

# The Treasury

## Budget 2022 Information Release

### August 2022

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#### Cabinet Document Details

Title: **Cabinet Paper: CAB-21-SUB-0514: Fiscal Strategy for the Budget Policy Statement 2022**

Date: **2 December 2021**

Creator: Office of the Minister of Finance

#### Information Withheld

No information has been withheld.

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## **FISCAL STRATEGY FOR THE BUDGET POLICY STATEMENT 2022**

### **Proposal**

- 1 This paper seeks agreement to the fiscal strategy, including the level of allowances and Climate Emergency Response Fund (CERF) funding, to be announced in the Budget Policy Statement 2022 (BPS). It also informs Cabinet about the economic and fiscal forecasts for the Treasury's Half Year Economic and Fiscal Update 2021 (Half Year Update).

### **Relation to Government Priorities**

- 2 The Government's goals for this term are:
  - 2.1 Keeping New Zealanders safe from COVID-19;
  - 2.2 Accelerating the recovery and rebuild from the impacts of COVID-19; and
  - 2.3 Laying the foundations for the future, including addressing key issues such as climate change, housing affordability and child poverty.
- 3 The allowances and climate funding announced at the BPS will ensure that we continue to make progress against these goals, particularly in terms of addressing issues such as climate change.

### **Executive Summary**

- 4 The BPS will be released on 15 December 2021 and will provide an update on our fiscal strategy. The Treasury's Half Year Update will be released at the same time.
- 5 The economic outlook has improved since the publication of Treasury's Budget Economic and Fiscal Update 2021 (Budget Update) forecasts but remains highly uncertain due to COVID-19. Strong domestic demand, combined with a tight labour market, capacity constraints and global supply chain disruptions, is raising inflationary pressures and is expected to result in monetary policy continuing to gradually tighten (albeit from a low base).
- 6 The strong growth in tax revenue in the 2020/21 year is expected to continue and coupled with the improvement in the economic outlook leads to a much improved fiscal outlook from the 2022/23 year compared to the Budget Update. An operating balance before gains and losses (OBEGAL) surplus is expected in the 2023/24 year, while net core Crown debt is expected to be close to 30% of GDP by 2025/26. Given the uncertainty that we are dealing with, it is possible these numbers and dates will change by the time we reach Budget 2022.

- 7 I propose the BPS announces operating allowances of \$6.0 billion per annum for Budget 2022, \$4.0 billion per annum for Budget 2023, and \$3.0 billion per annum for Budgets 2024 and 2025. I also recommend increasing the 4-year rolling Multi-year Capital Allowance (MYCA) by \$4.0 billion at the BPS.
- 8 I also propose that the CERF is established with a starting quantum of \$4.5 billion of cash proceeds from the Emissions Trading Scheme, which equates to the forecast cash proceeds over the forecast period from 2022/23 to 2025/26.

## **Background**

- 9 The BPS will be released on 15 December 2021, alongside the Treasury's Half Year Update. Publication of the BPS is required by the Public Finance Act 1989 (PFA). The BPS must state the broad strategic priorities by which the Government will be guided in preparing the Budget for that financial year, and how this aligns with the Government's fiscal strategy. This usually includes setting the operating and capital allowances for Budgets across the forecast period.
- 10 The Budget Ministers group (the Prime Minister, Minister Woods and myself) has agreed the proposed changes in allowances and CERF funding for the BPS ahead of seeking Cabinet approval.

## **The Economic and Fiscal Outlook**

### *Economic context*

- 11 As set out in the Wellbeing Budget 2022: Strategy and Design paper that I took to Cabinet in August [CAB-21-MIN-0349], the domestic economy has proved more adaptable and resilient to the COVID-19 pandemic than previously expected. Since then, the Treasury expects the outbreak of the Delta variant to have reduced real GDP by about 6% in the September quarter. The recovery from this decline is expected to take several quarters reflecting that restrictions on activity, particularly in Auckland, continued during the December quarter.
- 12 The Treasury expects that the shift to our more permissive COVID-19 Protection Framework (CPF) will promote further recovery later in the December quarter and into the new year. Despite the strong economic recovery, COVID-19 presents ongoing risks to the economic outlook.
- 13 Core Crown tax revenue over the forecast period is expected to be \$48.5 billion higher compared to Treasury's Budget Update forecasts. This reflects the stronger economy in 2020/21 and higher near-term nominal GDP.
- 14 Annual Consumers Price Index (CPI) inflation reached a 10-year high of 4.9% in the September quarter, driven largely by international factors such as food and petrol prices, and capacity constraints in the domestic construction sector that have led to increases in the price of new housing. Despite the Delta outbreak, Treasury forecasts assume an upward shift in the CPI inflation profile across the forecast period, with annual CPI inflation expected to peak at 5.6% in the March 2022 quarter. This increase is consistent with elevated rates of inflation internationally, as resurgent global demand has hit up against supply-side bottlenecks and disruptions to global supply chains.

