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

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[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

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Fiscal Strategy for Budget 2022

Date:	3 March 2022	**Report No:**	T2022/244
		File Number:	MC-1-5-2-2022

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Consider** recommendations and provide feedback at Budget Matters on Monday 7 March. **Refer** this report to Budget Ministers.	7 March 2022

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Hamish Dick	Analyst, Macroeconomic and Fiscal Policy	[39]	N/A (mob)	
Phoebe Sparrow	Senior Analyst, Macroeconomic and Fiscal Policy		N/A (mob)	✓
Ben Gaukrodger	Acting Team Leader, Macroeconomic and Fiscal Policy		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Refer this report to Budget Ministers, subject to the Minister of Finance's agreement.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Fiscal Strategy for Budget 2022

Executive Summary

This report provides advice on the fiscal strategy and allowances for Budget 2022 and beyond. It recommends leaving your forecast period allowances unchanged at Budget and considering a new strategy for expenses and revenue that will be sustainable over the medium term.

Our preliminary economic forecasts for Budget 2022 show a slightly weaker outlook for economic activity than our Half Year Economic and Fiscal Update 2021 (HYEFU) forecasts. Despite better than expected real GDP growth in late 2021, the spread of the Omicron variant is now expected to see March quarter 2022 growth 2.5 percentage points lower than we forecast in December.

While preliminary fiscal forecasts are still forthcoming, we expect both the Operating Balance before Gains and Losses (OBEGAL) and net core Crown debt to deteriorate in the near term compared with HYEFU, before improving towards the end of the forecast period.

Omicron will impact the economy through both supply and demand channels. Given announced support measures will help maintain demand, we expect that the supply impacts may dominate the demand impacts, thereby increasing inflationary pressures from already elevated levels. In this environment, fiscal policy should ideally support monetary policy and remain contractionary to avoid exacerbating inflation. Limiting spending growth will also mitigate the delivery risks of new spending and promote fiscal sustainability.

To this end, we strongly recommend keeping within your current Budget 2022 operating allowance. Although this allowance will not be sufficient to fund all of your priorities, we recommend you consider deprioritising new initiatives to stay within the $6 billion per annum signalled at the Budget Policy Statement 2022. You could also consider deferring initiatives to future Budgets, but this may put pressure on future allowances.

We have recently recommended you adopt a new fiscal target of OBEGAL surpluses of no less than 0.5% of GDP (T2022/37 refers). It is likely you will meet this target in 2023/24, with OBEGAL currently expected to remain in surplus until the end of the projection period.
[34]

Meeting these new targets consistently will require you to maintain a balance between revenue and expenditure. Over the medium term this would require significantly constraining spending growth, unless your revenue strategy is adjusted to maintain a higher level of tax revenue-to-GDP in later years. Further, high inflation now will likely make it more challenging to manage within your allowances for Budgets 2023-2025, unless these are ‘cost pressure only’ Budgets.

Rather than increasing allowances now, however, we recommend taking time to reconsider your medium-term fiscal strategy, including allowances, expenditure and revenue options. [33] We will, however, provide further advice ahead of Budget Ministers 6 about the Budget 2023 allowance in light of precommitments. We may suggest then increasing the Budget 2023 allowance to ensure it remains a credible signal of future new spending.

Prioritising and sequencing your preferred capital package will be important to ensure value for money. Although our recommended debt ceiling would create more fiscal space for capital investment, current supply constraints mean that deliverability is challenging at present. We therefore recommend funding a modest capital package at Budget 2022, with new capital spending phased such that it largely comes from 2024/25 onwards, to avoid adding to near-term pressures. The current multi-year capital allowance (MYCA) balance will be sufficient to fund Budget 2022 packages, and we do not recommend an increase at this stage. If you do decide to increase the MYCA, we recommend this is communicated as a signal of your future investment intentions and not used for a larger Budget 2022 package.

We recommend considering a smaller Climate Emergency Response Fund (CERF) package than proposed by Climate CEs for Budget 2022. Even if the balance of the CERF is increased in line with reforecast Emissions Trading Scheme (ETS) revenues (approximately $750 million additional revenue), the package recommended by Climate CEs could be challenging to deliver in the near term and would leave very little remaining in the fund. Larger, higher-value initiatives are expected to seek funding in future years, and it would be prudent to leave a buffer for these by funding only high priority initiatives that are ready to implement now. Although there is headroom available for increased capital investment from the CERF over the medium term, we do not recommend a larger top-up of the CERF at Budget 2022.

Further replenishment of the COVID-19 Response and Recovery Fund (CRRF) is not needed. There is approximately $5.7 billion remaining in the CRRF (as at 3 March), after your $5 billion top-up on 1 February 2022, which is accounted for in our modelling. We expect that this balance will meet the costs of upcoming requests. Unless circumstances materially change, we recommend that you continue with your current approach towards the CRRF and not provide any further broad-based economic support at this time.

We will seek your feedback on this advice at Budget Matters on 7 March ahead of discussion by Budget Ministers on Tuesday 22 March (Budget Ministers 5). Following the completion of preliminary fiscal forecasts on 15 March, we will also provide an update on the fiscal outlook for Budget Ministers 5, and on 17 March we will provide you further advice on setting new short-term intentions and long-term objectives for fiscal policy. For the Treasury's forecasts to reflect as many Budget decisions as possible, we encourage you to take final decisions about your fiscal strategy no later than Budget Ministers 5.

Recommended Action

We recommend that you:

a **note** that preliminary economic and tax forecasts for the Budget Economic and Fiscal Update (BEFU) 2022 show an outlook that is similar to HYEFU forecasts, with significant downside risks relating to the spread of the Omicron variant of COVID-19

b **note** that elevated inflation, severe labour market tightness and global supply chain disruptions are expected to persist for most of 2022, which will generally increase delivery risks and worsen the value for money of new spending initiatives in the near term

c **note** that the forthcoming preliminary fiscal forecasts are expected to show a slightly weaker outlook for both OBEGAL and net core Crown debt in the near term compared to the HYEFU forecasts, but a slightly stronger OBEGAL by the end of the forecast period, with net debt returning to levels forecast at HYEFU

d **note** that meeting our recommended OBEGAL target over the medium term would require significantly constraining spending growth, unless your revenue strategy is adjusted to maintain a higher level of tax revenue-to-GDP in outyears e [33]

f **agree** to leave your current operating allowances for Budgets 2022-2025 unchanged for now, noting that we will provide further advice on the Budget 2023 allowance as needed

