mei-special-topic-household-balance-sheet-developments

shock will depend on circumstances. A prudent strategy would be to ensure sufficient fiscal buffers to allow public debt to increase following a future downside shock, including space for discretionary fiscal stimulus if needed, although a period of fiscal consolidation may still be required at some point (particularly if the shock leads to a permanent reduction in output and tax revenue).

Managing the transition to post-2021/22 fiscal rules

There are choices for managing the transition to new fiscal rules…

30. You have signalled that Budget 2019 will provide further clarity on the post-2021/22 fiscal strategy.

31. In the following sections, we set out the Treasury's initial thinking on the direction for the post-2021/22 fiscal rules. There are choices around the timing and nature of any transition to new fiscal rules.

32. There are three possible approaches for Budget 2019:

- *Minimal option* – maintain the current BRRs, but provide a broad directional signal in the 2019 Fiscal Strategy Report. For example, indicating that the Government's objective is to reduce net debt to 20 percent of GDP within five years of taking office, and then maintain net debt around 20 percent of GDP thereafter. This option preserves space for new Budget Responsibility Rules to be announced in the future.

- *Indicate post-2021/22 rules in Budget 2019* – the Government could announce new Budget Responsibility Rules in detail that would apply to the post-2021/22 period, while also maintaining the current BRRs.

- *Replace BRRs in Budget 2019* – the Government could announce that the existing BRRs will be replaced with new rules.

33. Given the limited time to take decisions before Budget, we recommend retaining the current BRRs and limiting the Budget announcement on the post-2021/22 fiscal strategy to broad directional statements. However, if you wish to make a more significant change to the BRRs at Budget 2019, then officials could provide further detailed advice on the specification of new rules.

34. The post-2021/22 fiscal rules will have implications for the fiscal outlook to the extent that it implies changes in future operating or capital allowances to meet the fiscal rules. The Treasury will provide advice on the medium-term fiscal projections following the finalisation of economic and fiscal forecasts.

…requiring clear communication to maintain a credible fiscal anchor

35. It will be important that any change to the fiscal strategy is credible and continues to provide a strong anchor for fiscal management.

36. Communication with stakeholders, including credit rating agencies, should be managed to maintain confidence in the credibility of the fiscal strategy:

- A clear public explanation of the strategy in the Fiscal Strategy Report, including a narrative that emphasises that there is a continuation of prudent fiscal policy that represents an evolution of the current BRRs.

- The Treasury would brief credit rating agencies about any changes to the fiscal strategy on Budget day, including on any changes to the BRRs as well as the impact of Budget decisions and other changes to the fiscal outlook. While it is unlikely that modest changes in the fiscal outlook would lead to any immediate change in the sovereign credit rating, confidence in the direction of the fiscal strategy will be important. In particular, Standard & Poor's (S&P) recently put New Zealand's sovereign credit rating on positive outlook, so changes in the direction of fiscal policy could matter to whether the credit rating is upgraded by S&P in the future.

Options for the debt anchor

37. We recommend the long-term fiscal strategy include a debt anchor and an operating balance rule (the latter is discussed in the next section). The debt anchor should focus on ensuring fiscal sustainability and resilience. The operating balance rule should provide guidance for the short- to medium-term path of fiscal policy, consistent with the debt anchor.

Maintaining net debt around current levels is prudent…

38. There are choices around the future path of net debt. Determining a prudent level of net debt requires an on-balance judgment that strikes a balance between building resilience to shocks (depending on risk preferences) with opportunities for high-value public investment. What is considered prudent can change over time. As well as the level of net debt, it is also important for resilience and sustainability that net debt is on a stable or declining trajectory over the medium term.

39. The current level of net core Crown debt of around 20 percent of GDP is prudent. At this level, there is sufficient buffering capacity to manage one major shock, although this depends on a judgment and risk preferences. Annex 2 outlines the analytical framework and evidence for determining the prudent level of net debt.

