The Treasury

Budget 2020 Information Release

July 2020

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Fiscal strategy for Budget 2020

Date:	26 February 2020	Report No:	T2020/15
		File Number:	MC-1-5-2 (Fiscal strategy)

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	Consider recommendations and discuss at Budget Matters	To be discussed at Budget Matters on **3 March 2020**

Contact for telephone discussion (if required)

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

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Executive Summary

This report sets out the Treasury's preliminary fiscal strategy advice for Budget 2020. The advice is intended to help you take decisions on Budget allowances.

The economic outlook is similar to HYEFU, with COVID-19 a key uncertainty likely to result in a weaker forecast

The preliminary BEFU forecasts show annual GDP growth averaging around 2.5% over the forecast period and an output gap around zero, reflected in a continued tight labour market and inflation around 2%, as described in advice you received on Monday (T2020/383). This picture is broadly unchanged from the HYEFU forecasts.

However, COVID-19 is a substantial downside risk and likely to lead to weaker forecasts. The economic forecasts currently assume only limited impact through a temporary global demand shock (described as scenario 1 in T2020/391). Recent information suggests the economic impact is likely to go beyond this, and forecasts will weaken before finalisation. However, short of the worst case scenario described in T2020/391, this is unlikely to materially affect our advice on the macroeconomic stance of fiscal policy. It will, however, exacerbate existing pressures on allowances as demands for new spending increase in response to COVID-19.

The key challenge to your fiscal strategy is meeting pressures against operating allowances while remaining consistent with your fiscal objectives

This challenge plays out over three time periods:

- Prioritising the high demand for **Budget 2020** operating spending to fit within allowances
- Setting allowances across **Budgets 2021 to 2023** to allow management of substantial future pressures, while meeting policy commitments
- Ensuring the spending path set through the next four Budgets is **sustainable in the long-run**

There are considerable pressures against the operating allowances across all periods, and decisions in one period will have trade-offs with decisions in the other periods.

Considering the balance of risks – including COVID-19 – there is a good case for looser fiscal policy over the medium term, while maintaining your fiscal strategy

At present, allowances can be increased while remaining consistent with your fiscal strategy and the PFA's principles of responsible fiscal management. Given the proximity of interest rates to their effective lower bound, the macroeconomic conditions favour higher spending. If growth is weaker than forecast, then looser fiscal policy will provide economic support and ease pressure on monetary policy to loosen, though deficits may be greater than expected and the risk of structural deficits increases. If growth is stronger than forecast, then higher spending can be supported with lower risk of deficits. The Reserve Bank may raise interest rates if higher spending drives inflation, which would increase monetary policy space but somewhat offset the impact of higher spending on growth.

However, increases to the Budget 2020 operating allowance should be limited to around $500 million to conserve fiscal space for use in later years

Raising the Budget 2020 operating allowance will worsen the deficit already forecast in 2020/21, while reducing the fiscal space available to increase operating allowances in Budgets 2021 to 2023. The impact on future Budgets will be exacerbated if increases in Budget 2020 allowance are used to fund discretionary initiatives rather than cost pressures, or if low value-for-money initiatives that do not address structural cost growth are prioritised. The exact increase will be subject to decisions you make on the Budget package.

Operating allowances for Budgets 2021 to 2023 should be increased to around $3 billion, reflecting the likely path of future fiscal policy

Current operating allowances will lead to core Crown expenses falling as a share of GDP by about 1.5 percentage points by 2023/24. This delivers rising surpluses and a prudent debt position over the forecast period. However, we estimate that meeting cost pressures will require between 80% and 110% of these future allowances. Keeping within these allowances will require either restraining cost pressure growth substantially, or minimising spending on new policy commitments. The proposed increase allows the bulk of the cost pressures discussed above to be met, while leaving some room for discretionary new spending. This approach risks increasing demand for discretionary initiatives; we recommend this is managed through explicit communication in the Budget documents that increased allowances are to address cost pressures, not fund new policy commitments.

Achieving fiscal sustainability beyond the next four years will require operating allowances below $3 billion, increased revenue, or other structural responses

Operating allowances of $3 billion per annum – if kept stable in real terms – will lead to a debt and OBEGAL path inconsistent with your fiscal objectives if continued beyond the next five years. Returning to a sustainable long run path will require either a reduction in operating allowances; increases in revenue; or structural changes to address cost growth. Your decisions around allowances in the near-term will directly influence the size of the future response needed to ensure sustainability.

Although there are large demands on the MYCA, delivering another significant capital package in Budget 2020 will be challenging

Budget 2020 bids and the capital intentions pipeline point to significant capital demand over the next four Budgets, in the realm of $28 billion or more. However, the capital packages announced in Budget 2019 and in December 2019 are forecast to raise capital expenditure to historically high levels. Market capacity and agency capability constraints will likely limit delivery of further projects in the short-term. As such, we recommend delivering a relatively limited capital package in Budget 2020 with a focus on the achievability of the funded initiatives. This is consistent with maintaining the MYCA at around current levels.

You will receive an update to this advice incorporating the preliminary fiscal forecasts in late March

We will provide an update on this fiscal strategy advice in late March after the preliminary BEFU fiscal forecasts are finalised, when we will also have an updated picture of the impacts of COVID-19. If you require further advice beyond an update on the material covered in this report, please let us know.

We also recommend, outside of the usual Budget cycle, you consider options for addressing the longer term fiscal strategy issues raised in this report.