Agree/disagree.

g **note** that, after precommitments and revised draft Budget packages, the remaining multi-year capital allowance (MYCA) will be approximately $5.3 billion and the remaining Climate Emergency Response Fund (CERF) will be approximately $0.1 billion (if Climate CEs' proposed CERF package is funded in full)

h **note** that we recommend phasing new capital expenditure announced at Budget 2022 such that it avoids adding to near-term delivery pressures

i **indicate** if you would like to increase funding available within the forecast period for the MYCA or the CERF

☐ Not increase MYCA at this time (**recommended**)	☐ Not increase CERF at this time
	☐ Increase CERF by approximately $750 million in line with updated forecasts for ETS revenues, subject to confirmation in the final fiscal forecasts (**recommended**)
☐ Increase MYCA by $_____	☐ Increase CERF by $_____

j **note** that the COVID-19 Response and Recovery Fund (CRRF) balance is currently $5.7 billion, which is expected to be sufficient for your short-term priorities.

k **note** that we will provide further advice on projection period assumptions and your short-term intentions and long-term objectives for the 2022 Fiscal Strategy Report

l **provide feedback** on this report at Budget Matters on Monday 7 March, with a focus on how we can support decision-making at Budget Ministers 5, and

m **refer** this report to:

- Rt Hon Jacinda Ardern, Prime Minister

  Refer/not referred.

- Hon Dr Megan Woods, Associate Minister of Finance

  Refer/not referred.

Ben Gaukrodger
Acting Team Leader, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal Strategy for Budget 2022

Purpose of Report

1. This report advises on your fiscal strategy for Budget 2022, building on our previous analysis and advice ahead of the Budget Policy Statement 2022 (BPS) (T2021/2424 refers). This advice is intended to help you take recommendations to Budget Ministers on forecast period allowances, including the Climate Emergency Response Fund (CERF) if necessary. Following your feedback on this report, we will support your office to bring these elements (including your new fiscal rules and indicators) together for the Fiscal Strategy published in the Budget.

2. The preliminary fiscal forecasts will not be finalised until Tuesday 15 March. Therefore, the fiscal scenarios in this report are based on the Half Year Economic and Fiscal Update (HYEFU) 2021 Fiscal Strategy Model (FSM), updated for the preliminary Budget Economic and Fiscal Update (BEFU) 2022 economic and tax forecasts.[1] We have also used the existing net core Crown debt definition throughout, rather than a new indicator.

3. The following sections of this report cover:

   - top-down analysis on the economic and fiscal outlook (drawing on preliminary BEFU 2022 economic and tax forecasts outlined in T2022/185) and implications for an appropriate fiscal stance

   - an updated assessment of operating and capital expenditure pressures at Budget 2022 and future Budgets, and implications for allowances and fiscal sustainability

   - advice on updating the CERF and COVID-19 Response and Recovery Fund (CRRF)

   - next steps in relation to the Budget 2022 timetable.

Economic and Fiscal Outlook

Preliminary BEFU economic forecasts show a slightly weaker outlook for economic activity than HYEFU 2021 forecasts, primarily due to the spread of Omicron.

4. We have recently provided advice on the preliminary economic and tax forecasts for BEFU 2022 (T2022/185 refers). The New Zealand economy has performed strongly in the context of the COVID-19 pandemic, including during the Delta outbreak last year. However, the emergence of the Omicron variant has had a significant impact on the economy, both domestically and internationally. Following stronger-than-expected real GDP growth in late 2021 as activity rebounded following the Delta outbreak, March 2022 quarter growth is forecast to be 2.5 percentage points lower than HYEFU forecasts due to the impact of Omicron.

5. Our preliminary economic forecasts were produced prior to the Russian invasion of Ukraine, which may result in revisions to our final forecasts. Our initial view is that the impacts on the New Zealand economy will be mainly indirect (through energy prices and

[1] We have also adjusted the HYEFU FSM to reflect updated benefit forecasts and the $5 billion CRRF replenishment on 1 February 2022. We assume for simplicity that all CRRF spending is time-limited operating expenditure ending in 2022/23.

volatility in financial markets) but we expect this to remain a continued area of uncertainty.

6. Our final Budget 2022 forecasts will also account for the proposal to introduce a Social Unemployment Insurance scheme (SUI). This is likely to affect both the economic and fiscal outlook, although the precise impacts are not quantifiable at this stage.

Elevated CPI inflation, severe labour market tightness and global supply chain disruptions are all expected to persist for most of 2022.

7. The unemployment rate has reached a record low level, and labour supply is expected to remain constrained in the short term. Although labour supply constraints are expected to ease as inward migration picks up recent data suggests that, while the peak may have passed, strong labour demand will persist.[2] This ongoing tightness is expected to increase annual wage growth, which is forecast to reach a peak of 5.6% by mid-2023 and remain elevated over the forecast period.

8. CPI inflation is at a three-decade high, and our preliminary BEFU forecasts are for inflation to peak at 6.3% early in 2022 and remain elevated before reducing over the forecast period. Our final forecasts are, however, likely to revise this figure upwards to around 6.5% as we incorporate recent petrol price developments. While we expect global pressures relating to supply chain disruptions and energy prices to ease towards the end of 2022, domestic inflationary pressures (such as labour market tightness) may be more persistent.

9. Lower aggregate demand from the Omicron outbreak will alleviate some of the inflationary pressure from lower aggregate supply. However, we expect supply impacts may dominate – particularly due to labour supply disruption, which will temporarily worsen as households and businesses face greater disruption from illness and self-isolation. To this end, we expect Omicron may contribute to already high inflation pressures, but consider these impacts would be largely transitory. We expect global supply chain disruptions to persist over 2022, however, particularly while China continues to pursue a COVID-19 elimination strategy.

In response to higher-than-anticipated inflation, we expect interest rates to peak slightly higher than forecast at HYEFU, with a larger contractionary impact.

10. In response to significantly higher near-term inflation expectations, the Monetary Policy Committee last week revised its Official Cash Rate (OCR) forecast to peak at about 3.4% in late 2024, compared to a peak of 2.6% forecast at the November 2021 Monetary Policy Statement. The increase in interest rates is anticipated to slow economic activity and reduce inflationary pressures more than we assumed at HYEFU (partly due to the impacts of the Omicron outbreak), resulting in a slightly faster rise in the unemployment rate from 2023 to the end of the forecast period.