- 15 Unemployment fell to 3.4% in the September quarter 2021, considerably below its pre-pandemic level. The Reserve Bank’s Monetary Policy Committee agreed in November to continue reducing monetary stimulus so as to achieve its inflation and employment objectives. Increases in the Official Cash Rate will affect the interest rates faced by individuals, businesses, and the Government.
- 16 The economic outlook also reflects skills shortages, capacity constraints and supply chain disruptions due to COVID-19. Combined with significantly higher inflation than previously forecast, this will lead to higher cost pressures sought in future Budgets in order to keep delivering the same level of government services. However, as supply chain disruptions ease and higher interest rates begin to influence activity, the Treasury expects inflationary pressures will also begin to decline towards the 2.0% mid-point of the Reserve Bank’s target range over the remainder of the forecast period.

### ***Fiscal outlook***

- 17 The Treasury expects the current fiscal outlook to be significantly weaker than the results reported in the Financial Statements of the Government for the year ended 30 June 2021, largely reflecting the Government’s response to the Delta outbreak. An operating balance before gains and losses (OBEGAL) deficit of \$20.8 billion is forecast in 2021/22, while net core Crown debt (including the assets from the Funding for Lending programme) increases by \$25.4 billion or 5.2% of GDP.
- 18 Looking beyond the current year, the Treasury expects a sharp recovery, with OBEGAL forecast to nearly be back in balance in 2022/23 and a surplus of \$2.1 billion expected in 2023/24, which then grows and reaches \$8.2 billion by 2025/26. Net core Crown debt (including the assets from the Funding for Lending programme) peaks at 35.3% of GDP in 2023/24, which is 6 percentage points lower and a year earlier than expected at the Budget Update. By the end of the forecast period, net core Crown debt falls to nearly 30% of GDP.
- 19 The improvement in the fiscal outlook from 2021/22 is underpinned by the stronger outlook of tax revenue and the unwinding of most of the temporary COVID-19 fiscal support measures. The Treasury’s economic and fiscal forecasts already reflect an increase in expenditure from the decisions I am seeking your approval of in this paper.
- 20 The uncertainty around COVID-19 and an environment of higher inflation and higher interest rates will pose a risk to the Treasury’s fiscal outlook, and these numbers could well be less positive when we reach Budget 2022. These risks will be presented in the Treasury’s Half Year Update.

### **Fiscal Strategy for the Budget Policy Statement**

#### ***Increases to the operating allowances***

- 21 I propose that we announce at the BPS operating allowances of \$6.0 billion per annum for Budget 2022, \$4.0 billion per annum for Budget 2023, and \$3.0 billion per annum for Budgets 2024 and 2025. This proposal is shown in Table 1.
- 22 The higher operating allowance for Budget 2022 is a one-off, reflecting substantial investment in support of the Government’s significant reform programmes, and made

possible by stronger-than-expected revenue due to the improvement in the economic outlook since Budget 2021.

- 23 Reforms to be funded through Budget 2022 include the transformation of the health system, and significant pre-commitments including the Three Waters Reform Support Package and the Main Benefit increase on 1 April 2022. Pre-commitments against the Budget 2022 operating allowance total approximately \$850 million per annum as at 2 December, leaving \$5.15 billion unallocated. If we were to compare the level of allowances to previous years, excluding the one-off impacts associated with a once in a generation reform of the health system and other major reform work, the Budget 2022 operating allowance is at an equivalent level, and will still require significant prioritisation among the bids that have been invited.

