The Treasury

Budget 2020 Information Release

July 2020

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

[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

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[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

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Fiscal Strategy for the 2020 Budget Policy Statement

Date:	30 October 2019	**Report No:**	T2019/3343
		File Number:	MC-1-5-2 (Fiscal strategy)

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Agree** to recommendations; agree to **lodge** attached Cabinet paper Seek Budget Ministers' approval to operating allowance recommendations	31 October 2019

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Angus Hawkins	Senior Analyst, Macroeconomic and Fiscal Policy	s9(2)(k)	n/a (mob)	✓
Renee Philip	Manager, Macroeconomic and Fiscal Policy		s9(2)(g)(ii)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Executive Summary

The economic and fiscal outlook is weaker than at Budget 2019. As discussed in our previous advice (T2019/2447, T2019/2887 and T2019/3177 refer), GDP growth is lower than previously forecast. This reflects uncertainty in the global economy and weak business confidence domestically. Despite the slowing economy, the labour market remains tight and there is evidence of ongoing capacity constraints. This suggests that despite slowing, the economy remains near its potential level.

The fiscal forecast is for small deficits in 2019/20 and 2020/21, before a return to surplus in 2021/22. The Operating Balance before Gains and Losses (OBEGAL) is forecast to remain in surplus, on average, over the forecast period. This suggests you are likely to meet your target of running operating surpluses over an economic cycle. However, there are a number of downside risks to this forecast, and any further deterioration in the operating balance should be closely monitored.

Net core Crown debt is forecast to peak at 20.9% of GDP in 2021/22 before falling thereafter. While net debt is forecast to exceed 20% of GDP five years after taking office, as specified in your Budget Responsibility Rules (BRRs), net debt remains at a prudent level and consistent with your long-term fiscal objectives for net debt to be between 15 and 25% of GDP.

These fiscal forecasts are subject to substantial downside risks. The most significant of these is the increase in forecast District Health Board deficits. The costs of this are highly uncertain, but if funded outside existing allowances would add approximately 0.5% of GDP to net core Crown debt over the forecast period. Further weakening in economic growth could also weaken the fiscal position further.

In light of the macroeconomic conditions, our view is that fiscal policy should be accommodative. Accordingly, we do not recommend reducing operating allowances to eliminate forecast deficits in the short-term, or bring net core Crown debt below 20% of GDP in 2021/22. However, given downside fiscal risks and possibility of persistent deficits we also do not recommend increasing the operating allowances or introducing a tax and welfare package at this time. s9(2)(f)(iv)

Instead, we recommend that any increase in spending is delivered by increasing capital expenditure by $12 billion. A number of factors lead us to support increasing capital allowances by this amount:

- A $12 billion increase in the capital allowances will allow you to meet a large proportion of expected demand for capital funding over the next four Budgets while continuing to prioritise high-quality expenditure.

- Low interest rates mean Crown borrowing costs are historically low levels, which reduces the lifetime costs of debt-funded capital expenditure.

- Increasing the capital allowances will not significantly impact the operating balance, while high-quality capital expenditure can be debt-funded while maintaining a prudent level of debt. This allows fiscal policy to support monetary policy, thereby reducing the risk of unconventional monetary policy being deployed, without undue fiscal risk.

We recommend that $8 billion of this increase is allocated to the multiyear capital allowance, to be spent in future Budgets. This includes the increase to the multiyear capital allowance from adding the year 2023/24 to the forecast period. We recommend the remaining $4 billion is used as a December spending package. We consider that this split allows for a meaningful spending package in December that will support the economy and provide certainty to businesses and households, while limiting the risks associated with an out-of-cycle spending package. It remains critical that both these spending mechanisms prioritise high value capital expenditure that supports productivity and growth.

Recommended Action

We recommend that you:

Fiscal and economic context

a **note** that, based on preliminary fiscal forecasts, net core Crown debt will be 20.9% of GDP in 2021/22

b **note** that, while this exceeds the 20% net debt target specified in your Budget Responsibility Rules, debt remains at prudent levels, and within the 15% to 25% target range

c **note** that, based on preliminary fiscal forecasts, the operating balance before gains and losses (OBEGAL) will be in deficit in 2019/20 and 2020/21 ($370 million and $646 million, respectively) before returning to surplus

d **note** that, while the current path of OBEGAL is consistent with your Budget Responsibility Rule to maintain a sustainable operating surplus across an economic cycle, there are downside fiscal risks and the possibility deficits persist

e **note** that there are likely to be macroeconomic benefits to a looser fiscal policy, through supporting monetary policy, reducing the risk of unconventional monetary policy being adopted; and supporting business and household confidence to encourage spending and investment

f **note** that, given the risks associated with larger OBEGAL deficits, and short-run constraints on capacity and capability, any increase in spending is best delivered through increased high quality capital expenditure rather further operating expenditure

g **note** that the fiscal forecasts do not fully incorporate the impact of higher DHB deficits; the impact of these is uncertain, but we currently estimate they will increase net core Crown debt by 0.5% of GDP across the forecast, if funded outside existing allowances

Capital allowance

h **note** that, under the multiyear capital allowance approach, an additional year of capital spending is rolled in to the allowance at the Budget Policy Statement

i **note** that the $4.4 billion of unallocated funding in the multiyear capital allowance will be insufficient to meet capital demands over the next four Budgets

j **agree** to increase the multiyear capital allowance by **$8 billion** to a total level of $12.4 billion, with the intention that this meet capital demands over the next four Budgets

Agree/disagree.

k **agree** to, in addition to this increase, committing to allocate **$4 billion** to capital projects between the Budget Policy Statement and Budget 2020, with the intention that this spending will support the macroeconomic objectives noted above.