Recommended Action

We recommend that you:

a **note** that, while the preliminary economic forecasts are broadly unchanged from the HYEFU, there is a weaker near-term outlook due to COVID-19, and further weakening is likely

b **note** the current operating allowance settings suggest fiscal policy will shift from supporting the economy over the coming year to becoming contractionary towards the end of the forecast period

c **note** expected future cost pressures are significant, and likely to fully- or over-utilise signalled operating allowances in Budgets 2020 and future Budgets

d **note** increasing the operating allowances to $3.5 billion for Budget 2020 will exacerbate the weak OBEGAL position in 2020/21

e **note** our advice to limit any increase to the Budget 2020 operating allowance to within $500 million, subject to preliminary BEFU fiscal forecasts

f **agree** in principle to increase operating allowances for Budgets 2021 to 2023 to $3 billion, subject to the preliminary BEFU fiscal forecasts

Agree/disagree.

g **note** either a reduction in future operating allowances, revenue increases, or structural changes will be needed to ensure a sustainable long-term fiscal position

h **note**, that light of agency capability and market capacity constraints, we recommend a relatively limited capital package in Budget 2020 with a focus on the achievability of the funded initiatives

i **agree** in principle to keep the MYCA at levels sufficient to ensure around $2 billion is available per annum for Budgets 2021 to 2023, subject to preliminary BEFU fiscal forecasts

Agree/disagree.

Renee Philip
Manager, Macroeconomic and Fiscal Policy Team

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal strategy for Budget 2020

Purpose of Report

1. This report sets out the Treasury's preliminary fiscal strategy advice for Budget 2020. The advice is intended to help you take decisions on Budget allowances.

2. The advice and scenarios in this report are based on

   a preliminary 2020 *Budget Economic and Fiscal Update* (BEFU) economic and tax forecasts and

   b 2019 *Half Year Economic and Fiscal Update* (HYEFU) fiscal forecasts (preliminary BEFU fiscal forecasts have not yet been finalised).

3. A second report with updated fiscal strategy advice will be sent to you in the week beginning 23 March following the finalisation of preliminary BEFU fiscal forecasts, when we will also have an updated picture of the impacts of COVID-19.

Context

The economic outlook is similar to HYEFU, with COVID-19 a key uncertainty likely to result in a weaker forecast

4. The preliminary BEFU forecasts show annual GDP growth averaging around 2.5% over the forecast period and an output gap around zero, reflected in a continued tight labour market and inflation around 2%, as described in advice you received earlier this week (T2020/383). This picture is broadly unchanged from the HYEFU forecasts.

5. The preliminary economic forecasts assume a COVID-19 situation similar to scenario 1 described in previous advice ('a temporary global demand shock', T2020/391), which is expected to drag on growth in the near-term. The final BEFU forecasts will likely reflect a weaker outlook, as the impact of COVID-19 becomes reflected in economic data and we update our forecasting judgements.

The fiscal outlook presented in this advice is based on HYEFU; there are downside risks to this forecast from both COVID-19 and other issues

6. The preliminary BEFU fiscal forecasts are still being developed. While early information from the unconsolidated preliminary BEFU tax and social security and welfare forecasts point to a slightly more positive fiscal position than forecast at HYEFU, this is based on economic forecasts showing a relatively muted impact from COVID-19.

7. At present, the main improvement in the fiscal position is driven by slightly higher core Crown tax revenue ($1.7 billion over the forecast period) and a technical change in the New Zealand Superannuation Fund (NZSF) forecasts, on which you have received further detail today in T2020/331. This change leads to the NZSF contribution formula suggesting contributions around $300 million lower from 2022/23 onwards, improving the projected net core Crown debt position by the same amount. This change does not affect OBEGAL significantly within the forecast period.

8. At this stage, the preliminary BEFU economic and tax forecasts point toward a similar outlook for OBEGAL as forecast in HYEFU. Very early indications from the preliminary BEFU fiscal forecasts point to some downside risks to the fiscal position (including

decommissioning expenditure for the Tui Oil field and ACC funding). As part of the preliminary fiscal forecasts the Treasury will also be revisiting some of our key central adjustments such as pay equity assumptions and District Health Board (DHB) deficit support which could potentially adversely impact the fiscal outlook.

9. The fiscal position will also weaken with a more severe COVID-19 scenario, which is a substantial downside risk to the view above. Initial modelling of scenario 2 (a longer lasting domestic shock) suggests OBEGAL deteriorating due to lower tax revenues and higher welfare payments over the short-run. There is substantial uncertainty around the magnitude of these effects, which we will continue to review as information improves.

A sustained impact from COVID-19 (scenario 2) would increase fiscal pressures, but not change our advice on the macroeconomic stance of fiscal policy

10. Our advice in scenario 2 would be to continue to allow automatic fiscal stabilisers to operate, provide support on a sectoral level as required, and, consistent with the advice in this report, adopt a looser fiscal policy relative to what was signalled at HYEFU. Our current view is that the shock of a more sustained outbreak, as described in scenario 2, would not be of a sufficient scale to justify a large scale fiscal stimulus. Additional spending to support the affected sectors would exacerbate the existing pressures on allowances discussed below, but would be unlikely to be of a magnitude that has macroeconomic impacts. A large scale fiscal stimulus targeted at macroeconomic objectives should be reserved for the 'global recession' described in scenario 3.

11. However, this judgement and modelling will be kept under review over the following weeks. We should expect the situation to change, and may need to update our fiscal advice if the fiscal impact appears greater than expected, or the worst case pandemic scenario becomes more likely. At present, however, we recommend taking fiscal policy decisions with reference to 'business as usual' considerations, and treating a macroeconomic response to COVID-19 as a risk factor, rather than the central scenario.

