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Cabinet Document Details

Title: **Cabinet Paper CAB-19-SUB-0572: Fiscal strategy for the Budget Policy Statement 2020**

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[27] 9(2)(ba)(ii) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely otherwise to damage the public interest

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[31] 9(2)(f)(ii) - to maintain the current constitutional conventions protecting collective and individual ministerial responsibility

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[36] 9(2)(h) - to maintain legal professional privilege

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

[40] not in scope

[41] 18(c)(i) - that the making available of the information requested would be contrary to the provisions of a specified enactment

[42] 18(d) - information is already publicly available or will be publicly available soon.

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Office of the Minister of Finance

Chair

Cabinet

Fiscal strategy for the Budget Policy Statement 2020

Proposal

1. This paper seeks agreement to the fiscal strategy to be announced in the Budget Policy Statement 2020 (BPS). In particular, it seeks agreement to the announcement of a capital investment package to help deliver our goal to invest more in the modern infrastructure that New Zealand needs to build a productive, sustainable and inclusive economy.

Executive Summary

2. The Budget Policy Statement 2020 will be released on 11 December 2019 and will provide an update on our fiscal strategy. The Treasury's Half Year Economic and Fiscal Update 2019 (HYEFU) will be released at the same time.

3. The economic outlook has weakened since the publication of the Treasury's Budget Economic and Fiscal Update 2019 (BEFU) forecasts as a result of slower global growth and increased business investment uncertainty. Very low interest rates mean the response of monetary policy may need to be added to by fiscal policy to support the economy through a period of weaker growth rates. This will also reduce the need for the Reserve Bank to deploy unconventional monetary policy.

4. The fiscal outlook has also weakened, and it is likely the Government's net core Crown debt Budget Responsibility Rule of 20% by 2021/22 will be breached. Treasury's preliminary HYEFU forecasts show net core Crown debt rising to 20.9% in 2021/22 and declining thereafter. Treasury's preliminary fiscal forecasts also show small operating balance before gains and losses (OBEGAL) deficits in 2019/20 and 2020/21, with surpluses thereafter.

5. I propose we announce a capital investment package in the Budget Policy Statement to help us achieve the key shift outlined in the Government's Economic Plan to have

more investment in infrastructure to help build a productive, sustainable and inclusive economy. An investment package will also support low emissions growth and business confidence, in the context of constrained monetary policy.

6. This paper proposes a package comprised of around $12 billion of additional capital spending. This will fund specific projects over the short, medium and long-term to support economic activity. A portion of this will also be allocated through the normal process for Budgets 2020 to 2023 for the Multi-year Capital Allowance (MYCA).

7. I do not propose changing operating allowances from those announced in Budget 2019 [33]
These options remain under active consideration for Budget 2020.

Background

8. The BPS will be released on 11 December 2019, alongside the Treasury's Half Year Economic and Fiscal Update. Publication of the BPS is required by the Public Finance Act 1989 (PFA). The BPS must state the broad strategic priorities by which the Government will be guided in preparing the Budget for that financial year, and how this aligns with the Government's fiscal strategy. This usually includes setting the operating and capital allowances for Budgets across the forecast period.

9. In September, Cabinet agreed the strategy and process for Budget 2020 [CAB-19-MIN-0481]. At this time, Cabinet agreed to delegate authority to the Budget Ministers group to agree any changes to allowance settings for the BPS.

10. I also advised Cabinet that the economic outlook had weakened since the Budget due to a combination of slower global growth and lower business confidence, and undertook to report to Cabinet on any additional fiscal support that may be required in this context.

The Economic and Fiscal Outlook

Economic context

11. The global economic outlook has weakened since the publication of the Treasury's BEFU forecasts. The global economy is experiencing a slowdown, with US-China trade tensions, continued policy uncertainty in Europe, and financial market volatility. These events have led to heightened uncertainty and weakened confidence. This has led to softer expectations for global growth. The International Monetary Fund's (IMF) October World Economic Outlook projects global growth of 3.0% for 2019. This is the weakest projection since 2009 and 0.3% weaker than was projected by the IMF in April this year.

12. While growth in New Zealand has slowed, growth remains positive and the economy continues to perform better than many of our trading partners. The labour market remains healthy and spare capacity remains low in most sectors. Nevertheless, there are signs that the deteriorating global outlook is beginning to affect domestic conditions. The Reserve Bank's decision to reduce the Official Cash Rate (OCR) to 1% will provide some support to the economy but risks remain, notably the degree to which weaker global conditions dampen demand for New Zealand exports.