11. With the majority of mortgage holders borrowing at interest rates that are fixed for less than a year, higher interest rates are likely to flow through to most borrowers by the end of 2022.[3] This could also lead to serviceability stress for some borrowers – particularly recent first home buyers – as the margin between current interest rates and banks' test rates in 2021 (around 6%) narrows significantly.[4] We expect house prices to ease slightly over the next two years and residential investment to decrease over the forecast period due to the impacts of rising interest rates, tightened lending conditions and elevated cost pressures.

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[2] In the NZ Institute of Economic Research's Quarterly Survey of Business Opinion, a net 9.9% of firms reported in the December quarter that they plan to increase headcount in the next quarter.

[3] Based on publicly available ANZ data.

[4] Reserve Bank analysis suggests that if mortgage rates were to rise to 5 per cent, close to a fifth of recent first-home buyers would face some serviceability stress.

These economic conditions have lifted tax revenue compared to HYEFU forecasts …

12. The significant improvements in the fiscal position since Budget 2020 forecasts are likely to be maintained in Budget 2022 forecasts, with net core Crown debt much lower than the originally forecast peak, and OBEGAL deficits reducing quickly.

13. Since HYEFU, the stronger labour market, higher interest rates, and slightly higher nominal GDP has lifted core Crown tax revenue by $5.0 billion over the forecast period compared to our previous forecasts. The majority of this increase is due to stronger wage growth, which results in higher source deductions towards the end of the forecast period.

… but the same factors driving higher tax are also expected to increase expenses.

14. Early indications ahead of the preliminary fiscal forecasts are that benefit expenses will be around $2 billion higher over the forecast period compared with HYEFU, due to inflation and wage-indexing of benefits and New Zealand Superannuation. In addition, the recent CRRF top-up of $5 billion will temporarily lift expenses in the near term.

15. Combined, this suggests that the outlook for OBEGAL will be weaker in the near term, with a larger deficit in 2022/23 and surpluses that are slightly stronger or similar to those forecast at HYEFU from 2023/24 onwards (Figure 1). Net core Crown debt will likely be marginally higher in the near term, but by the end of the forecast period it should return to similar levels as those forecast at HYEFU (Figure 2).

16. [34]

Figure 1: OBEGAL as a percentage of GDP

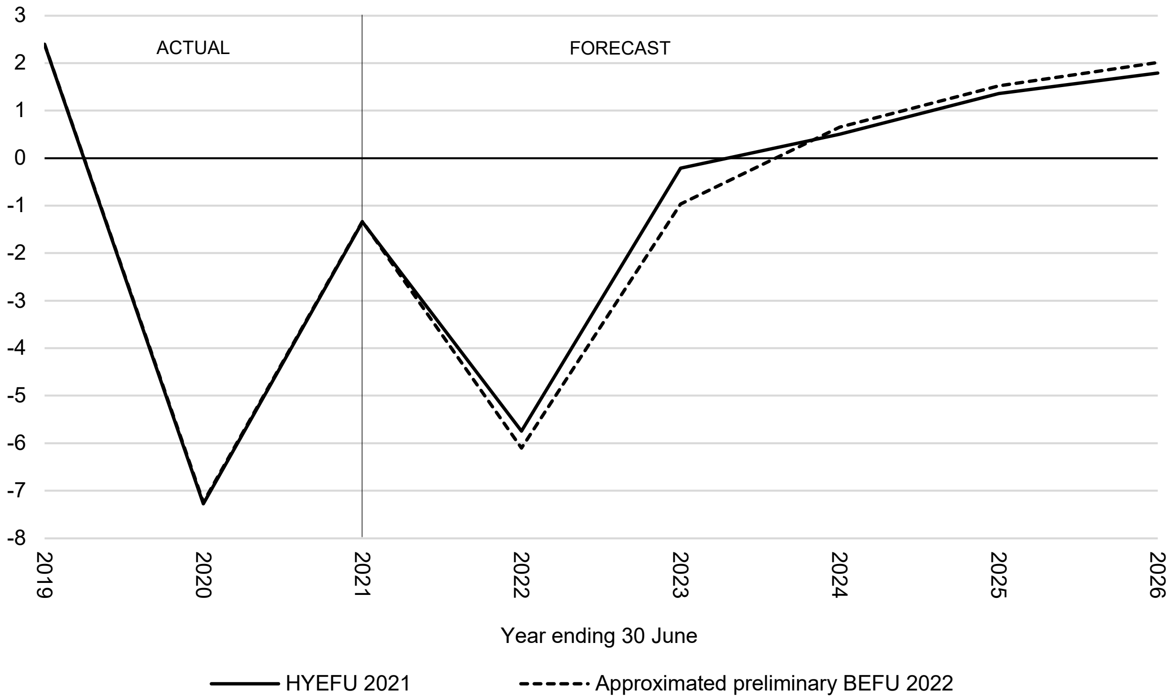
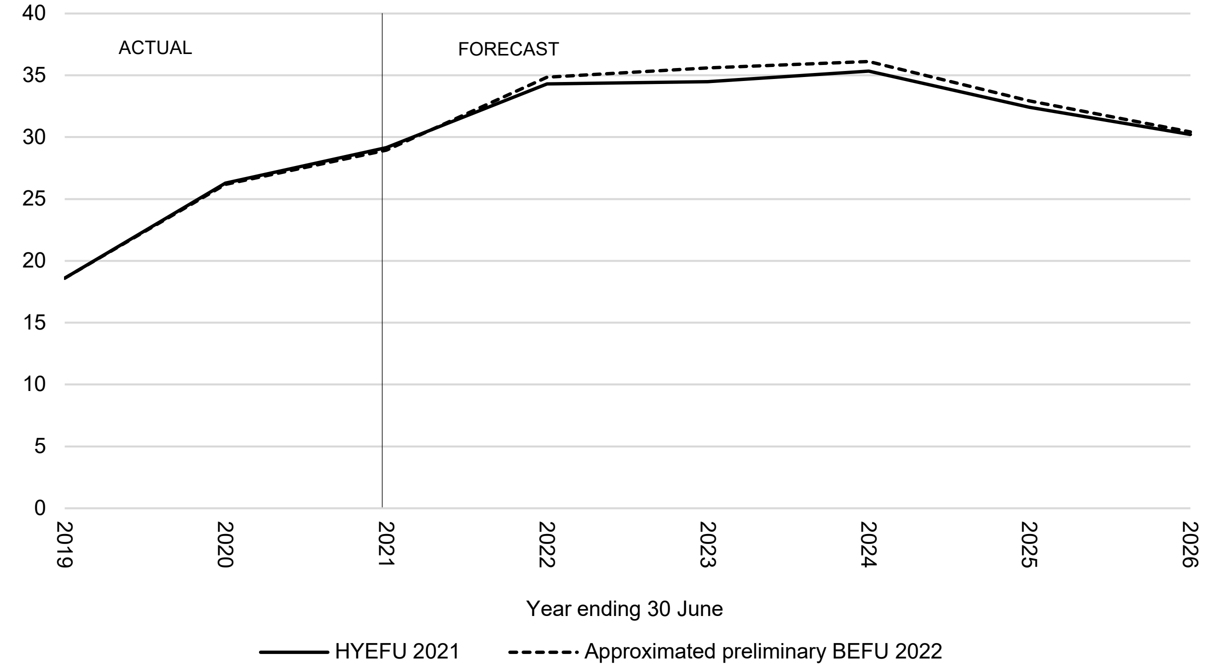