The 2020 Budget Policy Statement (BPS) signalled future allowances

12. Table 1 shows the Budget allowances signalled in the 2020 BPS. Operating allowances in Budgets 2021 to 2023 are lower than the $3.4 billion funded in Budget 2018 or $3.8 billion in Budget 2019.

Table 1. Allowances as per the BPS, before and after pre-commitments

$billions	Budget 2020	Budget 2021	Budget 2022	Budget 2023
BPS operating allowance	3.0	2.4	2.4	2.6
Operating allowance after pre-commitments	2.6	2.4	2.4	2.6
Multi-year capital allowance	8.4 before pre-commitments 8.3 after pre-commitments			

Operating pressures against Budgets 2020 to 2023 are significant

The Budget 2020 operating allowance is highly over-subscribed

13. As you are aware, demand for operating expenditure in Budget 2020 exceeds the $3 billion allowance. Figure 1 below summarises these pressures based on previous advice and our latest understanding of how the Budget package has developed.

Figure 1: Trade-offs for Budget 2020

[33]

14. Containing the Budget package to $3 billion will require challenging trade-offs within these components, implying either:

[33]

15. You have indicated you do not wish to pursue option A. We do not recommend option B. You have received Treasury advice on the case for more extensive funding of cost pressures, particularly in the health sector (T2020/323). Further reductions to the cost pressures funded through this Budget will transfer these costs to future Budgets while creating funding risks for some services in the meantime.

A higher allowance in Budget 2020 would remain consistent with your fiscal strategy…

16. An alternative option is to increase the operating allowance for Budget 2020. A relatively large increase in the allowance could be supported while maintaining your fiscal strategy and being consistent with the PFA principles of responsible fiscal management. Net core Crown debt is well within the 15% to 25% target range, and a single year increase to the operating allowance will not change this substantially.

17. With regard to the operating balance, your fiscal strategy commits to delivering a sustainable operating surplus across an economic cycle, and the PFA principles of responsible fiscal management include ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues. For the purposes of this advice, we interpret the above objectives as ensuring OBEGAL remains in surplus on average across the forecast period.

18. Under current allowance settings, the preliminary BEFU economic and tax forecasts indicate OBEGAL around zero in 2019/20 and 2020/21, followed by growing surpluses, averaging 0.7% of GDP.[1] The forecast deficit for this financial year remains relatively small and well within historical forecast error. This implies there is some room to run a larger deficit in the next financial year while still meeting your objective for the operating balance. However, this judgement should be considered in the context of downside economic and fiscal risks and pressures on future operating allowances. These may lead to any temporary deficit becoming structural and ongoing, which would raise more serious fiscal sustainability concerns.

…but we advise taking a four year view of any increase to allowances

19. However, looking at the allowance for Budget 2020 in isolation risks ignoring the longer term challenges to the fiscal strategy. The positive fiscal outlook for the latter part of the forecast period is predicated on maintaining smaller operating allowances in each of the next three Budgets. This is likely to be extremely challenging given both recent spending growth and upcoming pressures.

20. Figure 2 below summarises these upcoming pressures. Judgements around the size of these pressures are highly uncertain, but, at present represent our best estimate of the spending required to maintain core public services at current levels.

[33]

[1] Note, these estimates do not include the preliminary BEFU fiscal forecasts, and there are downside risks as discussed above.

[33]

[38,33]

b We assume wage costs in other parts of the public sector will rise in line with nominal GDP growth (about 5% per annum). This is assumed to account for both wage inflation and growth in workforces to keep up with population growth.

c We assume non-wage costs across the rest of the public sector will grow with CPI inflation (2% per annum). Note that this is lower than the rate of spending growth in most areas over the past years; we also include these costs growing with nominal GDP as a sensitivity.

[33]

22. We have also included a number of other costs drawn from the specific fiscal risks published at HYEFU, including both policy risks (green) and cost pressure risks (purple). The selected risks are either relatively high impact, or have a high probability of occurring. Not all of these will eventuate, but their inclusion highlights the other pressures on your available fiscal space.

23. Maintaining your current allowances would be feasible even if the cost pressures shown below eventuated in full. However, it would entail little to no discretionary spending on new policy commitments, and would require substantial restrictions on funding cost growth if any of the highlighted fiscal risks eventuated.

24. Figure 2 assumes that new costs are met from within allowances, in line with the Fiscal Management Approach (FMA). While some of these costs could be managed outside allowances – as, for example, pay equity has been – doing so does not change the underlying trade-offs or the amount of fiscal space available. A key benefit of the FMA is it provides a tool for you to prioritise between pressures and make explicit trade-offs. We recommend continuing to meet future pressures through operating allowances to ensure the FMA remains an effective mechanism to deliver your fiscal strategy.