40. There is already significant fiscal headroom in capital allowances for higher capital investment while keeping net debt around 20 percent of GDP over the projection period. Delivering a larger or earlier increase in capital expenditure would be challenging given capacity constraints in the economy over the forecast period. If in the future a materially greater scale of high-value public investment is identified and capacity constraints ease, there would be a case for increasing net debt up to a maximum of 30 percent of GDP while still remaining at a level that could be considered prudent. We would not recommend increasing net debt to 30 percent of GDP at the current time because doing so would increase the risk of funding low value investments and/or exacerbating capacity constraints, which would limit the ability to fund high-value investments in the future.

…and specifying the anchor as a range would support economic stability and provide greater fiscal flexibility…

41. We recommend specifying the debt anchor as a range, as point targets can lead to an excessive focus on managing a fiscal indicator to a particular point. Fiscal sustainability is a long-term concept, but point targets with a fixed date can incentivise a short-term focus, particularly as the target date nears. A range target would better support economic stability and a longer-term focus by enabling net debt to fluctuate with the economic cycle and recognising the uncertainty around debt projections. Depending on the range width, it could also allow more flexibility to accommodate high-value investment that benefits intergenerational wellbeing. For example, setting a range for net debt of 15-25 percent of GDP.

42. A range width of 10 percentage points of GDP is wide enough to account for most forecast uncertainty and would enable some space for additional high-value

investment.[6] Alternatively, a smaller range would provide a greater fiscal constraint and may have some communication advantages, although we would not recommend a range narrower than 5 percentage points as this would have similar disadvantages as a point target. A range larger than 10 percentage points would give greater flexibility for higher debt in the future but may not provide sufficient guidance about future fiscal policy. A 10 percentage point range is a judgment that strikes a balance between these considerations.

43. Ranges can be supplemented by a focus on the mid-point of the range. Mid-points can provide clearer guidance for fiscal policy, but risk the issues involved with point targets. We do not recommend explicitly targeting a mid-point, but it would be prudent to focus on remaining within the range with an appropriate buffer (rather than targeting the outer limit of the range).

…while stating the debt anchor binds in normal times would support accountability

44. A target range should bind in normal times, subject to a significant shock. A binding target range will ensure that there is a constraint across all forecast years, which supports accountability and transparency since its achievement can be monitored each year. It is important to include an escape clause to allow for deviations from the range in the case of a significant shock in order to provide flexibility for fiscal policy to respond to that shock. A significant shock would include events such as a recession, economic crisis or major natural disaster that would warrant a departure from the existing fiscal strategy.

[33]

6 [33]

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Next Steps

66. Officials would like to discuss these issues on the week of 17 April. We seek your feedback on:

- the approach you would like to take in Budget 2019;
- what further advice is required; and

- how you wish to engage with Budget Ministers and Cabinet.

67. Changes to the fiscal strategy will need to be reflected in the 2019 Fiscal Strategy Report, which is published on Budget day. The relevant legislative requirement is for the Government to specify long-term fiscal objectives for key fiscal indicators that cover a period of at least ten years.

68. The Treasury will provide advice on the medium-term fiscal projections following the finalisation of economic and fiscal forecasts.

69. Significant changes to the fiscal strategy would also need to be approved by Cabinet. We recommend seeking Cabinet approval by early May to allow time to reflect decisions in the 2019 Fiscal Strategy Report.

Annex 1: PFA requirements for fiscal objectives

Section 26 G) of the PFA outlines the following principles:

(1) The Government must pursue its policy objectives in accordance with the following principles (**the principles of responsible fiscal management**):

- (a) reducing total debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total debt in the future by ensuring that, until those levels have been achieved, total operating expenses in each financial year are less than total operating revenues in the same financial year; and
- (b) once prudent levels of total debt have been achieved, maintaining those levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues; and
- (c) achieving and maintaining levels of total net worth that provide a buffer against factors that may impact adversely on total net worth in the future; and
- (d) managing prudently the fiscal risks facing the Government; and
- (e) when formulating revenue strategy, having regard to efficiency and fairness, including the predictability and stability of tax rates; and
- (f) when formulating fiscal strategy, having regard to the interaction between fiscal policy and monetary policy; and
- (g) when formulating fiscal strategy, having regard to its likely impact on present and future generations; and
- (h) ensuring that the Crown's resources are managed effectively and efficiently.