Agree/disagree.

l **note** that the capital spending proposed above results in net core Crown debt rising to 22.5% of GDP in 2021/22 and falling thereafter (assuming no change in operating allowances)

Operating allowances

m s9(2)(f)(iv)

n

o **agree** to maintain operating allowances at the current levels in the Budget Policy Statement, s9(2)(f)(iv)

Agree/disagree.

p **note** that the HYEFU forecasts will need to include an operating allowance for Budget 2023, as the forecasts will be extended to 2023/24

q **agree** to seek Budget Ministers' approval to set the Budget 2023 operating allowance at $2.6 billion, based on the operating allowance assumed in the Budget 2019 projections

Agree/disagree

Next steps

r **instruct** the Treasury to lodge the attached Cabinet paper seeking agreement to recommendations (j) and (k) above, for consideration by Cabinet on 4 November

Renee Philip
Manager, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal Strategy for the 2020 Budget Policy Statement

Purpose of Report

1. This report provides advice on the level of allowances to be included in the Budget Policy Statement on 11 December. It also advises on the scale of a spending package to be announced at the same time, as discussed in our previous advice of 4 and 26 September (T2019/2447 and T2019/2887). The principal new information incorporated into this advice is the Treasury's preliminary fiscal, economic and tax forecasts.

2. Attached to this report is a Cabinet paper seeking agreement to our recommendations. We have revised this based on your feedback on the draft version your office received last Friday (25 October), and updated with the preliminary fiscal forecasts.

Economic and fiscal context

Since Budget 2019 growth has weakened and the economy remains close to potential, but downside fiscal and economic risks remain

3. We have discussed the economic forecasts and general outlook in our previous advice (T2019/2447, T2019/2887 and T2019/3177). Our view of the economy remains consistent with that advice, and much as discussed at Budget Matters on 22 October. GDP growth is weaker than forecast at Budget 2019, driven by slower investment growth, ongoing weak business sentiment associated with global and domestic policy uncertainty, and a softer outlook for GDP growth in New Zealand's top trading partners. Continued population growth offers some support. However, we would particularly highlight that per capita GDP growth for 2019/20, an imperfect proxy for the improvement in material living standards of New Zealanders, is now forecast to be half what was forecast at Budget 2019 – though the reductions in growth are smaller throughout the latter part of the forecast, and this partially reflects changed migration assumptions.

4. Despite slowing economic growth, the labour market remains tight, and there is anecdotal and survey evidence of ongoing capacity constraints. While there is some evidence that these are beginning to ease, overall this supports our view that the economy remains at or near its potential level. We are not facing a major economic shock or major fall in demand; the current slowdown is a more gradual weakening in growth. It remains uncertain how far the slowing is structural, and how much is cyclical.

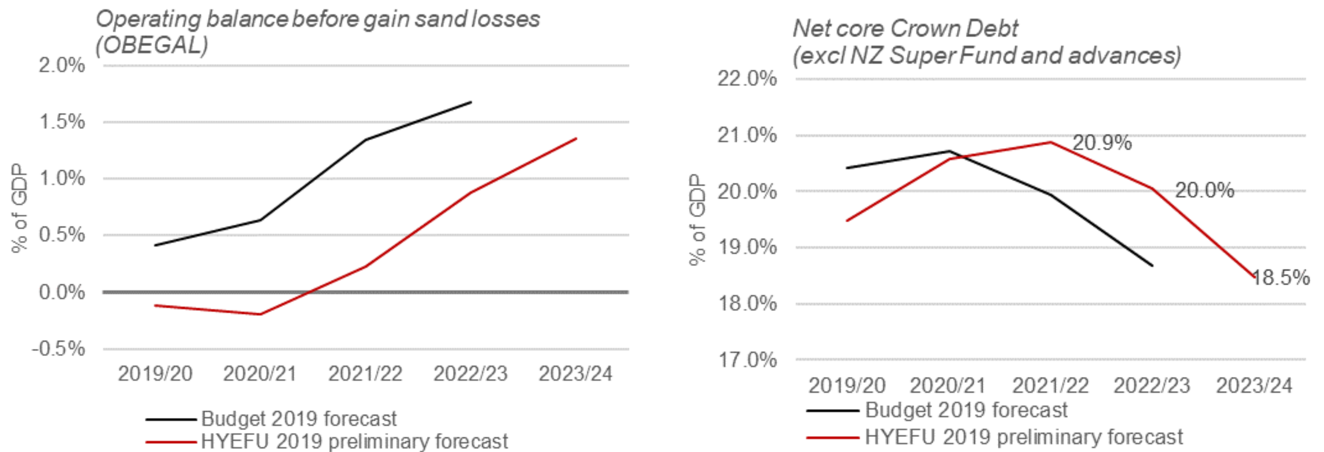
5. The most substantive macroeconomic risks remain the heightened risk of a global downturn; the limited space available for conventional monetary policy to support any further weakening in growth; and ongoing weak confidence constraining growth in business investment. All of these risks could be partially mitigated by adopting a looser fiscal policy relative to current levels; the merits and risks of this are discussed below.