Figure 2. Future operating pressures

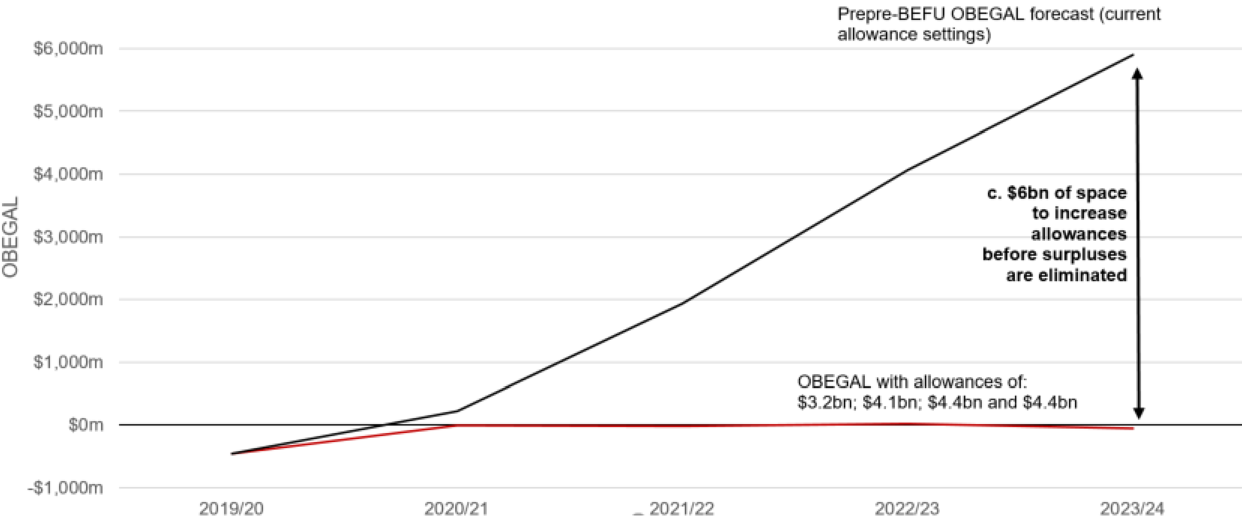
[33]

The case for higher operating allowances for Budgets 2020 to 2023

There remains space to increase allowances across the forecast period

25. There remains fiscal space to increase allowances over the next four years while still remaining consistent with your fiscal strategy and the PFA principles of responsible fiscal management, due to the growing surpluses currently forecast from 2021/22.

Figure 3. Estimate of the upper limit of fiscal space available[2]



26. We estimate an upper limit for operating allowances over the next four years, shown in Figure 3 above. Operating allowances could be increased up to around $16 billion in total over the forecast period (compared to $10.4 billion currently), averaging around $4 billion per year before OBEGAL would, on average, be zero across the forecast period, and the currently forecast $6 billion surplus in the final year would be eliminated entirely. Note that in this scenario, in part due to ongoing low interest rates, debt would remain within the target range, peaking at 22.3% of GDP by the end of the forecast period.

27. Naturally, we would not recommend using the entirety of this fiscal space on increasing operating allowances. This estimate of fiscal space is highly uncertain and could be rapidly reduced (or increased) by forecast changes, movements in the economic outlook, or the emergence of any fiscal risks outside of allowances. A principal risk to consider is COVID-19 – as discussed above, this has the potential to rapidly consume the forecast available fiscal space as tax revenue falls. Any response to COVID-19 to either support the affected sectors or manage the public health response will also place further pressure on allowances, increasing the demand on this finite space.

28. You may wish to preserve some of this fiscal space to buffer against these uncertainties to mitigate the risks of an unanticipated shock or worsening of the COVID-19 outlook resulting in a persistent deficit. In the event of such a shock we recommend letting the automatic stabilisers operate, which would likely entail tolerating larger or longer than expected OBEGAL deficits in the near-term.

29. Such temporary or cyclical deficits should not be viewed as a major concern if there is a credible path to return OBEGAL to surplus within the forecast period. However, they would become a concern for fiscal sustainability if any deficits become structural, or

[2] This figure shows estimates on a 'pre-preliminary BEFU' basis – that is, incorporating preliminary economic and tax forecasts, but not preliminary fiscal forecasts. As noted above, the preliminary fiscal forecasts are likely to show a weaker position.

OBEGAL deficits occur in periods of strong economic growth. This is a risk if economic and fiscal forecasts for the latter years of the forecast worsen substantially, reducing future fiscal space.

We recommend limiting any increase to the Budget 2020 operating allowance to around $500m

30. As discussed above, a relatively large increase in the Budget 2020 allowance could be supported while maintaining your fiscal strategy and being consistent with the PFA principles of responsible fiscal management.

31. However, on balance, we recommend limiting any increase in the Budget 2020 operating allowance to around $500 million per annum, and ensuring it high value for money initiatives are prioritised. This reflects several judgements:

    a **A higher Budget 2020 operating allowance will make managing within future operating allowances more difficult**. Higher spending in Budget 2020 will (1) reduce the fiscal space available to increase operating allowances in Budgets 2021 to 2023, and (2) embed a higher base of core Crown expenditure from which future cost pressures will grow, placing more pressure on future allowances. This will particularly be the case if increased expenditure in Budget 2020 does not address the drivers of cost pressure growth, and steps to address these structural challenges are not taken before the next Budget.

    b **Raising the Budget 2020 operating allowance will worsen an already weak OBEGAL position in 2020/21**. Running a sustainable operating surplus across an economic cycle will necessarily involve running surpluses in good times in order to offset deficits in downturns. However, the current economic outlook is relatively robust (notwithstanding significant downside risk from COVID-19), which would suggest it would be prudent to run a surplus. Given downside risk to the outlook, we would not recommend reducing allowances in order to run a surplus in 2020/21, but recommend against substantial further expansion of the deficit to fund discretionary initiatives. This judgment would change if the COVID-19 impact substantially worsened and a recession appeared likely, in which case a discretionary fiscal stimulus could be warranted.

    c **Estimates of the available fiscal space depend on forecast increases in future growth and revenue**. It would be a lower risk strategy to increase spending when these surpluses had eventuated, rather than spending now in the expectation of an improving fiscal position. This will reduce the risk of temporary deficits becoming persistent if future surpluses do not eventuate.

    d **There are macro-stability benefits from smoothing the impulse from government spending** over the forecast period, rather than generating small economic cycles through changes in government expenditure alone. This favours a smaller increase to the Budget 2020 operating allowance and increasing Budget 2021-23 allowances to comparable levels.

