The Treasury

Budget 2021 Information Release

August 2021

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Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

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

[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

[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

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

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

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

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

[40] Not in scope

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

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [23] appearing where information has been withheld in a release document refers to section 9(2)(a).

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Fiscal strategy intentions and objectives

Date:	26 November 2020	**Report No:**	T2020/3417
		File Number:	MC-1-8

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**agree** to change the short-term intentions and long-term objectives for fiscal policy in the 2021 Budget Policy Statement.	3 December 2020

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Suzie Harrison	Senior Analyst, Macroeconomic and Fiscal Policy	[39]	n/a (mob)	✓
Angus Hawkins	Team Leader, Macroeconomic and Fiscal Policy		n/a (mob)	

Minister's Office actions (if required)

Return the signed report to the Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Fiscal strategy intentions and objectives

Executive Summary

This report recommends setting new fiscal targets in the 2021 Budget Policy Statement to provide greater clarity on your fiscal strategy and to support spending control.

- We recommend revising your short-term operating balance intention to "reduce deficits over the forecast period, excluding any further temporary COVID-19 response and recovery expenditure". This imposes constraint on on-going spending while maintaining flexibility for further temporary fiscal support if the outlook worsens.
- We recommend maintaining your short-term debt intention as "allow the level of net core Crown debt to rise in the short term". The status quo provides broad flexibility for temporary fiscal support. Although it does not provide constraint on on-going spending, this is better enforced through the operating balance intention.
- We recommend revising your long-term operating balance intention to "run an operating balance consistent with the debt objective" removing the explicit commitment to return to surplus. This more accurately portrays your fiscal strategy and what will be needed to meet debt targets. Favourable debt dynamics mean lower debt could be achieved while running deficits.
- We recommend revising your long-term debt intention to "stabilise net core Crown debt as a percentage of GDP by the mid-2020s and then reduce it as conditions permit". This sets a soft target date range for stabilisation, to put a constraint on near-term on-going spending while leaving room to adjust the pace of fiscal support to ensure a strong and durable recovery. It also sets some commitment to rebuild fiscal buffers by indicating a trigger for debt reduction. A viable alternative option is a conditional target to stabilise debt once the unemployment rate (or some other metric of economic recovery) reaches a certain level.

[36]

Recommended Action

We recommend that you:

a **agree** to change the short-term intention for the operating balance in the 2021 Budget Policy Statement from: *Run operating deficits in the short term to fight COVID-19, cushion its impact and position New Zealand for recovery.*

to: *Reduce deficits over the forecast period, excluding any further temporary COVID-19 response and recovery expenditure.*

Agree/disagree.

b [36]

[36]

d **agree** that the current forecast levels of net core Crown debt is within what the Government regards as a prudent range of debt.

e **agree** to retain the existing short-term intentions for debt in the 2021 Budget Policy Statement at:

Allow the level of net core Crown debt to rise in the short term to fight COVID-19, cushion its impact and position New Zealand for recovery.

Agree/disagree.

f **agree** to change the long-term intention for debt in the 2021 Budget Policy Statement

from: *Stabilise and then reduce net core Crown debt to prudent levels over the long term (subject to any significant shocks) and beyond*.

to: *Stabilise net core Crown debt as a percentage of GDP by the mid-2020s and then reduce it as conditions permit (subject to any significant shocks).*

g **agree** to change the long-term objective for the operating balance in the 2021 Budget Policy Statement

from: *Return the operating balance to surplus over the long term and maintain an operating balance consistent with the debt objective thereafter.*

to: *Run an operating balance consistent with meeting the long-term debt objective.*

Agree/disagree.

h [36]

[36]

j indicate if you wish to take an item to cabinet on the proposed change to your fiscal targets.

Yes/No

Angus Hawkins
Team Leader, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal strategy intentions and objectives

Purpose of Report

1. This report provides advice on setting short-term intentions and long-term objectives (hereafter referred to collectively as 'fiscal targets') as required by the Public Finance Act 1989 ('the PFA').