The preliminary fiscal forecasts show small OBEGAL deficits in 2019/20 and 2020/21 and net core Crown debt at 20.9% of GDP in 2021/22

6. This reflects both weaker tax revenue and higher forecast expenses across the next five years. The weaker economic outlook and lower interest rates are the main contributors to the reduction in tax revenue forecasts compared to the *Budget Update*. Benefit expenses are expected to be more than previously expected, with greater recipient numbers based on actual data to date and a higher indexation adjustment for

most benefit types due to a higher wage track now expected. The results from Crown Entities are expected to be weaker with DHBs facing increased costs for delivering services and a drop in discount rates since the Budget, resulting in an increase in ACC claims costs.

Figure 1: OBEGAL and net core Crown debt, BEFU and prelim forecasts



7. The forecast OBEGAL deficits for this and the next financial year are relatively small, at $370 million and $646 million respectively, and the medium term track for OBEGAL continues to grow similar to the trend forecast at Budget, with steadily increasing surpluses from 2021/22, driven by improving economic growth and tax revenue. Similarly, although net debt is forecast to rise as a proportion of GDP over the next two years, it is forecast to begin to fall within the forecast period, reaching 18.5% of GDP by 2023/24.[1] Further details on the preliminary fiscal forecast are outlined in a separate report you are receiving today (T2019/3154).

8. It is worth noting that the net core Crown debt position reported in the preliminary fiscal forecasts has been positively impacted by the an increase in cash received under the Emission Trading Scheme (ETS) from the uptake of the Fixed Price Option (FPO). Although the uptake of the FPO has improved net core Crown debt, it has also increased the Government's obligation under the ETS, which will need to be settled in the future, and will impact net core Crown debt when settled. By the end of the forecast period the FPO has reduced net core Crown debt by around 0.7% of GDP.

9. It is important to note that these preliminary fiscal forecasts do not include the effect of potentially higher DHB deficit forecasts, on which you are receiving separate advice on Friday (T2019/3430). There are a number of options as to how these deficits can be funded, which will have different impacts on the fiscal forecasts. The exact impact is highly uncertain; it will be minimised by funding deficits within operating or capital allowances, although this will be difficult and will exacerbate future pressures on allowances.

10. If you choose to fund the deficits outside allowances, there will likely be a substantial impact on the fiscal forecasts. As a rough estimate, funding deficits outside allowances is likely to result in net core Crown debt increasing by approximately 0.5% of GDP by the end of the forecast period. The risk that DHB deficits impact fiscal forecasts should inform your decisions on the fiscal strategy; this and other downside fiscal risks are discussed below.

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[1] Note that the preliminary forecasts assume no increase in the multiyear capital allowance above current levels, and an operating allowance of $2.4 billion in Budget 2023.

Overall, we recommend an increase in high quality spending that meets your broader policy objectives, which will also provide further support to monetary policy and the wider economy in the context of heightened global risks

11. As discussed in our prior advice, a looser fiscal policy will provide further support to the economy in the context of ongoing global uncertainty. Loosening fiscal policy is based on a judgement over the balance of risks. In our view, the risks of doing nothing at this juncture, and leaving monetary policy as the principal tool to support the economy are outweighed by the, still meaningful, risks of an increase in spending.

12. However, it remains possible that the outlook will improve as global uncertainty begins to resolve over the next year, and any fiscal support provided will, with hindsight, have been unnecessary. For this reason, any spending should be on a 'least regrets' basis, and focus on supporting initiatives and policy objectives you would have supported in the absence of any slowdown in growth. Any spending package should not be treated as a conventional fiscal stimulus that aims to purely stimulate demand; the economic context supports a more conservative approach, and limiting new spending to high quality projects.

We would advise against tightening the current fiscal stance to either return OBEGAL to surplus, or to bring net debt below 20% of GDP in 2021/22

13. Despite the current forecast of an OBEGAL deficit, we do not recommend tightening fiscal policy in order to return to surplus immediately. Firstly, as discussed above, the current macroeconomic environment is highly uncertain and the short-term economic outlook has weakened. Reducing government expenditure at this stage would risk reducing economic growth, withdraw current support for the economy, and negatively affect confidence. If any spending is decreased to manage deficits, this should be focused on items which are unlikely to impact macroeconomic conditions.

14. Secondly, the forecast deficit remains relatively small. It is well within historical forecast error – based on historical variation, there is a reasonable probability the final data shows a surplus. The deficit is also not persistent, and OBEGAL returns to surplus by 2021/22. The deficit, as currently forecast, does not suggest that spending is on an unsustainable path or that fiscal policy will need to be tightened further in the medium-term.

15. However, this judgement should be considered in the context of substantial downside fiscal risks. The most notable of these is DHB deficits, as noted above; further economic weakening and a number of future pressures on allowances also remain risks. These risks would not justify a fiscal consolidation at this stage. They should nevertheless be monitored closely, for any sign that the current small deficits may become more persistent or expand further.

