The Treasury

Budget 2022 Information Release

August 2022

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[40] Out of Scope

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

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TE TAI ŌHANGA
THE TREASURY

Budget 2022:
Context, Strategy and Design

13 August 2021

Contents

Purpose

- The purpose of this slide pack is to **seek your agreement to the overall strategy and design for Budget 2022**.
- We have also provided an initial assessment on what the emerging themes in the economic outlook could mean for fiscal policy going into this Budget cycle. Ahead of the Budget Policy Statement 2022, we will provide you with further advice based on preliminary forecasts to support decisions on your fiscal strategy, including current and future Budget allowances.

Summary – Key Messages

1. **The economy has recovered faster and more strongly than expected**, and inflation is the highest it has been in a decade. There is a risk that labour and skills shortages could add to inflationary pressures. The economic outlook remains highly uncertain with significant upside and downside risks,
2. **Tax revenue has come in stronger than forecast** in the year to date which suggests an improved fiscal position. But there are many uncertainties that make the fiscal position difficult to quantify ahead of preliminary fiscal forecasts**.**
3. **Current allowances are unlikely to be sufficient** for funding cost pressures and your priorities. From a macroeconomic perspective, any additional spending in the short-term will add to demand and could exacerbate supply constraints.
4. Your fiscal strategy for the last two Budgets has focused on supporting the economy through the COVID-19 downturn. Updated forecasts are a good indication that **your focus at Budget 2022 should shift to sustaining the recovery** by focussing spending on a few strategic priorities and minimising the risk of over-heating the economy**.** There are also **capacity constraints** across the system.
5. Budget 2022 is your fourth Wellbeing Budget. In setting the **priorities for Budget 2022**, there are a number of **significant policy goals and commitments** that you could focus on. You have already signalled specific areas of focus and process changes for Budget 2022 that will pose a greater degree of complexity and will require **significant investment**.
6. As part of managing this complexity, Budget 2022 can **build on the work of previous Budgets** by incorporating a **strengthened approach to value for money and wellbeing analysis,** using **invitations** to control the scope of the core process**,** and building a better picture of the **investment pipeline** given system-wide capacity constraints**.**
7. The reform programmes you are integrating into Budget 2022 will also set a **trajectory for the future approach to budgeting** that will be markedly different from the status quo.

Summary - Design

Budget 2022 will be more complex from a design perspective compared to previous years, with a larger amount of initiative types and processes…

BUDGET 2022 PROCESS

Cost pressures (1)
- Strictly invitation only
- Two-step process where Ministers provide you with information on expected cost pressures, and Treasury provides you with advice to support decisions on invitations
- Funded from Budget 2022 allowances

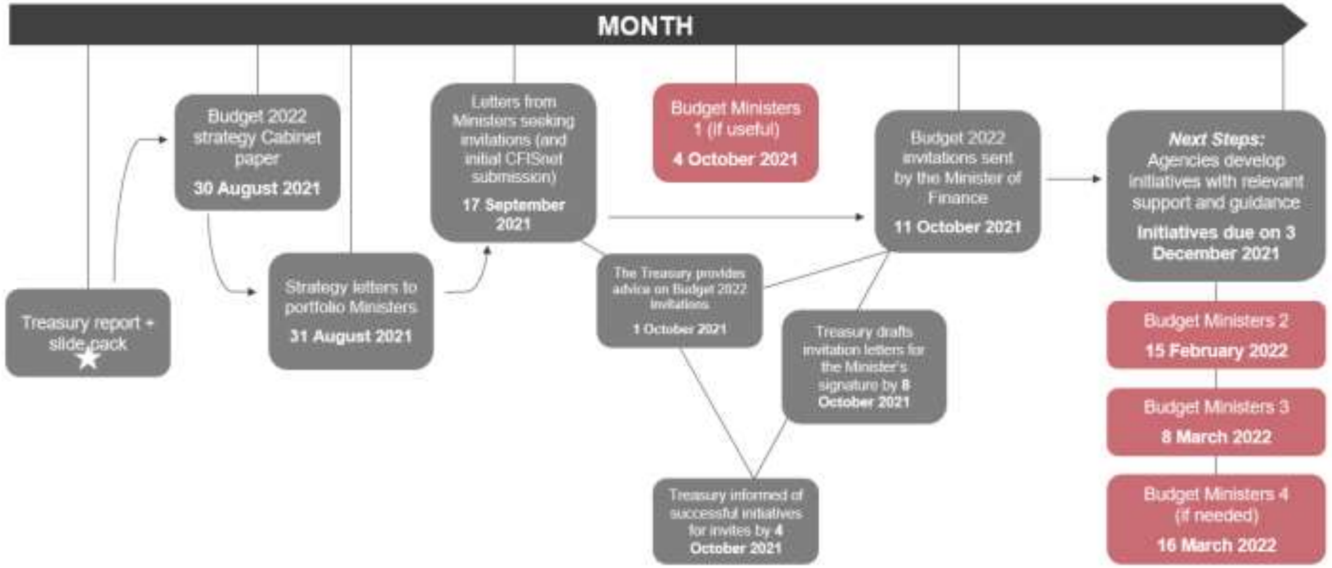
Manifesto priorities (2)
- Strictly invitation only
- Two-step process where Ministers provide you with information on manifesto commitments, and your Office provides you with advice to support decisions on invitations.
- Funded from Budget 2022 allowances

Climate fund (3)
- Strictly invitation only
- Treasury advice on invitations
- Funding envelope, with specific conditions, possibly funded from hypothecation of Emissions Trading Scheme (ETS) revenue
- Treasury advice informed by Climate CEs

Health (4)
- Strictly invitation only for new initiatives, with cost pressures and rebase to be run through separate envelope process
- Funded from Budget 2022 allowances, with possibility of Budget 2023 precommitments
- Two-year transitional agreement

Clusters (Justice & Natural Resources) (5)
- Not an invitation-only process
- Three-year funding agreements for operating only
- Pre-determined envelopes and likely managed against allowances for Budgets 2022-24

…but it also reflects a return to more "standard" timeframes, with increased time for development and assessment of initiatives.



Context

Context – Economic Conditions

The economy has recovered faster and more strongly than expected, and inflation is the highest it has been in a decade. Rather than insufficient demand, supply constraints are more likely to put the brakes on growth.

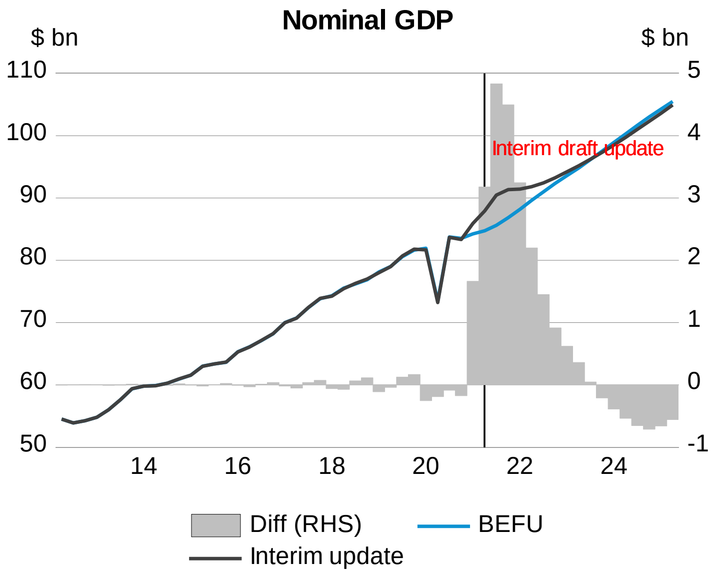
- Real Gross Domestic Product (GDP) grew 1.6% in the March 2021 quarter, compared to a forecast 0.2% decline at the Budget Economic and Fiscal Update 2021 (BEFU). Real GDP is now sitting 0.8% above pre-COVID-19 levels, and we currently estimate the output gap to be slightly positive. This reflects the strong economic recovery to date.
- Forward-looking indicators of domestic activity point to continued momentum in the domestic economy. Together with a stronger than forecast resurgence in global demand, this has boosted economic confidence, supporting ongoing strength in consumption as well as stronger outlook for investment and employment.
- However, capacity constraints are likely to constrain future growth relative to BEFU, with COVID-19 developments internationally limiting and/or delaying the pick up in international tourism and net migration.
- Inflation pressures have emerged. These pressures represent a mix of temporary and more persistent factors, and have resulted in market expectations that the Reserve Bank of New Zealand will need to raise the Official Cash Rate (OCR) much sooner than previously forecast (see slide 8).
- Despite slower real growth from the end of 2021 onwards, the significantly higher starting point has lifted cumulative nominal GDP in the five years to June 2025 to nearly $20 billion above BEFU forecasts.