13. While the risk of an immediate recession in New Zealand remains low, given recent developments I now anticipate the Treasury's HYEFU forecasts will show a weaker picture for domestic growth. It remains unclear, however, the extent to which this recent weakening reflects the beginning of a sustained period of slower growth or a short-term softening triggered by a period of unusual global economic uncertainty.

14. Fiscal policy may need to help monetary policy in supporting the economy through a weaker period of growth. In normal circumstances, monetary policy would support the economy through decreasing the OCR. However, existing low interest rates means the Reserve Bank's ability to use conventional monetary policy may be exhausted if growth falls significantly further. This could lead to the use of unconventional monetary policy options. [29] Increased support from fiscal policy can reduce the risk of unconventional monetary policy being employed.

The fiscal outlook

15. The fiscal position for 2018/19 was stronger than the Treasury expected at Budget 2019. We recorded an OBEGAL surplus of $7.5 billion in the 2018/19 financial year. This compares to an expected OBEGAL surplus of $3.5 billion.

16. The stronger than expected surplus partly reflected one-off factors that are not likely to persist in the future, such as the $2.6 billion positive impact from the revaluation of KiwiRail assets. The Government's investment programme meant capital spending exceeded net cash from the core Crown's operations. This resulted in a residual cash deficit of $0.7 billion, which contributed to a $0.2 billion increase in net core Crown debt to $57.7 billion. In GDP terms, net core Crown debt fell from 19.9% in 2017/18 to 19.2% this year.

17. The forecast for OBEGAL, assuming the Budget allowances announced at Budget 2019, is for small deficits in the current and next year, with surpluses thereafter. Net core Crown debt is forecast to increase slightly as a share of GDP, peaking at 20.9% of GDP in 2021/22. Net core Crown debt is expected to stay relatively stable as a share of the economy.

18. The fiscal outlook has deteriorated relative to the Budget forecasts, reflecting softer forecasts for economic growth, a stronger wage outlook and a lower interest rate track. As a result, tax revenue forecasts have been revised down, benefit expenses are now expected to be higher and the cost of future ACC claims have increased. In addition, there have been some items we have previously decided to manage outside of Budget allowances, for example pay equity settlements that have adversely impacted the fiscal outlook.

19. The Government's Budget Responsibility Rules (BRRs) for net core Crown debt and the operating balance are to:

    19.1. Reduce the level of net core Crown debt to 20 per cent of GDP within five years of taking office, and

    19.2. Deliver a sustainable operating surplus across an economic cycle.

20. The long-term objective for net core Crown debt was extended at Budget 2019 to specify a prudent range for net debt:

20.1. The Government will reduce the level of net core Crown debt to 20 per cent of GDP within five years of taking office and maintain it at prudent levels thereafter. Prudent levels of net core Crown debt are within a range of 15 to 25 per cent of GDP (subject to any significant shocks to the economy).

21. Treasury's preliminary HYEFU forecasts show the net debt BRR will be breached, with net core Crown debt of 20.9% of GDP in 2021/22. However, net debt is forecast to remain well within the prudent range of 15-25% of GDP outlined in the Government's long-term debt objective. OBEGAL is forecast to be in surplus on average over the forecast period, with small deficits in 2019/20 and 2020/21 (of -0.1% and -0.2% of GDP respectively) rising to a surplus of 1.4% of GDP by the end of the forecast period (2023/24).

22. In both Budgets 2018 and 2019 we were projected to deliver on our debt target in 2021/22. The Government is currently ahead of this target, having reduced debt to below 20% of GDP in June 2018.

Fiscal Strategy for the Budget Policy Statement 2020

23. I propose we announce a capital investment package in the Budget Policy Statement in light of the softer economic outlook and the importance of giving clear signals to support business investment whilst recognising the constraints facing monetary policy. This package will also help deliver our Economic Plan commitment to invest more in New Zealand infrastructure.

24. I am proposing this package be focused on an increase in capital spending in order to provide clarity and certainty to businesses around our investment intentions, to take advantage of low borrowing costs, and to support the economy and reduce the risk of unconventional monetary policy. A focus on capital also recognises that capital spending is largely one-off – while there is room to borrow more and remain within the debt range of 15-25% of GDP, there is very little room to increase ongoing operating spending without risking a period of sustained deficits.

25. I recommend the capital investment package comprise two parts totalling around $12 billion:

- **Announcement of a capital package** of specific initiatives to support the economy and provide certainty by funding specific capital projects over the short, medium and long-term. I seek Cabinet agreement for delegated authority for Budget Ministers to make decisions about the make-up of this package.