2. This report builds on our recently provided high-level advice on your fiscal strategy and targets (see *Fiscal Strategy – preliminary advice* slides that were attached to T2020/3409).

Background

3. Fiscal targets can help you meet and communicate your fiscal strategy by providing anchors to guide policy decisions. We recommend setting new fiscal targets at the upcoming Budget Policy Statement (BPS) to provide greater clarity on how and when debt will be brought under control and to support stricter spending control in the Budget process.

4. The PFA requires Budget 2021 to set out your short-term (up to at least 2023/24) and long-term (up to at least 2031/32) fiscal targets for the levels of debt, the operating balance, expenses, revenue and net worth.

5. The PFA requires the BPS to explain:

   - How Budget 2021 is expected to accord with the fiscal targets set out in Budget 2020 or any new fiscal targets announced at the BPS.
   - How any new fiscal targets meet the PFA's principles of responsible fiscal management ('the PFA principles' hereafter).
   - If the fiscal targets are inconsistent with the PFA principles, state the reason for departure; how you expect to return to the PFA principles; and the timeframe for doing so.
   - How any new short-term intentions accord with the relevant long-term objectives.

Macroeconomic Context and Fiscal Strategy

6. The economic outlook has improved but remains weak and exceptionally uncertain when compared to a pre COVID-19 environment. Conventional monetary policy is constrained, and alternative tools are unlikely to be a full substitute. Fiscal policy remains best placed to address the challenges from COVID-19.

7. The fiscal environment is also constrained. COVID-19 has increased the level of debt and created an on-going deficit. New Zealand also continues to face challenges of an ageing population and rising healthcare costs common to many developed economies. Stabilising debt will be a challenge and will require controlling the deficit through disciplined management of on-going spending.

8. In the short run your fiscal strategy needs to be flexible enough to allow for further fiscal support if the outlook worsens, while providing fiscal constraint to support stricter

management of on-going spending. In the long run your fiscal strategy should focus on stabilising debt and reducing it only as conditions allow. We recommend that you only seek to return to surplus or rebuild fiscal buffers once the economy has fully recovered.

Recommended Fiscal Targets

9. The Budget 2020 fiscal targets remain consistent with our recommended strategy. However, these targets were designed to be very broad given the highly uncertain economic outlook at the time. We recommend adjusting your fiscal targets, so they set a clearer anchor for medium-term policy and reinforce fiscal control through the Budget process, while still recognising the ongoing uncertainty in the economic outlook.

10. You will receive complementary advice on options for reviewing the fiscal indicators (T2020/3488) next week. The recommended targets are sufficiently flexible to still be applicable following changes in the debt and operating balance definitions.

11. The recommended targets focus on stabilising debt and reducing the operating deficit. We see these targets as enduring until the point where debt is stabilised, which is likely to be in the early-to-mid-2020s based on current forecasts. Hence, we see the targets as enduring for at least the current parliamentary term.

SHORT-TERM OPERATING BALANCE

12. We recommend revising your short-term operating balance intention as follows:

    - **Status quo:** Run operating deficits in the short term to fight COVID-19, cushion its impact and position New Zealand for recovery.

    - **Recommended option:** Reduce deficits over the forecast period, excluding any further temporary COVID-19 response and recovery expenditure.

13. The recommended option imposes constraint on on-going spending while maintaining flexibility for further temporary fiscal support. This appropriately balances the short-term objective for macroeconomic stabilisation with long-term objectives for sustainable public finances.

14. COVID-19 has created an on-going deficit, which (based on the pre-election forecasts) persists even when the temporary costs of the response are excluded. This persistent deficit is a concern from a fiscal sustainability perspective, particularly when considered in the context of the fiscal challenges of an ageing population and rising healthcare costs.

15. Implementing the recommended option will require you clearly to demarcate any further COVID-19 expenditure not already included in the forecasts. This may add complexity to the reporting of fiscal indicators but allows you to respond to COVID-19 as needed without adjusting your fiscal targets.

16. We interpret this objective as requiring that the size of the deficit reduces across the forecast period, rather than a reduction in each and every year. On this basis, this fiscal target was met in the pre-election forecasts. Although the OBEGAL deficit was forecast to rise to 10.5% of GDP in 2020/21 from 7.7% of GDP in 2019/20, it still fell to 3.4% of GDP by the end of the forecast period. This target was also met at the preliminary half-year forecast.

17. Alternative options such as rolling or fixed-date surplus targets are discussed in Annex 1. We recommend against setting hard targets with specific levels and dates, as we

place a high importance on retaining flexibility to provide further support if needed, adapt to forecast changes, and minimise the risk of becoming locked into sub-optimal fiscal paths.

[36]

SHORT-TERM DEBT

20. We recommend maintaining your short-term debt intention as follows:

    - **Status quo:** allow the level of net core Crown debt to rise in the short term to fight COVID-19, cushion its impact and position New Zealand for recovery.

21. The status quo provides broad flexibility for temporary fiscal support. The forecast level of debt is not a concern for fiscal sustainability, and there remains space for further temporary support if needed.

22. Although the recommended option does not provide constraint on on-going spending, this is better enforced through the operating balance intention above rather than a debt objective in the short-term.

23. This fiscal target was forecast to be met at the pre-election forecasts and, given the flexibility of the target, will be met at any future iteration including the preliminary half-year forecasts.

24. As explained above, we recommend against alternative options such as hard targets as we place a high importance on retaining flexibility to provide further support (more details in Annex 1).

[36]

LONG-TERM DEBT

26. We recommend revising your long-term debt intention as follows:

    - **Status quo:** Stabilise and then reduce net core Crown debt to prudent levels over the long term (subject to any significant shocks) and beyond.

- **Recommended option:** Stabilise net core Crown debt as a percentage of GDP by the mid-2020s and then reduce it as conditions permit (subject to any significant shocks).

- **Viable Alternative:** Stabilise debt once the [unemployment rate/OCR/output gap] is [below/above] X% and then reduce it as conditions permit.

27. Our recommended long-term debt target sets a soft target date for stabilisation, to put a constraint on near-term on-going spending while leaving room for manoeuvre should the recovery take longer. It also sets a slightly stronger commitment to rebuild fiscal buffers by indicating a trigger for debt reduction. Suitable conditions could be following better-than-expected fiscal results or normalisation of interest rates.

28. Adding an escape clause to the long-term debt target, by saying that the target is "subject to any significant shocks", reduces this risk of consolidating too soon and provides flexibility to respond to any further shocks beyond COVID-19. The clause slightly reduces accountability given the ambiguity of the term "significant", but it has been used in previous targets.

29. The mid-2020s could be too soon to withdraw fiscal support, if the recovery takes longer than currently forecast. Setting the target date as the mid-2020s rather than a specific year (e.g. 2025) mitigates this risk. As such, we recommend against setting a hard date or level target given the level of uncertainty in the forecasts.

30. A viable alternative option is a conditional target to stabilise debt once the unemployment rate (or some other metric of economic recovery) reaches a certain level. This is similar to the Australian target to stabilise and reduce debt once the unemployment rate is "comfortably below 6%". The advantage of this option is that it would signal intentions more clearly and seek to avoid pressure to tighten fiscal policy prematurely. "Comfortably below" also retains considerable flexibility. The recommended option above is preferred due to its simplicity. This is discussed further in Annex 1 and we can provide further advice on this if requested.

31. This fiscal target was forecast to be met at the pre-election forecasts, where debt stabilised in 2024/25, and is met in the preliminary half-year fiscal forecast. The objective to stabilise by the mid-2020s does not prevent you from stabilising and reducing debt sooner, if conditions permit.

[36]

LONG-TERM OPERATING BALANCE

33. We recommend revising your long-term operating balance intention as follows:

- **Status quo:** return the operating balance to surplus over the long term and maintain an operating balance consistent with the debt objective thereafter.

- **Recommended option:** run an operating balance consistent with the debt objective.

34. This option is modified from our initial proposal in T2020/3409. It removes the explicit commitment to return the operating balance to surplus.

35. Given current low interest rates, it is possible to stabilise or reduce debt – therefore meeting the proposed debt objective – without running a surplus. The proposed operating balance objective provides scope for deficits to continue as long as interest rates remain below the growth rate of the economy.

36. Stabilising debt without returning to surplus is a justifiable fiscal strategy under current conditions. However, it exposes New Zealand to greater fiscal risk than a return to surplus.

37. Based on the pre-election projections, returning to surplus would reduce debt to around 45% of GDP from its peak at 56%. A higher debt level exposes New Zealand to higher interest rate expenses. With current low interest rate these costs are under 1% of GDP, but these could increase in future as or when interest rates increase.

38. Furthermore, aiming to return to surplus, rather than stabilise debt, provides a buffer to prevent debt ratcheting up in the case of higher interest rates or lower than expected growth or tax revenue.

39. [36]

40. The alternative would be to retain the status quo. This would require substantially tighter fiscal policy to achieve within a reasonable timeframe.

41. The recommended fiscal target was met at the pre-election forecasts. It will be met at any future iteration, including the preliminary half-year forecasts, so long as the long-term debt objective is met.

[36]

[36]

OTHER TARGETS

47. We do not recommend making substantive changes to the targets for expenses, revenue and net worth, [36]

48. The short-term intentions for expenses and revenue only require you to "ensure consistency with the operating balance objective". They therefore remain consistent with the recommended operating balance objective. The short-term intention for net-worth also remains consistent with your fiscal strategy.

49. The long-term objectives for expenses, revenue and net worth were unchanged in response to COVID-19 and still reflect your long-term strategy.

Short-term intentions	*Expenses*	Our intention is to ensure expenses are consistent with the operating balance objective.
	Revenue	Our intention is to ensure revenue is consistent with the operating balance objective.
	Net worth	Our intention is to use the Crown's net worth to fight COVID-19, cushion its impact and position New Zealand for recovery. Significant risks will be transferred onto the Crown's balance sheet through the response period.
Long-term objectives	*Expenses*	The Government will ensure operating expenses support a responsible and proportionate role for the Government in maintaining a productive, sustainable and inclusive economy, consistent with the debt and operating balance objectives.
	Revenue	The Government will ensure a progressive taxation system that is fair, balanced and promotes the long-term sustainability and productivity of the economy, consistent with the debt and operating balance objectives.

	Net worth	The Government will use the Crown's net worth to maintain a productive, sustainable and inclusive economy, consistent with the debt and operating balance objectives.

Next Steps

50. You will receive advice on the drafting on the BPS on the 3 December. Subject to your agreement, we will include these revised fiscal targets [36]

Annex 1: Options for fiscal targets

Table 1 – Short-term: operating balance		
Option	**Pros**	**Cons**
1A – Budget 2020 Run operating deficits in the short term.	Provides broad flexibility for temporary fiscal support.	Imposes no constraint on on-going spending by not targeting a reduction in deficits.
1B – Rolling target Reduce deficits to no more than X% of GDP by the end of the forecast period (or until we achieve surpluses/stabilise debt).	Imposes more constraint on on-going spending.	Provides less flexibility for temporary fiscal support. Imposes low level of accountability as target only needs to be met at end of the rolling forecast period. Difficultly in estimating the x% target given the high level of uncertainty.
1C – COVID exclusion (recommended) Reduce deficits over the forecast period, excluding further temporary COVID-19 response and recovery expenditure.	Imposes constraint on on-going spending while maintaining flexibility for further temporary fiscal support.	Adds complexity to the measure of operating balance and requires splitting further temporary COVID-19 spending from baselines increase.
1D – Hard target Reduce deficits to no more than X% of GDP by 2024.	Imposes stronger constraint on on-going spending. Imposes higher level of accountability as target needs to be met by specific date.	Provides less flexibility for temporary fiscal support. Difficultly in estimating the target level given the high level of uncertainty.
Table 2 – Short-term: debt		
Option	**Pros**	**Cons**
2A – Budget 2020 (recommended) Allow debt to rise in the short term.	Provides broad flexibility for temporary fiscal support.	Imposes no constraint on on-going spending by not targeting stabilisation of debt.
2B – Hard target Allow debt to rise to no more than 60% of GDP over the forecast period.	Imposes constraint on on-going spending by targeting maximum level of debt.	Provides less flexibility for temporary fiscal support. Difficultly in estimating the debt target given the high level of uncertainty.
Table 3 – Long-term: operating balance		
Option	**Pros**	**Cons**
3A - Budget 2020 Return to surplus over the long term.	[36]	Does not align with the current or recommended short-term intention to run deficits in the short term. Does not align with the current pre-election projections, which do not return to surplus by the end of the projection period. Lacks transparency over what defines the 'long term' period.
3B – Debt stabilisation (recommended) Maintain an operating balance consistent with the debt objective.	More accurately portrays your fiscal strategy and what will be needed to meet debt targets, given favourable debt dynamics mean lower debt could be achieved while running deficits.	[36]
3C – More specificity	Adds more specificity under the condition in which you would return	[36]

Return to surplus as conditions require, consistent with meeting the net debt objective.	to surplus. As above conditions could include a worsen in the debt dynamics with an increase in interest rates.	[36]

Table 4 – Long-term: debt

Option	Pros	Cons
4A – Budget 2020 Stabilise debt and then reduce it to prudent levels over the long term and beyond.	Provides flexibility for temporary fiscal support by not targeting a level of debt stabilisation.	Imposes little constraint on near-term increases in on-going spending by not targeting a date for debt stabilisation. Sets weak commitment to rebuild fiscal buffers by not targeting a level or date for debt reduction.
4B – Soft target date (recommended) Stabilise debt by the mid-2020s and then reduce it as conditions permit.	Imposes constraint on near-term increases in on-going spending by targeting a date for debt stabilisation. Sets slightly stronger commitment to rebuild fiscal buffers by indicating a trigger for debt reduction. Suitable conditions could be e.g. following better-than-expected fiscal results.	The mid-2020s could be too soon to withdraw fiscal support, if recovery takes longer than expected. Setting the target date as the mid-2020s rather than e.g. 2025 mitigates this risk.
4C – Hard target date and level Stabilise debt by the mid-2020s and then reduce it to below 50% by the early 2030s.	Sets stronger commitment to rebuild fiscal buffers by targeting a level and date for debt reduction.	It's currently uncertain whether the optimal level of debt will be below 50% by the early 2030s.
4D – Conditional target Stabilise debt once the [unemployment rate/OCR/output gap] reaches X% and then reduce it as conditions permit. Similar to the Australian Fiscal Strategy to stabilise and then reduce debt "once the unemployment rate is comfortably below 6%". Based on their economic forecasts for unemployment, this means stabilising debt around 2024. Translating this strategy into a New Zealand context likely means stabilising debt once unemployment rate is comfortably below around 5%. Based on the half-year forecasts this means stabilising debt from around 2024 onwards.	Provides greater flexibility to respond if the economic outlook deteriorates. Provides a metric for communicating the economic rationale to wait to stabilise debt i.e. to reduce the level of unemployment. "Comfortably below" retains considerable flexibility.	Given the high level of uncertainty in setting the conditional target level, there is a risk this target requires consolidating too soon or not soon enough. o The unemployment forecast is highly uncertain and has been revised substantially between the pre-election and half-year forecast. o The 'equilibrium level' of unemployment or the level of unemployment when the economy is at full capacity is unmeasurable and highly uncertain. There is no one perfect measure of an economic recovery. Based on the half-year forecasts this target requires consolidating sooner than the soft target date above.