

The Treasury

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Treasury Report: Proposal for a review of fiscal indicators

Date:	3 December 2020	Report No:	T2020/3488
		File Number:	MC-1-5-4

Action sought

	Action sought	Deadline
Hon Grant Robertson Minister of Finance	<p>Agree to the proposed scope, process and timeline for reviewing the headline fiscal indicators ahead of Budget 2021</p> <p>Note that we intend to signal the scope of this review at HYEPU</p>	22 December 2020

Contact for telephone discussion (if required)

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

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Executive Summary

You have requested advice on a review of the fiscal indicators to be completed by Budget 2021 for implementation in the Budget Economic and Fiscal Update 2021 (BEFU). The impact of alternative monetary policy (AMP) tools and other existing issues on the fiscal indicators suggest this review is necessary to ensure the indicators remain fit-for-purpose.

We propose limiting the scope of this work ahead of Budget 2021 to reviewing the choice of indicators used for the headline operating and debt indicators – currently the Operating Balance before Gains and Losses (OBEGAL) and net core Crown debt (excluding the New Zealand Super Fund and advances). Therefore, we would not consider the following within scope:

- the specific intentions and objectives for fiscal policy, as separate advice is provided on a regular basis to review these, or
- changes to the Public Finance Act 1989 (PFA), as more time would be required for public consultation, policy design and legislative drafting.

Changes to the PFA, such as revisiting the principles of responsible fiscal management, could be considered through a longer-term work programme on macroeconomic frameworks. However, for a policy issue of this magnitude we suggest taking a longer period of time to undertake a first principles analysis, conduct broad public consultation, and consider the long-term economic outlook. This will help to ensure that any PFA reform in this area is long-lasting. We do not believe a review of this scale is feasible to deliver by Budget 2021.

Our analysis ahead of Budget 2021 will focus on an assessment of possible modifications that could be made to existing headline fiscal indicators, and a review of currently published, but less prominent, fiscal indicators to assess their suitability as headline indicators. Underpinning this work, we propose the following set of objectives (in order of priority) for determining a 'good' fiscal indicator:

- **Policy intent** – the indicator reflects the policy decisions of the Government.
- **Fiscal position** – the indicator is an accurate reflection of the fiscal position of the Crown.
- **Integrity** – the definition and measurement of the indicator is clear and consistent, for example, through adherence to a recognised accounting standard.
- **Neutrality** – the indicator's definition does not influence policy decisions and does not incentivise 'gaming'.
- **Communication** – the indicator can be easily communicated to the public and other stakeholders.
- **Comparability** – the indicator can be easily compared to other countries' data and can be understood in the context of historic New Zealand data.

There will be trade-offs between these objectives, and it is possible the current indicators of net core Crown debt and OBEGAL may remain the least worst options. We will expose these trade-offs in our advice on potential options to enable you to reach an informed decision.

We intend to conduct the bulk of our analysis and targeted consultation over January and February to allow for interim advice before March 2021. We will require decisions on our final recommendations by the end of March to enable implementation of any changes by Budget 2021.

If you agree to our proposal for this review, we will indicate the scope and timing of the review in HYEPU. You may wish to provide further detail in the Budget Policy Statement about this review and likely changes that may be implemented at BEPU. We can incorporate this into subsequent drafts of the Budget Policy Statement if required.

Recommended Action

We recommend that you:

- a **agree** to the Treasury commencing a review of fiscal indicators, with any changes to be implemented at Budget 2021

Agree/disagree.

- b **agree** to limit the scope of this review to assessing the headline operating balance and debt indicators

Agree/disagree.

- c **agree** to the following set of objectives (in order of priority) for determining a 'good' fiscal indicator:

- **Policy intent** – the indicator reflects the policy decisions of the Government.
- **Fiscal position** – the indicator is an accurate reflection of the fiscal position of the Crown.
- **Integrity** – the definition and measurement of the indicator is clear and consistent, for example, through adherence to a recognised accounting standard.
- **Neutrality** – the indicator's definition does not influence policy decisions and does not incentivise 'gaming'.
- **Communication** – the indicator can be easily communicated to the public and other stakeholders.
- **Comparability** – the indicator can be easily compared to other countries' data and can be understood in the context of historic New Zealand data.

Agree/disagree.

- d **note** that we intend to consider broader macroeconomic and fiscal policy frameworks over the next two-to-three years as part of the Treasury's longer-term work programme.

- e **note** that, if you agree to recommendations a and b, the scope and timing of this review will be signalled in the 2020 Half Year Economic and Fiscal Update.