(2) However, the Government may depart from the principles of responsible fiscal management if—

- (a) the departure from those principles is temporary; and
- (b) the Minister, in accordance with this Act, states—
  - (i) the reasons for the departure from those principles; and
  - (ii) the approach the Government intends to take to return to those principles; and
  - (iii) the period of time that the Government expects to take to return to those principles.

Section 26 J) of the PFA requires the fiscal strategy report specify **long-term objectives**

(1) The fiscal strategy report must—

- (a) state the Government's long-term objectives for fiscal policy and, in particular, for the following variables:
  - (i) total operating expenses:
  - (ii) total operating revenues:
  - (iii) the balance between total operating expenses and total operating revenues:
  - (iv) the level of total debt:
  - (v) the level of total net worth; and

(b) explain how those long-term objectives accord with the principles of responsible fiscal management; and

(c) state the period to which those long-term objectives relate (which must be a period of 10 or more consecutive financial years commencing with the financial year to which the fiscal strategy report relates).

Section 26 KA) of the PFA requires the fiscal strategy report specify **management of the Crown's resources**

(1) The fiscal strategy report must include details of the Government's strategy for managing expenditure, assets, and liabilities in the period of at least 3 financial years commencing with the financial year to which the report relates.

(2) Details of the Government's strategy for managing expenditure, assets, and liabilities may include—

(a) the outcomes sought from new or reallocated expenditure, assets, and liabilities; and

(b) any expected change over time in the major components of expenditure, assets, and liabilities.

The Public Finance Act requires the Government to determine a prudent debt level

70. New Zealand Governments have used a debt anchor to guide fiscal management since the early 1990s. This is consistent with the Public Finance Act's requirement to set a long-term objective for public debt (covering at least ten years) consistent with the principles for responsible fiscal management, including maintaining debt at prudent levels. However, the Public Finance Act does not define what a prudent level of debt is. This flexibility in definition is a strength as it allows the level of prudent debt to change through time reflecting changing circumstances. Typically, a prudent level of debt is one which entails a low risk of debt reaching unsustainably high levels. This requires an on-balance judgment that depends on the Government's risk tolerance.

71. Our analysis draws insights from the frameworks used in the international literature, particularly reflecting the current thinking in the International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD). However, it is also important that the approach is tailored to New Zealand's circumstances and institutions.

72. The approach we have taken is to estimate the upper limit of a prudent range for public debt by taking three steps: 1) identify a maximum level of public debt, 2) estimate a *safety buffer*, then 3) identify a *prudent debt ceiling*.[9]

73. Our analysis suggests that a prudent upper limit for net core Crown debt in New Zealand would be around 30 percent of GDP to provide a buffer against a significant shock. However, this is subject to considerable uncertainty and depends on risks preferences. Our reasoning for this judgment follows.

A maximum level of net debt is estimated to be around 50-60 percent of GDP…

74. The literature suggests different ways to think about a maximum level of public debt:

- The *debt sustainability* approach considers the level of debt above which the government would simply be insolvent. That is because the interest expenses on the debt would be so large that the government's tax revenue could not be sufficient.

- *The market access perspective* considers the level of debt such that beyond it, creditors are no longer willing to lend on reasonable terms. Market confidence is lost, and governments cannot roll over debt.

- A third approach to consider the level of public debt beyond which there are likely to be *adverse wellbeing consequences* (ie, welfare reducing).

75. We have followed the third approach that estimates the maximum level for public debt beyond which there are likely to be adverse consequences for wellbeing. It is likely that the level at which public debt would trigger concerns about insolvency or market access would be much higher than these levels.

