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Office of the Minister of Finance

Cabinet

Setting Fiscal Rules for the Fiscal Strategy Report 2022

Proposal

- 1 This paper seeks agreement to new fiscal rules to be announced for Budget 2022. It also informs Cabinet about a change in the net debt measure to communicate our fiscal position in a more accurate and comparable manner.

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 new fiscal rules will support our goals by ensuring the Government maintains a sustainable fiscal position over the longer term. This will support intergenerational wellbeing by ensuring there is adequate fiscal headroom to address long-term challenges.

Executive Summary

- 4 I propose adopting two new fiscal rules for Budget 2022: an operating balance before gains and losses (OBEGAL) rule, and a net debt ceiling. The OBEGAL rule focuses on targeting a small surplus over time (in the range of 0-2% of GDP) as the main fiscal rule for informing fiscal strategy decisions. This would be coupled with a net debt ceiling, which would be higher than previous debt targets allowing more fiscal space to fund high-quality investments that will improve productivity and living standards.
- 5 A new net debt measure will be introduced to communicate our fiscal position and the new fiscal rules. This new indicator includes Crown entity borrowings, financial advances (such as student loans), and the New Zealand Superannuation Fund (NZSF). I consider this broader measure is a better indicator for fiscal sustainability and is more internationally comparable. To ensure transparency at Budget 2022, we will publish debt levels and forecasts using both the old and new net debt indicators.

- 6 Consistent with the proposed new fiscal rules, this paper also proposes new short-term intentions and long-term objectives for fiscal policy to be set out in the Fiscal Strategy Report 2022, in line with Public Finance Act 1989 (PFA) requirements.

Background

- 7 As New Zealand is moving past the immediate COVID-response phase and towards recovery, it is now the right time to recalibrate our fiscal rules. Fiscal rules are important to support responsible fiscal management, and to communicate our fiscal approach. Governments have typically set specific net debt targets coupled with a target for the OBEGAL.
- 8 In 2020, we introduced relatively permissive fiscal rules to allow flexibility for the Government to respond to COVID-19. The Government is on track to meet the short-term intentions and long-term objectives set in the Fiscal Strategy Report 2021, including the objective 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).
- 9 As uncertainty from COVID-19 is reducing, I consider that more definite fiscal rules should be adopted that reflect the current economic context, as well as broader fiscal considerations, in order to support long-term fiscal sustainability. Our intention to set new fiscal rules was signalled in the Budget Policy Statement 2022 published in December 2021.

Setting new fiscal rules

- 10 With significant and rising cost pressures to deliver government services, I consider that the new fiscal rules should place more emphasis on managing costs on the operating side. On the capital side, we have a significant infrastructure gap and we will need to make large investment decisions over the medium term, which will require more fiscal space.
- 11 I therefore propose focusing on the OBEGAL rule as the main fiscal rule for driving fiscal strategy decisions. We should target a level of OBEGAL that ensures that over time operating expenses do not add to net debt as a share of GDP. This will mean aiming to run small surpluses (in the range of 0-2% of GDP) so that deficits can be run as needed following shocks. This supports intergenerational equity and will likely result in a fiscally sustainable position as debt would not be used to fund current consumption.
- 12 I propose that the OBEGAL rule is complemented with a ceiling on net debt. This debt ceiling would be higher than previous debt targets, and it would therefore allow us to use the available fiscal space to borrow for long-term investments that enhance living standards and improve productivity. It is appropriate that the cost of these investments can be spread across generations as the benefits are felt across generations.
- 13 This is a shift from the previous approach which emphasised a binding debt target as the central focus for fiscal strategy decisions. If fiscal rules are too

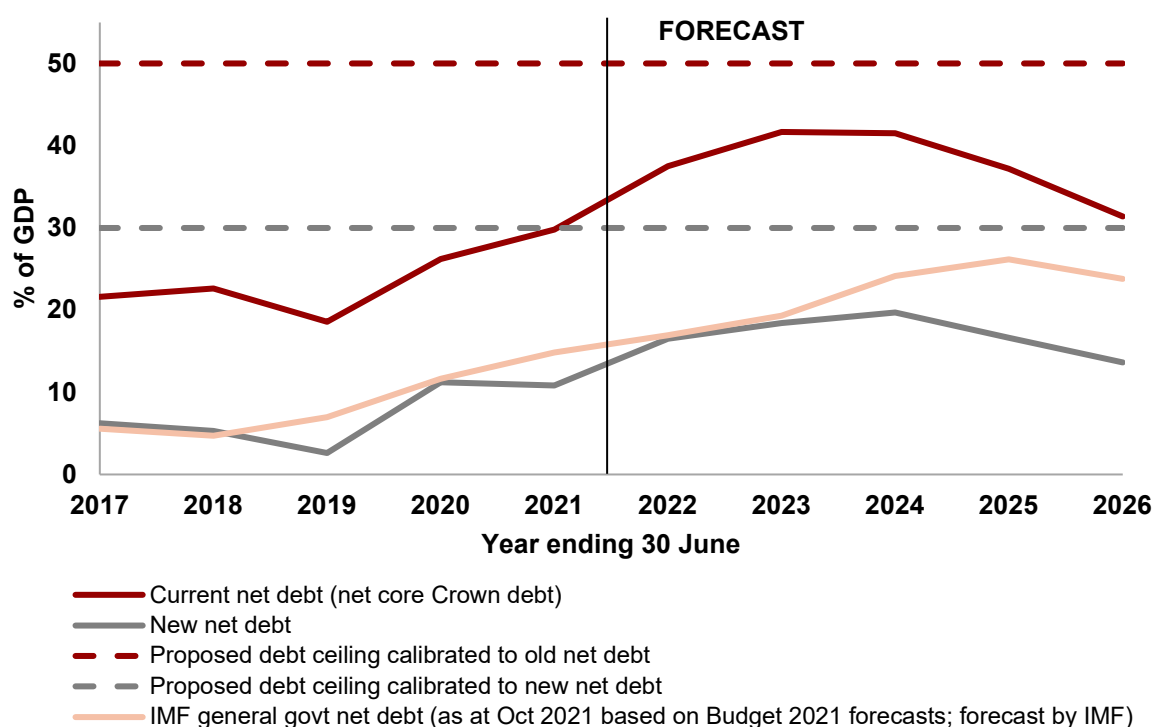
binding, it can lead to sub-optimal policy decisions and underinvestment, where updates to forecasts can drive the level of investment rather than assessments of value for money and the impact on living standards.

- 14 I want to emphasise that the new debt ceiling is not a point target that we would aim for. Instead, it is the level that the Government should aim to keep debt below. This will also provide a buffer for responding to larger shocks while maintaining fiscal sustainability.
- 15 The Treasury has recommended we set this debt ceiling at 50% of GDP based on the current net debt measure. This level is based on relatively conservative assumptions about the future state of the world – including the interest rate environment, future GDP growth rates and possible economic shocks.
- 16 The new debt ceiling will need to be accompanied by the consistent use of strong value-for-money tools like business cases to ensure that we only fund high quality investments. It will also be important to continue our approach of considering deliverability and capacity constraints when making investment decisions. The New Zealand infrastructure strategy developed by Te Waihanga and the Treasury's investment pipeline will both be critical elements in ensuring our investments are properly developed, sequenced and understood.

Adopting a new net debt measure

- 17 I have decided to adopt a new net debt measure, which will include Crown entity borrowings, the NZSF, and advances such as student loans and the Reserve Bank's 'Funding for Lending Programme' which do not have a long-term impact on the fiscal position. I consider that this new and broader net debt measure better reflects New Zealand's fiscal position for the purposes of fiscal management and fiscal sustainability. It is also more closely aligned with the measures used by Australia and the International Monetary Fund (IMF), and will therefore improve our international comparability.
- 18 Including the NZSF lowers net debt by around 20 percentage points of GDP as its sizeable assets are netted off against debt. To ensure that we do not borrow against the NZSF, I propose that the net debt ceiling using the new measure would be set at 30% of GDP (equivalent to 50% under the current measure).
- 19 Figure 1 shows the new net debt measure (including the NZSF) compared to the current one (excluding the NZSF) and the IMF's general government net debt measure. It also depicts the corresponding net debt ceilings.

Figure 1: Net debt indicators and corresponding debt ceiling (preliminary BEFU 2022 data and forecasts)



20 There are risks associated with including the NZSF in the net debt measure. It will increase the volatility of the measure and could be perceived as an intention to borrow against the NZSF. To help address these risks, and to promote transparency, the Treasury will continue publishing both net debt measures.

Communicating the short-term intentions and long-term objectives

21 The PFA requires the Government to set short-term intentions and long-term objectives for fiscal policy in relation to five variables in the Fiscal Strategy Report: total debt, total operating expenses, total operating revenue, the operating balance, and net worth.

22 I propose the following short-term intentions and long-term objectives to be communicated in the Fiscal Strategy Report 2022, noting that the precise wording of these and the fiscal forecasts are yet to be finalised:

Table 1 – Short-term intentions for the next three years – proposed for Budget 2022, compared to the 2021 Fiscal Strategy Report

| | 2022 Fiscal Strategy Report | 2021 Fiscal Strategy Report |
|-------------|--|---|
| Debt | Maintain net debt at below 30 per cent of GDP based on new net debt measure including the NZSF, subject to significant shocks. | Our intention is to 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. |

| | 2022 Fiscal Strategy Report | 2021 Fiscal Strategy Report |
|--------------------------|---|---|
| | <p>Net debt is forecast to peak at [just below 20] per cent of GDP in 2023/24 and reduce over the forecast period to [14] per cent of GDP in 2025/26.</p> <p>This corresponds to maintaining total borrowings at below 65 per cent of GDP, subject to significant shocks.</p> <p>Total borrowings is forecast to be [52] per cent of GDP at the end of the forecast period.</p> | |
| Operating balance | <p>Our intention is to return to an operating surplus (before gains and losses) by [2024/25], subject to economic and fiscal conditions.</p> <p>The operating balance is forecast to be [3] percent of GDP at the end of the forecast period.</p> | <p>The Government will use fiscal policy to secure the economic recovery for New Zealand and reduce deficits over the forecast period as economic conditions allow.</p> |
| Expenses | <p>Our intention is to ensure expenses are consistent with the operating balance objective.</p> <p>Core Crown expenses are forecast to be [29.6] per cent of GDP in 2025/26. Total Crown expenses are forecast to be [36.9] per cent of GDP in 2025/26.</p> | <p>Our intention is to ensure expenses are consistent with the operating balance objective.</p> |
| Revenue | <p>Our intention is to ensure revenue is consistent with the operating balance objective.</p> <p>Total Crown revenues are forecast to be [38.5] per cent of GDP in 2026.</p> <p>Core Crown revenues are forecast to be [32] per cent of GDP in 2026.</p> <p>Core Crown tax revenues are forecast to be [29.7] per cent of GDP in 2026.</p> | <p>Our intention is to ensure revenue is consistent with the operating balance objective.</p> |
| Net worth | <p>Our intention is to maintain net worth consistent with the operating balance objective.</p> <p>Total net worth attributable to the Crown is forecast to be [34] per cent of GDP in 2025/26.</p> <p>Total Crown net worth is forecast to be [35.3] per cent of GDP in 2025/26.</p> | <p>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.</p> |

Table 2 – Long-term objectives for at least the next ten years – proposed for Budget 2022, compared to the 2021 Fiscal Strategy Report

| | 2022 Fiscal Strategy Report | 2021 Fiscal Strategy Report |
|--------------------------|---|---|
| Debt | <p>Maintain net debt at below 30 percent of GDP based on new net debt measure including the NZSF, subject to significant shocks.</p> <p>This corresponds to maintaining total borrowings at below 65 percent of GDP, subject to significant shocks.</p> | <p>The Government will 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).</p> |
| Operating balance | <p>Once the operating balance (before gains and losses) has returned to a surplus, our long-term objective is to maintain an average surplus in the range of 0-2 percent of GDP, subject to economic and fiscal conditions.</p> | <p>The Government will run an operating balance consistent with meeting the long-term debt objective.</p> |
| Expenses | <p>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.</p> | <p>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.</p> |
| Revenue | <p>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.</p> | <p>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.</p> |
| Net worth | <p>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.</p> | <p>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.</p> |

Financial Implications

23 The decisions in this paper will have implications for the future fiscal strategy, but there are no direct financial implications at this time.

Legislative Implications

24 There are no legislative implications associated with this paper.

Impact Analysis

Regulatory Impact Statement

25 There are no regulatory implications associated with this paper.

Climate Implications of Policy Assessment

- 26 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.

Population Implications

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

Human Rights

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

Consultation

- 29 This paper was prepared by the Treasury. Due to Budget sensitivity, consultation has been limited. I have consulted with Budget Ministers on this proposal. Treasury officials have consulted the Department of the Prime Minister and Cabinet, and discussed some of these proposals with counterparts at the IMF, HM Treasury, and the Australian Treasury.

Communications

- 30 I will announce the new fiscal rules in a speech before Budget. The Treasury will also publish an analytical note which sets out the analysis underlying the changes. Subsequently, the new fiscal rules including the short-term intentions and long-term objectives will be communicated in the Fiscal Strategy Report which is released on 19 May 2022.

Proactive Release

- 31 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

The Minister of Finance recommends that Cabinet:

- 1 **note** that the Government will meet the short-term intentions and long-term objectives set in the Fiscal Strategy Report 2021;
- 2 **note** that the intention to set new fiscal rules was signalled in the Budget Policy Statement 2022 published in December 2021;
- 3 **agree** to focus on the operating balance before gains and losses (OBEGAL) as the main fiscal rule for informing fiscal strategy decisions;

- 4 **agree** to aim for small OBEGAL surpluses of 0-2% of GDP on average to ensure that operating expenses do not add to net debt as a share of GDP over time, thus supporting fiscal sustainability and intergenerational equity;
- 5 **agree** to complement the OBEGAL target with a ceiling on net debt;
- 6 **note** that a new net debt measure will be adopted which includes the New Zealand Superannuation Fund, Crown entity borrowings, and advances such as student loans and the Reserve Bank’s ‘Funding for Lending Programme’;
- 7 **agree** that the net debt ceiling will be set at 30% of GDP based on the new net debt measure. This corresponds to 50% of GDP based on the current net debt measure;
- 8 **note** that both the current and the new net debt measure will continue to be published by the Treasury to support transparency;
- 9 **note** that the new net debt measure will be used to communicate the new debt ceiling in the short-term intentions and long-term objectives for fiscal policy;
- 10 **agree in principle** to the following short-term intentions and long-term objectives for the Fiscal Strategy Report 2022;

| | Short-term intentions | Long-term objectives |
|--------------------------|---|---|
| Debt | <p>Maintain net debt at below 30 per cent of GDP based on new net debt measure including the NZSF, subject to significant shocks.</p> <p>Net debt is forecast to peak at [just below 20] per cent of GDP in 2023/24 and reduce over the forecast period to [14] per cent of GDP in 2025/26.</p> <p>This corresponds to maintaining total borrowings at below 65 per cent of GDP, subject to significant shocks.</p> <p>Total borrowings is forecast to be [52] per cent of GDP at the end of the forecast period.</p> | <p>Maintain net debt at below 30 percent of GDP based on new net debt measure including the NZSF, subject to significant shocks.</p> <p>This corresponds to maintaining total borrowings at below 65 percent of GDP, subject to significant shocks.</p> |
| Operating balance | <p>Our intention is to return to an operating surplus (before gains and losses) by [2024/25], subject to economic and fiscal conditions.</p> <p>The operating balance is forecast to be [3] percent of GDP at the end of the forecast period.</p> | <p>Once the operating balance (before gains and losses) has returned to a surplus, our long-term objective is to maintain an average surplus in the range of 0-2 percent of GDP, subject to economic and fiscal conditions.</p> |

| | Short-term intentions | Long-term objectives |
|------------------|--|---|
| Expenses | <p>Our intention is to ensure expenses are consistent with the operating balance objective.</p> <p>Core Crown expenses are forecast to be [29.6] per cent of GDP in 2025/26. Total Crown expenses are forecast to be [36.9] per cent of GDP in 2025/26.</p> | <p>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.</p> |
| Revenue | <p>Our intention is to ensure revenue is consistent with the operating balance objective.</p> <p>Total Crown revenues are forecast to be [38.5] per cent of GDP in 2026.</p> <p>Core Crown revenues are forecast to be [32] per cent of GDP in 2026.</p> <p>Core Crown tax revenues are forecast to be [29.7] per cent of GDP in 2026.</p> | <p>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.</p> |
| Net worth | <p>Our intention is to maintain net worth consistent with the operating balance objective.</p> <p>Total net worth attributable to the Crown is forecast to be [34] per cent of GDP in 2025/26.</p> <p>Total Crown net worth is forecast to be [35.3] per cent of GDP in 2025/26.</p> | <p>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.</p> |

- 11 **authorise** the Minister of Finance to make further changes as needed to finalise the short-term intentions and long-term objectives as part of the drafting process of the Fiscal Strategy Report 2022;
- 12 **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