Figure 2: Net core Crown debt (incl. Funding for Lending advances) as a percentage of GDP



Fiscal Stance and the Budget 2022 Operating Allowance

While we expect fiscal policy to be contractionary in 2022/23 compared to the previous year, [33]

17. Although monetary policy is the main tool for managing economic cycles, ideally fiscal policy should work in the same direction to avoid putting additional pressure on monetary policy. If monetary policy needs to over-compensate to achieve its inflation objective, this will result in a higher-than-otherwise OCR. While this will help to normalise monetary policy and reduce the risk of another period at the effective lower bound, it can also influence distributional outcomes. For example, an increased OCR will, all else being equal, appreciate our exchange rate. These changes may benefit creditors and importers, at a cost to borrowers and exporters.

18. Fiscal policy is expected to be contractionary in 2022/23, as revenue growth is forecast to exceed expenditure growth (largely due to temporary COVID-19 spending dropping off).[5] We expect the structural and cyclically-adjusted deficits to decline and return to surplus by the end of the forecast period, but remain slightly below OBEGAL, reflecting the fact that the economy is expected to be operating above potential for the duration of the forecast period. We expect the fiscal impulse will show fiscal policy remaining contractionary over this time, although decisions to increase future budget allowances could change this. [33]

19. The proposed SUI scheme will enhance the counter-cyclicality of fiscal policy once it is introduced (that is, fiscal policy will be more contractionary when the economy is operating above potential, but more expansionary in a downturn). This will therefore support your macroeconomic stability objectives towards the end of the forecast period.

[5] Fiscal policy is contractionary when deficits are reduced or surpluses are increased, such that it contributes less to aggregate demand than it did in the previous year.

Ongoing uncertainty due to the pandemic will require continual balancing of the risks of providing too much support against the risks of providing too little support.

20. Although economic activity has remained resilient through previous COVID-19 outbreaks, there remains a risk of scarring, particularly in parts of the economy that rely on people gathering. If the level of support proves inadequate and leads to business failures, the current Omicron outbreak could be followed by a deterioration in the economic outlook. On the other hand, if support exceeds the level that is needed to prevent scarring, there is a risk that it could add to current inflationary pressures.

21. Given these risks, and while demand remains strong, we support the shift away from the types of broad-based support that were provided in 2020 and 2021. We also consider it would be advantageous to tighten the eligibility requirements of existing firm support to ensure it is well targeted at those otherwise viable firms that are badly affected by the current outbreak. The outlook remains uncertain and could change quickly, so it will be important to monitor the situation and change your approach if needed. In this situation, you have existing support policies that would be possible to redeploy (though it may be administratively difficult), and sufficient headroom in the CRRF to fund these policies again if required.

While there may only be relatively small macro-stabilisation gains from cutting back Budget 2022 packages, it will be important to not exceed your current allowance.

22. At this stage in the Budget process, substantially reducing your Budget 2022 operating allowance would require you to scale back previously signalled priorities, which may not be feasible, and defer critical cost pressures to future Budgets, which we do not recommend.

23. Further, we consider that announcing a Budget operating package of, for example, $5.5 billion per annum (a reduction of $500 million from the current allowance) may not be enough of a contraction to have a noticeable impact on the economy.[6] To this end, we recommend managing your Budget 2022 package to ensure you do not exceed the $6 billion operating allowance that has already been signalled.

Deliverability of Budget 2022 packages will need to be carefully assessed given heightened inflation, capacity constraints and the tight labour market.

24. Maintaining your $6 billion operating allowance for Budget 2022 will also support the credibility of your fiscal strategy in the near term. Although your Budget 2022 operating allowance is larger than allowances in previous years, Budget 2022 is ambitious in its scope and is still oversubscribed. It will be possible to meet your goals for this Budget while staying within this allowance, as we recommend, but it will require careful scaling, prioritisation and sequencing of initiatives across multiple Budgets (T2022/6 refers).

25. If delivered well, much of your new spending at Budget 2022 will be welfare-enhancing over the longer term – for example, reforming the health system – but persistent supply constraints and record low unemployment will make some types of spending difficult to deliver in the near term, particularly where new workers (FTEs) are required.

26. The Treasury's draft Budget 2022 package considered labour market and inflation pressures and recommended scaling the number of FTEs sought by about 40% to approximately 3,400 new FTEs and contractors. The revised Budget package still includes approximately 3,100 new FTEs and contractors, which could result in significant public service workforce growth.[7] Delivering additional roles will be challenging and will increase the risk that new initiatives funded to begin in 2022/23 stall due to recruitment

[6] Although, we note that this would structurally improve the fiscal position, leaving room for higher spending in later years when it is less likely to be pro-cyclical.

[7] These estimates are based on data submitted to the Treasury and Vote Analyst comments on scaling; the actual numbers may be different given gaps or errors in the data.

delays as a result of a constrained labour market, simultaneously putting upward pressure on wages and other input costs.[8]

27. As new FTEs will be required to deliver major reform programmes and new functions being established, it will be important to balance the Government's ambitions with significant near-term risks to deliverability. If it is important that new programmes are not delayed or deferred, it may be worth considering whether there are options to reprioritise existing public sector FTEs while current market conditions persist.