76. The level of net debt that is likely to have adverse wellbeing consequences is estimated to be at least 50-60 percent of GDP, although there is considerable uncertainty around the estimates.[10] Above this level, debt is estimated to reduce economic growth (which could occur through a range of channels, including crowding

9 Eyraud L., Baum, A., Hodge, A., Jarmuzek, M., Elif Ture, H., Mbaye, S., and K. Young. (2018b) "How to calibrate fiscal rules: A primer," IMF Fiscal Affairs Department How-To Notes, International Monetary Fund.

10 The estimates in the literature generally refer to general government gross debt for international comparability. We have mapped the gross debt estimates to New Zealand's net core Crown debt by subtracting the amount of liquid financial assets included in net core Crown debt.

out private investment and higher risk premia), a heightened risk of a debt distress episode and impeding the effectiveness of fiscal stimulus.[11] There is a range of estimates and we have taken a conservative approach given New Zealand is a small, open economy that is vulnerable to natural disasters and external shocks, with high levels of private debt and lower than average GDP-per-capita relative to other advanced countries.

…and a safety buffer for a major shock would be around 20 percent of GDP…

77. The appropriate safety margin is a buffer that would be sufficient to ensure with high probability that a shock would not send net debt above the maximum debt limit. Countries face sudden increases in debt because of negative macroeconomic shocks or other events. Decisions around buffer size depend on risk preferences (how many shocks to buffer against) and views around future risks (their size and frequency).

78. We recommend maintaining a buffer of at least 20 percentage points of GDP against this maximum debt limit to ensure it is not surpassed following a negative shock. We judge this would be sufficient to manage a major macroeconomic shock without an unduly contractionary fiscal policy response.

79. The safety margin judgment has been made with reference the following evidence:

- *Historical experience with recessions and other shocks.*
    - i New Zealand recessions in the post-war era have been associated with increases in public debt by 10 percentage points of GDP on average.
    - ii Net core Crown debt increased by around 20 percentage points of GDP following the Global Financial Crisis and Canterbury earthquakes (although not all of the change is attributable to these events and the outcome included a policy response).
    - iii Following the Global Financial Crisis, public debt increased by an average of around 20 percentage points of GDP in advanced economies.
- *Scenario analysis of major shocks.*
    - i Fiscal stress tests published in the Treasury's 2018 *Investment Statement* found that shocks would increase net debt by 5-15 percentage points of GDP after five years in the absence of a fiscal policy response. The shocks considered included a major international economic downturn, foot-and-mouth disease outbreak and major earthquake in Wellington.
    - ii Recent scenario analysis by the Treasury modelled a severe international downturn with an active fiscal policy response. This analysis indicated that a debt buffer of 20 percentage points of GDP would likely be needed (see Figure 1).
- *Modelling simulations in the international literature*. OECD and IMF economic modelling suggests that a safety margin of around 15 percentage points of GDP would ensure there is a high probability of keeping public debt under a ceiling in the face of macroeconomic uncertainty.

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[11] This is based on a review of the literature, which includes estimates for OECD countries that include New Zealand in the sample.
Fall, F., Bloch, D., Fournier, J. & Hoeller, P. (2015). "Prudent Debt Targets and Fiscal Frameworks," *OECD Economic Policy Papers*. No. 15.
Eyraud et al., 2018b.
OECD. (2015). Achieving Prudent Debt Targets Using Fiscal Rules. *OECD Economic Department Policy Note,* No. 28.

80. We have made a conservative judgment to use 20 percentage point of GDP buffer, which is at the upper end of estimates for a major shock. The buffer would likely be large enough to absorb two smaller shocks.

81. In addition, the size and frequency of shocks in the future may be different to the past. For example, there is likely to be a higher frequency of extreme weather events than in the past owing to climate change. Judgments around the desired level of fiscal resilience also need to be balanced with providing space for investment that could also enhance the resilience of, for example, physical infrastructure or human capital.