We recommend that operating allowances for Budgets 2021 to 2023 are increased to around $3 billion…

32. Both a macroeconomic and fiscal management perspective suggest a case for higher operating allowances in the later years of the forecast.

33. From a <u>fiscal management</u> perspective, higher allowances of around $3 billion per Budget will allow the bulk of the largely non-discretionary cost pressures discussed above to be met, with some limited space available for further discretionary spending. If allowances are not increased now, you will likely need to increase allowances in future, or make difficult trade-offs to reduce expenditure growth or increase revenue. For the purposes of transparency and clearly signalling your intentions to agencies, we

recommend an increase in allowances now, to ensure fiscal forecasts reflect the most likely path for fiscal policy.

34. From a macroeconomic perspective, higher allowances would represent a relative loosening of fiscal policy and offset the tightening in fiscal policy currently forecast for 2021/22 onwards. Given the current stance of monetary policy and proximity of the effective lower bound, we view the risks of looser fiscal policy as asymmetric. Running fiscal policy 'too loose' – for example, if macroeconomic conditions improve as policy loosens – will likely result in interest rates slightly higher than otherwise (increasing monetary policy space). Conversely, running fiscal policy too tight – for example, if growth weakens, or the COVID-19 situation worsens – risks monetary policy needing to loosen further, increasing the risk unconventional policy is used.

35. There are, however, risks to higher levels of spending, which you should consider:

   a **Operating allowances of $3 billion cannot be sustained in the long-run.** The long-term fiscal sustainability impact of higher allowances are explored further from paragraph 45 onwards below.

   b **Higher allowances may reduce the incentive to address the structural drivers of cost growth.** In the absence of tax increases, maintaining a sustainable fiscal position in the long run will require reducing growth in public spending from the levels seen in the past two years. Higher allowances in the short run will need to be to fund changes to public services that allow this cost growth to be reduced – more generous allowances may reduce the incentive to do so, and allow 'business as usual' top continue for longer.

   c **Demand for funding new policy initiatives will increase further.** An increased allowance may be taken as a signal by agencies that more funding is available for new or discretionary policy initiatives. We recommend mitigating this risk by communicating explicitly through the Budget documents that the increase in allowances is to manage cost growth, rather than fund new policy.

   d **Saving for future generations will be reduced.** The Public Finance Act requires you have regard to the impact of your fiscal policy choices on current and future generations. Smaller surpluses will reduce the extent to which you are saving for future generations, and, under current forecasts, imply borrowing to pay for contributions to the New Zealand Super Fund. This is not a fundamental barrier to increasing spending now, but you should note the distributional implications.

…or that policies to either reduce cost growth or raise revenue are developed

36. If you wish to maintain a more prudent fiscal position and view the disadvantages of higher operating allowances as too great, measures to control spending growth or raise revenue will be required to manage the pressures identified above. Some high level options are described in paragraph 50 below. We recommend further consideration of these options outside the Budget cycle.

Multi-year capital allowance for Budgets 2020 to 2023

There are large demands on the multi-year capital allowance (MYCA)

37. [33,26]

[33,26]

Delivering another significant capital package in Budget 2020 will likely be challenging

38. Together, the capital packages announced in Budget 2019 and in December 2019 represent an $18.4 billion injection of capital funding, and are forecast to raise capital expenditure to historically high levels.

39. Agency capability constraints will likely limit delivery of further projects in the short-term. The pool of skilled public sector workers is small and facing high demand, as seen with recent FTE bids. The Capital Investment Panel[3] raised concerns around the achievability and implementation-readiness of a number of initiatives identified for Budget 2020, with only [33] of the 17 largest initiatives having completed business cases available. Further, there are concerns based on the historic ability of agencies to deliver similar projects.

40. Market capacity constraints mean short-term increases in expenditure risk not being delivered, crowding-out private activity, or driving cost inflation. The labour market remains stretched by historical standards, with businesses reporting difficulty finding labour (particularly in construction) leading to increasing price and wage pressures. These constraints do appear to vary by region and sector.

41. Given agency capability and market capacity constraints, we recommend delivering a relatively limited capital package in Budget 2020 with a focus on the achievability of the funded initiatives. This is consistent with the advice of the Capital Investment Panel (T2020/263), which recommended further development of business cases for many of the larger capital projects before funding was committed.

[3] The Capital Investment Panel is comprised of: Treasury's Investment Management and Asset Performance team, the Government's Chief Data Officer and Chief Data Steward, the New Zealand Infrastructure Commission, and New Zealand Government Procurement and Property.

The current MYCA suggests only a small proportion of future capital demand will be funded

42. The scale of expected future demand means the current level of the MYCA may be difficult to maintain. We advised prior to HYEFU that an unallocated allowance of between $10 billion and $12 billion over the next four Budgets was likely required to meet agencies' future capital demand, assuming around half of identified future pressures were funded.

43. This is not a strict requirement, and naturally, lower levels of MYCA can be maintained if there is stricter prioritisation of future capital expenditure and a lower proportion of future demand is funded. The current MYCA of $8.4 billion suggests funding around a third of currently identified demand, and maintaining capital allowances slightly below the average level from Budgets 2000 to 2019.

44. This is a credible path for future capital expenditure, although suggests a decline in amount of new spending from recent Budgets. Given the constraints discussed above, this is an appropriate strategy. The MYCA will be reviewed at the next Budget Policy Statement when a further year will be rolled in; this will provide an opportunity to update this judgement if the view of capability and capacity constraints has shifted.

Impact of higher allowances on long-run fiscal sustainability

Reductions to operating allowances will likely be necessary in the long-run if near-term allowances are increased

45. Spending decisions taken in the current Budget will impact your future fiscal policy choices. Higher spending in the near-term is not sustainable if this rate of spending growth is continued in the long-run. Any moderate increase in operating spending over the next four years will require some future reduction in allowances or increases in revenue to ensure consistency with your fiscal strategy and the requirements of the PFA.

46. This is demonstrated in figure 5 below, which shows the impact on OBEGAL and net core Crown debt of:

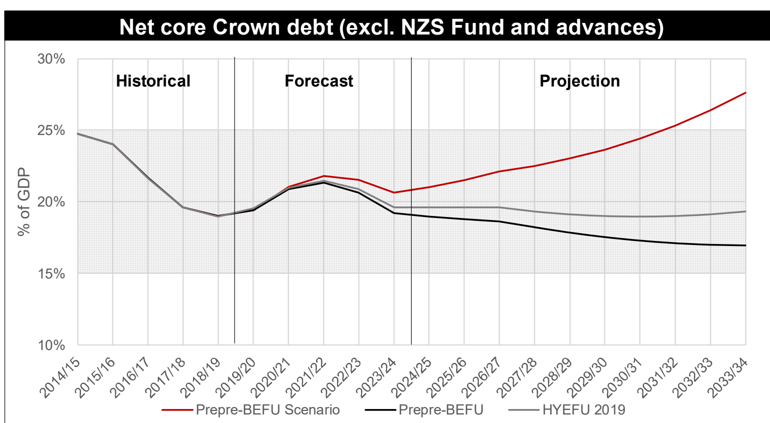
    a Increasing the Budget 2020 operating allowance to $3.5 billion.

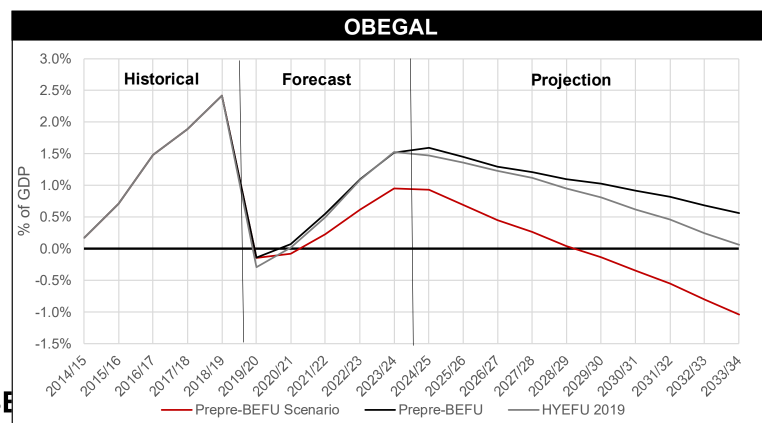
    b Increasing the operating allowances for Budgets 2021 to 2023 to $3 billion.

    c Setting the operating allowance for Budget 2024 at $3 billion, and growing allowances at 4.2% per annum (as assumed at HYEFU).

    In this scenario, while these allowances are sustainable within the forecast period, they lead to a debt and OBEGAL position inconsistent with your long-run fiscal objectives within the next 15 years.

Figure 5: impact of maintaining allowances at $3 billion, growing at 4.2%.





47. Ensuring the higher spending over the next four years does not threaten long run sustainability will require a transition to lower levels of operating allowance. For example, in order to avoid growing OBEGAL deficits, the path for allowances discussed above ($3.5 billion in this Budget followed by $3 billion in the following Budgets) needs to be followed in Budget 2024 by:

    a an operating allowance of $2.5 billion, growing by 4.2%, approximately in line with nominal GDP, or

    b an operating allowance of $2.8 billion, growing by 2.0%, approximately in line with inflation.

48. The scale of increases in the short-term materially affects the scale of the long-term adjustment required. In the examples above, if operating allowances were $4 billion in Budget 2020 and $3.5 billion from 2021 to 2023, the operating allowance in 2024 would need to be $2.3 billion (if growing at 4.2%) or $2.5 billion (if growing at 2%) respectively to maintain surpluses in the projection period.

49. These results are sensitive to the long-run assumptions made in the fiscal strategy model. The impact of altering these assumptions is discussed in the annex.

50. There are choices as to whether fiscal sustainability is achieved through limiting growth in operating or capital expenditure, or raising revenue. Operating allowances represent the net increase in spending, so gross spending could always exceed the allowances if matched with revenue raising measures. Broad options are raised below; we can provide more advice on these options if you wish.

    a **Operating spending**. There are a number of short-term options for restraining growth in operating spending. Examples include limiting wage increases through collective bargaining and the living wage implementation, reducing service delivery or eligibility, or changes to operating models.

    In the long-term, even keeping expenditure as a share of GDP constant will be challenging as New Zealand Superannuation (NZS) and health expense pressures grow as a share of GDP. This suggests structural change will be needed if operating spending is to be the main driver of future consolidation.

    b **Capital spending.** It will be difficult to achieve fiscal sustainability through reducing future capital spending. This is because the capital spending affects the operating balance only through its associated costs on the operating side and has only a one-off impact on net debt. Large reductions in capital spending are required to achieve similar outcomes as small reductions in operating allowances.

    c **Revenue options.** Sustained higher operating allowances are possible if the Government is willing pursue options to increase tax revenue as a share of GDP. Further advice can be provided on revenue options if required.

51. These long run challenges do not require immediate responses. However, we recommend you remain cognisant of these challenges and the trade-offs they expose when setting allowances for the next four Budgets. They highlight that current levels of spending growth cannot be sustained indefinitely, and a long-term position consistent with your fiscal strategy will require slowing expenditure growth in future.