Operating Allowances for Budgets 2023 to 2025 and Medium-term Fiscal Strategy

We recommend that you leave your Budget 2023-2025 allowances unchanged for now.

28. Although these operating allowances get smaller over time, we do not recommend that they are increased at Budget 2022. As we explain below, delivering Budget packages within these allowances will be challenging and it will likely be necessary to reconsider the size of these allowances eventually. We do not see Budget 2022 as the best point in time for this decision, however, given the value in weighing the size of your allowances alongside your medium-term reprioritisation and revenue options.

We do, however, recommend starting to reconsider your medium-term strategy given new fiscal targets.

29. Achieving our proposed new OBEGAL rule – targeting small surpluses (no less than 0.5% of GDP) subject to significant shocks – will require you to maintain a balance between operating expenses and revenue by keeping your tax-to-GDP ratio broadly similar to your expenses-to-GDP ratio (T2022/37 refers). If growth in expenses outstrips revenues as a share of GDP over the medium-term, your OBEGAL surplus will eventually decline.

30. Preliminary BEFU forecasts imply that you will be able to meet this target from 2023/24 onwards, and then through the projection period, based on current allowance settings. However, as illustrated in Figure 3, this will become increasingly challenging through the projection period, relying on tight allowances to control expenditure growth or fiscal drag to raise revenue.

Your level of ambition for government services will ultimately drive your expenses (and therefore allowances for new spending) as a share of GDP.

31. Operating allowances from Budget 2023 onward imply that expenses as a share of GDP will reduce to around 29% of GDP by 2024/25 as temporary CRRF spending ends. Limiting expenditure growth in the forecast period to fit within the current signalled allowances would maintain this level of core Crown expenses through the projection period (Figure 4).

32. Operating allowances of $4 billion per annum from Budget 2023 onwards, which would be in line with recent Budgets, would put expenses on an upward trajectory from the end of the forecast period. Alternatively, a larger operating allowance of $6 billion at Budget 2023, and then allowances of $4 billion at Budgets 2024 and 2025, combined with your current projection period assumption of $2.75 billion operating allowances from Budget 2026, would see core Crown expenses settle at around 30% of GDP from the end of the forecast period.

[8] Increasingly large underspends at an aggregate level are a good indication that this is already happening, as agencies need more time to implement new initiatives from past Budgets.

Figure 3: OBEGAL as a percentage of GDP with different expense and revenue assumptions

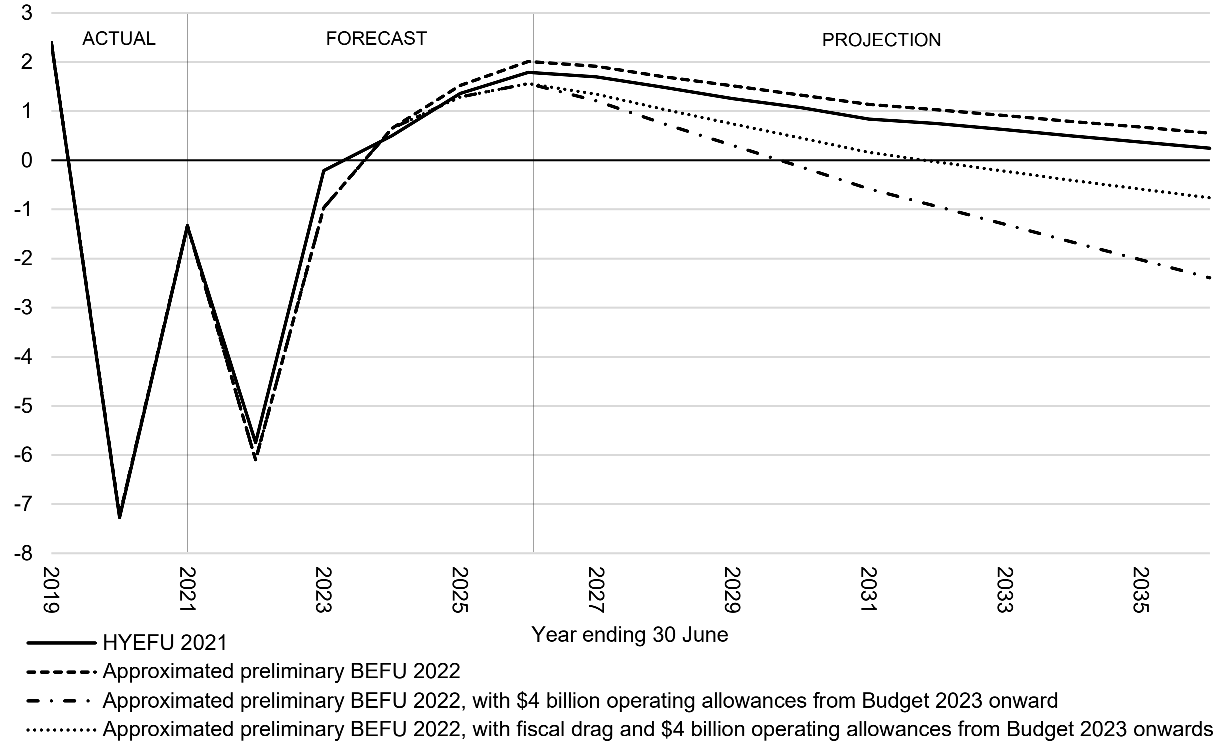
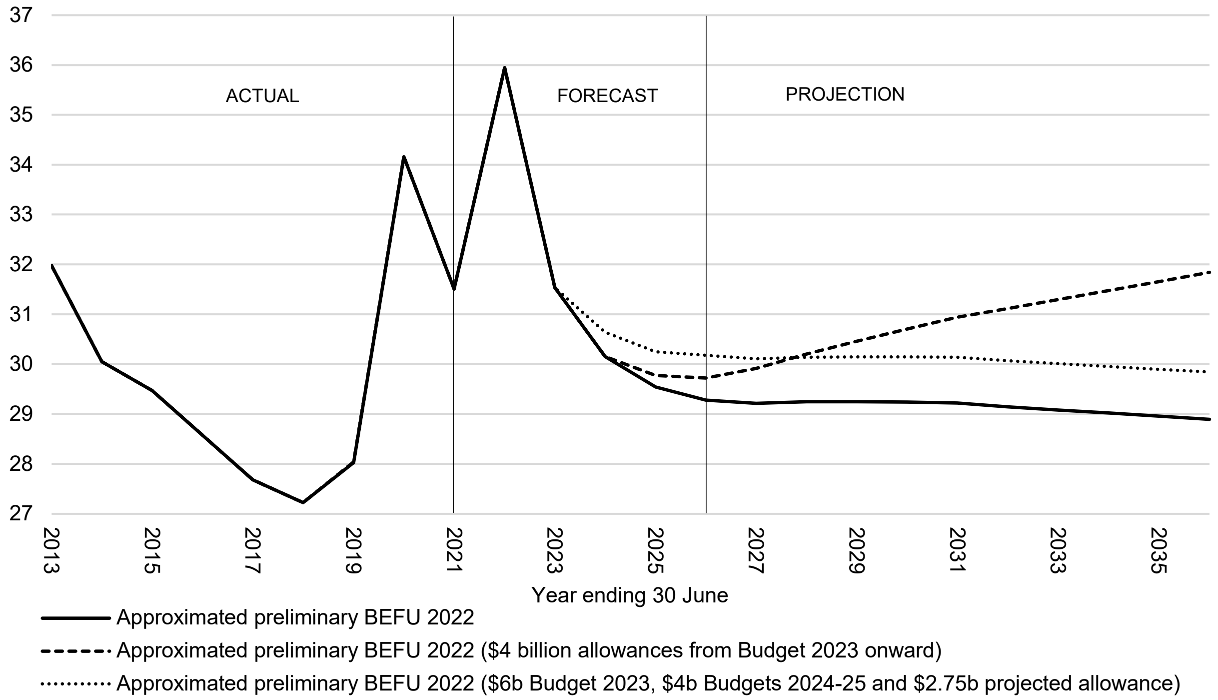