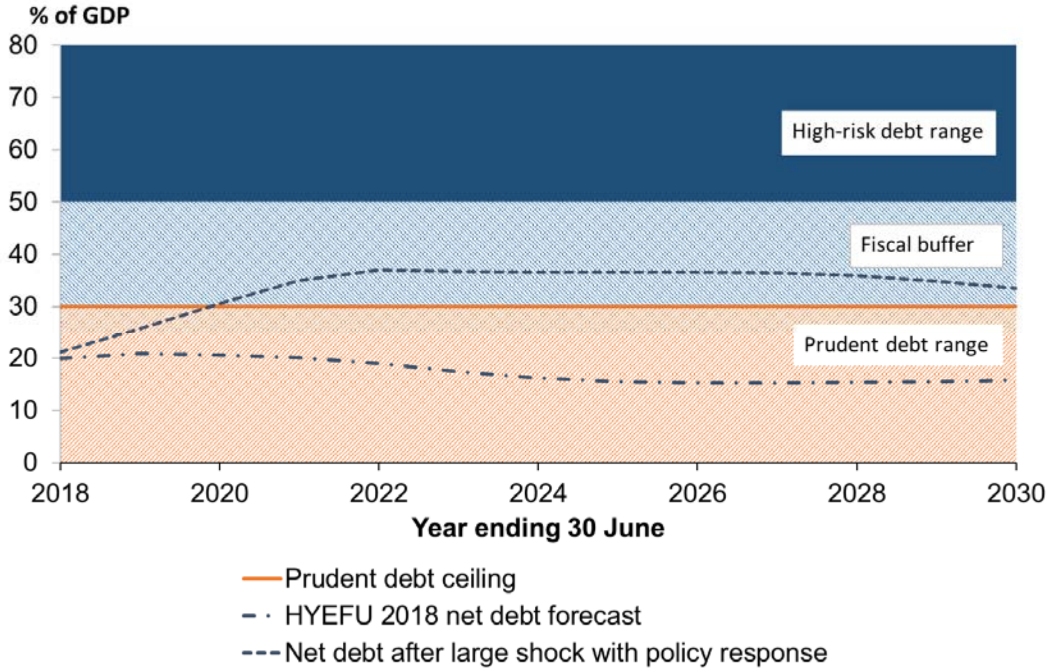
…implying that a prudent limit for net debt would be around 30 percent of GDP

82. A conservative maximum level of debt of 50 percent of GDP, less a buffer of 20 percent of GDP, implies a prudent upper limit for net debt of 30 percent of GDP. A less conservative judgment around the maximum level of debt would increase the prudent upper limit, while a desire to buffer against more than one large shock would decrease the prudent upper limit. We recommend more conservative judgments given there is large uncertainty around what level debt becomes welfare reducing, with significant costs to exceeding this level but relatively low costs in undershooting it.

83. Figure 4 illustrates the estimated prudent debt ceiling, the HYEFU 2018 net debt projection and an illustrative shock scenario. The shock scenario is illustrative and depends on assumptions about the nature of the shock, the fiscal policy response and the behaviour of the economy. This scenario presents the impact of a significant negative shock,[12] followed by a fiscal stimulus and then a gradual period of fiscal consolidation. The scenario indicates how a shock could increase net debt by around 20 percentage of GDP, but be kept below the high-risk level if the initial level of net debt is below the prudent debt ceiling and there is a period of fiscal consolidation.

84. As noted above, the fiscal outlook also faces long-term pressures from an ageing population and other structural trends. We have not reviewed the appropriate level of pre-funding for future expenses via the New Zealand Superannuation Fund.

Figure 4. Different levels of net debt from a fiscal sustainability perspective



Source: The Treasury

12 The scenario tested is a severe international economic downturn, followed by four years of fiscal stimulus peaking at 3 percent of GDP, after which fiscal consolidation is undertaken with OBEGAL surpluses rising to 3 percent of GDP.