Next Steps

52. We are available to discuss this advice or provide further analysis at your request.

53. You will receive a report on the preliminary BEFU fiscal forecasts and a separate report with updated fiscal strategy advice in the week beginning 23 March. The updated fiscal strategy advice will incorporate the preliminary BEFU fiscal forecasts and the latest information on COVID-19.

54. You will receive final BEFU economic and tax forecasts on 3 April, and final fiscal forecasts will follow in the week beginning 27 April.

55. You will also receive a report in April to establish the allowance assumptions used in the Fiscal Strategy Model before we prepare final fiscal projections for publication at Budget.

Annex: Sensitivity of the Fiscal Strategy Model results

56. This annex describes the sensitivity of the Fiscal Strategy Model (FSM) results presented in this report to two key economic and policy assumptions of fiscal drag and the long-run government bond rate. This follows our discussion with you on the role of these assumptions on 24 February.

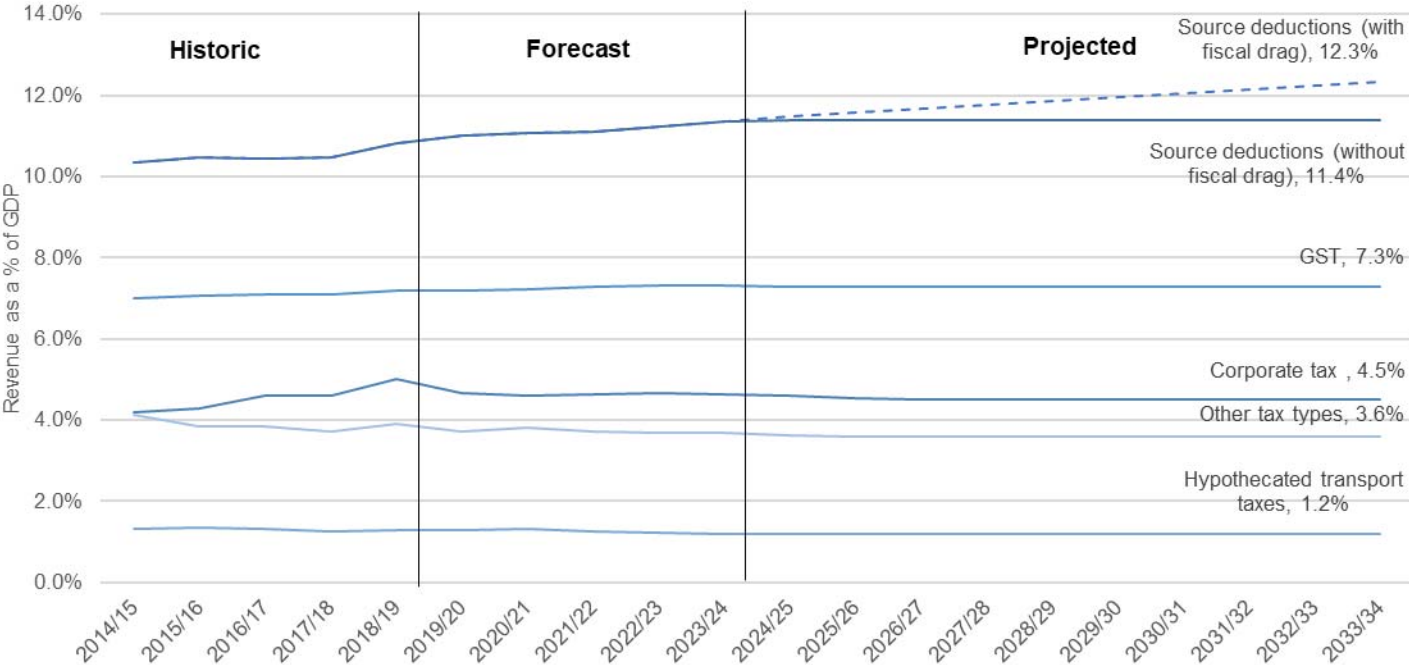
57. The results below are all based on the same version of the FSM used in the body of the report, which is based on:

- Preliminary BEFU economic forecasts
- Preliminary BEFU tax forecasts
- HYEFU fiscal forecasts

58. The FSM will be updated following the production of the preliminary fiscal forecasts in the week of 23 March. As noted in the body of the report, we expect this will show a weaker fiscal position, likely eliminating the current small surplus in the current and next financial year.

Fiscal drag[4]

Figure 6: assumed tax revenue path in the FSM



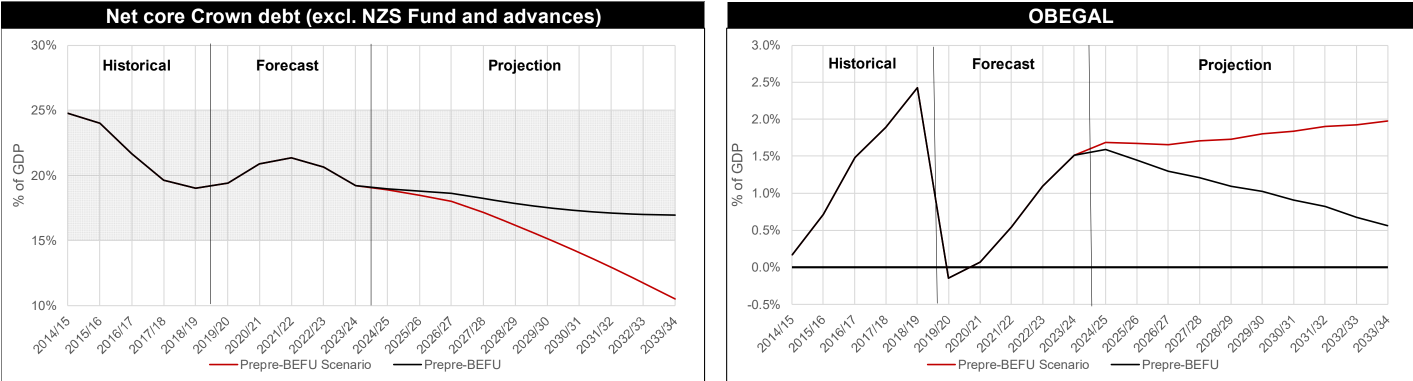
59. The standard assumption used in the FSM is that fiscal drag ceases at the beginning of the projection period (2024/25). In practice, this means each of the sources of tax revenue converges to a stable share of GDP. In the case of source deductions, this implicitly assumes that income tax brackets will be indexed to wage inflation from this point onwards, or there will be other personal tax reductions that return tax revenue to a stable percentage of GDP.