Figure 4: Core Crown expenses as a percentage of GDP with higher allowance scenarios



[33]

33. **Precommitments will absorb a significant amount of the Budget 2023 allowance.** We anticipate decisions taken at Budget 2022 will precommit up to $2.0 billion of your Budget 2023 operating allowance, leaving approximately $2.0 billion remaining.[9] [34]

[9] Includes Health new spending, which we understand you are considering precommitting against your Budget 2023 allowance (T2022/410 refers).

[34]

We will provide further advice once we have more certainty about Budget 2022 decisions and how these may impact the level of precommitments against future allowances. If we recommend increasing the Budget 2023 allowance, you could raise this at Budget Ministers 6.

34. **A significant number of manifesto commitments remain unfunded.** At the draft package stage, unfunded manifesto initiatives totalled approximately [33]

This number also includes initiatives that unsuccessfully sought an invitation for Budget 2022, as some initiatives were not invited on the basis that they may seek Budget 2023 funding. Invited manifesto initiatives recommended specifically for deferral through the Budget 2022 process totalled [33] at the draft package stage. While you may choose to fund more initiatives through the Budget 2022 process than recommended by the Treasury (reducing pressure on future allowances), this would only increase oversubscription of your Budget 2022 operating allowance unless other initiatives are deferred indefinitely.

35. **Cost pressures are likely to grow in the medium-term due to the larger base.** Core Crown expenses as a percentage of GDP are forecast to be higher after the pandemic than they were before it, even once temporary COVID-19 expenditure ends. While growth in expenses has been critical in supporting the economy through the pandemic, this higher base of expenditure means cost pressures are likely to grow in size over the medium term. [33]

36. [33]

[12] However, there is generally a lag between increased actual costs of providing services and bids seeking Budget funding as departments may have the means to meet cost pressures in the short term (i.e. departments have not sought $6.2 billion in funding for cost pressures at Budget 2022). This means that the impacts of higher inflation now may yet flow through to pressures on allowances beyond the forecast period.

37. **Cost pressures are likely to continue to grow over time**, in part driven by an ageing population putting increased pressure on the health and welfare systems. As incomes increase, people's expectations and demand for what the healthcare system should deliver also increase. At the same time, however, having a greater proportion of the population out of the workforce will limit your ability to fund increased government services.[13]

[34]

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[10] Based only on information provided by departments to the Treasury. Some initiatives submitted as "manifesto" commitments may not be government priorities.

[33]

[12] We reach these figures by adjusting the portion of core Crown expenses that derives growth from a share of the operating allowances for current inflation and wage growth forecasts.

[13] He Tirohanga Mokopuna 2021: The Treasury's combined Statement on the Long-term Fiscal Position and Long-term Insights Briefing sets out these challenges in greater detail.

[34]

It is highly improbable that all risks would materialise at once and, when risks do materialise, you have choices around how these are managed. Nonetheless, the number and scale of risks of which we are aware suggest it is prudent to leave some headroom in your operating allowances to ensure their ongoing credibility as a signal of government expenditure over the medium term.

You have options to manage these pressures without increasing expenses, but this will require hard choices.

39. It is unlikely that these pressures can be fully met within your existing operating allowances. Unchanged gross allowances are therefore likely to require focusing mostly or solely on funding cost pressures for existing projects and services, rather than new spending initiatives.

40. **You could choose to leverage departments' fixed nominal baselines and not fully fund cost pressures in line with inflation.** Doing so would require departments to either identify savings or efficiencies within their baselines or scale back the services they provide. Requiring departments to absorb price increases can therefore provide an annual efficiency dividend for government expenditure (though this can also have the effect of suppressing some cost pressures until they are eventually funded, or eroding the quality of public services).

41. **You could consider options to reduce or remove spending on existing lower priority areas and reduce ambition for new projects.** The Government has previously run reprioritisation and savings exercises as part of the Budget process, but the returns from these have been mixed. Relying on reprioritisation to increase gross new spending would only be effective if the Government is prepared to take difficult and large-scale policy decisions. [34]

42. **You could choose to defer, prioritise or sequence initiatives across Budgets, or provide time-limited funding only.** While this may be appropriate to manage the phasing of priorities, deferring or time-limiting initiatives can put significant pressure on future Budget allowances unless other policy decisions are also taken (e.g. adjusting eligibility requirements for a service). Time limiting funding is only recommended in instances where there is a clear and definite end date for funding and you may wish to defer some initiatives indefinitely to ensure the ongoing credibility of future allowances. If not, deferred and time-limited initiatives (particularly cost pressures) can become "effective" precommitments against future Budget allowances, thereby obscuring your real headroom for new expenditure.