Angus Hawkins
Team Leader, Macroeconomic & Fiscal Policy Team

Hon Grant Robertson
Minister of Finance

Treasury Report: Options for reviewing the main fiscal indicators

Purpose of Report

1. This report seeks your agreement to the scope and purpose of a review of the headline fiscal indicators. You have requested that this review be completed by Budget 2021 so that any changes to the definitions of fiscal indicators or their prominence can be implemented in the Budget Economic and Fiscal Update 2021 (BEFU).
2. We have set out a proposal for the scope of the review that can be delivered by Budget 2021. We have also indicated some of the broader questions and issues that could be considered through a longer-term work programme over the Parliamentary term.

Background

The Government is required to report regularly on several fiscal indicators

3. The Public Finance Act 1989 (PFA) sets the basic framework for reporting fiscal indicators. It requires that the Government's long-term objectives and short-term intentions for fiscal policy to be stated in relation to the following variables:
 - Total operating expenses
 - Total operating revenues
 - The balance between total operating expenses and total operating revenues
 - The level of total debt, and
 - The level of total net worth.
4. The PFA requires financial statements of the Government to be prepared in accordance with generally accepted accounting principles (GAAP). In some cases, the headline GAAP fiscal indicators may not be the most appropriate when communicating the Government's fiscal strategy or informing fiscal policy decisions. Therefore, in addition to the GAAP fiscal indicators, a number of other non-GAAP fiscal indicators are reported.
5. Since 2009, the two most prominent indicators have been net core Crown debt (excluding the New Zealand Super Fund and advances) and Operating Balance before Gains and Losses (OBEGAL). Both are non-GAAP measures the Treasury constructs to monitor the Government's fiscal objectives. These indicators are frequently used more prominently in public communication than the legally required GAAP indicators [T2020/3274 refers].

Several issues with headline fiscal indicators have arisen in recent years

6. You have received advice over the last year regarding the implementation of alternative monetary policy (AMP) and its interaction with the fiscal indicators. This has required public communications about 'looking through' the impacts of AMP to ensure the fiscal indicators are interpreted correctly and led to issues with presentation of the government's financial statements. In particular:

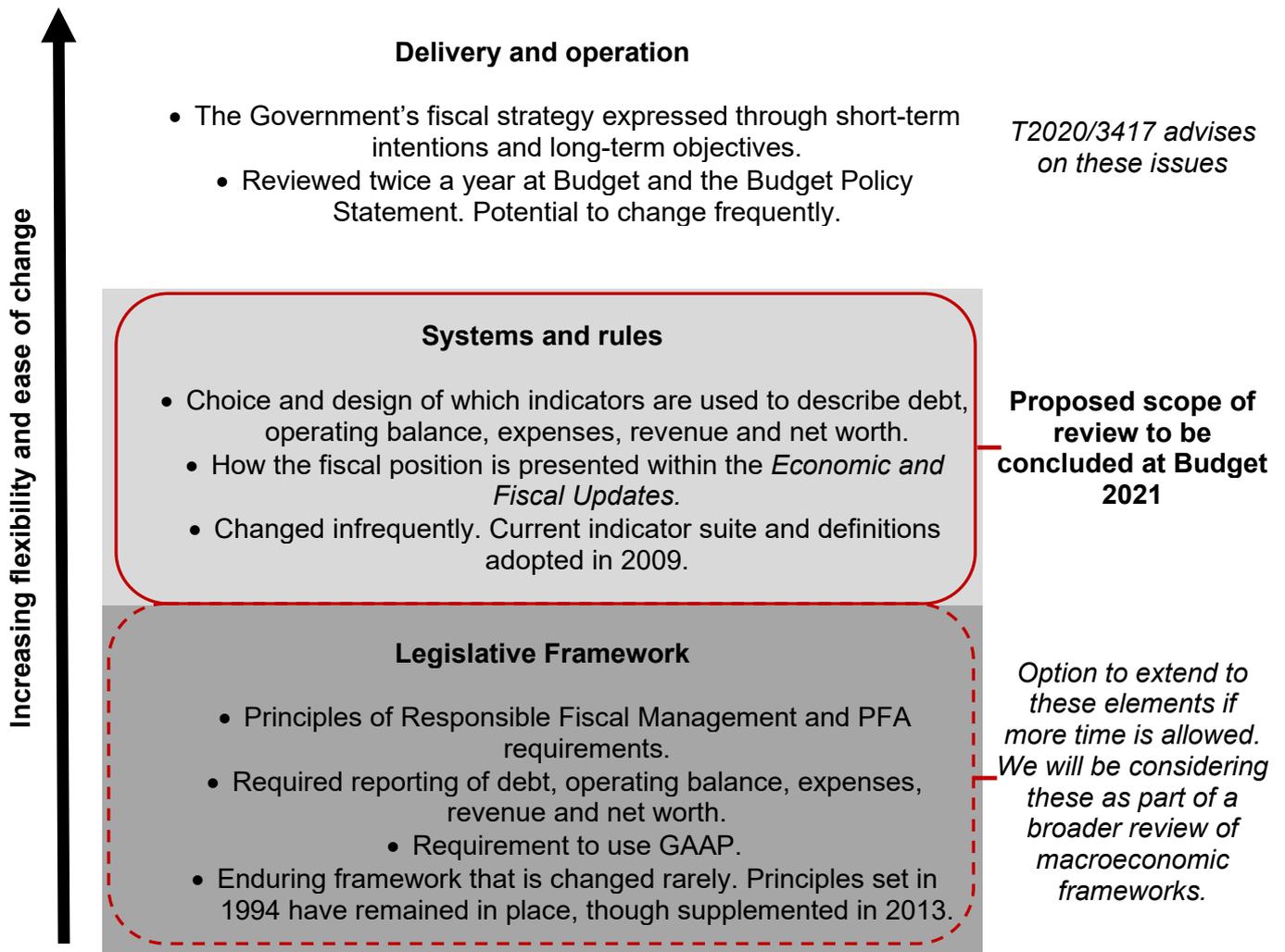
- The **Funding for Lending Programme (FLP)** announced by the Reserve Bank of New Zealand (RBNZ) in November 2020 will increase net core Crown debt by approximately 9% of GDP [T2020/3359 refers]. This is because our current definition of net core Crown debt includes the RBNZ's settlement deposits as a liability, but excludes the corresponding asset generated by FLP as it is classified as an advance.
 - Under the RBNZ's **Large-Scale Asset Purchases (LSAP)** programme, the RBNZ intends to buy up to \$100 billion of New Zealand Government Bonds (NZGBs) and Local Government Funding Agency (LGFA) Bonds in the secondary market. To acquire these assets, the RBNZ must pay current bondholders the market price for those bonds. This creates a valuation difference on consolidation between the current market value (paid by the RBNZ for the NZGBs in the secondary market) and the historical value of the NZGB liability on the Government's balance sheet. Although these losses are temporary (as they reverse over time through a reduction in future finance costs), they materially worsen OBEGAL [T2020/3274 refers].
7. The inclusion of non-GAAP indicators in the Financial Statements of the Government (FSG) has become more challenging as significant judgements are required to determine what components should be included or excluded in non-GAAP indicators. For example, the Treasury's position at BEFU 2020 was to report the losses from LSAP outside of OBEGAL. However, at year-end, the Office of the Auditor General (OAG) considered that excluding the LSAP losses does not fairly present the performance of the Government for the year, given the prominence of OBEGAL as a communication tool.
 8. The increasing prevalence of Crown Entity (CE) borrowing presents another issue for fiscal indicators as CE borrowing is not captured in net core Crown debt. This understates the government's fiscal risks, because if a CE such as Kāinga Ora defaulted, the government would likely step in. CE borrowing also tends to be more expensive than borrowing through the Crown so therefore attracts additional interest costs to the government.
 9. A longer-standing issue is the inconsistency between the coverage of OBEGAL (total Crown) and net core Crown debt (core Crown). This stock/flow measurement inconsistency means that our main flow indicator cannot be derived simply from our main stock indicator, and vice versa. Although this issue does not urgently need to be resolved, this review could be a sensible opportunity to consider whether we should seek to better align the coverage of the main stock and flow indicators.

Scope of the Review

We recommend a review focused on the measures used to monitor debt and the operating balance

10. For a review ahead of Budget 2021, we propose limiting the scope of this work to reviewing the 'systems and rules' as outlined in Figure 1. Within the five variables set out in the PFA, the highest priority for a review is the headline operating and debt indicators (currently OBEGAL and net core Crown debt). Further work on reviewing the full suite of fiscal indicators is less urgent given that some indicators do not present any immediate issues, and therefore this work could be completed on a longer timeframe.

Figure 1: Framework, systems and delivery of fiscal indicators



11. Therefore, we would not consider the following within scope:

- PFA changes, as more time would be required for public consultation, policy design and legislative drafting, or
- the specific intentions and objectives for fiscal policy, as separate advice is provided on a regular basis to review these.

We plan to undertake a broader review of macroeconomic and fiscal policy frameworks during the current parliamentary term, but not before Budget 2021.

12. We understand that you are interested in a broader review that includes possible PFA reform. The principles of responsible fiscal management and other opportunities for PFA reform are worth revisiting post-COVID-19, but this type of review would take longer than the time available between now and Budget 2021. For example, the principles of responsible fiscal management that focus on maintaining ‘prudent levels of debt’ have not been substantially reviewed or changed since the PFA was introduced. For a policy issue of this magnitude we suggest taking a longer period of time to undertake a first principles analysis, conduct broad public consultation, and consider the long-term economic outlook, so that any PFA reform in this area is able to be long-lasting. If this work was compressed into a shorter time period, consultation would be necessarily streamlined and further amendments to the PFA would likely be required at a later date.

13. Our preference would be to keep the scope narrow and tightly defined for the review between now and Budget 2021, focusing solely on the headline operating and debt indicators, with any further work progressed over a longer time frame.

Objectives of the Review

14. We propose that the review ahead of Budget 2021 focus on identifying measures of debt and the operating balance that best meet our objectives of a 'good' fiscal indicator. We consider these to be, in order of priority:
 - **Policy intent** – the indicator reflects the policy decisions of the Government.
 - **Fiscal position** – the indicator is an accurate reflection of the fiscal position of the Crown.
 - **Integrity** – the definition and measurement of the indicator is clear and consistent, for example, through adherence to a recognised accounting standard.
 - **Neutrality** – the indicator's definition does not influence policy decisions and does not incentivise 'gaming'.
 - **Communication** – the indicator can be easily communicated to the public and other stakeholders.
 - **Comparability** – the indicator can be easily compared to other countries' data and can be understood in the context of historic New Zealand data.

The current fiscal indicators only partially meet these objectives.

15. As noted in paragraphs 7-10, a number of emerging issues mean that OBEGAL and net core Crown debt are not currently meeting these objectives.
16. A review of the fiscal indicators should seek to address this by investigating whether any existing indicators currently reported in the EFU documents are better aligned with these objectives than the current headline operating and debt indicators and, if not, recommending changes to the definitions of the existing headline indicators to ensure they better meet these objectives.
17. No indicator will perfectly meet all of our objectives. There will be trade-offs between these objectives, and it is possible the current indicators of net core Crown debt and OBEGAL may remain the least worst options. We will expose these trade-offs in our advice on potential options to enable you to reach an informed decision.

Process for the Review

We intend to conduct the bulk of our analysis over January and February, to allow for targeted consultation and interim advice before March 2021.

18. This analysis will principally consist of:
- A review of international approaches to fiscal indicators, and past indicators used in New Zealand.
 - A review of currently published, but less prominent, fiscal indicators (for example, Gross Sovereign Issued Debt or core Crown residual cash) to assess their suitability as headline indicators based on the objectives above.
 - An assessment of possible minor modifications that could be made to existing fiscal indicators to improve their suitability as headline indicators (for example, inclusion or exclusion certain asset types).
 - An assessment of the feasibility of more fundamental changes to fiscal reporting, such as the definition of the 'core Crown' segment, and whether the benefits of any fiscal indicators produced by these changes would justify the costs. Adopting a fiscal indicator requiring fundamental changes to the Crown accounts is unlikely to be feasible by Budget 2021, but any changes could be signalled at that point.
19. We will draft an appraisal of the options on the basis of this analysis, which we will use as the basis for engaging in targeted consultation of a small group of international and domestic experts on fiscal issues, in addition to key stakeholders, such as the OAG. Wider public consultation may be possible, but would likely need to extend past Budget 2021. We can also provide you with an update on our interim views in February for your feedback.

We will require final decisions by the end of March to enable implementation of any changes by Budget 2021.

20. On the basis of this analysis and targeted consultation, we intend to make final recommendations to you by the end of March next year. This will allow any changes to be incorporated into the fiscal forecasts for Budget 2021.
21. We propose the following timeline for any changes that could be made to indicators in the 2021 Budget Economic and Fiscal Update.

Jan-Feb 2021	Targeted consultation with key stakeholders
February 2021	TR with interim advice
March 2021	TR on options and final recommendations (pre Budget forecasts)
Pre Budget Day	Possible release of document explaining changes to be made at BEFU
Mid-May 2021	Budget Day – changes to indicators set out in BEFU document

Signalling this review in HYEFU and the BPS

22. The draft HYEFU you have received today includes the following text, which is subject to your agreement to the proposed review:

"The current definition for both the operating balance before gains and losses and net core Crown debt have been in place since the late 2000's. With the recent increasing influence from monetary policy decisions on the Government's current key fiscal indicators and other trends such as the increasing level of borrowings by Crown Entities, the Treasury is reviewing the appropriateness of the Government's current key fiscal indicators. The Treasury will provide advice from this review to the Minister of Finance to consider ahead of Budget 2021."

23. You may wish to provide further detail in the Budget Policy Statement about this review and likely changes that may be implemented at BEFU. We can incorporate this into subsequent drafts of the Budget Policy Statement if required.