#### ***Increase to the multi-year capital allowance (MYCA)***

- 24 I recommend increasing the Multi-year Capital Allowance (MYCA) by \$4.0 billion at Budget 2022. This brings the total unallocated MYCA to \$9.8 billion, or an average of \$2.45 billion to be allocated per Budget in addition to \$2.3 billion of pre-committed Budget 2022 initiatives. This proposal is shown in Table 1.

#### ***Climate Emergency Response Fund***

- 25 The Budget 2022 Strategy paper established the Climate Emergency Response Fund: an enduring, multi-year budgetary mechanism that allows for the prioritisation of initiatives aligned with our climate objectives [CAB-21-MIN-0349 refers].
- 26 More recently, we agreed to a structure for the CERF that would resemble the multi-year capital allowance [CAB-21-MIN-0507 refers]. We also agreed that both operating and capital expenditure could be charged against the CERF, but to forecast an indicative notional 50:50 operating to capital split.
- 27 An outstanding design element for the CERF is its size. I propose that the CERF be established with a starting quantum of \$4.5 billion of cash proceeds from the Emissions Trading Scheme, which equates to the forecast cash proceeds over the forecast period from 2022/23 to 2025/26. I see this as a “down-payment” towards the emissions reductions investment that is required. I would also note that there are other sources of funding for emissions reductions work including the National Land Transport Fund, and through other sources such as NZ Green Investment Finance Ltd.
- 28 I note that several pre-commitments have already been made against the Budget 2022 allowances, and these will be reflected in the material presented in the Budget Policy Statement. This is also true of the CERF, which has had \$840 million charged against it to support our international climate finance contribution for 2022-2025 [CAB-21-MIN-0410 refers]. This leaves a remainder of \$3.7 billion available in the CERF, as demonstrated in Table 1.

Table 1. Budget allowances and the CERF at the BPS 2022

<b>\$ billions</b>	<b>Budget 2022</b>	<b>Budget 2023</b>	<b>Budget 2024</b>	<b>Budget 2025</b>
Operating allowances per year (before pre-commitments)	6.0	4.0	3.0	3.0
Multi-year capital allowance (after pre-commitments)	←————— 9.8 —————→			
Climate Emergency Response Fund (CERF) (after international climate finance charge)	←————— 3.7 —————→			

**Short-term intentions and long-term objectives**

- 29 The ongoing uncertainty around COVID-19 and volatility in the global economy means that the current short-term intentions and long-term objectives remain fit for purpose, and I therefore propose to keep them unchanged in the BPS.
- 30 The BPS will signal that the Government is committed to set new fiscal targets at Budget 2022 with the expectation that the global economic outlook and conditions will stabilise.

**Financial Implications**

- 31 The decisions in this paper will have implications for the future fiscal position, but there are no direct financial implications at this time.
- 32 Based on Treasury’s Half Year Update forecasts, my proposed operating and capital spending settings (including health and climate change spending) will see net core Crown debt including Funding for Lending (FLP) assets peak in 2023/24 at 35.3% of GDP. These settings will see the OBEGAL return to surplus in 2023/24, compared to 2026/27 projected at Budget 2021.
- 33 The establishment of the CERF in Budget 2022 will also have fiscal implications, impacting net core Crown debt by at least \$4.5 billion. The impact on the operating balance is somewhat unknown as it will be dependent on the nature of the investments funded from the Climate Emergency Response Fund. These impacts will be forecast from the Half Year Update and included in the Budget Policy Statement.
- 34 Ahead of Budget 2022, decisions on the allocation of operating and capital allowances, and the CERF will be taken by Budget Ministers.

**Legislative Implications**

- 35 There are no legislative implications associated with this paper.

## **Impact Analysis**

### ***Regulatory Impact Statement***

36 There are no regulatory implications associated with this paper.

### ***Climate Implications of Policy Assessment***

37 The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply as there is no direct emissions impact at this stage. Initiatives funded through the CERF are likely to have direct emissions impacts, but these will be presented to Cabinet through the relevant Budget Cabinet paper.

## **Population Implications**

38 There are no gender or disability implications associated with this paper.

## **Human Rights**

39 The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

## **Consultation**

40 This paper was prepared by the Treasury.

41 Due to Budget sensitivity, consultation has been limited. The Treasury has consulted with the Ministry for the Environment on the establishment of the CERF.