In the short term, there is also headroom to increase allowances …

43. Given that OBEGAL is forecast to be comfortably above the 0.5% of GDP target at the end of the forecast period and beginning of the projection period, there is scope to increase allowances in the short term to help manage some of these pressures while still running an operating surplus. The achievability of delivering larger allowances in the forecast period, however, would still be limited by the capacity of departments to deliver on initiatives despite current supply constraints and inflationary pressures (presuming that Budget allocations can be spent) as discussed above.

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[34]

44. The fiscal consequence of increasing your allowances in the near term would be that OBEGAL would likely fall under the 0.5% of GDP target earlier in the projection period than would otherwise be the case. Current allowances and projection period assumptions see an OBEGAL surplus of around 0.6% in 2035/36, but allowances of $4 billion in Budgets 2024 and 2025 (leaving the projection period allowance at $2.75 billion) would see the OBEGAL surplus fall below 0.5% of GDP around 2032/33.

[33]

[33]

Capital Investment

Our recommended new debt ceiling will create more fiscal space for capital …

51. Relative to operating expenditure, adopting our recommended fiscal targets would allow greater flexibility around the timing and quantum of your capital spend over the medium term (T2022/37 refers). Whether to use this fiscal space (and when) will depend on factors such as the quality of the investment pipeline, value-for-money considerations, and market capacity and capability.

[33]

53. Funding all of these projects would be a significant step change from historic levels[19] of capital investment (as shown in Figure 5), with implications for inflationary pressures, supply constraints, and construction sector capacity and capability. Consequently, it will be important to prioritise and sequence this pipeline (including the associated operating costs) over the medium term to ensure that high priority projects are not crowded out, either by short-term capacity constraints or longer-term fiscal constraints, and delivery of existing investments is completed.

… however, delays and cost escalations relating to existing projects are likely to be significant in the near term, and your future spending plans should account for this.

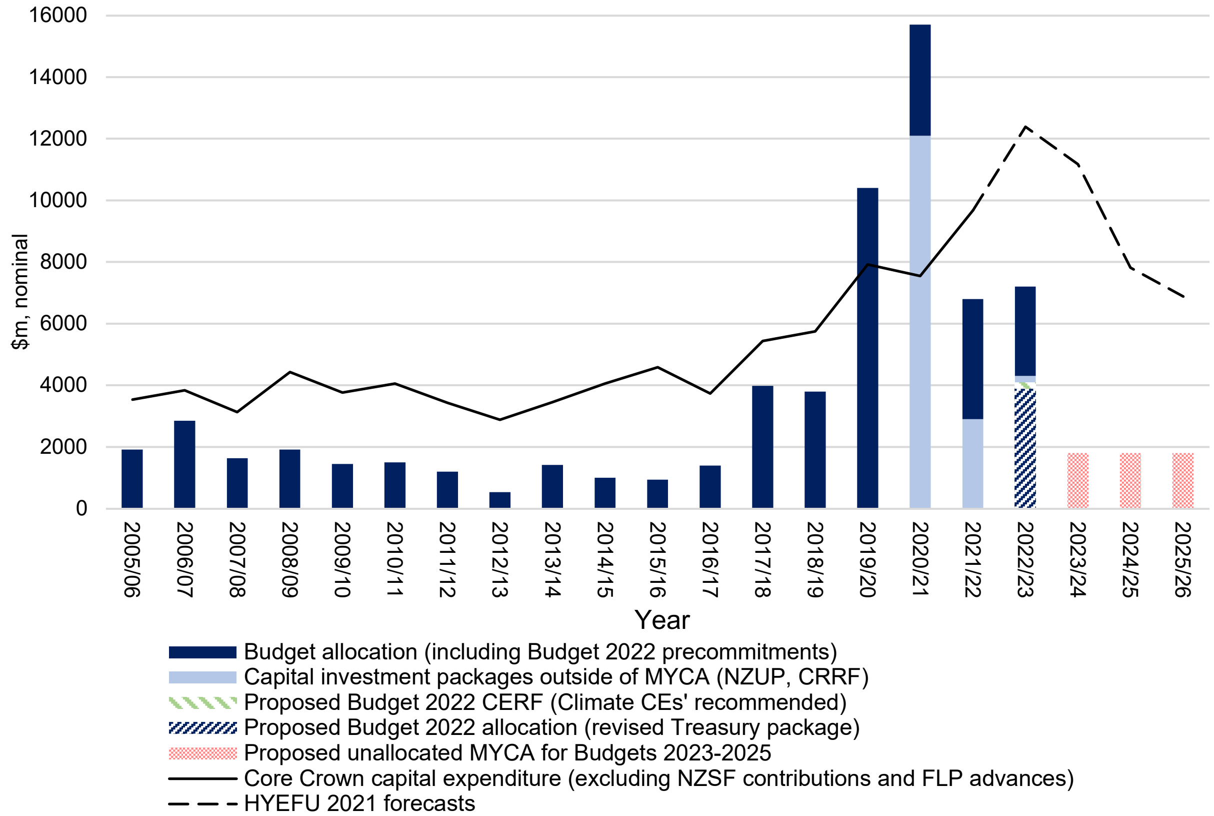
54. [33]

55. You have options for how you manage these cost escalations, including through the prioritisation and sequencing of existing projects and/or establishment of a centralised contingency (T2022/379 refers). However, the current environment is such that further near-term capital expenditure beyond that recommended by the Treasury would risk impeding the deliverability of your existing projects, while also reducing the value for money of your new investments, impacting both their achievability and affordability.

[33]

[19] Across Budgets 2018 to 2021, your Budget capital allocations have averaged $5.4 billion. This is weighted to the high side by a $10.4 billion capital package allocated at Budget 2019, but excludes non-MYCA commitments, such as the initial $8 billion of New Zealand Upgrade Programme commitments and $7.2 billion in gross capital allocations from the CRRF and 16 March COVID-19 Response package.

Figure 5: Net capital spending and allocations (actual and forecast)



We recommend phasing new spending announced at Budget 2022 so that it contributes to a sustainable capital pipeline and avoids worsening near-term issues.

56. Budget 2022 capital initiatives invited and submitted by Ministers total $5.7 billion. We recommended a draft Budget 2022 capital package, focusing on those initiatives that we consider represent the best value for money in the context of the current investment environment, of $3.7 billion total capital over ten years. After incorporating your feedback, the emerging capital package is currently $3.9 billion.[20]

57. Although the capital investment recommended for Budget 2022 fits within your current fiscal constraints (including the remaining MYCA), the value for money and deliverability of capital projects should be seen as real constraints on investment, given limited market capacity to deliver projects on time and to budget in the near term. Vote teams have incorporated these constraints in assessing which initiatives to support, but it will still be important to consider from a top-down perspective whether further scaling of the draft package is possible to mitigate the risk of further exacerbating capacity issues and inflationary pressures.

58. Of the projects you choose to fund for Budget 2022, we recommend considering how these can be phased over the ten-year horizon so as to avoid adding further expenditure to the expected peak in the earlier years of the forecast period (indicated by the capital expenditure line in Figure 5). We suggest prioritising projects that are well planned and are foundational for future investment or are critical cost pressures. Beyond this, we recommend deferring to future Budgets any projects that have not undertaken sufficient planning so that this can be completed before funding decisions are taken.

[20] As at Thursday 3 March. All figures exclude the $2.9 billion total already committed against the MYCA since Budget 2021.

We recommend not topping up the MYCA at Budget 2022, but you should consider a top-up at the Budget Policy Statement 2023 to signal future levels of investment.

59. Without a top-up at Budget 2022, the emerging capital package would leave a MYCA balance of $5.3 billion.[21] We recommend deferring any decisions on increasing the MYCA until the next Budget Policy Statement when the 2026/27 fiscal year is added to the four-year envelope. This would allow decisions on the MYCA to be based on more up-to-date capital pipeline reporting and a clearer medium-term economic outlook. However, this means there will be little room for funding new investments beyond cost escalations until HYEFU when the MYCA is topped up. If you do wish to increase the MYCA now, we recommend this increase is communicated as a signal of your future investment intentions and not allocated at Budget 2022.

60. If you choose to fund a much larger capital allocation at Budget 2022 than the Treasury-recommended package, you may wish to communicate an increase to the balance of the MYCA at Budget 2022, so as to ensure that this allowance remains a credible signal of new capital investment to be allocated across the next three Budgets.

Updating the CERF and the CRRF

Deliverability, value for money and medium-term strategy should be key factors in deciding how much climate investment to fund at Budget 2022.

61. The CERF was established with a total of $4.5 billion funding available over the forecast period (CAB-21-MIN-0514 refers). For Budget 2022, you are considering a draft package of $3.5 billion (Climate CE ‘high priority’ package). Supporting this package would leave $133 million remaining in the CERF after Budget 2022.

62. Although the costs of the climate transition will be significant, funding a package of this size at Budget 2022 is likely to have high deliverability risks and could add to current inflationary pressures. Further, we have previously advised that the Government will need to rely on a combination of price, regulation and investment levers to achieve its emissions budgets, while carefully considering where public investment is needed.

63. As the CERF is a multi-year fund, we suggest you prioritise high value initiatives with a strong rationale for government spending when they are ready, rather than seeking to fund all Emissions Reduction Plan (ERP) actions early on. We also recommend leaving a buffer in the CERF for future investments.

64. We expect that demand for CERF funding will increase in future budgets, and that larger, higher-value initiatives will be more implementation ready in future years – by which time we expect current deliverability risks and capacity issues to have subsided. Given this, our overall recommendation remains for a smaller package that would not exhaust the CERF this year.

65. We have provided options in the draft Budget Ministers 4 slides to reduce the draft package from $3.5 billion to $2.4 billion. These will also be discussed in advice on the CERF early next week.

Updated forecasts for ETS revenues will allow you to hypothecate a further $750 million to the CERF balance, with larger increases made in the future.

66. We understand you may wish to adjust the CERF balance to match the updated forecast for ETS cash proceeds. March Baseline Update figures indicate an increase in cash

[21] Your total Budget 2022 MYCA before precommitments was $12.1 billion. The balance remaining at the BPS was $9.8 billion (after a $4 billion top-up and $2.3 billion of precommitments). A further $0.6 billion has since been precommitted, leaving $9.2 billion for allocation across Budgets 2022 to 2025.

proceeds of $750 million over the forecast period compared to HYEFU forecasts. If you would like to top up the CERF proportionally to this increase, we will look to confirm the precise amount following fiscal forecasts. Although there is headroom available for increased capital investment from the CERF over the medium term, we do not recommend a larger top-up to the CERF at this time.

67. You will receive separate advice about the ongoing approach to revising the size of the CERF next week. In this advice we will also test our assumptions around phasing of expenditure and the operating/capital split. CERF initiatives to date have been weighted towards operating expenditure, and some of it is ongoing, which will impact the structural position.

For the CRRF, a further replenishment is not needed at this time.

68. There is approximately $5.7 billion remaining in the CRRF. We expect that this balance will be sufficient to meet the costs of upcoming requests, and we understand you are considering closing the CRRF at the end of this financial year (T2022/337 refers). We are therefore not recommending a further top-up, unless circumstances materially change. We recommend continuing with your current approach for the CRRF and not providing any further broad-based economic support at this time. Further COVID-19 expenditure, over and above the remainder of the CRRF, will have a corresponding impact on the fiscal position, but if funding is strictly time-limited it would be unlikely to impact your ability to return to surplus in future years.

Next Steps

69. We are available to discuss this advice with you at Budget Matters on Monday 7 March, ahead of discussion at Budget Ministers 5 on Tuesday 22 March. Other key dates for setting your new fiscal strategy are set out in the table below.

Table 1: Key milestones ahead of finalising the fiscal strategy for Budget 2022

Date	Milestone
Monday 7 March	Budget Matters
Wednesday 9 March	Budget Ministers 4
Tuesday 15 March	Preliminary fiscal forecasts
Thursday 17 March	Advice on short-term intentions and long-term objectives
Tuesday 22 March	Budget Ministers 5 – discussion on fiscal strategy, including key recommendations from this report
Thursday 24 March	Final economic forecasts
Tuesday 29 March	Budget Matters
Friday 1 April	Budget Ministers 6 – final decisions on allowances and fiscal targets, if required
Mid-April (TBC)	Possible cabinet paper on new fiscal targets
Mid-April (TBC)	Draft fiscal strategy provided for comment
By early May	Advice on assumptions for fiscal projections

70. For the Treasury's forecasts to reflect as many Budget decisions as possible, we encourage you to take the majority of your Budget 2022 decisions, including decisions about your fiscal strategy, at Budget Ministers 5 on Tuesday 22 March 2022, with these decisions confirmed as necessary at Budget Ministers 6 (T2021/2720 refers).