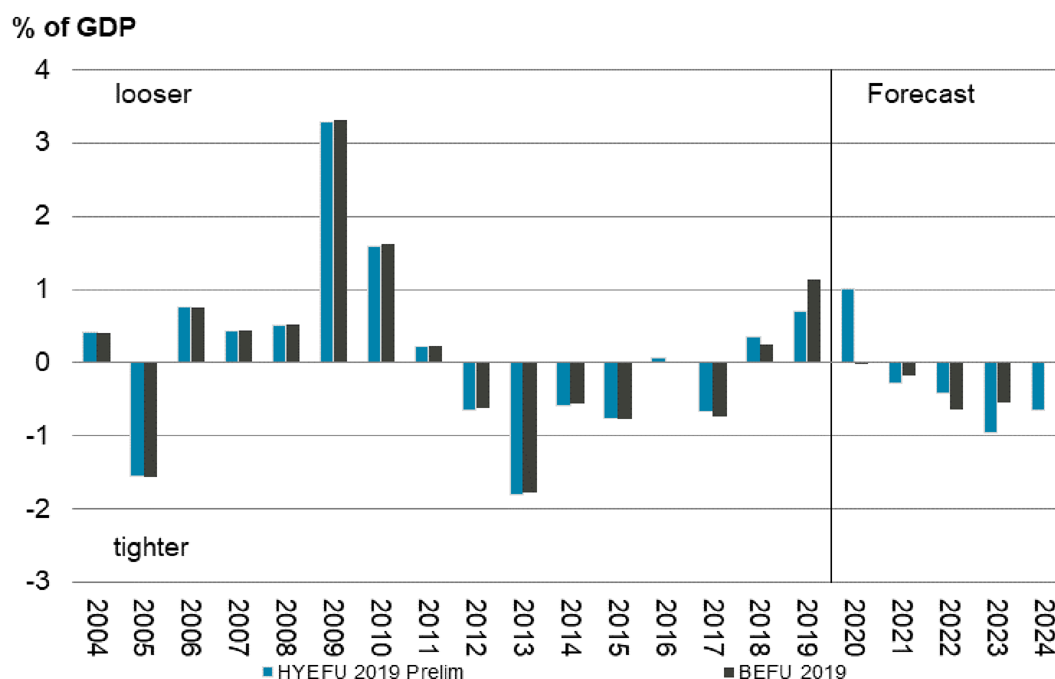
16. The argument against immediate fiscal tightening also applies to the 20% net debt target. We would not advise changing policy to ensure net debt is 20% of GDP or lower in 2021/22. Small changes in net debt are not economically significant, and a contraction in fiscal policy is not advisable given the downside risks to the fiscal position and the pressures against Budget allowances.

Fiscal policy is currently relatively contractionary beyond the next year; a more expansionary policy could provide further support over the medium term

17. While the increase to allowances at Budget 2019 has provided a significant degree of support to the economy, which is reflected in our forecasts, this fades later in the forecast period, reflecting the ongoing effect of fiscal drag and stable allowances later in the period.

18. This is reflected through several measures of the fiscal position. The cyclically adjusted balance – adjusting OBEGAL for the position of the economic cycle – is forecast to reach a surplus of 1.4% of GDP by 2023/24. Core Crown expenses are forecast to fall from 29.9% of GDP in 2020/21 to 28.7% of GDP in 2023/24, reflecting government expenditure forming a decreasing share of economic activity. Finally, figure 2 below shows the fiscal impulse, updated with preliminary fiscal forecasts. While this is an imperfect measure, it still provides an approximation of the stance of fiscal policy over the forecast period, and indicates fiscal policy tightening over the latter part of the forecast period.

Figure 2: forecast fiscal impulse, based on preliminary forecasts



19. These indicators suggests that there is space to loosen fiscal policy beyond the next year, without policy becoming pro-cyclical. Increases in spending in the next two years are more likely to influence monetary policy decision making in the short run; spending increases beyond that will also provide macroeconomic support through supporting confidence, and ensuring fiscal policy is largely neutral across the forecast period.

Capacity and capability constraints will limit immediate operational or capital spending increases

20. This focus on the medium term is supported by our view of capacity and capability constraints. As discussed at Budget Matters on 22 October, there remains anecdotal and survey evidence that the labour market is tight and capacity in many sectors, especially construction, is strained. In this context, focusing on short term increases in expenditure risks either delaying the impacts of government spending; or displacing high value private sector expenditure.

21. This challenge is likely to be particularly acute for any short-term increases in capital expenditure. However, committing to projects further in future may partially avoid these constraints. Longer term commitments, particularly if large in scale, could support improvements in capacity, or make use of spare capacity if constraints ease over the next two to three years. However, such longer term commitments, aside from the effect

on confidence, would have limited short-term benefits for monetary policy. The justification for such expenditure would need to be strongly justified by the value of the initiatives for long-run growth and productivity.

22. You have also received advice on the workforce capability challenges in the public service (T2019/2621). The issues discussed in this paper regarding meeting increasing demand for specialised public sector workers are likely to continue in the medium term. These will impact all public spending, but may especially constrain large increases in operating expenditure in the short run, where those increases in spending rely on development of new policy programmes or expansions in the workforce of already in-demand professions.

23. Public sector capability constraints will also be present, to a lesser extent, regarding increasing capital expenditure. In the first instance, delivery of large capital projects requires substantial specialised capability, which major spending agencies may not be able to increase quickly. Secondly, the operating expenditure associated with some types of capital expenditure – for example, expanding service provision to make use of a new asset – will be subject to the same constraints, which may limit the impact of new capital spending on public service delivery in the short run.

Your commitment to maintain net core Crown debt between 15% and 25% of GDP remains prudent; there is space before this limit is exceeded

24. Keeping net core Crown debt in the range of 15% to 25% of GDP remains prudent in the current economic context. Although your Budget Responsibility Rule features a clause noting that it remains 'subject to a major economic shock', as advised previously, this condition has not been met, and debt should remain in this range throughout the forecast period.

The operating balance presents a greater constraint; it is prudent to maintain a surplus on average; and ensure a return to surplus over the forecast period

25. While temporary OBEGAL deficits can be consistent with fiscal sustainability, as noted above, persistent deficits over the forecast period should be avoided. Persistent deficits are not consistent with fiscal sustainability, particularly while output remains above potential, and risk setting net debt on an unsustainable upward trajectory requiring future fiscal consolidation.

26. There is always a risk that a temporary deficit, such as the one currently forecast, becomes persistent. A further weakening in growth; downside fiscal risks crystallising; or growth not recovering as quickly as expected could all easily lead to persistent deficits throughout the forecast period, even with no change to the current fiscal strategy. Naturally, the risk of this increases the larger 'temporary' deficits become; the extent to which you wish to avoid any larger deficits will reflect the risk tolerance for maintaining persistent deficits in the current context.

27. At the most extreme, we would advise running an OBEGAL deficit no greater than 1% of GDP in any year of the forecast. Any deficit greater than this, based on current forecasts and historic rates of increase in OBEGAL, would be unlikely to be eliminated by the end of the forecast period. Reducing OBEGAL to this level in the current economic context would represent the limit of prudent fiscal policy; we would advise adopting a more conservative position to maintain resilience against potential fiscal shocks.

28. In addition to avoiding large deficits in individual years of the forecast, we would also advise ensuring, on average, OBEGAL is not in deficit across the forecast period. Currently, the average OBEGAL surplus is 0.4% of GDP across the forecast period, suggesting there remains some space before this limit is reached. s9(2)(f)(iv) s9(2)(f)(iv)

s9(2)(f)(iv)

30. As with limiting deficits to 1% of GDP in any individual year, we would advise treating the limit of maintaining OBEGAL at zero on average as the extreme case, with a more risk averse policy advisable in the current economic context. Under the current economic and fiscal forecasts, the return to surplus is driven by an improvement in growth from 2021/22. The risk that growth does not improve – for example, if current lower growth rates persist in future – supports maintaining OBEGAL at or near its current average levels. This implies, from a fiscal sustainability perspective, that capital expenditure is likely to be a preferable option to operating expenditure or changes in tax policy in any fiscal expansion.

s9(2)(d)

s9(2)(d)

s9(2)(f)(iv)

s9(2)(f)(iv)

s9(2)(f)(iv)

Finally, we advise setting the allowance for Budget 2023 at $2.6 billion, based on the projection used at Budget 2019

43. Cabinet have delegated authority to Budget ministers to set allowances for the Budget Policy Statement.

44. An operating allowance of $2.6 billion in the final year of the forecast is consistent with the assumptions made at Budget 2019, and reflects that (over time) annual operating allowances will need to increase to account for inflation and economic growth. This approach differs from that taken in previous Budget Policy Statements, which typically rolled forward the operating allowance from the previous year, rather than using the projection from the previous Budget.

45. In our view, this change in approach is easily justified – if the previous year's allowance is always rolled forward, there will, in the long-run be no increases in allowances to account for growth and inflation. However, this change in approach may attract comment. If it does, we suggest explaining it with reference to the strong fiscal position forecast for 2023/24, and noting that an increase in allowances for the final year of the forecast accounts for inflation and economic growth after two years of maintaining fixed allowances.

Options for the capital allowance

Historically low interest rates, debt at prudent levels, a pipeline of projects, and broader macroeconomic conditions support an in increase in quality capital spending

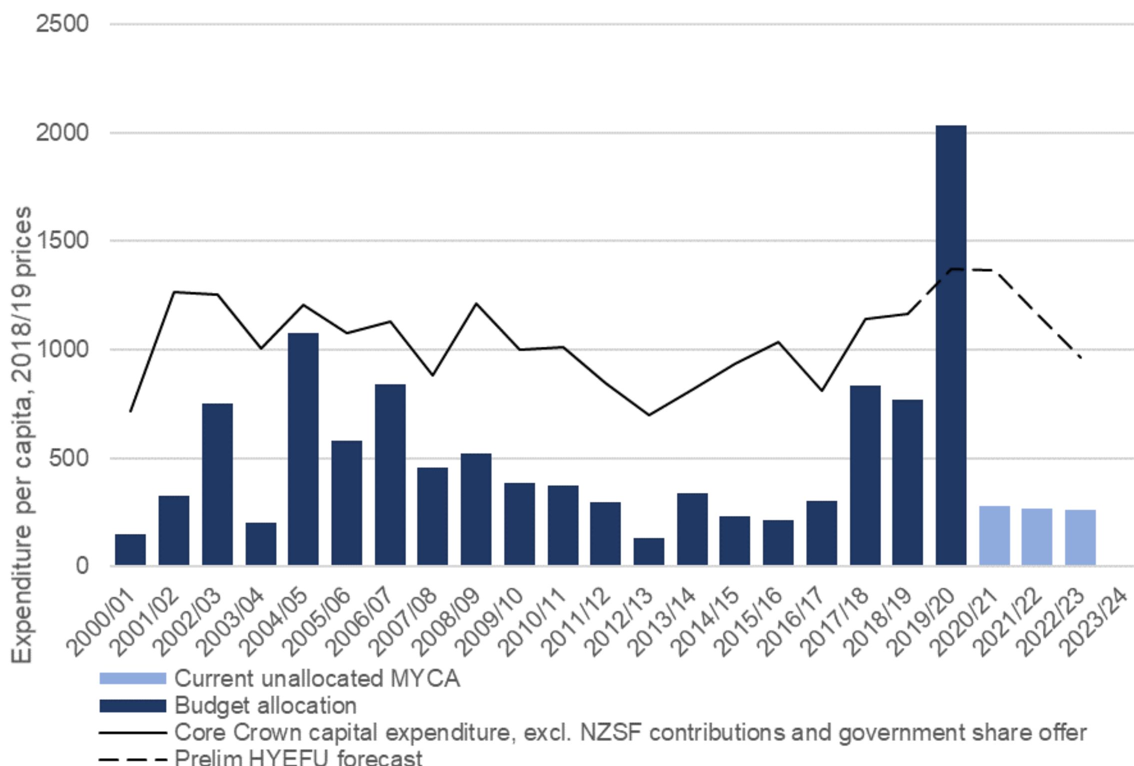
46. There is a good rationale for increased capital expenditure from the currently allocated levels, in addition to the macroeconomic judgements discussed above. In particular, government borrowing rates are at historic lows, with the 10 year New Zealand Government bond yield averaging 1.16% over the past 20 days. This reduces the long run fiscal cost of government borrowing; although debt will still need to be rolled over in future when newly issued bonds reach maturity, so it remains important that borrowing finances investments that continue to support long run growth.

Recent capital allowances have been high by historical standards, but spending is set to fall in future

47. Figure 4 below shows capital allowances and expenditure in historical context, adjusted for inflation and population growth. Although the capital allocated at Budget 2019 was much larger than historical standards, the current unallocated multiyear capital

allowance ($4.4 billion in nominal terms), spread over the next three years is somewhat lower than historical allowances, though in line with post GFC levels of capital allowances. This results in capital spending falling later in the forecast period towards historical averages.

Figure 4: Historical core Crown capital expenditure, adjusted for inflation and population growth



An increase in capital expenditure, as well as maintaining spending at historical levels, will provide long to medium term macroeconomic support

48. We have previously advised considering an increase to total capital expenditure of between $10 billion and $15 billion (T2019/2887 refers). We expect that this increase to capital expenditure will be divided between: (1) an increase to the multiyear capital allowance (MYCA), to be allocated over the next four Budgets (including the new year 2023/24 that will be rolled into the HYEFU forecasts), and (2) a spending package to be announced at the Budget Policy Statement, and allocated to projects between now and Budget 2020.

49. We have used the following process to inform our judgement regarding the level of capital expenditure allocated to the MYCA and the December spending package:

   a Determine the **total level** of desired capital expenditure with reference to macroeconomic objectives, debt constraints, and capacity and capability constraints.

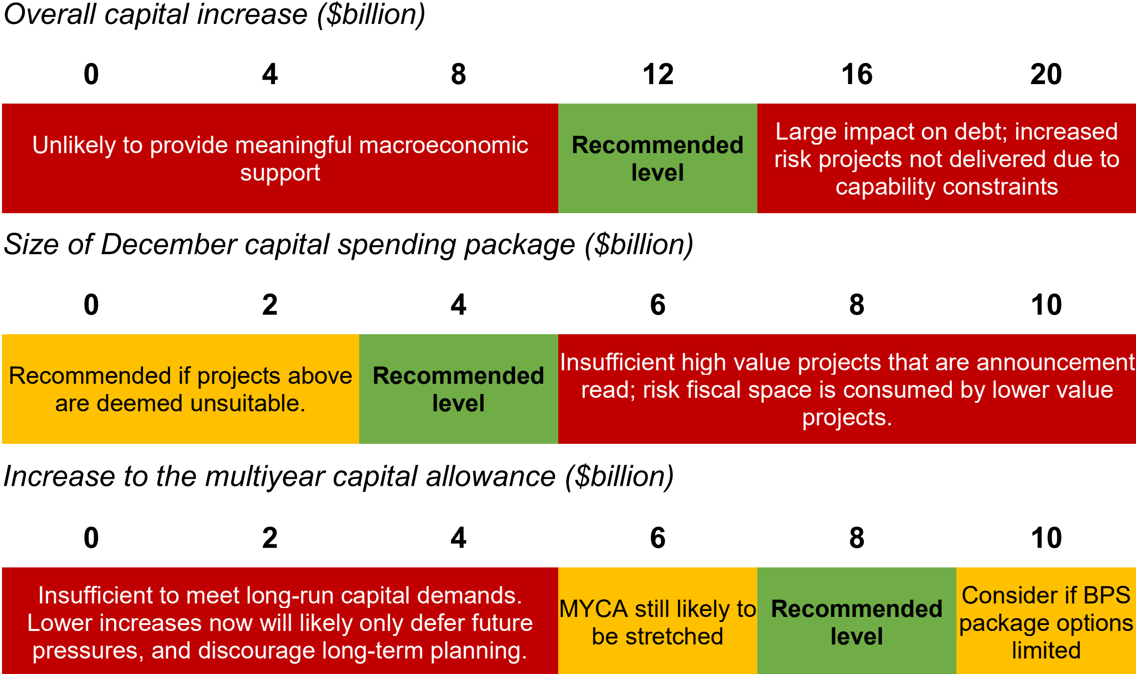
   b Determine a feasible range for any **increase to the MYCA** based on expected future demands and historical levels of capital expenditure.

   c Determine a feasible size of **package to be announced in December**, based on the potential projects identified in previous advice.

   d Reconcile these three judgements to form an overall capital package, alongside a judgement around the overall quality of expenditure to be supported.

50. This sequence of judgements are summarised in figure 5, and each discussed in turn below. We would expect capital projects funded through either of these routes to face similar levels of scrutiny and due diligence to ensure a focus on high value projects. The principal difference between what is funded through the standard process and what is announced at the Budget Policy Statement will be the timing of announcements and the public communications.

Figure 5: Recommended approach to capital expenditure increases



An increase in capital expenditure of $12 billion above currently planned levels is likely to adequately balance macroeconomic benefits and risks

51. The overall increase in capital expenditure should be informed by a judgement regarding net core Crown debt, balanced against macroeconomic considerations and the value of initiatives to be funded. Fiscal policy should aim to continue to keep net core Crown debt within the range of 15% to 25% of GDP. Under current economic and fiscal forecasts, and using standard assumptions regarding the phasing of capital expenditure, an unfeasibly large increase in planned capital expenditure – in excess of $30 billion allocated over the next four years – would be required for debt to rise above 25% of GDP by the end of the forecast period.

52. However, we would advise a more conservative approach than consuming the entirety of available fiscal space with a single change to the allowance. This estimate of fiscal space does not allow for any further weakening in the economic or fiscal forecasts, or for any expansion in operating expenditure due to the fiscal risks discussed above. It would be prudent to allow space for either of these to occur without debt exceeding the 25% limit. The impact of a range of possible capital increases on net debt is summarised in table 2 below. We have assumed a spending package of $4 billion to be announced at the Budget Policy Statement, with the remainder of any increase allocated to the multiyear capital allowance.

53. An overall increase in capital expenditure of $12 billion (highlighted in green) results in debt peaking at 22.5% of GDP in 2021/22 and falling thereafter. We view this as an appropriate path for net debt that still allows some fiscal space beneath the upper limit of the 15% to 25% debt range, in the event of a weakening in the fiscal or economic position, or future decisions to increase operating expenditure.

Table 2: debt impact of alternative capital expenditure scenarios (recommendation highlighted)

Total increase to capital expenditure ($bn)	*Net core crown debt as a percentage of GDP, excl. NZSF and advances*				
	2019/20	**2020/21**	**2021/22**	**2022/23**	**2023/24**
10	19.6%	21.3%	22.3%	22.1%	20.9%
11	19.6%	21.3%	22.4%	22.2%	21.1%
12	19.6%	21.4%	22.5%	22.4%	21.3%
13	19.6%	21.4%	22.6%	22.5%	21.5%
14	19.6%	21.4%	22.7%	22.7%	21.7%
15	19.6%	21.5%	22.8%	22.8%	21.9%

54. Note that whether expenditure is allocated to the multiyear capital allowance, or included in the BPS spending package has minimal impact on debt. In either case, the above analysis assumes that the expenditure of any allocated allowance, and therefore the impact on debt, is spread over the five years following the allocation of new capital.

55. The debt profiles above are estimates based on simple assumptions about the profile of spending, made in the absence of any more detailed information about the projects that will be funded. The impact on debt will change as projects are decided on and announced, based on the expected spending profile of specific proposals. This will mean, for example, that a December spending package that prioritises long term transport projects will likely have a more limited impact on debt in the short run than the profile above.

s9(2)(f)(iv)

s9(2)(f)(iv)

s9(2)(f)(iv)

This, based on the overall level of capital expenditure recommended above, suggests a December spending package of $4 billion

61. An increase in the MYCA of $8 billion, plus a December capital package of $4 billion would give a total increase of $12 billion, as proposed above. The December spending package could be used to meet either spending package options that are outside the future capital pressures; or part fund some of the capital pressures which are also suitable for providing macroeconomic support.

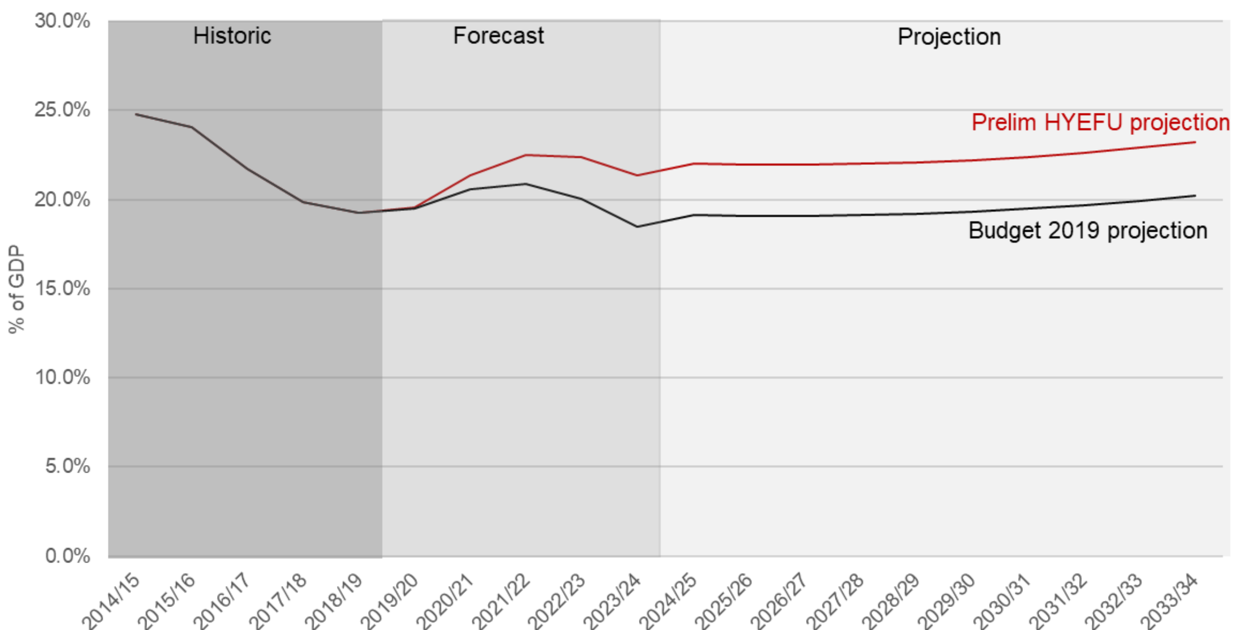
62. There would be risks of announcing a spending package larger than this in December. In particular, we would be concerned that, in the absence of a comprehensive process of soliciting and appraising bids, you would risk prioritising funding for visible and announcement ready projects over higher value ones that might be identified through a more thorough process. Regardless of its size, any BPS spending package should be subject to the same assessments of value for money and impact appraisal as is normally applied to public spending proposals. A larger package risks undermining this process, and consuming available fiscal space on lower value expenditure, crowding out space to invest in future higher value projects.

Longer-term scenario analysis

The proposed approach is consistent with maintaining a prudent fiscal strategy beyond the forecast period

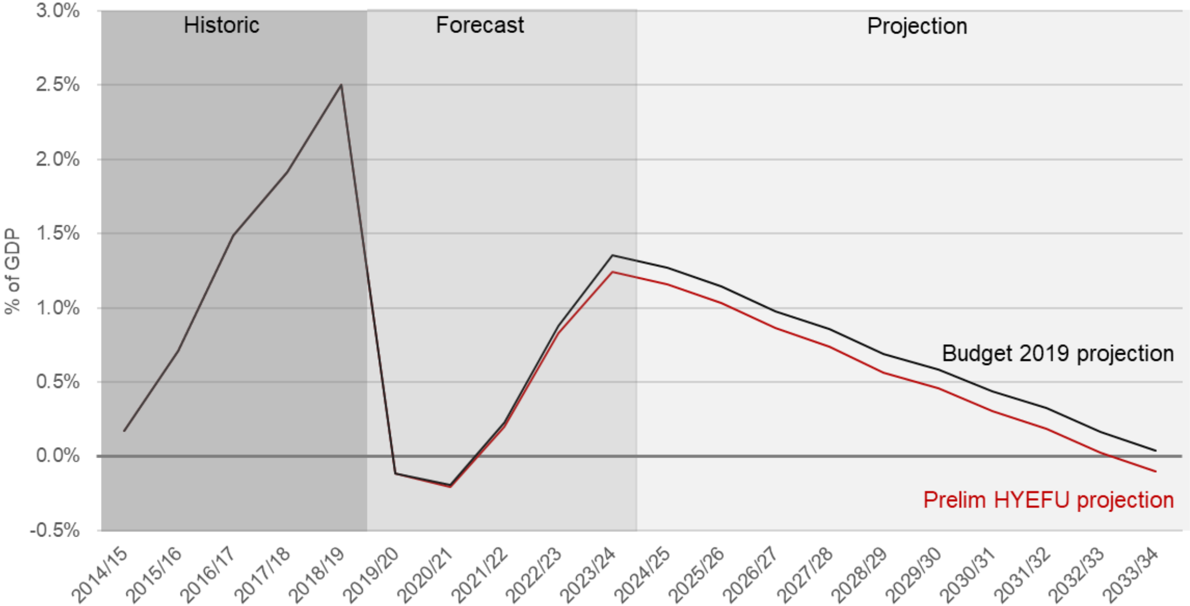
63. The above analysis has predominantly focused on the impact of fiscal strategy changes within the forecast period. You should also consider the longer term implications of any additional spending. On the basis of our longer term projections, we are comfortable that the proposed increase in capital expenditure remains prudent in the long run. Figure 7 below shows the impact of the proposed $12 billion increase in capital expenditure on net core Crown debt beyond the forecast period.

Figure 7: net core Crown debt as a % of GDP, long term projection



64. Figure 8 below shows the long run impact on OBEGAL. A combination of changes in the forecast, projection assumptions, and the effect of increased capital expenditure and consequent higher interest payments results in an OBEGAL deficit in the final year of the projection. This is a relatively small deficit that we do not believe represents a long-run risk to the proposed increase in spending. Small adjustments in the assumed long run level of spending would be sufficient to eliminate this deficit in the final year of the projection period – for example, reducing the assumed operating allowance growth from 4.5% per annum to 4.0%.

Figure 8: OBEGAL as a proportion of GDP, long term projection



65. The economic projections underlying figures 7 and 8 have been updated to assume an updated productivity growth rate of 1.2% per annum, and to account for the higher net migration level within the forecast period, as discussed in previous advice (T2019/3177).

66. Note that these projections use the same policy assumptions as used at Budget 2019, with a fixed capital expenditure of $6.6 billion per annum, and operating allowances beginning at $2.6 billion and rising at 4.5% per annum. You will have the opportunity to review and make final decisions regarding these assumptions following the production of final fiscal forecasts, and prior to the publication of the projection model on the Treasury's website.

Next Steps

67. Attached to this report is a revised version of the Cabinet Paper your office received on incorporating your earlier comments, and updating the recommendations and narrative to reflect this advice and the preliminary fiscal forecasts.

68. We recommend this paper is lodged this week, to be considered at Cabinet on 4 November. Cabinet agreeing to the overall level of allowances at this stage provides sufficient time for this increased expenditure to be fully incorporated into our economic and fiscal forecasts over the following weeks.