## **Communications**

42 The levels of new spending approved through this paper will be announced when the BPS is released on 15 December 2021. This announcement will include the level of operating allowances, the MYCA, and the level of the CERF. A number of announcements about specific initiatives will then be made after the release of the BPS and before Budget 2022.

43 The communication of initiatives and the BPS will be led by the Minister of Finance's office.

## **Proactive Release**

44 I propose delaying the release of this paper beyond the standard 30 business days as it will be released separately through the proactive release of Budget material following Budget 2022.

## Recommendations

45 The Minister of Finance recommends that Cabinet:

### *Economic and fiscal outlook*

- 1 **Note** that the Budget Policy Statement 2022 (BPS) and the Half Year Economic and Fiscal Update (Half Year Update) are due to be released publicly on 15 December;
- 2 **Note** that the economic outlook shows stronger economic activity than Treasury's Budget Economic and Fiscal Update 2021 (Budget Update) forecasts, but higher and more persistent inflation over the forecast period;
- 3 **Note** that strong growth in tax revenue leads to a significantly improved fiscal outlook from the 2022/23 year compared to the Budget Update. An operating balance before gains and losses (OBEGAL) surplus is expected in the 2023/24 year, while net core Crown debt (including FLP assets) is expected to be close to 30% of GDP by 2025/26;

### *Budget Allowances*

- 4 **Agree** to announce operating allowances of \$6.0 billion at Budget 2022, \$4.0 billion at Budget 2023, and \$3.0 billion at Budgets 2024 and 2025 in the BPS;
- 5 **Note** that the \$6.0 billion operating allowance for Budget 2022 is a one-off in recognition of the investment required for major government reform programmes, including the health reforms;
- 6 **Note** that excluding the investment in the reform programmes and the pre-commitments already made against Budget 2022, there will still need to be significant prioritisation decisions among the bids that have been invited;
- 7 **Agree** to increase the multi-year capital allowance by \$4.0 billion at Budget 2022;
- 8 **Note** that the allocation of the agreed operating and multi-year capital allowances will be agreed through the normal processes for Budget 2022;

### *Climate Emergency Response Fund*

- 9 **Note** that as part of its decisions on the Budget 2022 Strategy, Cabinet agreed to establish a Climate Emergency Response Fund [CAB-21-MIN-0349 refers];
- 10 **Note** that Cabinet has agreed that the Climate Emergency Response Fund be established with cash proceeds from the Emissions Trading Scheme [CAB-21-MIN-0507];
- 11 **Note** that the Treasury's Half Year Update Forecasts estimate that cash proceeds from the Emissions Trading Scheme will be \$4.5 billion over the forecast period from 2022/23 to 2025/26;



- 12 **Note** that the Treasury’s Half Year Update Forecasts will be assuming the cash proceeds in recommendation 9 will be spent on climate-related initiatives;
- 13 **Agree** that the Climate Emergency Response Fund should be established with \$4.5 billion of funding available over the forecast period (\$3.7 billion after the international climate finance commitment);
- 14 **Note** that the proposal in recommendation 11 will have a corresponding impact on net core Crown debt, although the impact on the operating balance is somewhat unknown as it will be dependent on the nature of the investments funded from the Climate Emergency Response Fund;
- 15 **Agree** that the Climate Emergency Response Fund should be announced in the Budget Policy Statement;
- 16 **Note** the intention for the quantum of the CERF to be at least the forecast ETS proceeds, and that the level of the Fund may exceed ETS proceeds as determined by Cabinet during the Budget 2022 process [CAB-21-MIN-0507 refers];

***Short-term intentions and long-term objectives***

- 17 **Note** that short-term intentions and long-term objectives for fiscal policy will remain unchanged in the BPS;
- 18 **Note** that the BPS will state that the Government is committed to setting new fiscal targets at Budget 2022 with the expectation that the global economic outlook and conditions will stabilise;

***Fiscal implications***

- 19 **Note** that this paper has no direct fiscal implications, but the combined impact of increasing Budget allowances and establishing the CERF will increase net core Crown debt and will have implications for OBEGAL;

***Timeframes***

- 20 **Note** that the proactive release of this paper will be delayed beyond the standard 30 business days as it will be released separately following Budget 2022.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance