

The Treasury

Budget 2022 Information Release

August 2022

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- [33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;
- [36] 9(2)(h) - to maintain legal professional privilege
- [37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice
- [38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice
- [39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage
- [40] 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
- [42] 18(d) - information is already publicly available or will be publicly available soon

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Treasury Report: Fiscal Strategy for the Budget Policy Statement

Date:	22 October 2021	Report No:	T2021/2424
		File Number:	MC-1-5-2-2022

Action sought

	Action sought	Deadline
Hon Grant Robertson Minister of Finance	<p>Consider recommendations and provide feedback at Budget Matters on 28 October 2021.</p> <p>Refer this report to Budget Ministers.</p>	28 October 2021

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Phoebe Sparrow	Senior Analyst, Macroeconomic and Fiscal Policy	[39]	N/A (mob) ✓
Sarah Unwin	Graduate Analyst, Macroeconomic and Fiscal Policy		N/A (mob)
Katy Simpson	Team Leader, Macroeconomic and Fiscal Policy	[35]	
Bryan Chapple	Deputy Secretary, Macroeconomics and Growth		

Minister's Office actions (if required)

<p>Return the signed report to Treasury.</p> <p>Refer this report to Budget Ministers, subject to the Minister of Finance's agreement.</p>
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Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Fiscal Strategy for the Budget Policy Statement

Executive Summary

This report provides advice on your fiscal strategy and budget allowances for communication at the Budget Policy Statement 2022 (BPS) on 15 December 2021. We have made in-principle recommendations because preliminary fiscal forecasts for the Half-Year Economic and Fiscal Update 2021 (HYEFU) will not be finalised until early November, and we understand you wish to discuss the fiscal strategy alongside the preliminary forecasts with Budget Ministers on 8 November.

Preliminary HYEFU economic and tax forecasts show a stronger economic outlook and suggest that the economy is running ahead of capacity. Tax revenue, partly driven by higher inflation, is estimated to be \$36 billion higher over the next four years compared to Budget 2021 forecasts. Because the cost increases associated with higher inflation are yet to flow through, these forecasts provide an overly optimistic take on the fiscal position.

The economic and fiscal outlook remains highly uncertain due to COVID-19. There will be ongoing challenges as we transition to a new strategy for managing COVID-19 and reopen the New Zealand border. Despite this uncertainty, 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).

In this macroeconomic environment, increasing your previously announced Budget allowances would effectively work against the automatic stabilisers, have higher delivery risks, and could exacerbate supply-side issues. Returning to surplus earlier than previously forecast would position New Zealand well to respond to longer-term challenges once the economy has more capacity to absorb new expenditure.

The scale of Government commitments already signalled for the coming budget (including pre-committed initiatives, cost pressures, manifesto initiatives and health system reform) suggests you will need a Budget 2022 operating allowance of between \$6.0 billion and [38] per annum, without further revenue or savings options. We think that this is higher than the economy can absorb (or the public sector can deliver in terms of value for money) and recommend an allowance of around \$4.0 billion for Budget 2022.

We also recommend increasing the operating allowances for Budgets 2023 to 2025 to \$3 billion, in anticipation of higher cost pressures over the forecast period. This will position you well to return to surplus earlier than forecast at Budget 2021. However, you should remain cognisant of the macroeconomic risks of higher spending and be aware that, if macroeconomic pressures build further, you may need to consider a reduction in spending growth, or revenue raising measures, in order to reduce pressure on interest rates.

These allowances will not allow you to maintain current services and deliver all the commitments that the Government has signalled. Accordingly, we recommend that you consider options for the composition and phasing of new spending to ensure that it delivers value for money, can be implemented on time and within budget, and contributes to sustainable improvements in long-term wellbeing – rather than pushing economic activity further above its current potential. We can assist you with this through the development of Budget packages.

Ultimately, you are likely to need revenue or savings packages to offset operating allowances, in order to deliver on your commitments with a smaller impact on both aggregate demand in the near term and fiscal sustainability in the medium term (although delivery

capacity of agencies will remain a constraint). Reprioritisation exercises have typically identified only small savings in baseline expenditure, which suggests that structural change would be a better option if operating spending is to be a main driver of future consolidation. Tax changes would take time to implement, so may be most useful for beyond Budget 2022.

Where you choose to set the allowances will depend on your judgement about the relative importance of micro and macro objectives, credibility of allowances, and tactical considerations.

We also recommend increasing the multi-year capital allowance (MYCA) by \$4.0 billion when 2025/26 is brought into the forecast period at HYEFU. We do not recommend funding a significant capital package at Budget 2022 beyond critical cost pressures and your previously stated commitments. Instead, we propose reserving most of this allowance for future Budgets to ensure the MYCA provides a credible signal of new capital expenditure to be allocated over Budgets 2022 to 2025.

We do not consider it is necessary to increase the balance of the COVID-19 Response and Recovery Fund (CRRF) at this time, but we recommend reassessing this ahead of Budget if it becomes necessary.

HYEFU fiscal forecasts will assume increased expenditure on climate change mitigation of approximately \$4.5 billion across the forecast period (equivalent to Emissions Trading Scheme (ETS) revenues). We recommend limiting the initial size of the Climate Emergency Response Fund (CERF) to this level. The size of the CERF could then be reconsidered at Budget when it is possible to coordinate choices about how the CERF will operate and what it will fund, with potential changes to your fiscal strategy and the Emissions Reduction Plan.

Ahead of preliminary fiscal forecasts, we estimate that this combination of recommended allowances and a \$4.5 billion CERF over the forecast period would result in net core Crown debt as a percentage of GDP (including Funding for Lending (FLP) advances) peaking at approximately 38% in 2022/23 (compared to 41.4% in 2024/25 at Budget 2021), and OBEGAL returning to surplus in 2023/24 (compared to 2026/27 projected at Budget 2021).

Both the proposed CERF approach and the recommended set of allowances are consistent with your current fiscal targets (which you have agreed to leave largely unchanged for now). We have provided separate advice about making more substantive changes to your fiscal targets at Budget (T2021/2416 refers).

We will seek your feedback on this advice at Budget Matters on 28 October. Your preferred options (updated for preliminary fiscal forecasts, if possible) will then be discussed at Budget Ministers 2 on 8 November. We require your decisions on any significant policy changes for the BPS by 9 November so these can be incorporated into final economic forecasts.

Recommended Action

We recommend that you:

- a **note** that preliminary economic and tax forecasts for HYEFU 2021 show an economic outlook that is stronger than Budget 2021 forecasts, but the outlook remains highly uncertain, and there are significant downside risks relating to COVID-19
- b **note** that our analysis suggests a Budget 2022 operating allowance of between \$6.0 billion and [38] average operating per annum would be required to fund indicative packages, based on Government commitments signalled for the coming budget, unless these can be partially offset by further savings or revenue options
- c **note** that capacity constraints in the economy and across agencies increase the delivery risks associated with new government expenditure, indicating that value-for-money spending in the range in recommendation b would be difficult to deliver
- d **note** that the persistence of higher inflation will make it harder for agencies to manage within fixed nominal baselines, and your future spending plans should account for this
- e **note** that your preferred set of allowances for the BPS will depend on your judgement about the relative importance of setting allowances now that stick, versus retaining flexibility to make adjustments as needed ahead of Budget 2022, as well as the balance between micro and macro considerations
- f **agree in principle**, subject to review and amendment after the finalisation of the preliminary HYEFU fiscal forecasts, and agreement with Budget Ministers, to:
 - i. increase the Budget 2022 operating allowance at the BPS from \$2.7 billion per annum to around \$4.0 billion per annum
Agree/disagree.
 - ii. increase the Budgets 2023–2025 operating allowances at the BPS (from \$2.7 billion, \$2.7 billion, and \$2.0 billion, respectively) to \$3.0 billion per annum, in anticipation of higher cost pressures over the forecast period
Agree/disagree.
 - iii. provide a \$4 billion increase to the Multi-Year Capital Allowance when 2025/26 is added to the forecast period at HYEFU (\$5.8 billion remains in the MYCA after pre-committments as at 15 October, so this would result in a MYCA balance of approximately \$9.8 billion over the HYEFU forecast period)
Agree/disagree.
 - iv. leave the COVID-19 Response and Recovery Fund (CRRF) balance unchanged at the BPS (as at 15 October 2021 the unused portion of this fund is approximately \$10.6 billion)
Agree/disagree.

- g **note** that, based on the Government's announcements to hypothecate ETS revenue, the HYEPU preliminary fiscal forecasts will include an assumption of increased expenditure on climate change mitigation of \$4.5 billion across the forecast period
- h **note** that we will provide further advice alongside preliminary fiscal forecasts in early November, to confirm allowances and also consider if any minor changes to your short-term intentions and long-term objectives for fiscal policy are required for consistency
- i **indicate** if you would like us to consider any other specific combination(s) of allowances and/or amounts in relation to recommendations f and g
- j **provide feedback** on this report at Budget Matters on Thursday 28 October, with a particular focus on how we can support decision-making at Budget Ministers 2 on Monday 8 November
- k **refer** this report to:
- Rt Hon Jacinda Ardern, Prime Minister
Refer/not referred.
 - Hon Dr Megan Woods, Associate Minister of Finance
Refer/not referred.

Bryan Chapple
Deputy Secretary, Macroeconomics and Growth

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal Strategy for the Budget Policy Statement

Purpose of Report

1. This report seeks agreement in principle to your fiscal strategy and budget allowances for the Budget Policy Statement 2022 (BPS).
2. Following discussion with you at Budget Matters on 28 October, we will provide further material alongside preliminary fiscal forecasts to confirm budget allowances for communication at the BPS.
3. The following sections of this report cover:
 - How we have approached the fiscal strategy in the current economic context
 - Top-down analysis on the economic and fiscal outlook (drawing on preliminary economic and tax forecasts outlined in T2021/2525) and implications for the appropriate macroeconomic stance
 - A bottom-up assessment of operating and capital expenditure pressures at Budget 2022 and future budgets, and what this suggests for Budget allowances
 - Fiscal strategy considerations for setting the level of the Climate Emergency Response Fund (CERF) ahead of Budget 2022
 - Consistency with your current fiscal strategy, illustrating the overall fiscal impact of our recommendations across the preceding sections, and
 - Next steps in relation to the HYEFU and BPS timetables.

Context

The BPS will be published on 15 December alongside the HYEFU.

4. The BPS provides an opportunity to publicly communicate the Government's fiscal strategy for the upcoming Budget. We recently advised on what material the BPS needs to include to meet its requirements under the Public Finance Act 1989 (PFA) in relation to the fiscal strategy (T2021/2485 refers).

You have indicated that your fiscal strategy will remain largely unchanged at the BPS, with more substantive changes to come at Budget 2022.

5. Given the high degree of uncertainty in the economic and fiscal outlook, you agreed to keep your fiscal targets (short-term intentions and long-term objectives for fiscal policy) and your strategy for managing expenditure, assets and liabilities broadly unchanged at the BPS. Instead, the BPS will signal your intention to set new fiscal targets in the Fiscal Strategy Report (FSR) at Budget 2022.
6. In the interim, once preliminary fiscal forecasts are available, we will assess the suitability of your current short-term intentions and long-term objectives and, if necessary, provide further advice ahead of the BPS on any minor tweaks. We have provided preliminary advice on new fiscal targets post-COVID-19 (T2021/2416 refers).

We recommend your current budget allowances are reconsidered.

7. Budget 2022 is unusual in that almost a third of the operating allowance announced at Budget 2021 (\$2.7 billion) has already been used (even after adding in a revenue-raising initiative). At this relatively early stage in the Budget cycle we also have a good understanding of the fiscal impacts of other significant policy commitments (notably, transitioning to the new health system). Combined, this information suggests that the current Budget 2022 operating allowance is not credible to communicate in the BPS.
8. Although there is no requirement to stick to the Budget allowances announced in the BPS for Budget 2022, repeatedly changing allowances can undermine their credibility and reduces their ability to help manage expectations. We therefore recommend that allowances are signalled at a credible level to meet initiatives that are expected to be funded through Budget 2022 and ideally would not be changed again after the BPS.

Determining budget allowances at the BPS will require challenging trade-offs

9. Where you choose to set allowances at the BPS will ultimately depend on your judgement about the relative importance of four key factors:
 - From a purely **micro** perspective, there is potentially welfare-enhancing expenditure over the longer term, such as delivering health reform and establishing a CERF. Funding these, alongside other expenditure pressures, would require higher allowances, although it is not yet clear that agencies are able to deliver value-for-money initiatives across all the signalled areas.
 - From a purely **macro** perspective, although there is uncertainty about how the economic outlook will evolve by Budget, it is likely that strong demand, capacity constraints (impacting deliverability) and inflation will remain an issue – with increasing downside risks due to COVID-19. This would suggest a modest allowance.
 - For **credibility** – there are benefits to re-establishing allowances as a fiscal management tool by having the allowances announced at the BPS stand the test of time through to Budget. This would suggest an allowance that you expect to stick to in May.
 - **Tactically** – you may want to encourage prioritisation and discipline through the Budget package development stage by keeping the Budget 2022 operating allowance realistic but tight. This would suggest a lower allowance than you anticipate using, although repeatedly increasing allowances at Budget will reduce the effectiveness of this approach.
10. On balance, we recommend announcing allowances that are consistent with the macroeconomic situation and seeking to stick to these at Budget 2022.

Economic outlook

Preliminary economic and tax forecasts show an economic outlook that is stronger than Budget 2021 forecasts ...

11. Data since Budget 2021 demonstrates that the New Zealand economy has proved more adaptable and resilient to the COVID-19 pandemic than previously forecast (T2021/2525 refers). Even in the context of the Delta outbreak beginning in August 2021, consumer and business confidence levels have only fallen mildly and high-

frequency indicators suggest economic activity fell significantly less than in the 2020 Alert Level 4 period.

12. Tax revenue over the next four years is forecast to be \$36 billion higher compared to Budget Economic and Fiscal Update (BEFU) 2021 forecasts. This reflects the higher-than-expected tax take over the 2020/21 year, which persists across the forecast period. Higher nominal GDP in the near term, driven by higher real activity and higher prices, is also expected to contribute to the stronger tax forecasts.

... however, this artificially flatters the fiscal position, and doesn't represent a structural improvement.

13. Higher nominal GDP reflects stronger real activity (assuming a relatively swift recovery from the Delta outbreak). But it also reflects higher inflation, which will make it harder for agencies to manage within fixed nominal baselines, leading to higher cost pressures in future Budgets. Therefore, until high inflation is also factored into the expenditure side, it will provide a misleading impression of the fiscal outlook.
14. The supply potential of the economy has been revised slightly lower, reflecting ongoing disruptions related to the pandemic and elevated public health restrictions over the medium term. Recent forecasts have seen tax revenue revised up but, on average, we expect tax errors on the downside as often as the upside. Historically, tax revenue has surprised on the upside in good times and has been more likely to come in below forecast as the economy slows. We expect the economy to be operating above its sustainable level for much of the forecast period, and there is a risk that the recent run of positive tax surprises reverses.
15. Given the volatility in the economy, it is also more difficult than normal to determine the underlying fiscal position. In response to COVID-19, exceptional levels of government spending alongside monetary policy stimulus have maintained strong economic activity. Significant increases in operating spending run the risk of creating an ongoing structural deficit.

Uncertainty around the economic outlook remains higher than usual, with significant risks from COVID-19.

16. There are some downside risks to the preliminary forecasts, particularly for real activity. These forecasts were produced shortly before announcements about shifting towards a more targeted public health framework and away from the elimination strategy in Auckland, and assumed a stepped return to Alert Level 1. Forecasts may be revised down if it takes longer to vaccinate a sufficient portion of the population, border restrictions take longer to ease than currently forecast, or the behavioural response to the new strategy reduces the speed of the bounce-back.
17. Public health restrictions remaining in place in Auckland for an extended period increases the likelihood of firm failures, higher unemployment and lower business investment. International economic risks are also significant, although such shocks tend to be less predictable than domestic risks.
18. This broad uncertainty reinforces the need to maintain your current 'watch and wait' approach to COVID-19 support, to avoid adding to aggregate demand at a time where it may be unnecessary, while maintaining flexibility to increase fiscal support through the COVID-19 Response and Recovery Fund (CRRF) as required.
19. We do not anticipate the need for a further CRRF replenishment ahead of HYEFU but recommend reassessing this ahead of Budget if it becomes necessary.

Inflationary pressures have increased due to capacity constraints ...

20. Annual CPI inflation reached a ten-year high of 4.9% in the September quarter. Despite the Delta outbreak, preliminary forecasts assume an upward shift in the CPI inflation profile across the forecast period.
21. COVID-19 has impacted the balance of supply and demand differently to previous downturns, with a relatively greater impact on supply. This has resulted in worsening labour/skills shortages, capacity constraints, and supply chain disruptions. We expect supply chain disruptions to ease next year, resulting in slightly lower tradables inflation.
22. Some other inflation pressures are anticipated to be transitory, such as petrol and food prices. However, inflation expectations have been shifting upwards with expected inflation one year out increasing to 3.0% (the highest in a decade) and expectations for inflation two year out having increased to 2.3% (the highest in seven years). Further increases can be anticipated as these surveyed expectations precede the surprisingly high September quarter inflation result. Higher inflation increases living costs and, if wages don't keep up, reduce wellbeing, with the brunt of the impact often felt by the worse off.
23. The increase in inflation in the September quarter was much larger than incorporated in the preliminary forecasts. The degree of persistence in inflation will be a key judgement in the final forecasts, with more persistent inflation boosting nominal GDP and therefore tax revenue. This makes the caveat above, around the need for assessments of the overall fiscal position to take the impacts of inflation on both the revenue and expenditure sides into account, particularly relevant.

... and monetary policy has started to gradually tighten in response.

24. In response to these inflationary pressures, the Reserve Bank of New Zealand (RBNZ) is expected to continue to gradually tighten monetary policy to bring inflation within the 1-3% target band. Market expectations are for the official cash rate (OCR) to be increased by 25 basis points in November, with markets expecting the OCR to reach around 2.0% by the end of 2022.
25. Fiscal policy and monetary policy should ideally reinforce each other, to avoid either one needing to over-compensate to achieve its policy objectives. Stronger tax revenue means fiscal policy is expected to be less expansionary than at Budget 2021, but increasing expenditure would act to offset the automatic stabilisers.
26. More expansionary fiscal policy in the near term may hasten further monetary tightening, with potential flow-on impacts to interest rates and associated increased debt servicing costs for the government alongside valuation impacts.¹ The size of this effect is hard to quantify and varies depending on the factors such as the economic cycle and type and timing of spending: previous Treasury estimates suggest a fiscal stimulus of 1% of GDP (approximately \$3.5 billion) would lead to an OCR increase of around 30 basis points.
27. Given the current low level of the OCR, monetary policy will remain stimulatory (eg, below neutral) for some time. Shifting away from the effective lower bound would provide more flexibility for monetary policy to respond to future shocks without necessarily needing to deploy alternative monetary policy (AMP) tools.
28. A macroeconomic mix with higher interest rates and higher government spending would have distributional impacts, and there would be winners and losers. Higher

¹ Sensitivity analysis on the fiscal impacts of interest rate changes will be included in the fiscal sensitivities disclosed in the Risks to the Fiscal Forecasts chapter in the HYEUFU.

interest rates would crowd out some private investment, and would also likely act to moderate house price growth. But – at high enough levels – they could put pressure on first home buyers: Reserve Bank analysis suggests that approximately half of all lending to first home buyers in the year to June 2021 would experience serviceability stress if mortgage rates rose to 6.0%. Conversely, savers would benefit from higher returns on bank deposits.

29. The risks and trade-offs of higher interest rates would become more significant if New Zealand's tightening cycle becomes significantly out of step with other countries. In this situation, comparatively higher interest rates in New Zealand could lead to appreciation of our exchange rate, with impacts on New Zealand's global competitiveness and current account balance. We will continue to monitor these risks and provide further advice if the situation deteriorates.

Fiscal Outlook and Stance

Forthcoming fiscal forecasts are also expected to show an improvement.

30. The recently published 2020/2021 results show a significant improvement in the starting point for the operating balance before gains and losses (OBEGAL) deficit and net core Crown debt, compared to the BEFU 2021 fiscal forecasts.
31. Overall, we expect most key fiscal indicators in our preliminary HYEFU fiscal forecasts to be significantly stronger than previously expected, as they take on the stronger tax outturn and forecasts, but continue to be based on the allowances assumed at Budget 2021.²
32. In the near-term, we expect expenses to be higher than previously forecast, primarily due to our expectation that the remaining funding in the CRRF (including the \$10 billion top-up) will be spent over the next two fiscal years. In addition, our preliminary fiscal forecast will be assuming that cash proceeds from the ETS will be used to fund the CERF, which will lift expenditure by approximately \$4.5 billion over the forecast period, compared to the 2021 fiscal forecasts.
33. The preliminary HYEFU fiscal forecasts will not be finalised until early November. As such, the advice and scenarios in this report are based on the BEFU 2021 fiscal outlook, updated for outturn data, the preliminary HYEFU 2021 economic and tax forecasts and any other significant fiscal changes (such as the CRRF replenishment).

If current policy settings are retained, OBEGAL will likely be in surplus by 2023/24

34. If current policy settings (that is, Budget allowances as announced at Budget 2021) were to be maintained, the operating balance before gains and losses (OBEGAL) is expected to return to surplus in the year ending June 2024. For comparison, forecasts at BEFU 2021 showed OBEGAL returning to surplus in the year ending June 2027.
35. We also anticipate a significant improvement in the trajectory of net core Crown debt (including Funding for Lending (FLP) advances) as a percentage of GDP over the latter part of the forecast period. With current policy settings retained, net debt would peak in 2022/23 at around 37% of GDP, compared to 41.4% of GDP in 2024/25 in the Budget 2021 forecasts.

² Preliminary fiscal forecasts will be based on Budget 2021 allowances, and will assume a 2025 Budget operating allowance for \$2.7 billion. These assumptions will be updated for final HYEFU forecasts.

While some of this improvement will be needed for higher expenditure in the future ...

36. There are likely to be large calls on both operating and capital expenditure over the medium-to-long term to deal with the flow-on impacts of higher inflation on cost pressures, and as you address the impacts of climate change and an ageing population (the section below on the CERF illustrates the potential impact on fiscal projections in Figure 4, assuming spending at the lower end of possible costs). The improvement in the fiscal position gives more scope to address these long-term challenges either by lowering debt or ring-fencing funding for future spending.
37. From a macroeconomic perspective, we consider current debt levels to be prudent with space for debt to rise further than forecast while maintaining market access. However, fiscal space will also be needed to deal with future shocks and known medium-term pressures, especially in the context of significant uncertainty around the economic outlook.

... additional spending in the short term could exacerbate supply constraints, increase delivery risks, and have other unintended consequences.

38. Supply constraints have emerged as the biggest challenge to economic growth in the short-term. As a result of the global nature of these constraints, we are expecting to see capacity pressures, skill shortages and inflationary pressures persist, even after domestic supply chain and immigration issues relating to COVID-19 have been resolved.
39. In this context, changes to the allowances should be considered alongside CRRF spending. In particular, increasing the level of support provided via the Resurgence Support Payment (T2021/2654 refers) while also significantly increasing budget allowances risks compounding inflationary pressures and delivery risks.
40. To mitigate these risks, we recommend COVID-19 economic support be limited to what is required to mitigate scarring effects in the economy. Beyond that, you should consider options for the phasing of new spending and sequencing of policies to ensure near-term spending increases are focused on your top priorities and deliver value for money, given the short-term risks of exacerbating existing capacity constraints, and the medium-term risks to fiscal sustainability.

Fiscal sustainability is not an immediate concern, but current levels of spending growth will be difficult to sustain in future years without structural policy change.

41. Consistent with our previous advice, we see no need for additional discretionary fiscal support to the economic recovery at this time, nor an imperative for undertaking structural consolidation faster than would be implied by the forecast improvements.
42. [33]

43. These long-run challenges do not require immediate responses. However, we recommend you remain cognisant of these challenges and the trade-offs they expose when setting allowances for the next four Budgets. Our advice on setting new fiscal targets ahead of Budget 2022 will consider options for embedding fiscal sustainability objectives.

Operating Expenditure Pressures

Current operating allowances over the next four budgets will likely be oversubscribed.

44. Significantly advancing the Government's agenda as signalled in various consultation documents across multiple portfolios over the past year or so will involve substantial levels of new funding.
45. Figure 1 on page 13 illustrates how pre-commitments and anticipated expenditure pressures compare to the current operating allowances, shown on the left-hand side. Solid bars in the chart show our 'low' estimates, and the shaded bars illustrate the additional spending incorporated in our 'high' estimates.
46. Figure 1 indicates that, even with our lowest estimates of new expenditure over the next forecast period (the solid coloured boxes), the combined operating allowances per annum required over the next four budgets would be over \$12 billion, before factoring in any manifesto initiatives beyond the current Budget, or specific fiscal risks. Operating allowances per annum for Budgets 2022-2025 currently total \$10.1 billion.

We recommend managing all ongoing spending increases within allowances.

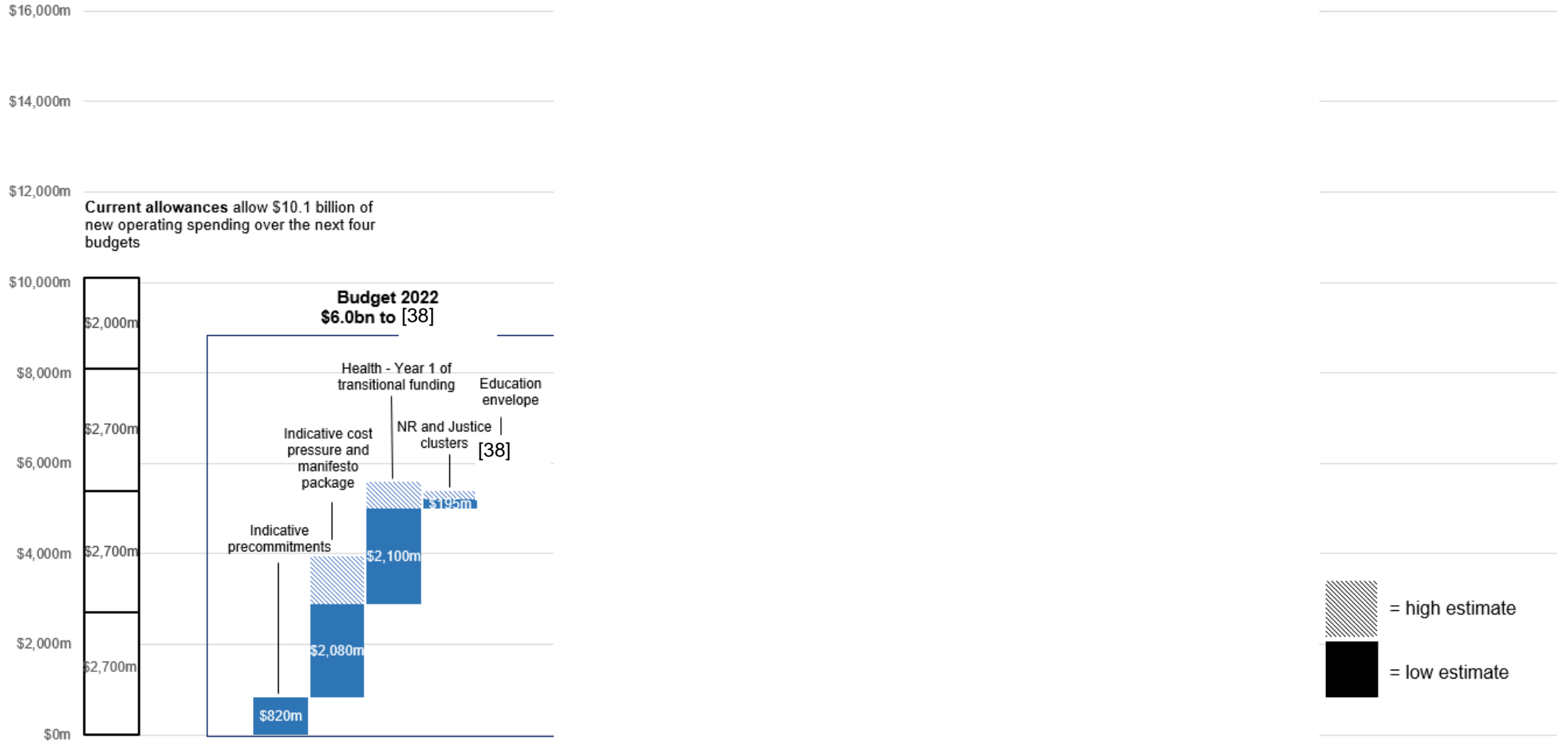
47. Budget 2022 may include new multi-year funding arrangements (eg, health transitional package, the CERF and the first two PFS clusters), where a profile of spending increases intended to cover more than one Budget is effectively allocated in advance.
48. This report focuses on the fiscal impacts of these decisions, and assumes that funding increases relating to future years (ie, the increase provided through the second year of the Health transitional package) are allocated to the relevant *future* Budget allowances (and so would reduce the level of Budget allowance that is available to manage expenditure pressures and other priorities arising in that year).
49. Ahead of Budget 2022, you have choices around how multi-year arrangements are treated under the fiscal management approach (FMA) and how they are communicated. We will provide further advice on how they interact with the existing annual operating allowance framework ahead of the BPS.
50. Instead of funding large or one-off costs (such as the Health transitional package) outside of allowances, we recommend wherever possible to use allowances. This both aids transparency and ensures trade-offs are made across all types of spending.

Our bottom up analysis suggests you would require a Budget 2022 operating allowance of at least \$6.0 billion per annum, assuming significant scaling, to deliver on your priorities (without further offsetting further revenue changes or savings).

51. For Budget 2022, the operating allowances required for our 'low' and 'high' estimates are approximately \$6.0 billion and [38] per annum, respectively (including pre-commitments). To reach these estimates, we have assumed you wish to proceed with:

Figure 1: Future Pressures on Operating Allowances

[33]



- **Pre-committed initiatives**, which currently total \$750 million average operating p.a. (including the offsetting impact of the housing tax package). We have also factored in a further anticipated Working for Families initiative of approximately \$70 million per annum. This gives a total of \$820 million as shown in Figure 1.
- **Transitioning to a new health system**, which includes the following components – noting these are highly indicative costings (T2021/1992 refers):
 - a ‘rebase’ of approximately [33]³
 - a cost pressure uplift package of approximately \$1.0 billion p.a. in Budget 2022 with an additional \$1.1 billion allocated against the Budget 2023 allowance (we note that this package is scalable, but reducing the uplift would have trade-offs, such as the risk of further deficits in the new system), and
 - a discretionary new investment package – you have asked the Minister of Health to present packages of between \$300 million p.a. (low) and \$900 million p.a. (high), but you have choices to fund less than \$300 million of new expenditure. Both our low and high scenarios assume no further new investment is allocated in Budget 2023.⁴
- **An education envelope** [38]
- **Justice and Natural Resources Clusters** (“PFS clusters”), between the ‘low’ and ‘middle’ envelope amounts (our low and high estimates, respectively) as set out in Annex 1, with incremental increases allocated against the Budget 2023 and Budget 2024 operating allowances.
- **Remaining cost pressures and manifesto initiatives** – as a proxy for indicative package amounts, we have used the total cost of remaining initiatives (outside health, education, CERF and PFS clusters) that you have invited ministers to submit (approximately \$4.2 billion per annum), and scaled this to 50% (\$2.1 billion) for our low estimate, and 75% (\$3.1 billion) for our high estimate.^{6 7}

52. Beyond Budget 2022, we have modelled total cost pressures using a top-down methodology and included these estimates in Figure 1. This methodology estimates cost pressures exclusive of health, PFS clusters, and social security and welfare of between \$0.9 and \$2.5 billion per annum across Budgets 2023 to 2025 – the level of spending growth we expect will be required to maintain current levels of public services, in the absence of substantial productivity improvements or changes in operating models. For comparison, over the last three Budgets you funded between \$1.9 billion and \$2.7 billion of operating cost pressures per annum.⁸

³ Note that the OBEGAL impact of the health system rebase will be indirectly cushioned by the removal of the \$600 million DHB deficit forecast from fiscal forecasts. [33]

⁵ You have invited the Minister of Education to submit an envelope of \$750 million p.a. [38]

⁶ These estimates may be understated as they do not include [33]

⁷ You have indicated that manifesto initiatives totalling [33] should be deferred to Budget 2023. These have been included under Budget 2023 in Figure 1, with a scaled amount of [33] estimated for a ‘low’ package. These amounts may be overstated due to the late inclusion of Industry Transformation Plans in Budget 2022 invites, which had previously been deferred to Budget 2023.

⁸ Note that this number is inclusive of all vote expenditure, ie, including those that fall under health and the PFS clusters. Health cost pressures usually take up a significant proportion of the cost pressure package each year.

53. Annex 2 explains the judgements involved in developing these estimates. Even the low end of this range would suggest cost pressures consuming a significant portion of allowances, due to significantly higher pressure on prices and wages.
54. There also remain substantive specific fiscal risks (SFRs) that would place significant further pressure on allowances if they materialised. There were 142 SFRs disclosed to the Treasury for BEFU 2021, totalling [33] across the forecast period [33]

9

We recommend, where possible, either not funding or deferring some of these priorities given the current macroeconomic position and the higher-than-usual delivery risks associated with new initiatives, or offsetting with savings/revenue.

55. At the BPS, we recommend announcing a higher Budget 2022 operating allowance of around \$4.0 billion per annum, and operating allowances of around \$3.0 billion per annum for Budgets 2023-2025. These allowances will not be sufficient to maintain existing services (given inflation) and progress your priorities. On balance, we recommend delaying further spending in some areas (for example, PFS clusters, manifesto commitments, and ‘new investment’ in health) given the scale of change needed and the work required to ensure that spending will deliver the outcomes sought.
56. As mentioned in paragraph 9, where you choose to set the Budget 2022 allowance within our recommended range will depend on your judgement about the relative importance of micro and macro objectives, allowance credibility, and tactical considerations.
57. An operating allowance of \$4.0 billion per annum would be similar to previous budgets – for comparison, the Wellbeing Budgets in 2019 and 2021 had final operating allowances of \$3.8 billion per annum. However, a large proportion of new (non-COVID-19 related) expenditure announced in recent Budgets has been funded outside of allowances (e.g. the \$3.8 billion Housing Acceleration Fund at Budget 2021, and the CRRF Foundational Package at Budget 2020).
58. We recommend you remain cognisant of the near-term macroeconomic risks of higher spending, as discussed in paragraphs 38-40. This means you should consider:
 - options for your **composition of spending** that limit the immediate upward pressure on demand and inflation, and instead focus on growing the real economy and lifting long-term living standards – provided there is capacity in the economy to absorb the spending and achieve the desired outcomes.
 - **sequencing and phasing** spending to ensure Budget packages can be successfully implemented, deliver value for money, and avoid exacerbating existing supply constraints – for example, by deferring to future budgets any manifesto initiatives that haven’t been previously signalled or announced.
 - [33]

⁹ For comparison, 196 risks totalling [33] were submitted for HYEUFU 2020. The SFR figures are estimates based on data submitted by departments with limited scrutiny from the Treasury. Therefore, the data may be incomplete, and some entries may be inaccurate, meaning that the expected costs presented should be treated as highly uncertain.

59. Figures 2 and 3 show the approximate impact of increases in operating allowances on the fiscal indicators.¹⁰ With an operating allowance of \$4 billion at Budget 2022 and \$3 billion at Budgets 2023 to 2025, net core Crown debt will peak in 2022/23 at approximately 38% of GDP before falling back to 33% of GDP by the end of the forecast period. For an illustrative higher set of operating allowances, of \$7 billion at Budget 2022 and \$4.0 billion at Budgets 2023 to 2025, will see net core Crown debt peak in 2022/23 at 38% of GDP before reaching 37% of GDP by the end of the forecast period.

Figure 2: Impact of recommended allowances on net core Crown debt ex-FLP as % of GDP

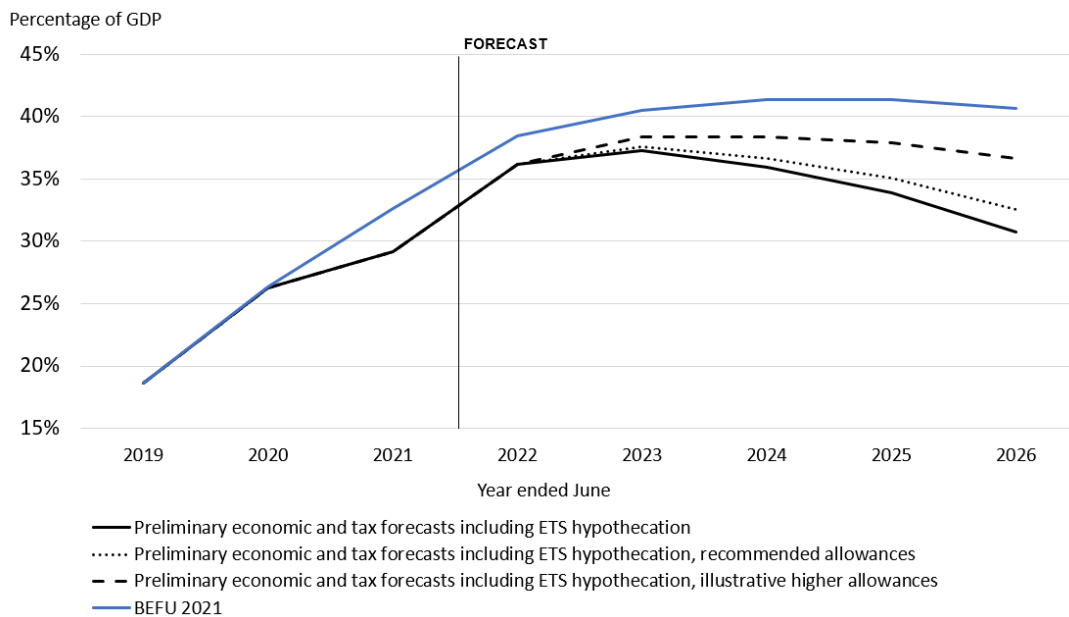
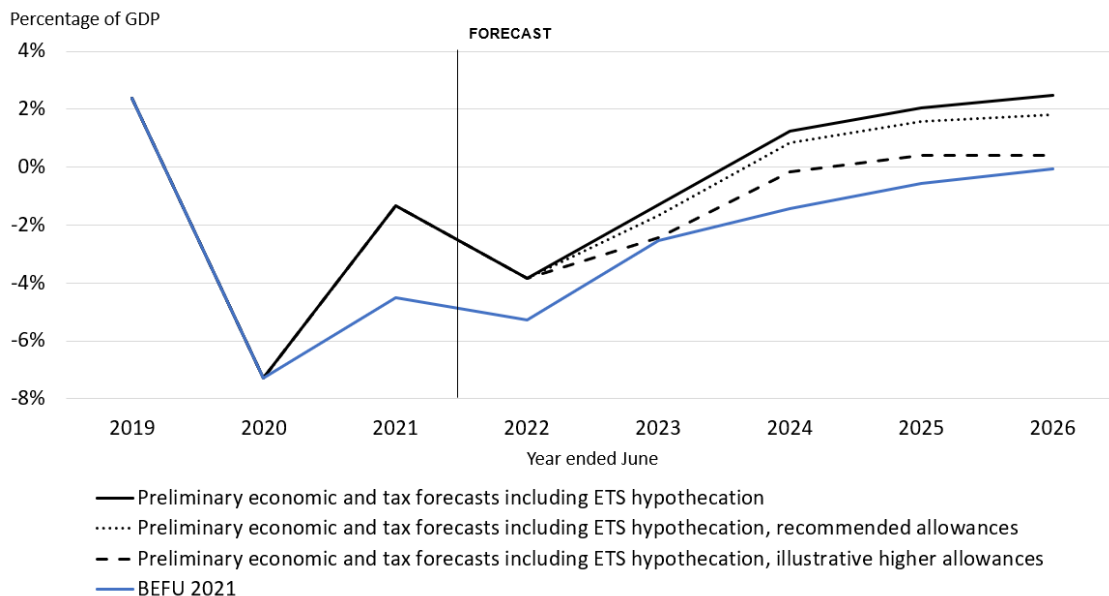


Figure 3: Impact of recommended allowances on OBEGAL as a % of GDP



¹⁰ We note that these are preliminary tracks that will change once HYEPU economic and fiscal forecasts have been finalised, and the treatment of initiatives funded from the CERF have been confirmed as either one-off or ongoing.
T2021/2424 Fiscal Strategy for the Budget Policy Statement

Increased spending on climate mitigation has implications for your fiscal strategy.

60. You have received separate advice (T2021/2536 refers) about setting the size of the Climate Emergency Response Fund (CERF). This advice indicates that the HYEUFU preliminary fiscal forecasts are expected to include an assumption of increased expenditure, focused on climate mitigation. This is to reflect your previous public statements about Emissions Trading Scheme (ETS) revenues being hypothecated for spending on climate change mitigation measures.
61. Hypothecation of ETS revenues will have implications for your fiscal strategy, as will any decisions to increase spending on climate mitigation beyond what can be funded through ETS hypothecation. If additional climate mitigation measures are set equal to ETS revenues in the HYEUFU forecasts, and using the simplifying assumption that the CERF is entirely capital spending, then the impact on net debt will be relatively small. Net core Crown debt will increase by around one percent of GDP by the end of the forecast period.¹¹
62. Additional climate-related spending beyond forecast ETS revenues will likely be required to make progress on your climate objectives. However, even with an increase to Budget allowances as recommended in this report, a larger fund would likely remain consistent with your current long-term objectives for fiscal policy. [33]
63. The accompanying advice on the CERF also indicates that the costs of transition are likely to increase significantly beyond the forecast period. There are choices about what projections assumptions are shown, [33]

12

We recommend limiting climate expenditure to ETS revenues for HYEUFU and revisiting the scale of the CERF closer to Budget 2022.

64. We recommend limiting the increase in climate expenditure to ETS revenues for the forecast period (which are expected to be around \$4.5 billion, subject to an updated forecast at HYEUFU). The scale of the CERF could then be revisited at Budget, with any announcement at the BPS presented as a initial amount that may be increased. This recommendation is explained in full in the accompanying advice on the CERF (T2021/2536 refers), but there are two primary reasons for it from a fiscal strategy perspective:
 - First, it means decisions on the size of the CERF can be considered fully through the Budget process. This enables coordination with changes to your fiscal strategy, which we expect to revisit in detail for the Fiscal Strategy Report published on Budget day. Coordination with the fiscal strategy is important given that one implication of ring-fenced funding is that it limits fiscal flexibility and resilience.
 - Second, decisions about the level of the CERF should ideally be coordinated with decisions about the CERF's design. This reflects that the overall fiscal cost faced by the Crown as part of the transition will depend critically on how costs are shared with the private sector, and private sector involvement in turn depends on both the size

¹¹ If spending is operating rather than capital, there would also be a corresponding impact on OBEGAL. However, provided the spending is not ongoing, any OBEGAL impact would be transitory.

¹² Figure 4 assumes a CERF expenditure equal to ETS revenues of \$4.5 billion of capital expenditure during the forecast period, [33]

and design of the CERF. Deferring the substantive decision until Budget also allows consideration to be given to how the cost of the CERF is fairly spread across current and future generations and different population groups, which will depend on how the CERF will be used and the initiatives it will be used to fund.¹³

[33]

Multi-year Capital Allowance for Budgets 2022 to 2025

The current MYCA has \$5.8 billion remaining over the next three Budgets. Projections at Budget 2021 assumed that \$4.0 billion would be added to this for 2025/26.

65. At Budget 2021, the MYCA for the remaining 2022-2024 forecast period was set at \$8.1 billion. After pre-committed initiatives totalling \$2.3 billion, the remaining amount in the MYCA is \$5.8 billion (as at 11 October). The MYCA operates as a four-year rolling envelope, but it is assumed that MYCA expenditure that is allocated in each Budget is spread over a ten-year period.
66. The HYEPU forecasts will include the 2025/26 year for the first time, and so will include the level of the MYCA for Budgets 2022 to 2025. Fiscal projections at Budget 2021 assumed that \$4.0 billion of capital expenditure would be added to the MYCA (against Budget 2025), which would take the current balance to \$9.8 billion for the 2022-2025 forecast period (an average of \$2.45 billion to be allocated per Budget, in addition to the pre-committed Budget 2022 initiatives).

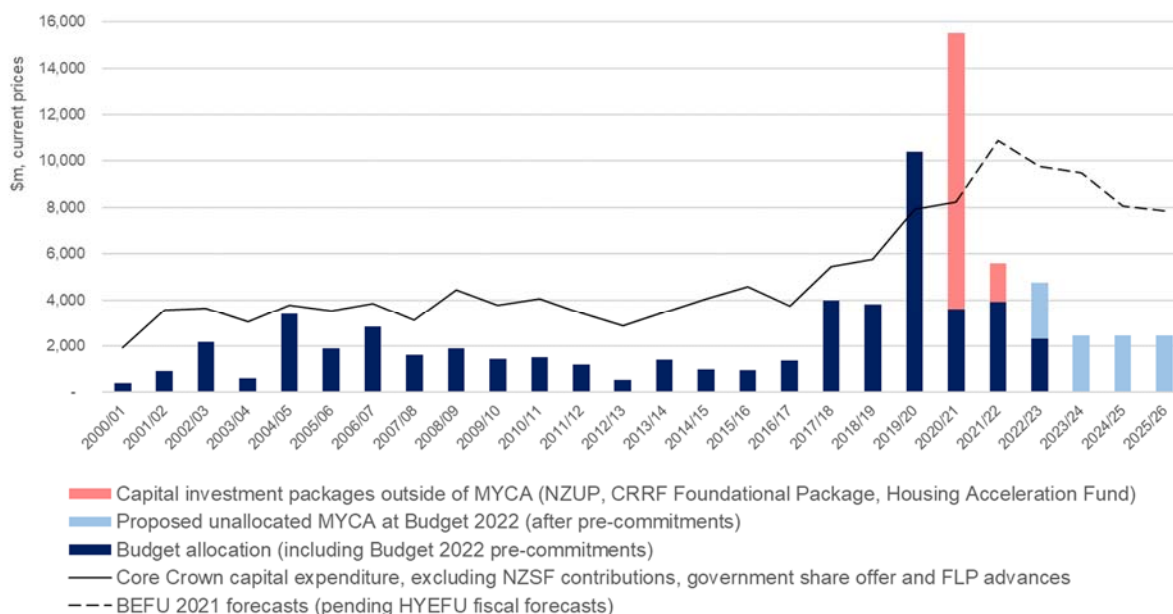
¹³ As at 11 October, \$735 million over the forecast period has already been pre-committed to the CERF. A further \$1.6 billion total capital and \$10.3 total operating has been sought from the CERF through the Budget process.

[33]

We recommend increasing the MYCA by \$4 billion, consistent with the Budget 2021 projection assumptions.

67. Increasing the MYCA to \$9.8 billion is recommended on the basis that this will provide a credible signal of new capital expenditure to be allocated over Budgets 2022 to 2025. We currently estimate that the final capital expenditure allocated from the MYCA at Budget 2022 (after initiatives already pre-committed) will be between \$2.5 billion and \$4.7 billion total capital,¹⁵ from a total of \$8.2 billion sought by agencies, which would be workable given the assumed average allocation of \$2.45 billion per Budget if the MYCA was increased by \$4 billion. These allocations compared to previous Budget allocations are shown in Figure 5.

Figure 5: Budget capital allocations and core Crown capital expenditure, historic and forecast



68. Beyond Budget 2022, agencies have signalled their intentions to seek capital funding of a further \$5.2 billion over Budgets 2023 and Budget 2024. This will be an underestimation of actual demand – typically, capital sought at Budget is around two to three times the amount signalled in advance. This figure also does not include the demand for large manifesto initiatives, such as Auckland Light Rail.¹⁶

We propose ring-fencing most of this allowance for future Budgets.

69. Given ongoing capacity and capability constraints in the construction sector, we do not recommend funding a significant capital package at Budget 2022 beyond critical cost pressures and your previously stated commitments. Instead, we propose reserving most of this allowance for future Budgets. This will help address the risk of front-loading for capital investment projects, where funding is focused at the beginning of the projects rather than being sequenced appropriately.

¹⁵ Budget 2022 estimate of \$2.5 billion to \$4.7 billion assumes between \$300 million and \$1 billion for cost pressures, between \$200 million and \$1.2 billion for manifesto initiatives, between \$500 million and \$1 billion for education capital, and \$1.5 billion for health capital.

¹⁶ You have received separate advice regarding the proposal for Auckland Light Rail (T2021/2570 refers). The current cost estimates of options (surface running light rail or tunnelled light rail) range from \$9 billion [33,37]

We understand you have invited a budget initiative for the next phase of the project (detailed business case phase). Further work is needed to understand the capital/operating split and to refine this costing (and cost allocation) as this work is developed and, as such, we have assumed the construction costs of the project will not be funded through Budget 2022.

70. Front-loading increases the risk of not delivering projects on time and within budget, with flow on impacts to the achievability of outcomes expected. By limiting how much is committed to in the near term and smoothing the spread of capital funding across the forecast period, you can ensure that capital expenditure over Budgets 2022 to 2025 contributes to a sustainable pipeline of high value investments.

Fiscal Strategy Implications

The combined fiscal impact of the recommendations in this report shows an improvement in the fiscal outlook compared to Budget 2021 forecasts.

71. Figures 6 and 7 show the range between our recommended allowances (\$4.0 billion at Budget 2022 and \$3.0 billion at Budgets 2023 to 2025) and an illustrative set of higher allowances (\$7.0 billion at Budget 2022 and \$4.0 billion at Budgets 2023 to 2025), in combination with [33] and assumed projection period operating allowances of \$3.0 billion per annum and capital allowances of \$4.0 billion per annum.
72. The illustrative higher allowance scenario leaves net debt settling at around 35% of GDP, whereas our recommended allowances see debt falling to around 25% of GDP by June 2031. However, all scenarios show a deterioration in the OBEGAL position from 2026 onwards – even with the simplifying assumption that all CERF spending is capital (if it is instead ongoing operating spending, it would have a bigger impact on the fiscal position). [33]

These recommendations are also consistent with your current fiscal targets, particularly your long-term objective to stabilise debt by the mid-2020s.

73. Although it would be possible to set more ambitious fiscal targets now based on the improved outlook, the current set of short-term intentions and long-term objectives is suitable for retaining at the BPS given the levels of uncertainty around COVID-19. We can provide further advice to confirm this following preliminary fiscal forecasts. As mentioned, you can use the BPS to signal that changes to these targets are forthcoming.

Next Steps

74. We will discuss this advice with you at Budget Matters on 28 October. In particular, we are keen to seek your feedback on your preferred set of allowances to take to Budget Ministers 2. Based on this feedback, we can provide further advice following the finalisation of the preliminary fiscal forecasts.
75. You are meeting with Budget Ministers on Monday 8 November to confirm any changes to Budget allowances for communicating at the BPS. In advance of the meeting, you may wish to refer this Treasury Report to the Prime Minister and Minister Woods.
76. We require your decisions on any significant policy changes for the BPS on 9 November at the latest, to ensure the BPS and HYEPU reflect a consistent set of economic and fiscal forecasts.

Annex 1: Budget 2022 cluster operating envelopes

Table 1: Assumed packages for Natural Resources and Justice Clusters

Total annual amount in addition to current cluster baselines, \$ million	2022/23	2023/24	2024/25 and out years
<i>Justice cluster</i>			
Low	140	300	475
Middle	280	580	900
<i>Natural Resources cluster</i>			
Low	55	120	195
Middle	100	220	360

[33]