The Treasury

Budget 2020 Information Release

July 2020

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[1] 6(a) - to avoid prejudice to the security or defence of New Zealand or the international relations of the government

[2] 6(b)(i) - to avoid prejudice the entrusting of information to the Government of New Zealand on a basis of confidence by the Government of any other country or any agency of such a Government

[5] 6(d) - to prevent endangerment of the safety of any person

[9] 6(e)(iv) - to prevent serious damage to the economy of New Zealand by disclosing prematurely decisions to change or continue government economic or financial policies relating to the stability, control, and adjustment of prices of goods and services, rents, and other costs, and rates of wages, salaries, and other incomes

[23] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information

[26] 9(2)(ba)(i) - 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 to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied

[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

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

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Communicating Long-Term Fiscal Strategy at Budget

Date:	23 April 2020	**Report No:**	T2020/940
		File Number:	MC-1-5-2 (Fiscal strategy)

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Indicate** your preferred fiscal trajectory in the Budget Economic and Fiscal Update (BEFU) 2020 Fiscal Strategy Model (FSM) to achieve your long-term objectives in the projection period.	Wednesday 29 April 2020

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Shefalika	Analyst, Modelling and Research	[39]	N/A (mob)	✓
Peter Gardiner	Manager, Forecasting, Modelling and Research		[23]	

Minister's Office actions

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Communicating Long-Term Fiscal Strategy at Budget

1. The Public Finance Act (PFA) requires the Budget to include projections of fiscal variables over at least the next 10 years. This report provides options on a range of trajectories you could present, developed using the Fiscal Strategy Model.

2. We are seeking your view on these projections as they will be presented in the Fiscal Strategy Report alongside your long-term fiscal objectives, and are intended to show your future fiscal policy intentions. They also expose quantitatively some of the long-run trade-offs you will face in your fiscal strategy choices.

3. Your revised long-term fiscal objectives (T2020/759) allow for a degree of flexibility in how they are met. We have interpreted them to allow the construction of more specific projection as follows:

   a) Stabilising net core Crown debt in the projection period near or below the level it reaches in 2023/24; and

   b) Returning total Crown operating balance before gains and losses (OBEGAL) to surplus <u>or</u> a stable OBEGAL trajectory in the projection period.

4. The options presented are based on the preliminary rather than final fiscal forecasts, with adjustments made to incorporate the $50 billion COVID-19 Response and Recovery Fund (CRRF). They will not exactly match the final projections published in the Budget Economic and Fiscal Update (BEFU), but we expect minimal changes to the long-run position from the forecast finalisation.

5. Given the high level of uncertainty around the projections, you may wish to present two or more options in the Fiscal Strategy Report. These could include any or all of:

   a) different policy assumptions to reach your long run objectives; or

   b) projections based under different economic forecasts, such as those published in the Budget Economic and Fiscal Update.

6. Our analysis in this report is based on the central forecasts, but if you wish to investigate the fiscal trajectories feasible under different economic forecast scenarios, we can work with you to provide that information.

There are three principal policy assumptions in the Fiscal Strategy Model you can adjust to meet your desired long-term fiscal strategy

7. These are:

   a) **Operating allowances,** reflecting growth in ongoing expenditure. Adjustments to these have the largest impact on OBEGAL and net core Crown debt.

   b) **Capital allowances,** reflecting one-off expenditure. These affect net core Crown debt but have minimal impact on OBEGAL.

c) **Growth rate of allowances**. Operating and capital allowances are each set at an assumed level for Budget 2024, and grow at a fixed annual rate thereafter. Adjusting the growth rates of either allowance has only small impact on the key fiscal variables.

8. In addition to spending assumptions, you can also adjust assumed long run tax policy. This can include allowing fiscal drag to operate in the model[1]. All else equal, this results in tax revenue to rise steadily as a share of GDP across the projection. As you know, we do not view fiscal drag continuing indefinitely as a desirable or viable policy option, and so would advise against altering this assumption.

The table below presents three scenarios consistent with your revised long-run fiscal objectives

Table 1 – Possible assumptions and results

	Assumptions			**Results**			
	Initial operating allowance	Initial capital allowance	Fiscal drag	Net debt (2033/34)	Total Crown OBEGAL (2033/34)	First year of OBEGAL surplus	Core Crown Expenses (2033/34)
Option 1	$2.4bn	$5.5bn	No	52%	-0.6%	N/A	30.2%
Option 2	$2.1bn	$4.0bn	No	45%	0.2%	2028/29	29.4%
Option 3	$1.6bn	$3.5bn	Yes	36%	2.1%	2026/27	27.8%

9. By the end of the forecast period the output gap is projected to almost close and activity to return to its structural level. To be consistent with your long term fiscal objectives, all scenarios show some form of fiscal consolidation over the projection period.

10. In all scenarios we have assumed a lower growth rate of allowances at 2% (indexed to inflation) relative to the growth rate of 4.2% (indexed to nominal GDP growth) assumed in Half Yearly Economic and Fiscal Update (HYEFU) 2019. Assuming lower growth in allowances allows for a smaller reduction in the initial level of these allowances.

[1]HYEFU 2019 assumed $2.6 billion in operating allowances, $6.6 billion in capital allowances, allowances growth indexed to nominal GDP growth at 4.2% and for fiscal drag not to operate.

11. The assumptions used in achieving your long-term objectives demonstrate the trade-offs of different policy levers. The results are presented in the charts below against the HYEFU 2019 baseline for comparison. The three options are:

Option 1 - Stabilise net debt at 50% to 60% and bring OBEGAL to a stable trajectory (but not surplus) through a small reduction in operating and capital allowances. We expect this projection would then require you to indicate an intention to achieve an operating surplus outside of the projection period.

Option 2 - Lower net debt to 40% to 50% and bring OBEGAL to surplus by the end of the projection period through a larger reduction in operating and capital allowances.

Option 3 - Lower net debt to 30% to 40% and generate a significant OBEGAL surplus during the projection period through a large reduction in operating and capital allowances, and signalling future revenue raising measures. We proxy these by allowing fiscal drag to operate in the model.

12. Given the projections below are not based on the final forecasts, we recommend focussing on which path for the fiscal variables you wish to achieve, rather than the exact assumptions. We may need to make adjustments to the assumptions to meet your preferred path for fiscal variables.

13. The three options above represent different fiscal strategies with very different macroeconomic and societal implications. This report does not recommend one of these options over the other. However, we will make use of these projections in our upcoming substantive fiscal strategy advice to contextualise the long term impacts of the decisions you will make over the coming weeks.

Figure 1 - Net core Crown debt (% nominal GDP)

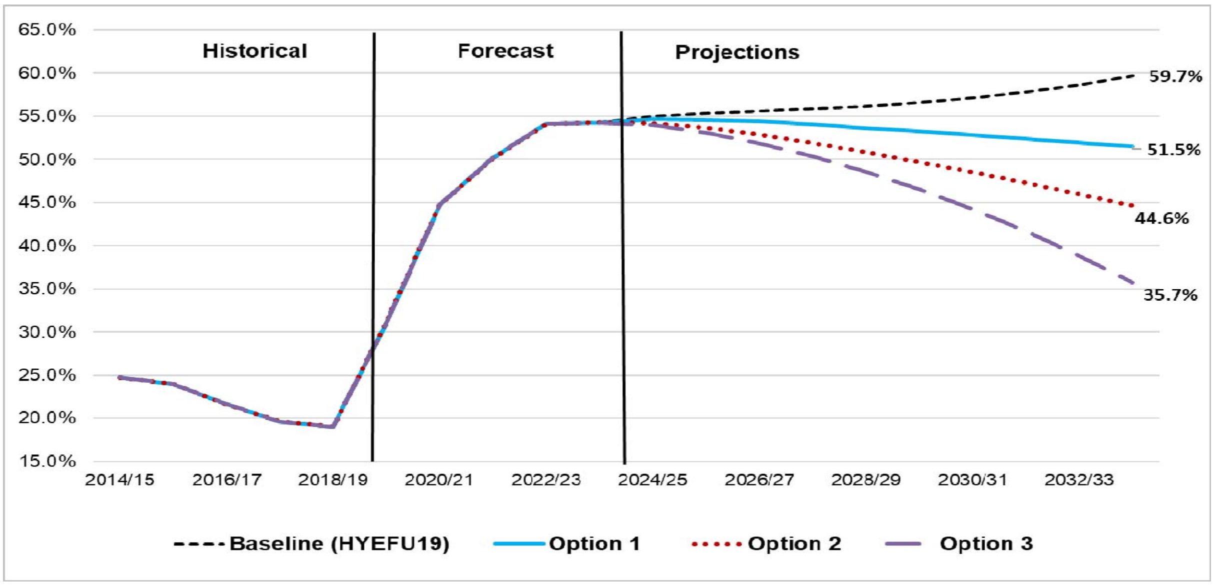


Figure 2 - Total Crown OBEGAL (% nominal GDP)

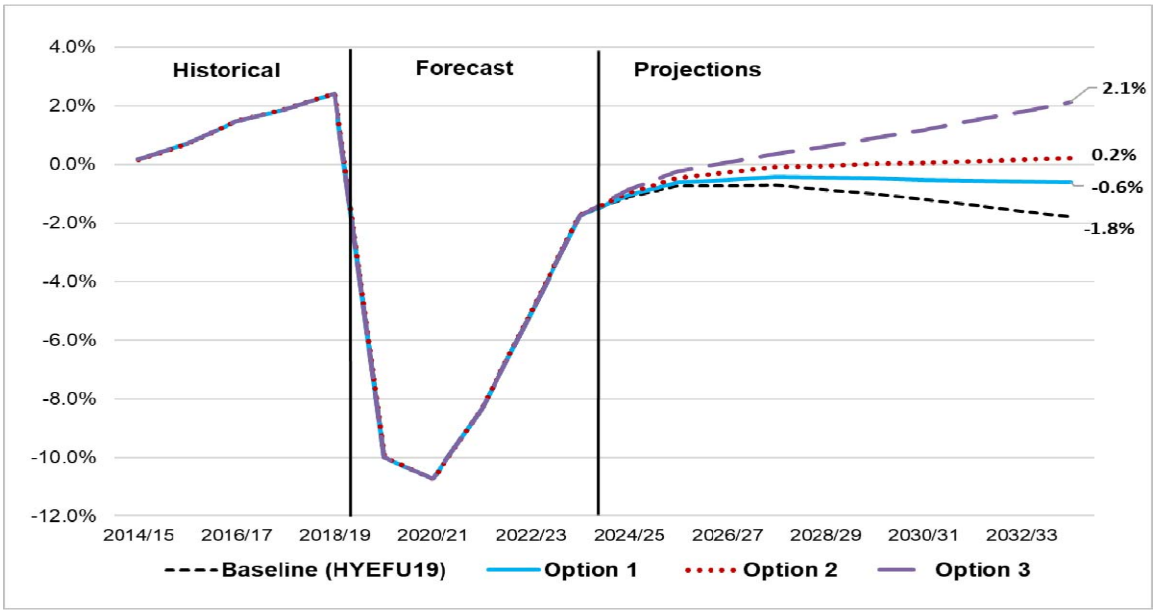
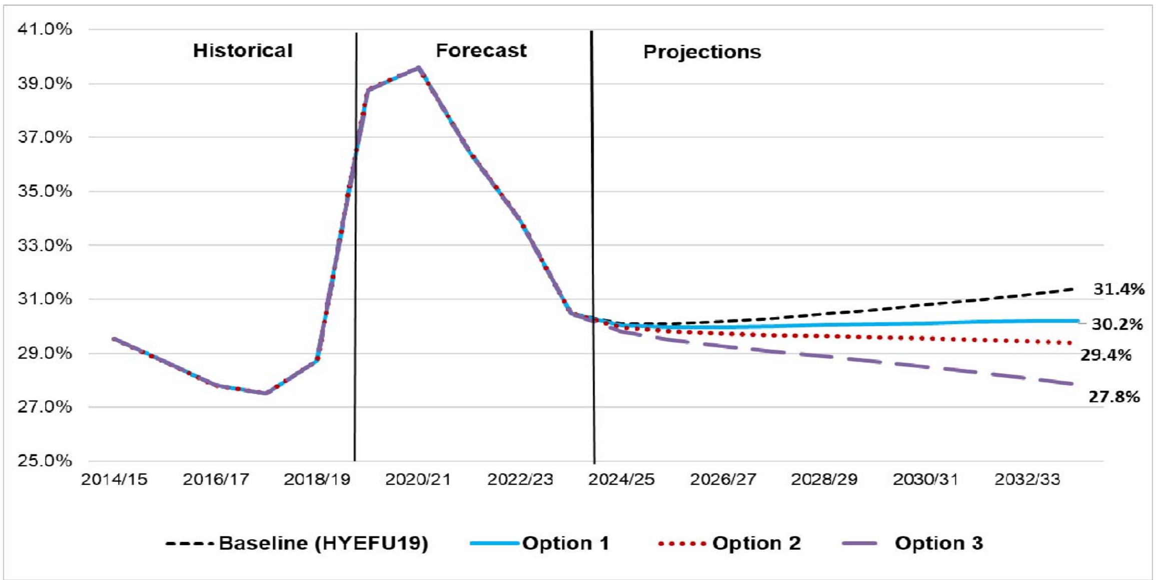


Figure 3 - Core Crown Expenses (% nominal GDP)



Based on current forecasts, debt can be stabilised relatively easily; achieving an OBEGAL surplus is more challenging

14. This is a consequence of low long term interest rates, which remain below the rate of nominal GDP growth for most of the projection period (leading to positive 'debt dynamics'). This allows for scenarios such as option 1, where the net core Crown debt to GDP ratio can fall steadily despite a persistent operating deficit. The full implications of this will be covered in our advice in May on long-run levels of prudent debt. Reducing capital allowances to $4 billion such as in option 2 makes it more consistent with historically typical levels and can be reasonably assumed in the projection period.

15. Achieving an operating surplus in the projection requires large reductions to operating allowances. As discussed in our previous fiscal strategy advice, gross operating allowances substantially below $3 billion are likely to leave limited space for any measures other than cost pressures. Operating allowances below $2 billion, such as those in option 3, will require a substantial reduction in the size of government, as shown by falling core Crown expenses as a share of GDP.

16. Raising revenue would be the alternative approach to achieving the trajectory for net core Crown debt and OBEGAL shown in option 3, without the reduction in spending. Option 3 already includes fiscal drag; achieving these fiscal paths without a major reduction in expenses as a share of GDP would require making assumptions about the long run share of taxes as a proportion of GDP. We can adjust these assumptions in the model if you wish to explore these options; but you should also consider how you would communicate the future policy direction these assumptions would signal through documents such as your revenue strategy.

17. There are numerous other possible options that can be achieved by making various combinations of assumptions. Table 2 demonstrates the relative effectiveness of different levers in achieving fiscal objectives. We can work with you to set alternative allowances in the projections should you wish to investigate different options from those presented here.

Table 2 - Percentage point change in fiscal metrics relative to HYEFU 19 baseline

Policy assumption levers	Percentage point change in fiscal metrics in 2033/34 relative to HYEFU19 baseline	
	Net core Crown Debt	Total Crown OBEGAL
$1 billion reduction in initial operating allowance	-12.5	2.6
$1 billion reduction in initial capital allowance	-2.5	0.1
1 percentage point increase in core Crown tax revenue as % GDP	-6.2	0.9
Continuing fiscal drag	-1.9	0.7
1 percentage point reduction in operating allowance growth rate	-0.9	0.3
1 percentage point reduction in capital allowance growth rate	-0.6	0.0

Risks and Considerations

18. These projections are based on central Budget 2020 forecasts incorporating:

    a. Updated economic and tax forecasts (which assumes 1 month at alert level 4, 1 month at level 3 followed by 10 months at level 2). Note that the economic forecasts have been revised since the 30 March forecasts to reflect the change in the expected health scenario.

    b. The updated economic and tax forecasts do not include the effects of the COVID-19 Response and Recovery Fund (CRRF) being spent in full.

    c. Preliminary fiscal forecasts (finalised on 17 March) with adjustments to approximate final Budget tax and welfare forecasts and New Zealand Superannuation Fund (NZSF) forecasts and projections.

    d. COVID-19 Response and Recovery Fund (CRRF) of $50 billion over the forecast period, spent according to the profile you agreed last week. This is in addition to the $12 billion of COVID-19 spending announced outside the CRRF.

    e. Theses fiscal forecasts do not reflect the changes in Crown assets and liabilities of Accident Compensation Corporation (ACC), other SOEs, and wider Crown operations as a result of COVID-19.

    f. These updates will be presented and explained in the report on the final fiscal forecasts next week.

19. You should also note that, if the size of CRRF increases, with implications for net debt, your fiscal strategy report will need further discussion on prudent debt. We will work with you to provide this.

20. Note that the assumptions you select for Budget 2020 will also be applied in the projections published in the Pre-Election Economic and Fiscal Update (PREFU). Consequently, you may wish to build in more of a buffer against achieving your desired trajectory than otherwise, opting for lower capital and operating balances.

21. We will provide further advice on the fiscal strategy for the CRRF, and advice reviewing how we interpret the principles of responsible fiscal management over the coming weeks. Naturally, the advised timing, size and type of fiscal policy response in this advice will differ from the assumptions used in the forecast period here.

Next Steps

22. Our intention is to include updated projections (including the finalised fiscal forecasts) in the final draft of the Fiscal Strategy report you will receive on the morning of **Thursday 30 April**. Consequently we would request your feedback on this report on the morning of **Wednesday 29 April** at the latest, and earlier if you wish to iterate alternative scenarios.

Recommended Action

We recommend that you:

a **Note** that we have interpreted your long-term fiscal objectives as:

- stabilising net core Crown debt near or below the level it reaches in 2023/24 and;
- bringing total Crown operating balance before gains and losses (OBEGAL) to surplus or to a stable trajectory in the projection period.

b **Note** the options presented and indicate your preferred fiscal trajectory in the projection period.

- **Option 1** - Stabilise net debt at 50%-60% and bring OBEGAL to stable trajectory (but not surplus) through a small reduction in operating and capital allowances.
- **Option 2** - Lower net debt to between 40-50% and bring OBEGAL to surplus by the end of the projection period through a relatively significant reduction in operating and capital allowances.
- **Option 3** - Lower net debt to 30-40% and bring OBEGAL to surplus during the projection period through a significant reduction in operating and capital allowances, signalling future revenue raising measures, and fiscal drag.

Peter Gardiner
Manager, Forecasting, Modelling and Research

Hon Grant Robertson
Minister of Finance