- **An increase to the MYCA**. The MYCA represents the available capital funding for Budgets 2020, 2021, 2022 and 2023, and will provide for an ongoing increase in capital spending and infrastructure investment over the longer-term. Again, I seek Cabinet agreement for delegated authority for Budget Ministers to make decisions about the size of the increase.

Announcement of a capital package

26. The announced capital package will consist of short-term measures that can be implemented straight away to support the economy, medium-term initiatives that address upcoming cost pressures, and measures that will feed into our long-term pipeline of capital intentions, enhance productivity and speed up the just transition to a low emissions economy. Investment will be directed into areas such as health, education, housing, and transport.

27. In the short-term, there is limited capacity in some industries, such as construction, to undertake large-scale investments and limited capability in the public sector to implement significant projects. Therefore any near-term spending needs to be of limited scale and implementation ready. However, over the medium and longer-term there are significant capital demands, and giving certainty as to the scale and nature of the projects will help provide clarity and confidence to the affected industries about our investment intentions. This should also help to build industry capacity to deliver such projects.

28. Capital and infrastructure investment choices made now will have implications for long-term greenhouse gas emissions trends, and high emissions choices now are likely to raise transition costs in the future, while low emissions choices now are likely to reduce future costs to the Crown and the whole economy.

Increase the MYCA

29. The MYCA was introduced in Budget 2019 and uses a four-year funding envelope rather than a single-year allowance. The intention is that the MYCA represents the amount the government expects to allocate to capital expenditure over the next four Budgets, taking into account future need for capital investment in the public sector, as well as macroeconomic factors.

30. The MYCA has been introduced to encourage decisions that take a long-term view of our capital needs. It supports better long-term investment decisions by allowing the Government to commit earlier to investment ready proposals that often require several years to procure, plan or design. The MYCA also provides greater clarity for the construction sector by providing more certainty about the scale of Government capital intentions than a single-year allowance.

Risks around the proposed capital package and increase to the MYCA

31. The proposed capital package and increase to the MYCA are accompanied by risks around public service capability constraints and private sector capacity constraints. The public service faces capability constraints, particularly regarding asset and investment management, and the major capital spending agencies (e.g. health and education) already have a large volume of new expenditure to manage over the near term. Capacity constraints in the private sector vary by industry, but are particularly concentrated in the ability to find skilled labour, and in the construction sector.

Implications for the economic and fiscal outlook

32. A capital investment package of around $12 billion will support business confidence, provide clarity around our capital intentions, and contribute to our goal to invest more in infrastructure and build a productive, sustainable and inclusive economy. Importantly, it will also support monetary policy and reduce the risk of unconventional monetary policy being employed.

33. Higher capital spending will increase the forecast level of net core Crown debt. The impact of higher capital spending on net debt will largely be determined by the timing of the specific projects we invest in, rather than whether projects are allocated through the capital package or the MYCA. The overall proposed increase in capital spending of around $12 billion will likely increase net debt to around 22.5% of GDP in 2021/22. The increase in net debt associated with the capital package and increased MYCA means there is a high probability that the 20% net debt Budget Responsibility Rule will not be met. Net debt is forecast to remain within 15-25% of GDP even after accounting for the increase in capital spending.

34. Increased capital spending will have implications for the path of OBEGAL. Higher operating expenditure will be required alongside increased capital spending to support the delivery of those initiatives. These pressures on operating expenditure are uncertain and will depend on the specific capital projects ultimately decided on.

35. The increase in debt associated with higher capital spending will reduce the headroom net debt has against its 25% of GDP upper prudent limit. This reduced headroom will limit the space available for future fiscal expansion, and increases the risk of net debt breaching 25% of GDP. For example, if nominal GDP growth is one percentage point weaker than expected this year and next year, the lower tax revenue alone would increase net debt as a share of GDP by around two percentage points in 2021/22.

Keep operating allowances as announced in Budget 2019 [33]

[33]

[33]

39. I also recommend keeping operating allowances at the levels announced in Budget 2019. These levels are shown in Table 1 below. In Budget 2019, 2023/24 was the first year of the projection period and had an assumed operating allowance of $2.6 billion. In the BPS, 2023/24 will be included in the forecast period. I propose the operating allowance for this year is kept unchanged from the level included in the fiscal projections at Budget 2019 ($2.6 billion).