[4] Fiscal drag refers to growth in tax revenues resulting from wages growing with inflation, while personal income tax brackets remain fixed in nominal terms.

60. The result of this assumption for tax revenue is shown in figure 6. The alternative approach is to assume that fiscal drag continues, and that revenue from source deductions continues to grow as a share of GDP. The revenue from other forms of tax is unaffected by changing this assumption.

61. The consequence of assuming fiscal drag continues is a 1.1% of GDP increase in tax revenue by the end of the projection period, also shown in figure 6 above. This feeds through to the final level of OBEGAL improving by about 1.4% of GDP, and the net core Crown debt position improving by about 6.5% of GDP by the end of the projection period. The impact on OBEGAL is greater than the immediate tax impact due to second order effects on superannuation and finance costs. These results are shown in figure 7 below.

Figure 7: impact of removing fiscal drag from the projections



62. The assumption regarding fiscal drag is a policy judgement. You can change this in the projections if you wish to signal that allowing fiscal drag to continue is the Government's preferred policy.

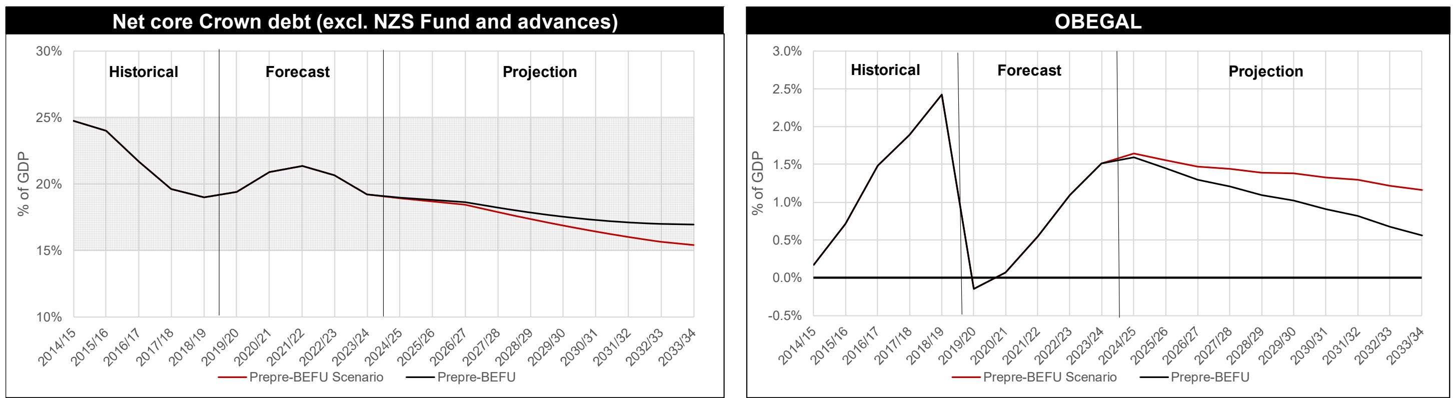
63. Whether to allow fiscal drag to continue depends on your objectives for the size of government and progressivity of the tax system. Fiscal drag increases overall personal tax rates over time and in the long run will reduce the progressivity of the tax system and reduce incentives to work and invest. These impacts should be compared with the benefits of other tax or spending measures that could be done with the revenue from fiscal drag.

Interest rates

64. The FSM also assumes convergence to a long-run 10 year government bond rate of 5%. This assumption is reached based on adding three separate components:

- 2.3% real rate of return (based on the United States Congressional Budget Office long-run assumption for the 10-year government bonds as a proxy for the global bond rate)
- 0.7% risk premium (this is based on based on historical differences between NZ bond returns and US ones)
- 2% inflation (the midpoint of the Reserve Bank's inflation target)

Figure 8: impact of holding government bond rate constant from 2024/25



65. The transition to this long-run assumption is relatively slow, with rates assumed to increase from their current level by (on average) around 15 basis points per annum. Consequently, rates do not reach the assumed long-run level of 5% even by the end of the projection period in 2033/34.

66. The impact of holding the 10 year bond rate constant at 2.5% from the end of the forecast period is shown in figure 8 above. This is a relatively drastic change to the projection assumptions which we would not recommend. However, the impact of such a large change on net core Crown debt and OBEGAL is relatively modest, improving the position of each by 1.6% and 0.6% of GDP respectively.

67. This reflects the fact that assuming lower interest rates, as well as reducing debt serving costs, also reduces revenue from investments and dividends. Note that this analysis does not review the other economic assumptions in the FSM for consistency with this change in interest rates.