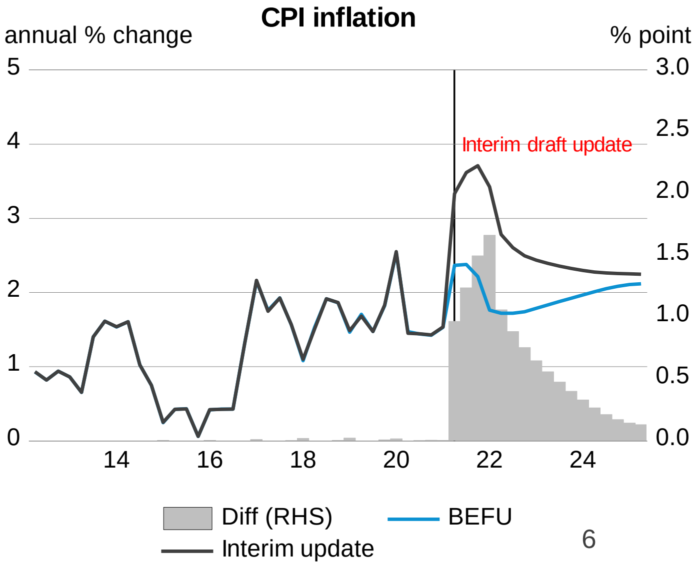
Note on the Treasury's updated economic forecasts

These forecasts are an 'interim update' to the Treasury's main economic forecasts, given the interest in understanding changes to the economic outlook since BEFU. They have not been through the same level of quality assurance as our usual preliminary or final forecasts ahead of an EFU publication and are not as comprehensive as a full EFU forecast.

We will produce our usual preliminary and final economic, tax and fiscal forecasts ahead of the Half Year Economic and Fiscal Update (HYEFU) from October through to late November and provide advice to you as we have new information to hand.

For this interim update, we have assumed the border will reopen progressively from the third quarter of 2022, which is more pessimistic than our assumption at BEFU 2021.





Context – Major Themes in the Economic Outlook

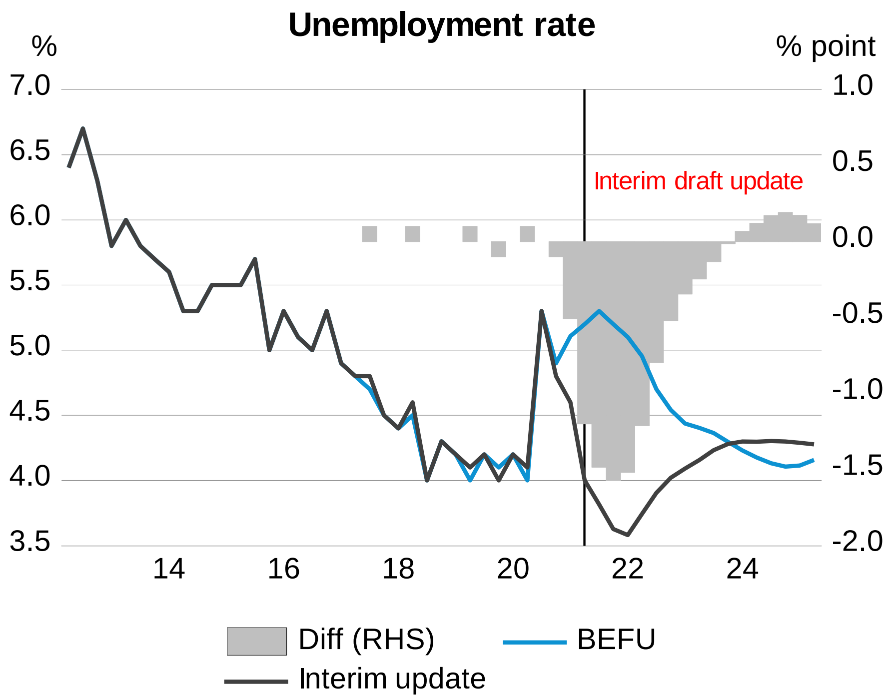
The economic outlook remains highly uncertain, and there are a number of significant upside and downside risks. Strong demand has resulted in labour and skills shortages becoming acute across a broad range of industries, which could add to inflationary pressures.

COVID-19 Uncertainty

The pandemic continues to have a major influence on the global economy, and data remains volatile. It will be important to maintain the ability to respond to any further resurgences of COVID-19, particularly given the risks of a Delta variant outbreak. Your policy settings are already in place to provide temporary support and cushion the economic impacts if this eventuates.

The timing and nature of the border reopening will be influenced by the vaccine rollout and developments abroad. A sustained border reopening will likely boost confidence and enable greater people flows, supporting tourism and providing a possible labour source for some skill-types and industries.

Theme	Possible implication(s)
Supply constraints	Slower economic growth but higher price pressures owing to shortages of labour and some materials.
Stronger near-term domestic demand	Lower unemployment and higher tax revenue. Higher starting point means even with slower growth, nominal GDP and tax revenue remain above levels forecast at BEFU for a considerable time.
Delayed border reopening	Business failures and lower employment in the tourism sector. More severe skills shortages and supply chain issues.
Stronger global demand	Higher terms of trade, promoting investment. Higher imported prices (e.g. oil prices) may boost inflation.



Skills shortages

Firms are reporting it is increasingly difficult to find skilled and unskilled labour, and there is some evidence of a mismatch between the skills available and the skills businesses need (T2021/1675 refers).

Compared with the fourth quarter of 2019, there were 22,000 more underutilised people in the labour force in the June quarter of 2021 (a total of 315,000 underutilised people). This includes those who are underemployed (i.e. working, but would like to work more), as well as the unemployed.

A sustained high number of underutilised people would indicate skills and/or location mismatches – the 48,000 decline in the number of underutilised people in the June quarter is encouraging, but it remains to be seen if this can be sustained.

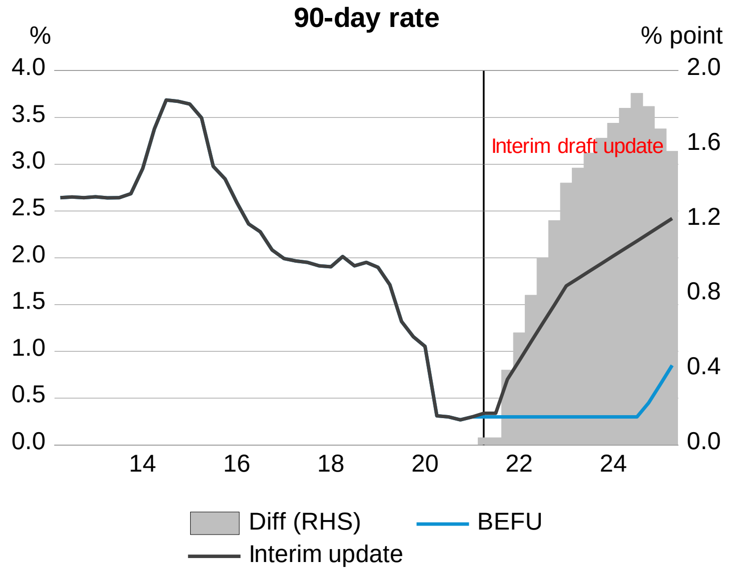
Context – Monetary Policy and House Prices

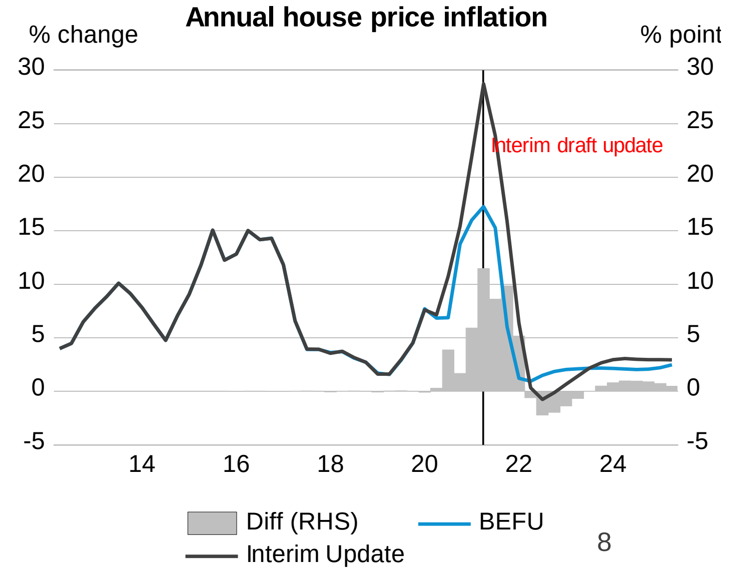
Monetary policy will remain relatively stimulatory for some time, but OCR expectations have ramped up significantly since Budget 2021.

- Due to higher inflation and a stronger economy, markets are now pricing in 100 basis points of increases to the OCR by July 2022. The first move is anticipated to be later this month.
- The RBNZ has already stopped Large-Scale Asset Purchases (LSAPs) and signalled further tightening to come. Any changes to fiscal policy will factor into future monetary policy decisions, but monetary policy is still likely to remain stimulatory for some time due to the uncertain medium-term outlook.
- House prices have continued to grow at a high rate. Rising interest rates over the second half of 2021, together with the March 2021 housing package and more stringent loan-to-value ratio restrictions for investors, are expected to reduce demand in the housing market. We are forecasting this will lead to a brief period of broadly flat house price growth over 2022, although house price inflation is expected to grow over the remainder of the forecast period as population growth rises on the back of increased migration. Lower house price growth will subdue growth in household spending and could cool demand pressures.

Illustrative impacts of higher inflation and higher interest rates…

…on businesses	…on individuals	…on government & RBNZ	…on the external sector
Interest rates: Higher borrowing costs, reducing investment. **Inflation:** Rising costs of raw materials and upwards pressure on wages, flowing through to prices of products.	**Interest rates:** Those with debt (i.e. home loans) face higher borrowing costs, initially impacting those with floating/flexible rates. Savers earn a higher nominal return on bank deposits. **Inflation:** If wages in some parts of the economy do not keep pace with CPI inflation, real incomes decrease. Outcomes may be worse for lower socioeconomic groups because more of their disposable income is spent on consumption.	**Inflation:** OCR shifts away from the effective lower bound, and alternative monetary policy winds down. Tax revenue increases in line with nominal GDP, but cost pressures increase over time. **Interest rates:** Debt servicing expenses increase, and interest earned increases after an initial lag. Long-term liabilities decrease.	**Interest rates:** If interest rates in NZ rise before other countries, NZ is more attractive to investors, which could put upward pressure on the exchange rate. This would make imports cheaper but our exports more expensive. However, there is currently no data to indicate pressure on the exchange rate.





Context – Fiscal Developments

Developments since Budget 2021 suggest an improved fiscal outlook for the Government, but the extent of this improvement will not be fully known and cannot be quantified until our next forecast round is underway. Tax revenue will be much stronger, but it is likely that government expenditure will also increase.

Outturns for the 2020/21 year

Early indications are that the fiscal position at the end of the 2020/21 fiscal years will be much stronger than expected at Budget 2021.

- The strength in tax revenue reported in the May 2021 accounts has continued, and both operating and capital spending at 30 June 2021 will be lower than previously forecast due to further delays (see Table 1), leading to a smaller OBEGAL deficit and a lower net debt position.
- This means the debt-to-GDP ratio for the year ended 30 June 2021 will be at least 3 percentage points lower than forecast at BEFU (down from 37.2 percent of GDP), reflecting both higher nominal GDP and the $10 billion improvement in net core Crown debt implied by Table 1.

Tax revenue outlook

The interim update to economic forecasts suggests that tax revenue over the next four years could be $18.8 billion higher compared to BEFU 2021 (see Table 2). This is mainly due to the stronger outturn in the 2021 year, which is expected to flow through to out-years. These tax estimates are indicative only and do not incorporate changes from specific policies. We anticipate incorporating these in our preliminary HYEFU forecasts, which may present additional upside risk to tax forecasts.

Indicative expenditure outlook

The interim update has not looked at revising the outlook for any government expenditure or non-tax revenue, but our high level assessment is that government expenditure will likely be higher than previously forecast, <u>even without any increases to Budget allowances or other new spending decisions</u>. This is due to a number of offsetting factors – for example:

- Welfare expenses reduce when unemployment reduces, but wage growth increases the rate that most benefits are indexed to;
- Higher tax revenue reduces the amount the Government needs to borrow, but higher interest rates lead to higher financing costs.
- The LSAP programme has resulted in more borrowings being held at floating rates, which will mean a larger portion of borrowings will be more sensitive to interest rate changes.
- Higher inflation will increase costs faced by agencies, leading to greater cost pressure bids in future Budgets. In addition there will be some direct impacts to expenses (e.g. higher ACC claims costs).
- A relatively large portion of funding that was set aside for Budget 2022 has already been committed, and we are aware of significant cost pressures (see slide 11) and other allowance constraints (see slide 12) which you are yet to make decisions on.

We will be able to provide quantification and further explanation of the fiscal position following our next forecast round later in the year. For now, **slide 10 provides three hypothetical scenarios for different expense tracks to illustrate their impacts on the fiscal position**.

Table 1: Estimated change to net core Crown debt from 30 June 2021 results relative to BEFU[1]

Item	($b)
Tax receipts	6.0
Other operating items	3.0
Capital items (incl valuation changes)	1.0
Total	**10.0**

Table 2: Estimated change in tax revenue relative to BEFU

Year	Tax Revenue ($b)
2022	7.8
2023	3.7
2024	3.8
2025	3.5
Total	**18.8**

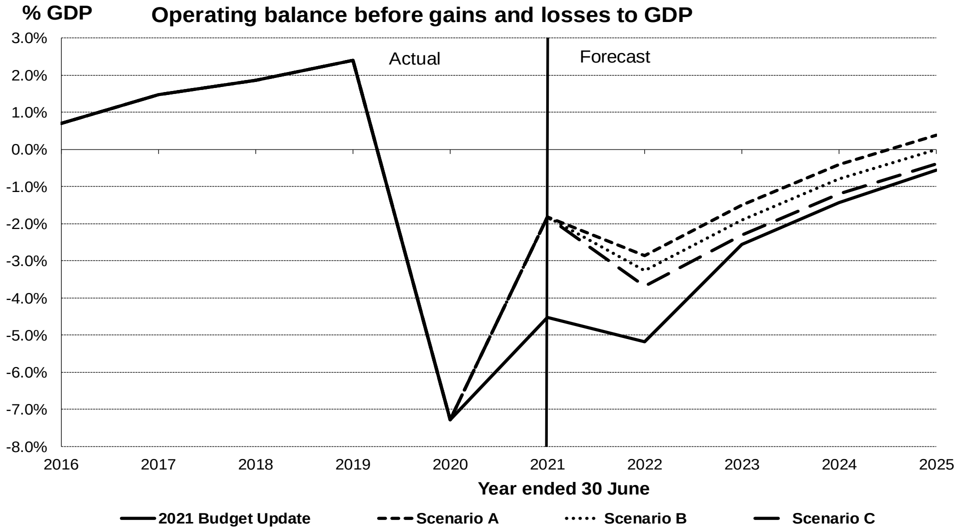
[1] Note that the change in OBEGAL will differ to this due to timing differences.

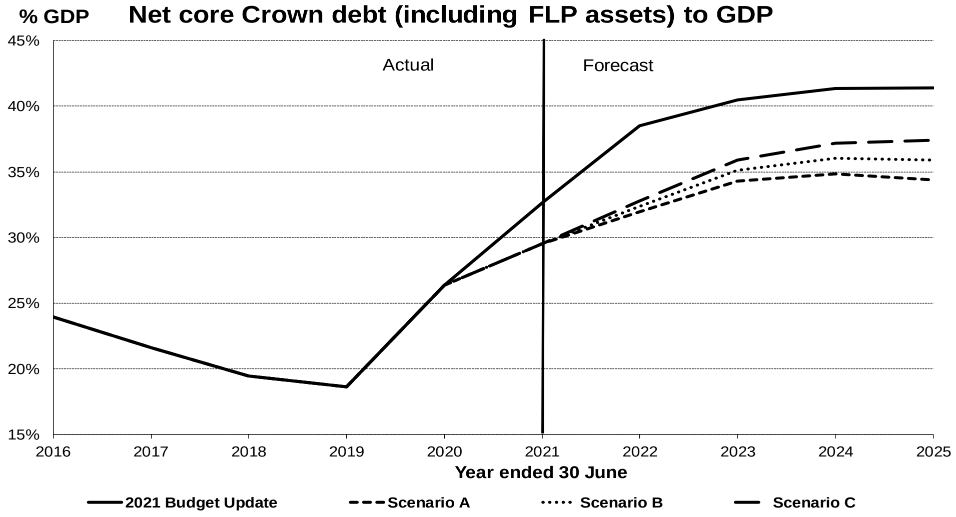
Context – Fiscal Outlook

The fiscal outlook for OBEGAL and net core Crown debt in our next forecast update will depend on the level of expenditure growth compared to BEFU forecasts. The types of expenditure growth illustrated on this slide could include new spending decisions in addition to any other expense changes, such as finance costs.

The scenarios in this slide have been modelled to illustrate how different expense tracks may impact on OBEGAL and net core Crown debt over the next four years. **These scenarios focus on overall expense increases**, so could include both changes that could come from forecast items <u>and</u> additional spending at Budget (e.g. increases in allowances). The base for these scenarios is the Budget 2021 fiscal forecasts updated to reflect very initial 30 June 2021 results and the impact on tax revenue forecasts from the interim update (both summarised on slide 9).

Scenario	Illustrative increase
Scenario A ----------	Assumes **no increase** in operating expenses compared to the Budget Update (*please note we do not consider this a realistic scenario*)
Scenario B ……….	Assumes a **$1.5 billion** increase in operating expenses from 2022/23 compared to the Budget Update
Scenario C – – – – –	Assumes a **$3.0 billion** increase in operating expenses from 2022/23 compared to the Budget Update





Expected track

BEFU forecasts showed OBEGAL deficits in all forecast years, but reducing to less than one percent of GDP by 2024/24. A return to OBEGAL surplus was expected in the second year of the projection period (2026/27).

Scenario A – a small OBEGAL surplus is expected in 2024/25, two years earlier than previously expected.

Scenario B – OBEGAL is broadly in balance by 2024/25.

Scenario C – OBEGAL deficits are expected over the next four years, with a return to surplus likely in 2025/26, which is a year earlier than previously expected.

BEFU forecasts showed net core Crown debt (including FLP assets) increasing over the forecast period and reaching 41.4 percent of GDP in 2024/25, before reducing over the projection period.

Scenario A – net core Crown debt (including FLP) peaks just below 35 percent of GDP in 2023/24, before reducing from 2024/25.

Scenario B – net core Crown debt (including FLP) peaks at 36 percent of GDP in 2023/24, before reducing from 2024/25.

Scenario C – net core Crown debt (including FLP) increases over the forecast period reaching 37.4 percent of GDP in 2024/25 and is likely to start reducing from 2025/26.

Context – Expenditure Pressures

Cost pressures make up a large part of the Budget each year and will continue to do so in the absence of changes to policy settings. Deferring or scaling cost pressures may be viable in some cases, but this can also push pressures underground and decrease agency resilience while degrading capability and capacity.

A number of significant cost pressures have already been flagged by agencies. For some of these pressures, there are choices that may be made around the timing and quantum of funding. For others, there may be little discretion. We are also aware of the **possibility for further significant Budget 2022 precommitments** in the areas of social development, police and climate change.

Past Budget cost pressures	Operating per annum ($m)	Ten-year capital total ($m)
Budget 2021	2,152	2,150
Budget 2020*	2,745	3,538
Budget 2019	1,932	4,661

Portfolio	Description of expected pressure**
Climate Change	We expect agencies to submit initiatives seeking around $4.8 billion operating and $12.1 billion capital over the next four years, though these figures will vary as initiatives are developed. It is unclear how much will be implementation ready and sought in Budget 2022.
Economic Development	The New Zealand Screen Production Grant (NZSPG) is a demand-driven, uncapped incentive with forecast Crown funding for the NZSPG reaching $450m in 2024/25. [33]
Education	We expect that the Ministry may seek up to [38] over the forecast period and $1 billion capital to cover cost pressures such as [38] and continuation of the School Property Works Programme.
Health	As part of a Budget 2022 transitional funding package, we expect funding to be sought for a health system 'rebase' alongside two years of cost pressure funding. [33]
Internal Affairs	Cabinet has made a number of policy and funding decisions during 2021 regarding Three Waters reforms, and our expectation is that Internal Affairs manages the reform programme within agreed funding. [33]
Social Development	Welfare Overhaul, Te Pae Tawhiti, Transforming Disability services and Social Sector Commissioning (SSC). The magnitude of this package will depend on decisions over the coming months. Excluding COVID-19 Response and Recovery Fund (CRRF) time-limited funding and decisions on Accommodation Supplement, Working for Families and SSC there are roughly [33] (over the forecast period) worth of pressures that the Ministry for Social Development may submit at Budget 2022.
Transport	Pressures include implementation of the Future of Rail, mitigating COVID-19 impacts on the aviation and maritime sectors and revenue pressures on the National Land Transport Fund (decisions expected late August). Meeting these may require approximately $700 million operating and $1.5 billion capital across the forecast period.

*Excludes CRRF initiatives, although some cost pressures progressed through Budget 2021 may have been exacerbated by the effects of COVID-19. **These costs are indicative only and based on information available to Vote teams. They are limited to the most significant pressures in the major spending portfolios.

Context – Allowance Constraints

Current Budget 2022 allowances are unlikely to be able to sufficiently fund cost pressures and your manifesto priorities.

At Budget 2021, you set operating allowances across the forecast period of:

Allowances ($m)	Budget 2022	Budget 2023	Budget 2024
Per annum operating allowance	2,700	2,700	2,700
Multi-year capital allowance		8,100	

Significant precommitments have been made against your operating and capital allowances for Budget 2022:

	Average per annum	Total
Budget 2022 operating precommitments	980	3,919
Multi-year capital precommitments	-	2,282

Your most significant operating precommitments include:

Main Benefit (1 April 2022) Increase	518	2,071
Delivering the Three Waters Reforms (Tagged Contingency)	250	1,000

This means that your remaining allowances are unlikely to be sufficient to fund key cost pressures and as well as key manifesto priorities.

Allowance balances*	Average per annum	Total
Budget 2022 operating allowance	1,720	6,881
Multi-year capital allowance	-	5,859
COVID-19 Response and Recovery Fund	-	4,727

In addition to the Health and Climate Change reform programmes you intend to progress through Budget 2022, you have agreed to the **following indicative funding envelopes for the Natural Resources and Justice clusters**, which will, at least in part, need to be managed against the Budget 2022 operating allowance:

Cluster envelopes ($m)	2022/23	2023/24	2024/25 and outyears	% of B22-B24 allowances
Justice				
Low	140	300	475	7%
Medium	280	580	900	13%
High	370	770	1,200	17%
Natural Resources				
Low	55	120	195	3%
Medium	100	220	360	5%
High	160	350	570	8%

In addition, we are aware of a number of additional precommitments that may be made ahead of Budget 2022, including in the Climate Change, Police and Social Development and Employment portfolios.

*As at 13 August 2021 and across the Budget 2022 forecast period (i.e. four-year operating average). Includes BEFU 2021 forecast Screen Production Grant (SPG) cost of $472 million across the forecast period, and this figure will be updated at HYEFU.

Context – CRRF Expenditure Update

As at Budget 2021, $57.1 billion had been allocated to COVID-19 response and recovery initiatives (now $57.5 billion, including $45.3 billion of CRRF spend). Looking at appropriation data provides us with a partial picture of expenditure. That data shows us that, as at 31 March 2021, $20.973 billion has been spent against COVID-19-specific appropriations.*

Vote Social Development expenditure accounts for **66%** of the **$20.973 billion spent** as at 31 March 2021.

Some Votes have a significant amount of expenditure outside the scope of this reporting. We are working on accessing better data in respect of that spend.

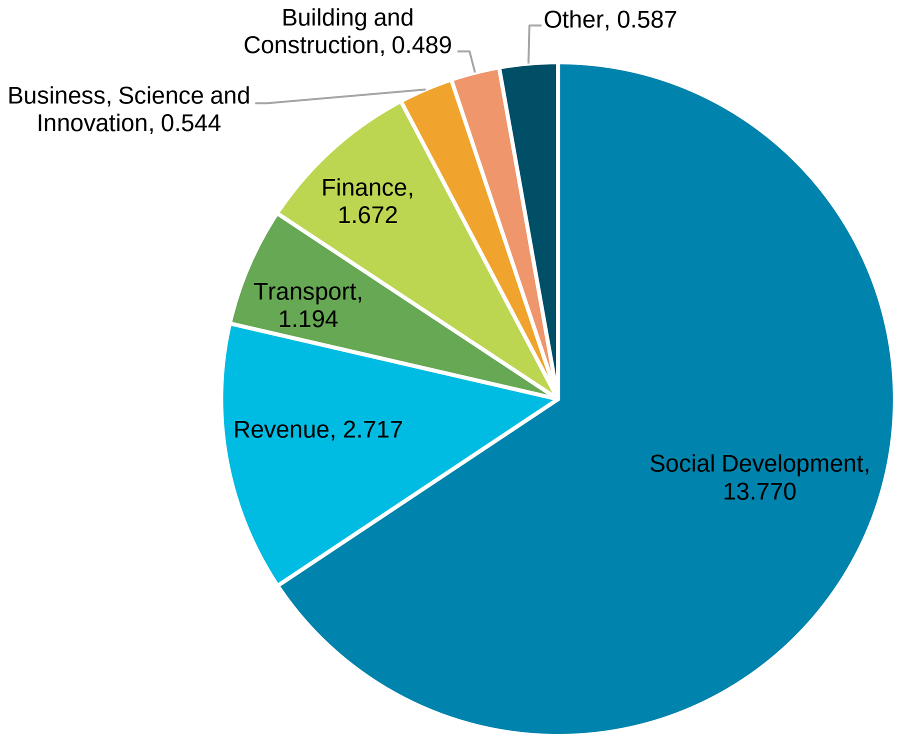
We hope to provide further information in respect of **Health and Education expenditure** in our next update (as at 30 June, due September).

Our next update will also reflect Budget 2021 CRRF decisions.

COVID-19 allocations ($m)	CRRF impact	Total impact
16 March package (and BBC)	-	12,206
CRRF Pre-11 May and 11 May package	29,787	29,787
CRRF Post-11 May and 6 July package	5,599	5,599
CRRF Post-6 July to Budget 2021	6,909	6,909
Budget 2021 CRRF charges	4,554	4,554
Post-Budget 2021	351	351
CRRF Returns	-1,926	-1,926
Total	**45,273**	**57,478**
Remaining CRRF	**4,727**	**-**

*Capital and operating.

Spend against COVID-19-specific appropriations ($bn) as at 31 March 2021



Strategy

Strategy – Refreshing Your Fiscal Strategy

Your fiscal strategy for the last two Budgets has focused on supporting the economy through the COVID-19 downturn. Updated forecasts are a good indication that your focus at Budget 2022 should shift to sustaining the recovery, not providing additional demand-side support.

- Although we don't yet know the extent to which current inflationary pressures are likely to be persistent, **it will be important to maintain optionality in your fiscal strategy** and make adjustments as the economic outlook becomes clearer. This means:
  - From a macroeconomic point of view, **we do not recommend adding to demand now** as this could crowd out private investment, exacerbate existing supply constraints and add to inflationary pressures, leading to monetary policy tightening faster than would otherwise be necessary. Fiscal policy and monetary policy should ideally reinforce each other, rather than working in different directions.
  - **we do not recommend a discretionary fiscal consolidation.** It is risky to consolidate too fast when the economic outlook is still highly uncertain and there could be further domestic outbreaks of COVID-19. Automatic stabilisers are already adjusting to higher economic activity and lower unemployment, and this means that the current level of fiscal support is already less expansionary than forecast at Budget 2021 (see slides 9-10 for more detail). Further, we consider that a substantial fiscal consolidation is not practically feasible at this time, as the current operating allowance of $2.7 billion per annum is not sufficient to fund expected cost pressures, precommitments and manifesto commitments signalled to date without a major revenue/savings package alongside new spending.
- **Decisions in Budget 2022 will present trade-offs between short-term and long-term, and macro and micro objectives**.
  - **Any additional spending in the short term will add to demand pressures and risk overheating the economy**; even initiatives that have substantial long-term benefits. This means new spending should meet a high justification threshold (e.g. it should deliver high value for money). There are options for the composition, phasing, and overall level of Budget 2022 packages that will minimise macroeconomic impacts, which slide 16 provides more detail on.
  - **Your response to higher-than-forecast revenue needs to be considered in light of the medium-term fiscal position.** While the fiscal position has likely improved in the short-term relative to BEFU, significant fiscal challenges remain in the medium- to long-term. New ongoing spending has the potential to exacerbate these challenges.
- **The Budget Policy Statement (BPS) provides an opportunity to reset your budget allowances**. We will provide more formal advice following preliminary forecasts later in the year, by which stage the economic outlook will be clearer.
- **You could consider announcing more substantive changes to the fiscal strategy at Budget 2022**. A refresh of your fiscal policy short-term intentions and long-term objectives on Budget Day could build on changes arising from the fiscal indicator review. This means you could specify new fiscal targets using the updated set of indicators.

Strategy – Macro Considerations

In the short-term, sustaining the recovery will mean constraining spending growth to minimise risks of overheating the economy. In the long-term, building capacity in the economy will be an important part of sustaining growth beyond the current cyclical upswing.

- Given the macroeconomic impacts, if you wish to increase spending now, we suggest a greater focus on value for money and ensuring that any new initiatives are aligned with your strategic priorities, addressing long term expenditure pressures, or alleviating capacity constraints. You should also consider if new spending can feasibly be delivered.
- You will have options for the composition, phasing and overall level of spending that will help you manage the economic and fiscal impacts of additional spending. Some of these levers would be more effective in the short term, while others would take longer to generate benefits. Some examples are set out below:

Composition of spending

Budget 2022 could start to shift the composition of spending from supporting demand to, where possible:

- tackling capacity/supply constraints, including by opening up the economy
- bringing in underutilised labour
- boosting the economy's long-term productive capacity, and
- building resilience to protect the economy's long-term productive capacity.

At a practical level, this means it will be important from a macroeconomic perspective to:

- target spending to regions and sectors with most capacity
- wind down spending that was focused on supporting demand during the COVID-19 shock
- consider deferring new demand-side initiatives that have not yet been funded, and
- keep the CRRF for resurgence use only (this is discussed in further detail on slide 20).

Measures that address supply constraints and build/protect the economy's long-term productive capacity would be challenging and costly to implement, and unlikely to have a major impact in the short term, but could have substantial longer-term benefits.

Phasing of new and existing initiatives

You should consider the timing of spending:

- Instead of front-loading, you could signal a strong pipeline. Your approach to PFS modernisation, health reform and climate change will be consistent with this.
- The border reopening has the potential to alleviate constraints in future years, making it a better time to kick off major investments in already constrained sectors.

One option to mitigate macro impacts and delivery risks in the near term could be to smooth out infrastructure spending planned over the next 2-3 years and aim for a more consistent level over the next 5-10 years.

It would be feasible to re-phase a significant level of new and existing policy commitments at Budget 2022 if requested, and this could be a relatively effective short term measure for managing the stronger economy.

Net level of new spending

You have several potential levers to unlock fiscal headroom that will also help you manage the strong economy and risks of overheating in the short-term:

- Deferring or discontinuing initiatives
- Savings or reprioritisation packages (e.g. a significant CRRF reprioritisation exercise)
- Revenue-positive tax policy changes.

Funding new initiatives as time-limited pilots before committing to ongoing expenditure could assist with medium-term fiscal sustainability, but would still add to demand in the short term.

Without additional resourcing, it would be administratively difficult for the Treasury to run a major savings or reprioritisation exercise in parallel with the main Budget process, and savings tracks have had limited success in previous years.

It would be possible to deliver marginal changes to existing taxes at Budget (e.g. rate/threshold changes) for implementation by the following tax year, but not structural changes such as new taxes or new income tax brackets. While increasing revenue may create headroom and support fiscal sustainability, it could have other consequences for equity and efficiency.

Strategy – Building on previous Budgets

Budget 2021 made a key process change aimed at more focussed annual budgeting which supported more strategic decision-making and we also trialled a new framework for assessing value-for-money.

Introducing an invitation-only process for Budget 2021 allowed you to take **early prioritisation decisions**, and **significantly reduced the number of initiatives** submitted into the Budget process.

Through the Budget 2021 review, agencies also expressed their support for the invitation process due to how it reduced wasted effort on initiatives that were unlikely to be funded.

Compared to previous years, the reduced number of initiatives allowed Budget Ministers to spend more time on the **key strategic choices** for investment and the associated trade-offs, alongside decisions on individual initiatives.

Incorporating He Ara Waiora into Budget 2021 was an important step in developing the Government's wellbeing approach so that it reflects the **national and cultural context unique to Aotearoa New Zealand**. We took an **indicative approach** to applying He Ara Waiora in Budget 2021 by considering the alignment of initiatives to He Ara Waiora concepts and principles. This was not just for the initiatives that were focused on Māori, but across the wider Budget package.

Budget 2022 can **build on the work of previous Budgets** by incorporating a **strengthened approach to value-for-money analysis,** using **invitations** to control the scope of the core process**,** and building a better picture of the **investment pipeline** given system-wide capacity constraints**.**

Strategy – Priorities for Budget 2022

The priorities for Budget 2021 focussed on responding to COVID-19, meeting critical cost pressures and time-sensitive manifesto commitments, and ensuring delivery. In setting the priorities for Budget 2022, there are a number of significant policy goals and commitments that you could focus on.

You have indicated that the next two Budgets will be aimed at continuing to make **progress against the Government's three goals** for this term of:

- Keeping New Zealanders safe from COVID-19
- Accelerating the recovery and rebuild from the impacts of COVID-19, and
- Laying the foundations for the future, including addressing key issues such as climate change, housing affordability and child poverty.

You have also publicly indicated two areas of **focus for new investment** in Budget 2022:

- addressing climate change by investing to reduce greenhouse gas emissions and secure a just transition,
- supporting the success of health reforms by implementing a transitional multi-year funding package.

These two areas of focus will support progress against your **Government's wellbeing objectives,** specifically Just Transitions and Physical and Mental Wellbeing. But they also represent changes in approach to budgeting that will be **complex to integrate** alongside the standard Budget process and require **significant investment**.

In addition, through Budget 2022 you are establishing the Natural Resources and Justice clusters as part of public finance system reforms. While these reforms build on the secretariat model from Budget 2020, they also represent a **significant change to how the Government approaches annual budgeting which focusses on outcomes and longer-term strategic planning**. One of your **key choices** is whether you wish to signal these reforms as an area of focus in order to ensure their success.

Key questions: Based on the above, what do you see as your priorities for Budget 2022? Are there any other areas that you envisage being a focus (such as child poverty, given ambitious interim child poverty targets and the Working for Families review)?

Strategy – Wellbeing Objectives

The priorities for Budget 2022 should also support progress against the Government's wellbeing objectives.

The wellbeing objectives are medium-term goals, which reflect that sustained investment is needed to address some of New Zealand's most significant challenges. They are intended to be enduring across multiple Budgets. These objectives are typically separate from short-term Budget priorities, which may change from year to year and are intended to support the choices and trade-offs required as part of Budget decision-making.

As part of developing the Budget Policy Statement 2022 (BPS), you have the opportunity to consider whether the current wellbeing objectives are still fit for purpose. In particular, you requested advice on (**a**) whether the references to COVID-19 could be removed, and (**b**) whether housing affordability issues could be more directly expressed.

On (**a**) we recommend that specific references to COVID-19 are removed from the objectives for Budget 2022. Continuing to support New Zealand's recovery from the pandemic (with a focus on those most impacted) implicitly underpins all of the objectives. We recommend that this is drawn out in setting the context for these objectives. We can also make specific references to COVID-19 in the description that sits underneath.

On (**b**), we recommend including specific references to housing into three of the objectives as follows:

- **Just Transition** – Supporting the transition to a climate-resilient, sustainable and low-emissions economy while providing for greater housing affordability.
- **Māori and Pacific** – Lifting Māori and Pacific incomes, skills and opportunities, including through access to affordable, safe and stable housing.
- **Child Wellbeing** – Reducing child poverty and improving child wellbeing, including through access to affordable, safe and stable housing.

As you requested, we will also be consulting with the Chief Science Advisors in August and September on these suggested changes and any other feedback they may have.

You also have the option of setting the wellbeing objectives as the priorities for Budget 2022. This would support your efforts to embed them as part of Budget decision-making. However, the current objectives are necessarily broad in scope and using them as short-term priorities may reduce your ability to signal a clear focus for Budget 2022.

Strategy – Future of the CRRF

While the vaccine rollout will reduce the threat posed by COVID-19, Australia's experiences with the Delta variant show that the pandemic's trajectory remains uncertain. Decisions on the future strategy for dealing with COVID-19 will have significant fiscal implications.

There is significant upcoming pressure on the COVID-19 Response and Recovery Fund (CRRF).

The fiscal flexibility provided by the CRRF has supported the Government's efforts to cushion the blow from the virus and invest in the recovery.

However, the balance of the CRRF is now $4.7 billion. Based on the current economic support for resurgence settings, a major resurgence requiring some form of extended lockdown would significantly deplete the remaining CRRF.

In the absence of a resurgence, there is no longer a need for further COVID stimulus from the CRRF given increasing inflationary pressures.

Over the next few months, the Government will also be taking decisions on the policy settings for reconnecting New Zealand and operating an effective COVID-19 response system over the longer term. This includes future border settings (including the function and form of MIQ, and integrating health protection into border management), and whether there is a need for an ongoing vaccination programme. Most of these choices will have fiscal costs.

We recommend tightening the criteria for accessing the COVID-19 Response and Recovery Fund (CRRF) in the short term…

In order to manage calls on the remaining balance, we recommend that you seek Cabinet's agreement to tighten the criteria for accessing the CRRF to:

- Responding to a COVID-19 resurgence (including economic support measures and public health response costs)
- Continuing the vaccine rollout
- Maintaining the Managed Isolation and Quarantine (MIQ) system, and
- Funding for significant policy changes relating to the *Reconnecting New Zealanders* work programme or long-term COVID-19 response.

…but future costs may need to be met from other funding sources.

Many of the key decisions around the future policy settings for dealing with COVID-19 will take place before the Budget 2022 process. However, there are likely to be some significant ongoing costs, and the CRRF may not be the best funding source for these.

Key question: Do you agree with our proposal to refine the criteria for accessing the CRRF?

Strategy – Strengthening Value for Money and Wellbeing

Budget 2022 continues to build on our value for money and wellbeing analysis by providing a more systematic approach. We will be working with agencies to develop exemplars to the application of value for money in Budget initiatives. We will provide more detailed advice and seek your formal agreement to scope and analytical options in a forthcoming Treasury report.

Proposed scope (strengthened or deep dive areas in **bold**):

Value

- **Intervention logic** to strengthen the building blocks of cost-benefit analysis (quantified where possible and desirable).
- **He Ara Waiora and Living Standards Framework** (2018 version).
- Distributional impacts. We propose focusing on Māori, Pacific, and children.
- Geographic impacts.

Alignment

- The Government's priorities and objectives, including impacts on child poverty and alignment to the Child and Youth Wellbeing Strategy.
- Agencies' Strategic Intentions.
- Other cross-Government strategies (data, digital, climate) and regulation.

Delivery

- **Bid hygiene**, including clearly defined outputs, supporting evidence that the bid will achieve the outputs and outcomes sought, and accurate, detailed costings.
- **Implementation readiness**, including market and workforce capacity and capability, and delivery plans and timelines.
- Monitoring and performance reporting.

In scope for relevant initiatives:

- Sector wellbeing strategies, e.g. Mental Health and Wellbeing Strategy, Child and Youth Wellbeing Strategy.
- Quantified cost-benefit analysis beyond elements already identified as in scope. Where quantification is possible and useful, we recommend it is undertaken. Agencies continue to have discretion over using CBAx.

Out of scope:

- 2021 update to Living Standards Framework. The update has not yet been finalised.
- Cross-government themes not already identified, e.g. Skills and Workforce; Education, Employment and Training. These have relatively less value to add than the other identified cross-government strategies.
- Distributional impacts for groups other than Māori, Pacific and children (e.g, gender). The identified groups are in the Government's wellbeing objectives, and are therefore a higher priority for analysis.

Strategy – Approach to Investment

Investment supports New Zealanders to move around the country, connect, learn, stay safe and live healthy lives. However, capacity constraints, both within investing agencies and the market, and poor planning are impacting delivery. Through Budget 2022, we will focus on building a better picture of the forward pipeline and the support investments require.

The benefits from investments are being diminished by poor delivery performance …

- Over the past four years there has been unprecedented levels of investment through the Budget process, New Zealand Upgrade Programme and the CRRF.
- The realisation of benefits from this investment has been less than expected due to significant delays and cost escalations occurring in multiple delivery areas.

…due to ongoing capacity constraints and the impact of poor planning.

- There is limited capacity in investing agencies and some markets for additional investment. The risks associated with funding decisions moving at pace are increasing.
- Reducing the quantity and increasing the quality of investments is important to ensure realistic delivery expectations. This requires enforcement of business case requirements, the use of system leader's advice, and collaboration across agencies.

Budget 2022 provides an opportunity to:

- Improve the **information on the planned pipeline** ahead of the Budget to ensure that initiatives have undergone sufficient planning and prioritisation before being considered for funding.
- Draw on support from across Investment System leads to **test the attractiveness and achievability of investment proposals**, including the consideration of capacity constraints.
- Develop a **greater range of options for Ministers on initiatives** to manage the fiscal demands and delivery risks.
- Consider undertaking a **further CRRF reprioritisation process** to sharpen expectations of delivery (although this would require a significant amount of resource within Treasury)

Design

Design – Budget 2022 Initiatives

BUDGET 2022 PROCESS

Cost pressures (1)
- Strictly invitation only
- Two-step process where Ministers provide you with information on expected cost pressures, and Treasury provides you with advice to support decisions on invitations.
- Funded from Budget 2022 allowances

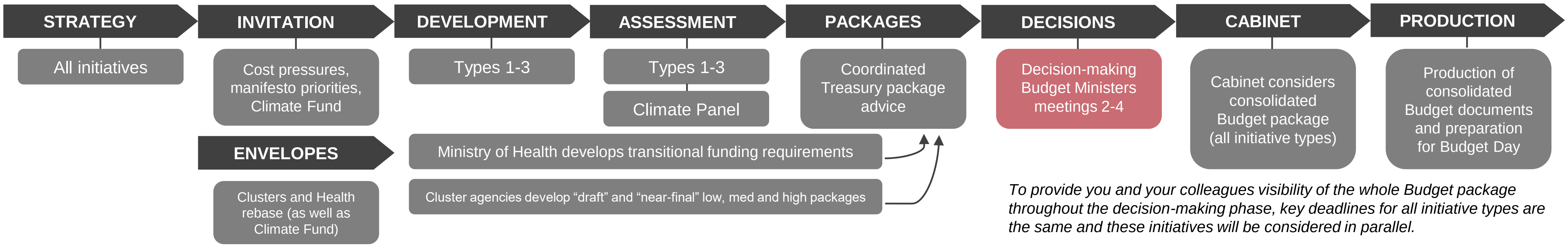
Manifesto priorities (2)
- Strictly invitation only
- Two-step process where Ministers provide you with information on manifesto commitments, and your Office provides you with advice to support decisions on invitations.
- Funded from Budget 2022 allowances

Climate Fund (3)
- Strictly invitation only
- Treasury advice on invitations
- Funding envelope, with specific conditions, possibly funded from hypothecation of ETS revenue
- Treasury advice informed by Climate CEs

Health (4)*
- Strictly invitation only for new initiatives, with cost pressures and rebase to be run through separate envelope process
- Funded from Budget 2022 allowances, with possibility of Budget 2023 precommitments
- Two-year transitional agreement

Clusters (Justice & Natural Resources) (5)*
- Not an invitation-only process
- Three-year funding agreements for operating only
- Pre-determined envelopes and likely managed against allowances for Budgets 2022-24

The Treasury will provide **coordinated package advice to you and Budget Ministers** that allows you to look across **all initiative types.** Essential information requirements (and key deadlines for Ministers and agencies) will be the same across (1) – (5), with relevant additional information being required of different initiative types. Packages for clusters, the Health sector rebase and cost pressures, and the main Budget process will be developed in parallel and will be presented as complete packages.



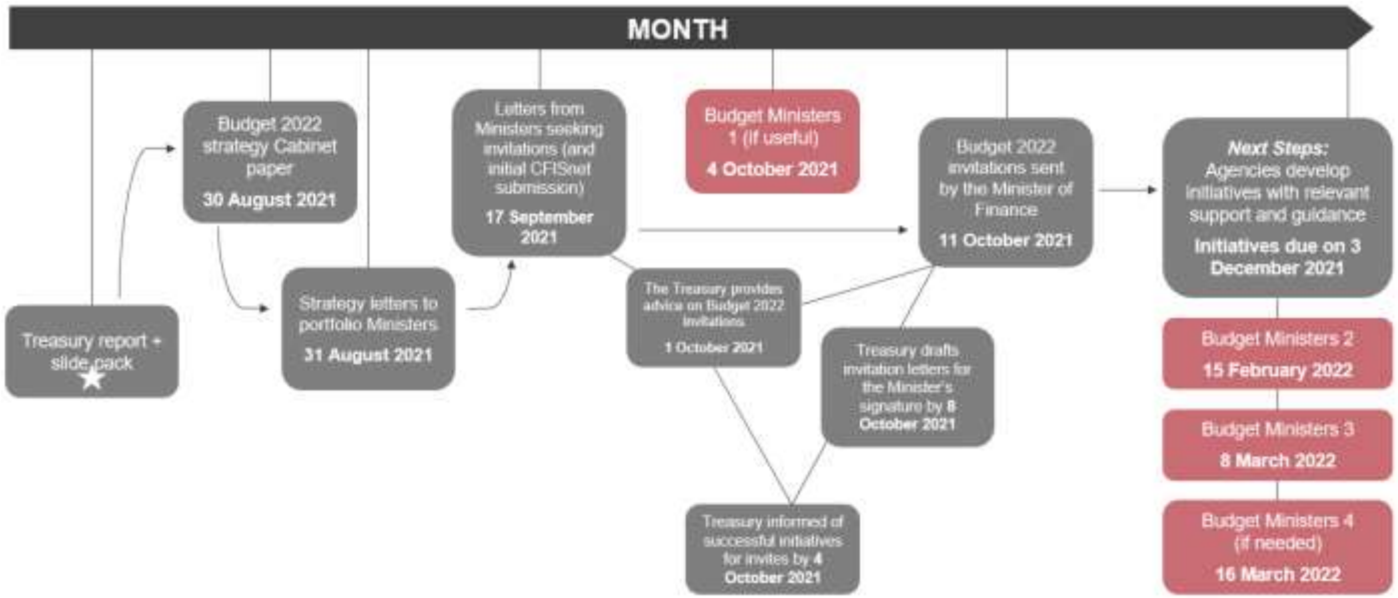
To provide you and your colleagues visibility of the whole Budget package throughout the decision-making phase, key deadlines for all initiative types are the same and these initiatives will be considered in parallel.

Key question: Are you comfortable with this level of complexity in terms of Budget design?

*Additional guidance will be provide to the Ministry of Health and cluster agencies.

Design – Budget 2022 Timeline

Budget 2022 reflects a return to more "standard" timeframes, with increased time for development and assessment of initiatives. To help manage complexity, our proposed approach ensures all packages progress in parallel and that our Budget advice to you and Budget Ministers provides visibility across all initiatives.



- Strategy letters should be sent to portfolio Ministers as soon as possible after the Cabinet paper is considered, allowing 2-3 weeks for Ministers' responses.
- All initiative types will follow similar timelines for invitation (where relevant), development and assessment, allowing the Treasury to provide coordinated advice at key milestones. The proposed timing of Budget Ministers meetings anchor the rest of the timeline.

Date	Key milestone
Monday 30 August	Budget 2022 Strategy and Design paper considered by Cabinet
Tuesday 31 August	Budget strategy letters to portfolio Ministers
Friday 17 September	Ministers submit initiative intention letters (excludes cluster Ministers)
Friday 24 September	Budget 2022 guidance for agencies (for all initiative types)
Monday 4 October	Budget Ministers 1: Initiative invitations*
Monday 11 October	Budget 2022 invitations sent
Early November	Preliminary *Half Year Update* fiscal forecasts
Late November	Final *Half Year Update* fiscal forecasts
Friday 3 December	All Budget 2022 initiatives submitted in CFISnet
Mid-December	*Half Year Update* and *Budget Policy Statement*
December to February	Treasury assessment of initiatives; potential bilateral meetings
Tuesday 15 February	Budget Ministers 2: Draft package
Tuesday 8 March	Budget Ministers 3: Near-final package
Mid-March	Preliminary *Budget Update* fiscal forecasts (TBC)
Wednesday 16 March	Budget Ministers 4: Final package
Monday 4 April	Budget 2022 package paper considered by Cabinet
Late April	Final *Budget Update* fiscal forecasts

Key question: Do you agree with the key milestones we are proposing out to the end of the year? Do you agree with the timing of Budget Ministers meetings?

*A Budget Ministers 1 meeting in October may be useful to discuss invitations for Budget 2022. A Budget Ministers meeting may also be useful in November ahead of the BPS.

Beyond Budget 2022

Beyond Budget 2022 - Future of Budgeting

The reform programmes being implemented through Budget 2022 represent a significant change in the focus and process for how the Government approaches budgeting. This includes moving away from the tenets of the Fiscal Management Approach to a system that prioritises certainty for sectors over fiscal flexibility. Decisions that you take in Budget 2022 will shape the form and focus of Budget 2023 and beyond.

Current approach to budgeting

- Fixed nominal baselines.
- Strong focus on marginal new spending instead of existing baselines.
- Annual process for allocating funding with all initiatives in a given budget round being traded off against one another.
- Global prioritisation with all initiatives in a given budget round being traded off against one another.
- Short-term focus around spending decisions.
- Allowances set at a level of spending consistent with achieving a certain fiscal strategy.
- Most new expenditure managed against allowances, outside of specific exceptions such as changes in the cost of debt servicing, Jobseeker Support benefits, and impairments or revaluations.
- Centralised decision-making with the Minister of Finance working with Budget Ministers to develop packages.

Proposed future approach to budgeting

- Multi-year funding packages with set baseline increases.
- Greater emphasis on understanding and scrutinising baseline spending alongside new funding.
- Budget process remains annual, but implementation of multi-year funding packages means that only certain areas of expenditure will be up for review in any given year.
- Less ability to prioritise among initiatives from different sectors in a given budget round. Sector funding envelopes used to set relative priority.
- Spending decisions influenced by more effective and longer-term planning focussed on achieving outcomes as well as spending reviews.
- Allowances less of a hard constraint, but greater focus on value for money and wellbeing to assess quality of spending.
- Devolved decision-making with packages developed by sector/cluster Ministers.
- More differentiated fiscal management rules deriving from the characteristics of sectors/clusters.