40. Table 1. Operating allowances at Budget 2019 ($m)

	Budget 2020	Budget 2021	Budget 2022	Budget 2023
Operating allowances at Budget 2019 ($m)	**3,000**	**2,400**	**2,400**	**2,600***

*Based on rolling in the first year of the Budget 2019 projection.

41. Slower economic growth means that the room for additional operating spending in Budget 2020 is very limited. Ministers should prepare their Budget 2020 bids in line with the current operating allowance.

Consultation

42. This paper was prepared by the Treasury.

43. Due to Budget sensitivity, consultation has been limited. The Department of Prime Minister and Cabinet has been informed, and the proposals in the paper reflect ongoing discussions between the Treasury and the Reserve Bank on the appropriate mix of monetary and fiscal policy.

44. The Treasury has consulted with relevant agencies about initiatives that could be announced in a capital package. Any initiatives that are announced as part of the capital package agreed by Budget Ministers will be finalised in consultation with the relevant agencies and Ministers.

Financial Implications

45. There are no direct financial implications in this paper. Decisions on the allocation of the capital package, along with any associated operating funding, will be taken by Budget Ministers ahead of Budget 2020. Decisions on the allocation of the MYCA will be taken through the normal Budget processes.

46. The decision in this paper to announce a capital investment package of around $12 billion will have implications for the future fiscal position, including for net core Crown debt and OBEGAL.

Legislative Implications

47. There are no legislative implications associated with this paper.

Impact Analysis

48. There are no regulatory implications associated with this paper.

Human Rights

49. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Gender Implications

50. There are no gender implications associated with this paper.

Disability Perspective

51. There are no disability implications associated with this paper.

Publicity

52. The capital package will be announced when the BPS is released on 11 December 2019. This announcement will include the total amounts that will be allocated to different portfolios and some specific initiatives that will be implemented. A number of announcements about specific initiatives will then be made after the release of the BPS and before Budget 2020.

53. The increase in the MYCA will also be announced when the BPS is released.

54. The communication of initiatives and the BPS will be led by the Minister of Finance's office.

Proactive Release

55. I propose delaying the release of this paper beyond the standard 30 business days as it will be released separately through the proactive release of Budget material following Budget 2020.

Recommendations

I recommend that Cabinet:

1. **note** the *Budget Policy Statement 2020* will be released on 11 December 2019 and will include an announcement about allowances for future Budgets;

2. **note** that Cabinet delegated authority to the Budget Ministers group to agree any changes to allowance settings in the *Budget Policy Statement 2020* [CAB-19-MIN-0481];

3. **note** the economic outlook has weakened since the publication of the Treasury's *Budget Economic and Fiscal Update 2019* forecasts as a result of slower global growth and lower business confidence;

4. **note** that very low interest rates mean fiscal policy may need to support the economy through a weaker period of growth and to reduce the risk of unconventional monetary policy being employed;

5. **note** the Government's Budget Responsibility Rules of reducing the level of net core Crown debt to 20 per cent of GDP within five years of taking office, and of delivering a sustainable operating surplus across an economic cycle;

6. **note** the Treasury's preliminary *Half Year Economic and Fiscal Update 2019* forecasts show net core Crown debt above 20 per cent of GDP in 2021/22 and operating balance before gains and losses (OBEGAL) in deficit in 2019/20 and 2020/21.

7. **agree** to the announcement of an additional $12 billion (approximately) capital investment package at the Budget Policy Statement 2020, that will build clarity around our future capital pipeline, speed up the just transition to a low emissions economy, support business confidence, and move towards a more productive, sustainable and inclusive economy;

8. **authorise** the Budget Ministers group to take decisions on the final details of the capital package, along with any associated operating funding;

9. **agree** to increase the multi-year capital allowance for Budgets 2020 to 2023 to fund future capital pressures, and for the size of this increase to be agreed by Budget Ministers;

10. **note** that the allocation of the multi-year capital allowance will be agreed through the normal processes for Budget 2020 and beyond;

11. **note** the combined impact of the capital investment package will increase net core Crown debt and, depending on the initiatives chosen, there will be implications for operating spending and OBEGAL;

[33]

13. **agree** to an operating allowance of $2.6 billion for Budget 2023, consistent with the operating allowance included in the fiscal projections at Budget 2019;

14. **note** initial announcements about a capital package and the increase to the multi-year capital allowance will be made on 11 December when the *Budget Policy Statement 2020* is released, but announcements of specific projects will continue to be announced after this date;

15. **note** that the proactive release of this paper will be delayed beyond the standard 30 business days as it will be released separately following Budget 2020.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance

Date: