The Treasury

Economic and Fiscal Context Slide Pack

February 2024

TE TAI ŌHANGA
THE TREASURY

Briefing to the Incoming Finance Minister

Economic and Fiscal Context

24 NOVEMBER

Purpose and contents of this briefing

The purpose of this briefing is to support your early engagements with the Treasury. It sets out the Treasury's view on New Zealand's economic and fiscal context, including some of the key policy issues you will likely grapple with. It is intended to provide context for subsequent, more detailed conversations between you and the Treasury. We are ready to provide advice on these, and other topics.

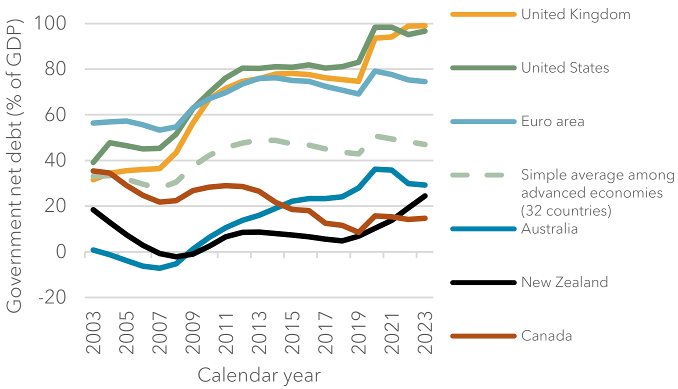
While New Zealand's economy and public finances have performed well in recent decades, New Zealand has incurred significant costs in responding to a series of recent shocks. Unwinding current macroeconomic imbalances and restoring fiscal sustainability, while addressing New Zealand's structural challenges and making the most of available opportunities, will require complex choices and prioritisation.

The Treasury is ready to brief you in more detail on these issues, and on your Government's priorities, including your first 100 days.

SECTION 1

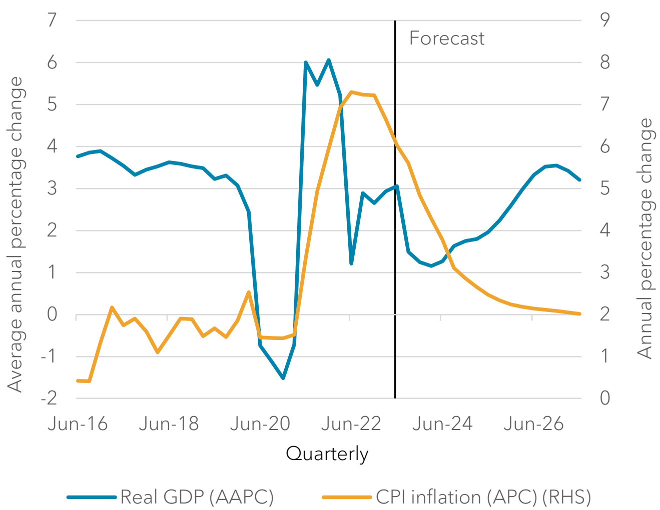
Summary

Figure 1: New Zealand's net public debt remains low, but has been increasing



Source: IMF, World Economic Outlook October 2023.
Data for 2023 (and 2022 for some countries) are IMF estimates.

Figure 2: GDP growth is forecast to be low and inflation is expected to decline



Source: The Treasury; Pre-election Economic and Fiscal Update 2023

The economic and fiscal situation will be challenging over 2024

Macroeconomic and fiscal restraint is needed

Sustainable fiscal policy is important for supporting economic performance and providing the public services that New Zealanders expect. As a small open economy vulnerable to external shocks and natural disasters New Zealand needs to retain a large buffer for emergencies.

New Zealand's net public debt remains low by international standards but has been rising over recent years (Figure 1). While the level of debt is currently not significantly impacting New Zealand's economic performance, resilience, or wider living standards, fiscal policy has been contributing to recent excess demand pressures in the economy.

Moreover, current spending exceeds current revenues. The Treasury estimates much of this gap is structural, reflecting a mix of short and long-term drivers. Long-term pressures such as demographics and climate change are being felt now, and finance costs have increased. A substantial fiscal consolidation is required to bring revenue and expenses back into balance and support fiscal sustainability, while also supporting monetary policy to bring inflation back into the target range.

The New Zealand economy has entered a period of slow growth in response to tighter monetary policy necessary to tackle inflation, and other economic headwinds such as slower global growth (Figure 2). The outlook is for the Official Cash Rate to remain around current levels for some time, for low growth to persist through the coming year, unemployment to rise somewhat, and inflation and the current account deficit to decline.

Responsible fiscal management is central to New Zealand's prosperity

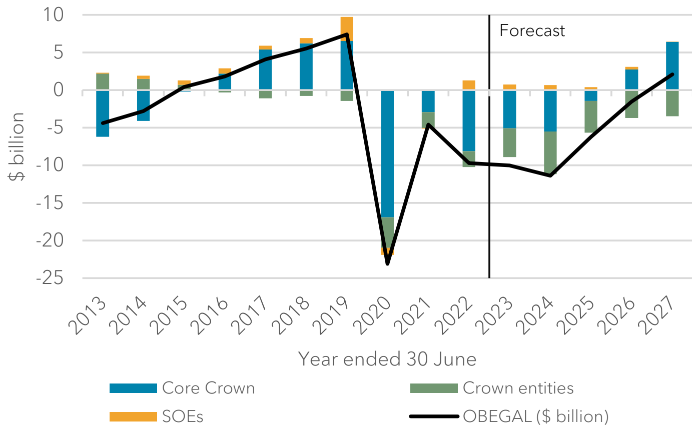
Given heightened levels of uncertainty globally, a strong Government commitment to preserving medium to long term fiscal sustainability, while maintaining sufficient space for prudent investment and closing infrastructure gaps, is critical for New Zealand's economic prosperity.

The integrity of the Government's commitment to fiscal sustainability depends on the strength of the institutions that support it. The Public Finance Act 1989 (PFA), and its principles of responsible fiscal management have underpinned New Zealand's strong fiscal performance over recent decades.

The Treasury has identified further opportunities to improve the public finance, investment and regulatory management systems in ways that would strengthen decision making across the public sector, deliver better value for money and increase public sector productivity.

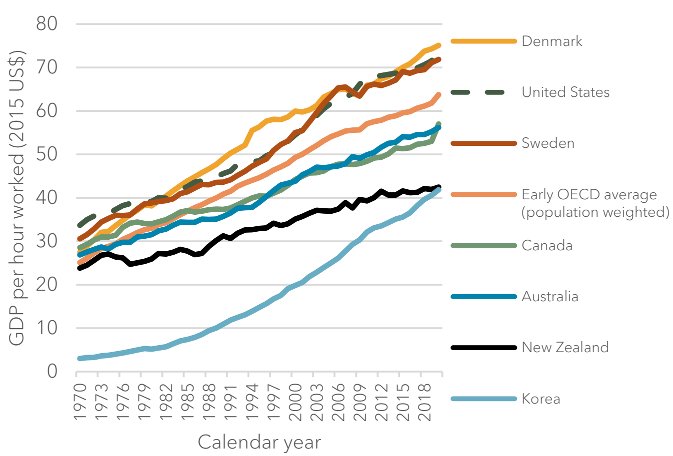
These systems will also need to be sufficiently flexible to adapt to changes in New Zealand society such as population aging, technological change, and evolving household structures, as well as changing geopolitics, economic shocks and climate change.

Figure 3: A return to surplus in 2026/27 will require tight control of revenue and expenses



Source: The Treasury, Pre-election Economic and Fiscal Update 2023

Figure 4: New Zealand's productivity has lagged other developed countries



Source: New Zealand Productivity Commission based on OECD data.
Early OECD countries are defined as those who joined the OECD prior to 1975.

A clear economic and fiscal strategy will create a strong base for growth

A return to surplus is a key fiscal commitment…

On balance, the Treasury recommends prioritising a return to surplus in 2026/27 at the latest. Such an objective would send a clear signal of the Government's commitment to responsible economic and fiscal management. It would support monetary policy to lower inflation, and higher government saving will also contribute to narrowing the current account deficit. Moreover, making early consolidation progress would help address structural expense pressures and increase flexibility should a further shock hit the economy.

Achieving such a target while delivering the 100-day plan and wider policy programme will require a sustained programme of work sequenced over the Parliamentary term. The Treasury recommends that the programme focus on:

- Creating fiscal space sufficient to fund Government commitments and the return to surplus.
- Orienting government to prioritise tight fiscal discipline and continuously improve value for money.

Securing a return to surplus in 2026/27 will require significant effort to constrain new spending, reduce current expenditure, and increase revenue. Collective ownership through Cabinet leadership and a culture of fiscal discipline, supported by robust institutional settings, will need to be a key focus. Ministers will need to consider how best to balance taking decisive action early to set a tone, with the need to sequence change across the term and manage impacts on services and infrastructure performance.

…alongside measures to lift growth, resilience and living standards

An economic strategy, complementing the fiscal strategy, will set a clear direction for the public and private sector to work together.

The Treasury has identified the following priorities for lifting New Zealand's productivity, resilience and living standards:

- Strengthening the business environment.
- Building human capability.
- Strengthening global connectivity and enhancing our economic security.
- Adapting to climate change whilst enabling a low emissions transition.

Creating an environment that is conducive to innovation and high-quality investment, including in infrastructure, will be key to positioning New Zealand to respond to emerging trends and opportunities in ways that lift long-term economic performance and deliver better outcomes for all New Zealanders.

New Zealand also must address the challenges & opportunities of a changing world

New Zealand faces some longstanding challenges for living standards…	**Low productivity** Labour productivity, capital intensity and income are all low in New Zealand, relative to comparable countries.	**International connections** New Zealand's international connectivity in terms of investment, trade, and absorption of ideas is relatively low.	**Student achievement** Student achievement is declining and will exacerbate intergenerational disadvantage and inhibit productivity growth.	**Housing affordability** Housing affordability is among the worst in OECD, creating pressure on households and distorting investment flows.
…while we navigate the effects of global mega-trends…	**Climate change** We are already bearing the costs of changing weather patterns. We must ensure we are prepared for and resilient to future climate change, while continuing to transition to a low-emissions economy.	**Demographic change** Global population trends are diverging. In New Zealand, the population is aging and changing in ethnic composition. This is set against increasing expectations of the quality of service in areas like health (including mental health) and education.	**Technological change** The shift towards services and technological change, including the emergence of Artificial Intelligence, presents new paths to prosperity, but also risks to social cohesion and security. Innovations will change how we work, and the skills society needs.	**Geopolitical change** A new era of great power rivalry is underway that suggests a less benign environment for New Zealand. This includes significant risks to the rules-based international order that underpins our participation in the global economy.
…but there are significant opportunities for us to seize.	Improving market and infrastructure settings and maintaining up-to-date and well-performing regulatory systems can give firms more confidence to invest, innovate and grow.	Growth and diversification of trade can present new economic opportunities, build supply chain resilience, and support the transition to a lower-emissions economy.	A skilled and adaptable workforce that enables technological diffusion and innovation can boost productivity and improve sustainability. Increasing the skills of the labour force can also lift living standards.	Improving policy settings can help build an economy that is better prepared for shocks and the physical impacts of climate change and allow us to take up opportunities.

SECTION 2

Economic and fiscal assessment

The New Zealand economy has delivered higher incomes over the last thirty years

As outlined in the Treasury's Wellbeing report, life in New Zealand has improved in many ways over the past twenty years

Improvements in New Zealand's infrastructure, institutions and economy have delivered many benefits. Compared to past generations, New Zealanders are healthier, have higher incomes and are better educated. We enjoy very clean air, strong relationships, high life satisfaction and have a relatively high level of social cohesion and trust in one another.

However, New Zealand performs worse than other developed nations in areas such as rental housing affordability and mental health. There are also large differences in wellbeing within New Zealand, with New Zealand performing worse on wellbeing for children and young people. The lower wellbeing of young people is particularly important for Māori and Pacific Peoples, two groups with lower average wellbeing and younger age profiles. We have also seen declining achievement among school students as measured by international surveys, and there are concerns about some aspects of our natural capital, such as the quality of rivers and drinking water.

New Zealand's income growth has outperformed the OECD median since the late 1990s

New Zealand's per capita income growth has been supported by labour productivity growth, an increasing share of the population in employment and a high terms of trade.

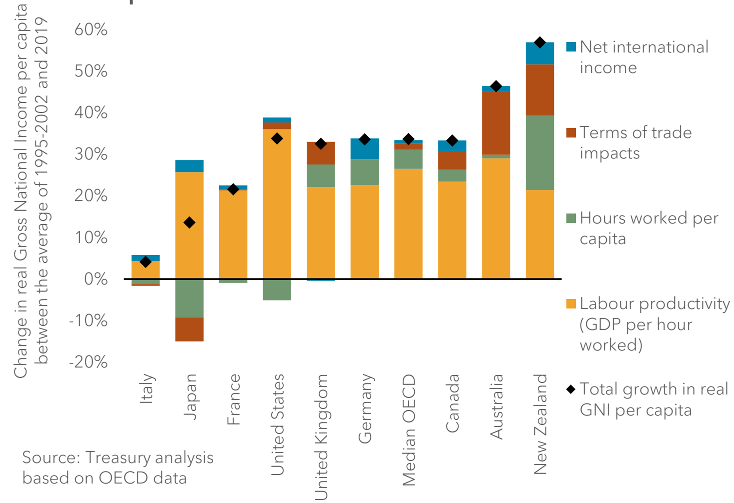
The latter two drivers have seen income growth exceed the OECD median, despite labour productivity growth slowing over this period (Figure 5).

However, the level of economic output and income per capita continues to lag our OECD peers (Figure 6). New Zealand's labour productivity is below the top half of the OECD average. And while incomes have increased overall, incomes are lower for certain groups (including Māori and Pacific people, people of Middle Eastern, Latin American or African ethnicity, sole parents, and people living alone).

Looking ahead, some of the past contributions to income growth may not be replicated, or at least not to the same extent. Labour utilisation is already high relative to most OECD countries (although further gains could come from reducing underutilisation in the labour market, particularly for females). The increasingly fragmented global environment may limit the potential for ongoing gains in the terms of trade.

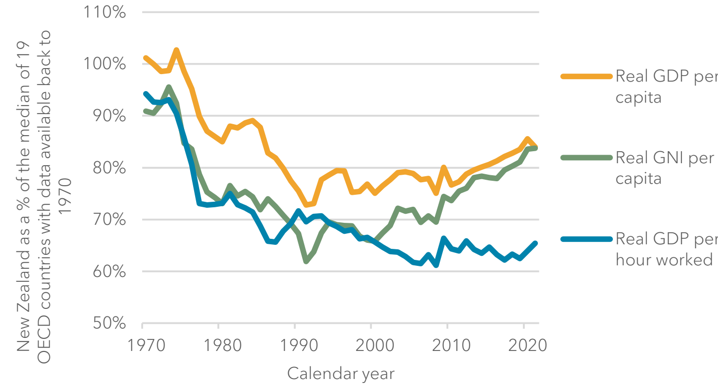
Increasing productivity will be critical to drive future gains in living standards. While income is not the sole determinant of living standards, the ability to fund public services and institutions, invest in infrastructure and preserve the natural environment all depend on the economy performing well.

Figure 5: New Zealand's income growth has outperformed the OECD median since the late 1990s



Source: Treasury analysis based on OECD data

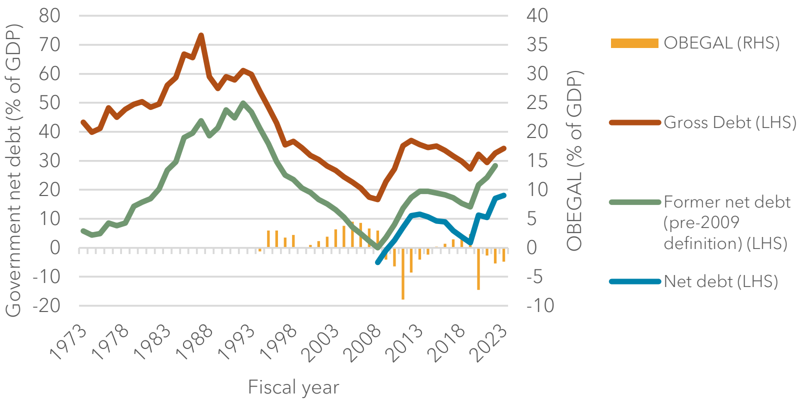
Figure 6: Economic output and income per capita lags our OECD peers



Source: The Treasury. Gross National Income, shown in the charts above, measures the total income of all residents within a territory. It captures income from domestic production (GDP), plus changes in income from movements in export and import prices (terms of trade gains) and net international income (such as net interest payments to non-residents).

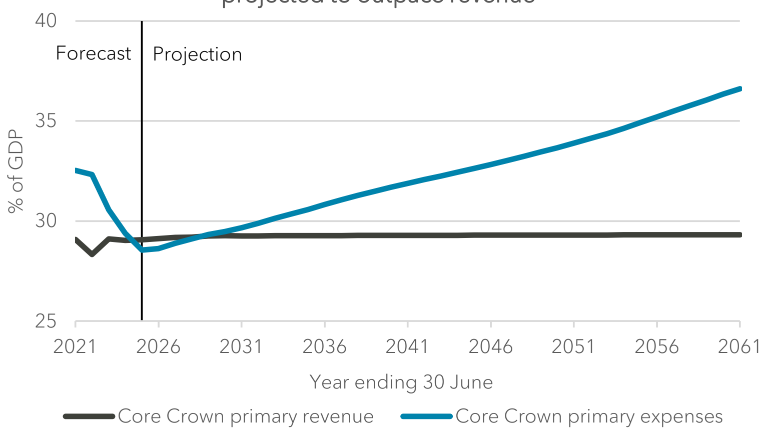
New Zealand's fiscal performance has improved since the 1980s but fiscal headwinds are already here

Figure 7: Following fiscal stress in the 1980s and 1990s governments restored fiscal buffers



Source: The Treasury

Figure 8: Following historical trends, expenses are projected to outpace revenue



Source: The Treasury

After a period of fiscal stress in the 1980s and early 1990s, governments reduced debt and built fiscal buffers

Through the 1970s and 1980s, the New Zealand government accumulated large quantities of debt, that eventually put pressure on fiscal sustainability. Since then, successive Governments undertook significant fiscal consolidation (Figure 7). Lower levels of government debt and a stronger Crown balance sheet have reduced the need to react sharply to shocks and lowered the risk premium in interest rates.

The building of fiscal buffers was supported by legislative changes to orient fiscal policy around medium-term sustainability and require transparent reporting of the Government's finances.

As a result, the Government has been in a better position to provide support to the economy through a range of economic shocks and natural disasters, while still maintaining a sound fiscal position.

In order to form a judgement on the prudent level of debt, the Treasury seeks to determine the maximum level at which debt can be stabilised, while still accommodating an allowance for shocks and investment. These assessments evolve through time in response to changing factors, such as interest rates or growth. Our current recommendation is for a ceiling of net debt of 30% of GDP. This ceiling retains headroom for shocks.

Long-term challenges and more frequent shocks are likely to put increasing pressure on public finances

Demographic, climate and geopolitical changes present challenges to New Zealand's public finances. Already, gross New Zealand Superannuation costs have increased from 4.6% of GDP in 2011/12 to 5.0% of GDP in 2022/23 and are forecast to rise to 5.4% in 2026/27. Weather-related events such as Cyclone Gabrielle are increasing in frequency. In addition, New Zealand is exposed to a very high level of risk from its natural environment. Lloyd's, the insurance marketplace, assesses New Zealand as having the second-highest risk of annual losses in the world, behind Bangladesh and ahead of Japan.

The 2021 Long Term Fiscal Statement illustrated that at historic rates and policy settings, New Zealand's core Crown expenditure will significantly outpace revenue over coming decades (Figure 8). The most significant spending pressures come from a combination of healthcare and NZ Superannuation.

Taken together, these imply a need for strong prioritisation and a focus on value for money in order to maintain medium-term fiscal sustainability.

A strong government balance sheet has buffered New Zealand through recent shocks

New Zealand has recovered strongly from the COVID-19 pandemic…

The onset of the COVID-19 pandemic generated a historic contraction in GDP, but the economy quickly recovered and then exceeded pre-pandemic activity levels. The unemployment rate fell to a historical low of 3.2% in the December 2021 quarter. New Zealand's GDP growth has outpaced that of many other advanced economies since the beginning of the pandemic (Figure 9).

The economic recovery was underpinned by the public health response to the pandemic, together with large-scale monetary and fiscal policy measures, which supported high rates of employment.

…but the Government incurred significant costs…

As a result of the size of fiscal policy measures, New Zealand's public debt increased at a faster rate than in most other countries (Figure 10). Between 2019 and 2023, the IMF estimates that New Zealand's government net debt increased by 18% of GDP, compared with a 4% increase for the average advanced economy. The fiscal impacts of the North Island Weather Events (NIWE) has added to debt in 2023 and will continue to do so over coming years.

Finance costs increased from a recent low of $1.9 billion in 2020/21 to $6.6 billion in 2022/23 reflecting both higher debt and interest rates.

Nevertheless, New Zealand's debt remains low relative to other advanced economies. The average government debt among advanced economies in 2023 was 47% of GDP, compared with 24% for New Zealand.

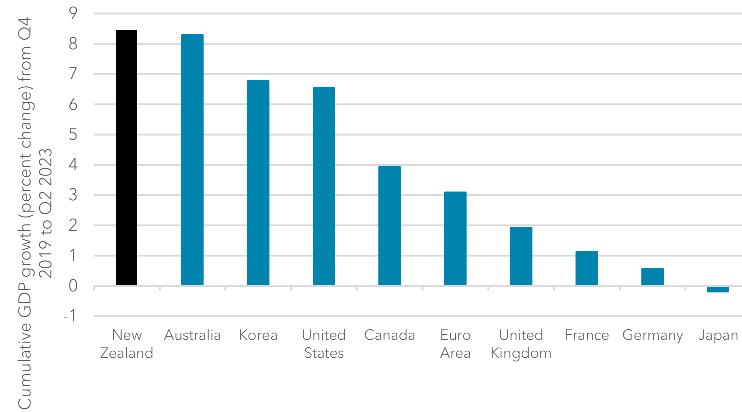
While there is uncertainty about explicit and implicit risks, particularly in the context of more frequent weather events and a more volatile global environment, the Crown balance sheet continues to have significant resilience and flexibility to respond to future events. However, retaining this buffer requires the OBEGAL deficit to be reduced.

… and economic imbalances have emerged

The combination of relatively strong growth alongside domestic and international supply constraints, has resulted in demand in the New Zealand economy exceeding its productive capacity.

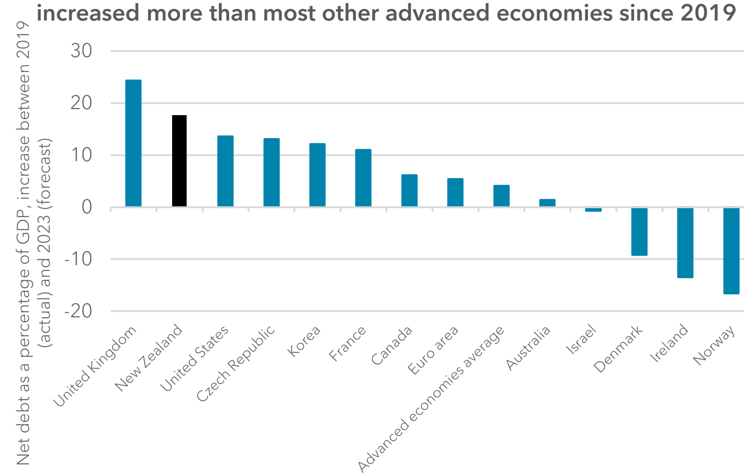
The resulting excess demand has contributed to high inflation and a large current account deficit (exacerbated by the international spill-overs from Russia's invasion of Ukraine). Some temporary factors have also contributed to the current account deficit, including the impact of COVID-related border closures on tourism and international education exports.

Figure 9: New Zealand's GDP growth exceeded many other advanced economies since the beginning of the pandemic



Source: IMF GDP data - real, seasonally adjusted.

Figure 10: New Zealand's net debt as a percentage of GDP has increased more than most other advanced economies since 2019



Source: The Treasury using IMF data. Advanced economies average is a simple average across 32 advanced economies.

Expenses have outgrown revenue in recent years

Core Crown expenditure was recently at a multi-decade high…

Core Crown expenses averaged about 30% of GDP between 1993/94 and 2018/19 but have grown sharply in the wake of the pandemic, peaking at around 35% in 2021/22 before falling back to about 32% last year (Figure 11). Between 2018/19 and 2022/23, the increase in nominal Core Crown expenses (47% growth) exceeded the increase in nominal GDP (27% growth).

While some of this expenditure was temporary (e.g., the responses to the COVID-19 pandemic and the severe NIWE in 2023), core Crown expenses as a percentage of GDP are forecast to remain above the previous long-term average throughout the forecast period (31% of GDP in 2026/27). Compared with pre-COVID levels, social security and welfare (including New Zealand Superannuation), health and finance costs are all forecast to be higher.

…outstripping the rise in revenue

Core Crown tax revenue has been rising as a percentage of GDP since 2012/13, peaking recently in 2021/22. This was due both to policy changes and income growth. Wage growth has resulted in a greater proportion of income being taxed at higher personal tax rates. The strong economic recovery from COVID-19, including high inflation, also supported higher nominal tax revenue, particularly from corporate and other persons. Looking forward, tax revenue is forecast to increase to 30% of GDP by 2026/27 on unchanged policy.

The net result of these movements in expenses and revenue and after stripping out large "one-off" expenditures and adjusting for the economic cycle, is that the government is currently running a structural OBEGAL deficit of around 2% of GDP.

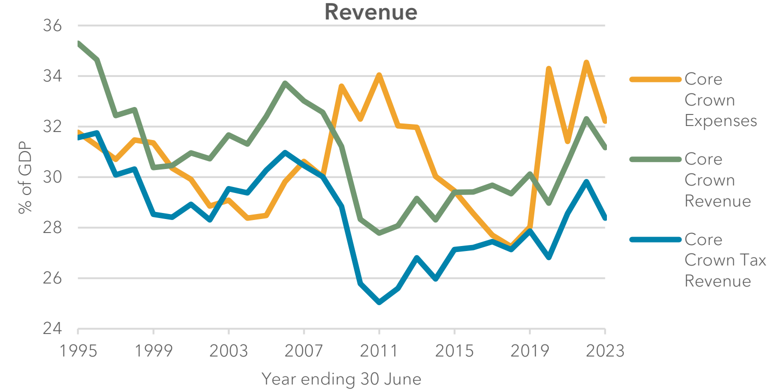
PREFU forecast assumes extended period of tight fiscal management

Real Government consumption, which excludes benefit payments (including New Zealand Superannuation), is forecast to fall from 21% of GDP in 2022/23 to 19% by 2026/27 (Figure 12). This decline is similar in size to the decrease seen in the early-mid 1990s but over a shorter timeframe.

While some of this decline will reflect the wind down of remaining COVID-19 and cyclone-related programmes, it is also a function of the lower Budget allowances assumed over the forecast period. Lower allowances will require prioritisation by the Government, such as scaling or stopping existing programmes, and driving efficiencies.

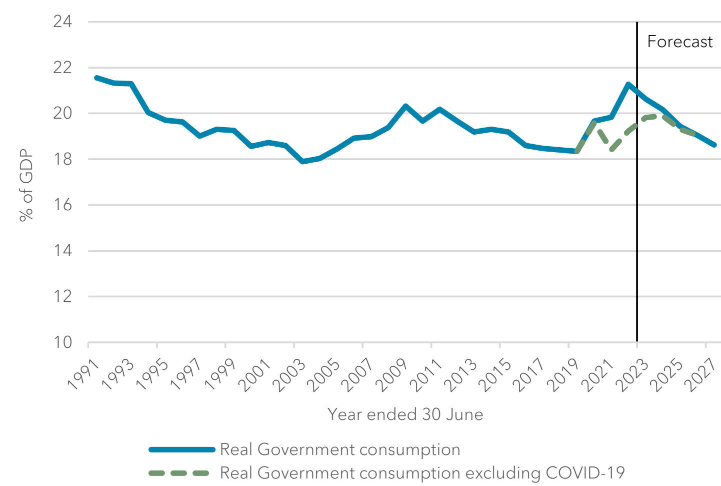
This will be occurring at the same time as demographic change will increase fiscal pressures, with population aging increasing superannuation costs and demand for health services.

Figure 11: Core Crown Expenses are larger than core Crown Revenue



Source: The Treasury; Pre-election Economic and Fiscal Update 2023 and Fiscal Time Series

Figure 12: Real government consumption is forecast to fall



Source: The Treasury; Pre-election Economic and Fiscal Update 2023

Non-departmental spending has been the main driver of rising expenses

Rising expenditure reflects strong growth in non-departmental expenses, including to address cost pressures

Core Crown expenses have risen as a percentage of GDP by around 4.4 percentage points between 2016/17 and 2022/23 (Figure 13). Growth was driven by increased spending in Social Security and Welfare, Health and other components of core Crown expenditure – such as transport and communications, housing and community development, and environmental protection.

Total Crown (core Crown plus Crown Entities and State-Owned Enterprises) expenses grew by around 83% in nominal terms or by around 5 percentage points to 41% as a share of GDP, between 2016/17 and 2022/23. This reflects a large increase in non-departmental spending, such as $5.3 billion for the Families Package in the 100-Day Plan / Budget 2018, and $11.1 billion for health system cost pressures and overhaul in Budget 2022.

A significant portion of increased operating expenses was to address cost pressures. Cost pressure spending as a percentage of Budget allowances ranged between 50% and almost 90% between Budgets 2018 and 2023 (noting this excludes a number of other new spending initiatives funded through the CRRF and CERF).

Wage and salary costs make up just under a quarter of total Crown expenses.

Figure 14 shows that the greatest increase in total Crown expenses, both as a percentage increase compared to 2016/17 expenditure and total, is in non-departmental spending. Non-departmental spending covers a range of core public services, such as health and education services and infrastructure investment.

A more detailed analysis of personnel costs and FTE numbers indicate that, though there has been growth in costs and total FTEs, as a proportion of total Crown expenses these costs remain steady. Core Crown and Crown Entity personnel costs increased by 56% between 2016/17 and 2022/23, from $23.5 billion in 2016/17 to an estimated $36.8 billion in 2022/23. Employment in the core public service (excluding non-departmental agencies) grew from approximately 47,000 FTEs in 2016/17 to just over 63,000 in 2022/23.

As a percentage of total Crown expenses, this spend remains relatively steady, making up 23.8% of total Crown expenses in 2016/17 and estimated to make up 22.7% in 2022/23. Compared to total Crown expense growth in figure 14, increases in wage and salary costs are a contributing but not a disproportionate cause of the increase in total Crown expenses over the past few years.

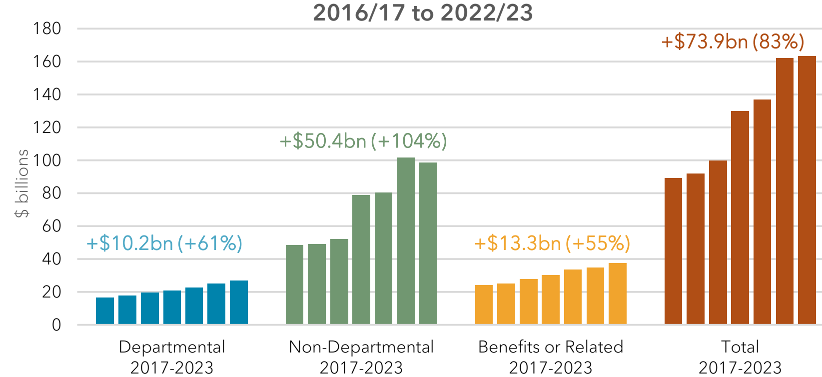
Figure 13: Welfare, health and a range of other areas have driven the increase in expenses

	2022/23 actual (% of GDP)	Change since 2016/17 (ppt of GDP)
Core Crown expenses	**32.2%**	**4.4**
Of which:		
Social security and welfare	10.5%	1.3
New Zealand Superannuation	4.9%	0.2
Other	5.6%	1.1
Health	7.2%	1.3
Education	4.6%	-0.2
Core government services	1.7%	0.3
Finance costs	1.7%	0.4
Law and order	1.6%	0.1
Other core Crown	5.0%	1.3

Note: numbers may not add to total due to rounding

Source: The Treasury

Figure 14: Total Crown expenses, annual, by type 2016/17 to 2022/23



Source: The Treasury

The economy faces global and domestic headwinds

The global environment create risks and uncertainties…

Global growth has slowed as high inflation has weighed on activity and central banks have tightened monetary policy. Growth, although varied across countries, is expected to be lower in 2023 and 2024 than it was last year as the global economy rebounded from the pandemic (Figure 15a). The US has been one of the better performers with positive revisions to growth forecasts this year, while China has experienced downgrades.

Compared with six months ago, global interest rates have moved higher, and current market-implied expectations of policy interest rates show a "higher for longer" picture. This reflects expectations that inflation, while easing, is mostly expected to be above target until 2025.

Economic fragmentation and heightened geopolitical tensions (such as the Russian invasion of Ukraine) add to uncertainties about the future and reinforce weak medium-term growth prospects. Since 2018, globally, the number of trade and Foreign Direct Investment (FDI) restrictions has increased three-fold, and FDI flows are increasingly concentrated among geopolitically aligned countries particularly in strategic sectors.

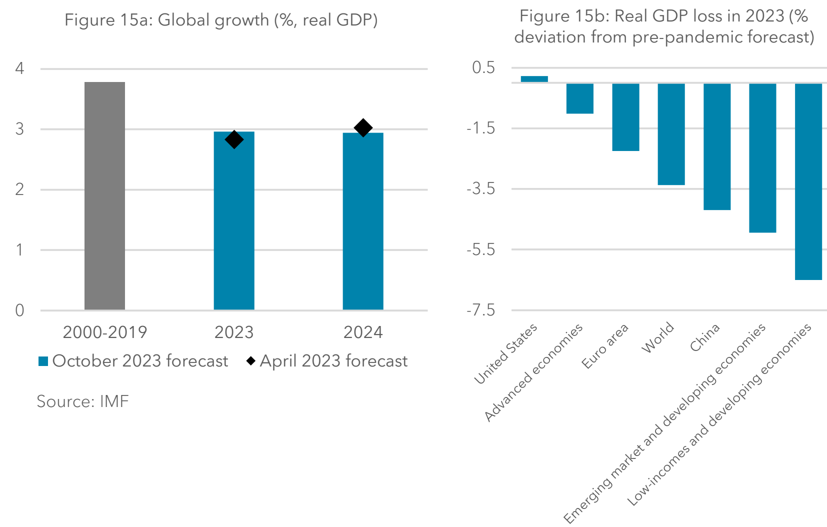
…which could amplify domestic drivers of slow growth

These external headwinds are weighing on New Zealand's export prices and the terms of trade. At the same time, the domestic economy has been weighed down by the effects of high inflation (which erodes real spending power), higher interest rates and reduced household wealth from lower house prices. A sharp turnaround in migration and a rebound in inbound tourism are providing some offset.

Slower growth for a period of time will help reduce inflation and ensure macroeconomic stability. But it will also likely see unemployment rise further over the year ahead and weigh on Crown revenues. The current account deficit is also expected to narrow as trade flows rebalance alongside slower domestic activity and services exports return toward pre-pandemic levels.

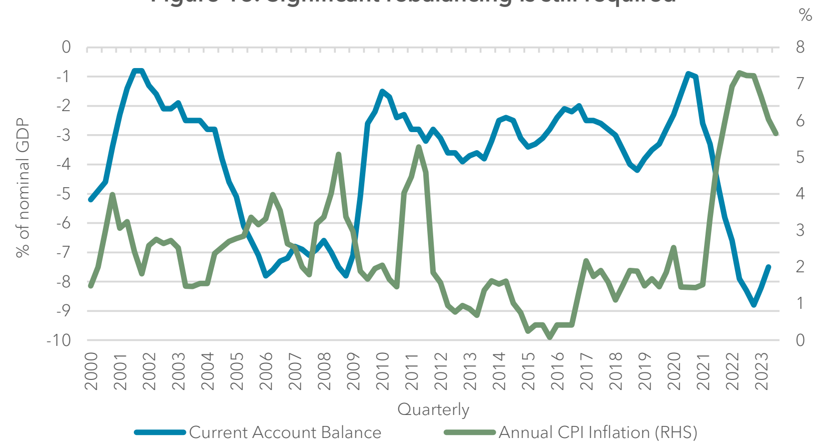
The pace of this rebalancing will be a key to short-term economic performance. Further monetary policy tightening could be required if inflation is more persistent than expected.

Figure 15: Global recovery from the pandemic is slow and uneven



Source: IMF

Figure 16: Significant rebalancing is still required



Source: Stats NZ

Deeper international connections could boost our productivity performance

New Zealand's productivity performance is lacklustre

Since the 1970s, New Zealand has had a low level of labour productivity and low rate of labour productivity growth relative to other OECD countries (Figure 17).

Furthermore, New Zealand's rate of productivity growth has gradually slowed over time, as it has globally. New Zealand achieved average labour productivity growth of 1.4% per year between 1993 to 2013, but only 0.3% annual productivity growth in the 10 years from 2013 to 2023.

The causes of New Zealand's lagging labour productivity include economic geography (New Zealand's small size and remoteness), low capital intensity, and our slow adoption of productivity-enhancing innovation from the global frontier.

Raising New Zealand's productivity performance will require a wide range of actions, including enhancing human capability, strengthening international connections, improving infrastructure settings and maintaining up-to-date and well-performing regulatory systems to give firms more confidence to invest and innovate.

International connections are weak

As a uniquely small and remote advanced economy, openness and global connectedness allows New Zealand to overcome our geographical distance from international markets, specialise in areas of comparative advantage and better achieve economies of scale. International connections also facilitate access to capital, competitively priced goods and services, skilled labour, networks and technology.

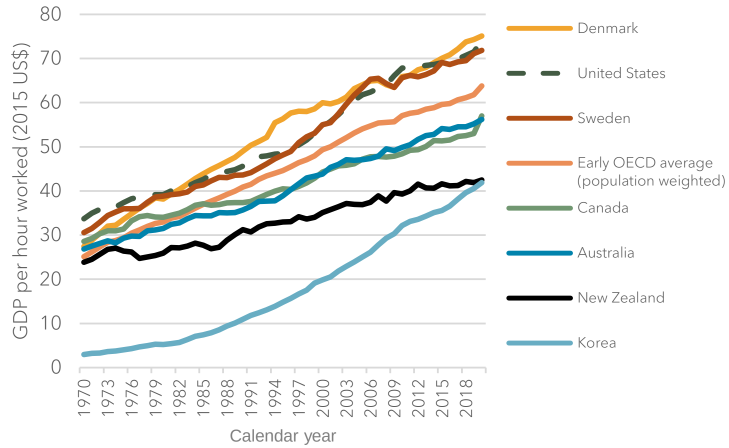
Exporting firms are typically more productive, and successful exporters tend to support an ecosystem of smaller businesses supplying complementary products or inputs. Imports deliver value to New Zealand consumers and producers and increase competition in our otherwise small market.

New Zealand's policy settings are generally open, but this has not translated to strong international connectivity. In 2021, New Zealand's trade as a percentage of GDP was 48%, lower than many other small open economies, and below the OECD average of 56% (Figure 18). The stock of foreign direct investment (both inward and outward) is also low, and there has been limited integration into global supply chains.

Reflecting New Zealand's persistent current account deficit, New Zealand is highly dependent on foreign flows of capital so ensuring the policy settings are right in this area is critical. FDI tends to more stable and less prone to sharp market driven movements.

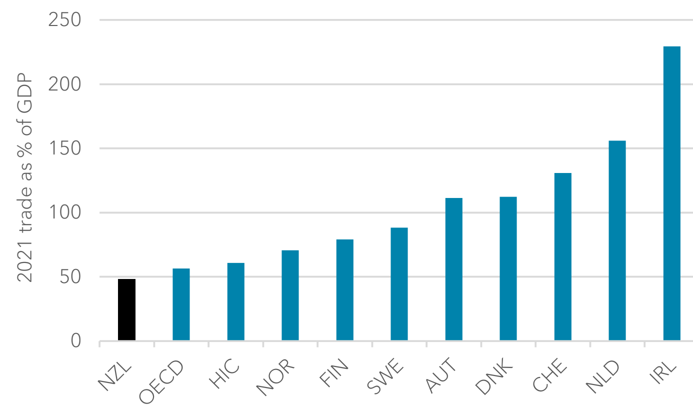
Growth and diversification of trade across goods and services and markets can also present new economic opportunities, while also contributing to enhancing our economic security.

Figure 17: New Zealand's productivity has lagged other developed countries



Source: New Zealand Productivity Commission based on OECD data.
Early OECD countries are defined as those who joined the OECD prior to 1975.

Figure 18: New Zealand's trade is low for a small open economy



Source: World Bank. HIC are High-income economies whose 2022 GNI per capita was more than USD $13,845

It is critical to increase student achievement and boost the supply of affordable housing

Student achievement has declined

While the New Zealand compulsory school system is still strong by international standards, growing numbers of children are reaching age 15 without basic levels of literacy and numeracy. Further, the performance of New Zealand students in international assessments of maths, science and reading has declined over the past two decades (Figure 19).

Improving student achievement is important to raising skills, improving labour market outcomes and lifting living standards. This is especially important as New Zealand's jobs are continuing to shift into the service sector, where high-paying jobs require high skill levels. Improving the performance of the education system is also a key element in building a skilled and adaptable workforce that can drive technological diffusion and innovation.

Improvements in education can also provide long-term wellbeing benefits for young people, including through persistent effects on physical and mental health.

While a range of explanations for educational attainment decline have been put forward, including drivers both within and outside the education system, teachers and schools are central.

Housing affordability is poor

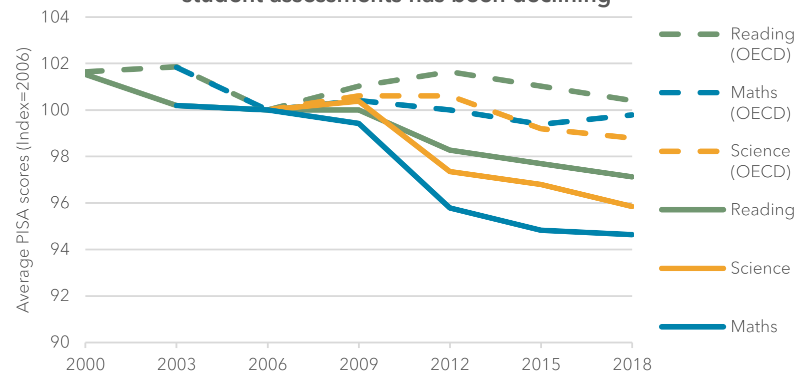
Over the past decade consents of new dwellings have increased, but housing affordability remains very poor in New Zealand. Compared with OECD countries, New Zealand has had the highest increase in real house prices since 2000 and rental affordability remains a challenge, with 1 in 4 households that are renting spending more than 40% of their disposable income on housing costs.

High prices can amplify the impact of housing cycles on the macroeconomy, increasing levels of household indebtedness and impacting macroeconomic stability.

Low interest rates combined with restrictions on urban expansion and intensification are key drivers of house price growth. The favourable tax treatment of capital gains from housing can also contribute. Low rental affordability contributes to high demand for government housing supports, with over $5 billion spent on support and other initiatives per year. Unaffordable and unhealthy homes also have wider social impacts, including on health and education outcomes.

Barriers to urban growth reduce productivity by limiting the agglomeration benefits of people and firms being close and by preventing workers from moving to more productive areas.

Figure 19: New Zealand's performance in international student assessments has been declining



Source: OECD PISA Database

The Māori economy is growing rapidly

The Māori economy – made up of individuals, small and medium enterprises, iwi businesses, trusts and post-settlement entities among others – has seen growth faster than the rest of the economy and represented 6.8% of national GDP in 2018.

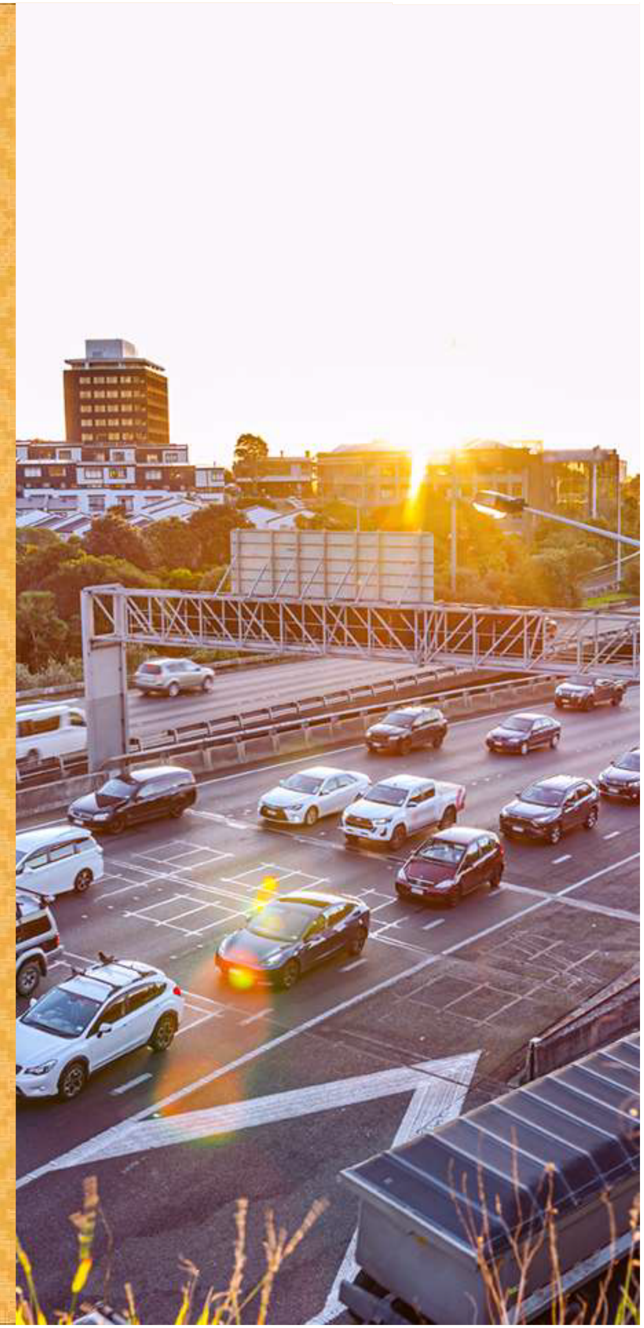
Exporting plays a significant role in the Māori economy. This has seen it benefit in recent years from high global commodity prices, but also make it vulnerable to trade disruptions, as seen by the impact of the COVID-19 pandemic on Māori tourism businesses. Concentration in land-based primary industries also make the Māori economy vulnerable to the effects of climate change.

Māori are gaining qualifications at a faster rate than the total population, and there is a growing proportion of Māori in higher-skilled employment, but educational achievement metrics still fall short of those for the general population. Māori also have lower-than-average rates of home ownership which, along with differences in lenders' treatment of Māori jointly-owned land, have made it more difficult for Māori businesses to access capital for business development.

Building on recent gains has the potential to increase sustainable and productive economic growth, including better intergenerational outcomes for Māori.

SECTION 3

Key policy issue #1: delivering fiscal sustainability



Credible fiscal commitments are key to responsible fiscal policy

New Zealand's fiscal framework is underpinned by the PFA which provides the core legislative framework within which the Government can borrow or spend public money. The PFA also sets out the principles of responsible fiscal management which promote sound fiscal policy and fiscal transparency.

The Treasury recommends a return to surplus in 2026/27

New Zealand has a strong track record over successive governments of responding effectively to deteriorations in the fiscal position and maintaining sound public finances. This record and New Zealand's strong fiscal frameworks support market and rating agency confidence in New Zealand's long-term fiscal sustainability, thereby supporting growth. The erosion of these frameworks, (e.g., through repeated delays in returning to operating surplus) could undermine this confidence and impose costs on the economy.

In the absence of any unexpected events or significant negative economic shocks, there is an "on balance" case for the Government committing to a return to surplus in 2026/27 at the latest. This would see government debt remain at prudent levels into the future and maintain the strength of the Crown balance sheet. Tighter fiscal policy would also lean against demand imbalances such as New Zealand's elevated current account deficit and high inflation, supporting macroeconomic stability.

Fiscal rules are an effective way to signal commitment to sound fiscal policy

Fiscal rules are set by the Government of the day. In line with the principles of responsible fiscal management, the Government should adopt fiscal rules that:

- Commit to maintain sustained operating surpluses over time to support counter-cyclical fiscal policy and build buffers to respond to shocks; and
- Maintain levels of prudent debt over time.

Adopting and adhering to fiscal rules of this nature means that the Government can use fiscal policy flexibly to achieve its objectives while supporting medium-term fiscal sustainability and supporting intergenerational fairness. Fiscal rules should also enable the Government to use the Crown balance sheet to contribute to broader economic performance and stability through enabling productivity enhancing investments and smoothing the economic impacts of shocks.

We consider that the broad design and calibration of the existing fiscal rules from 2022 remain appropriate, but that there is scope to review or refine these rules depending on your fiscal strategy (e.g., we can provide advice on the underlying indicators used to anchor the rules, and options to strengthen the rules to better support fiscal sustainability).

The fiscal strategy

New Zealand's fiscal frameworks require governments to set a fiscal strategy that adheres to principles of responsible fiscal management.

The following rules were introduced in 2022:

The operating balance before gains and losses (OBEGAL) should average between 0-2% across the long-run

Net debt should remain below a 30% of GDP ceiling

These rules were aimed at ensuring that over time operating expenses do not add to net debt as a share of GDP, providing fiscal space for high-quality capital investment and ensuring a sufficient fiscal buffer for any future shocks.

The three dimensions of fiscal policy

Revenue growth is unlikely to keep pace with expense pressures

Tax revenue growth has helped meet growing fiscal pressures (Figure 21). This growth has been driven by policy changes, fiscal drag[1], and cyclical factors (especially in recent years). Fiscal drag has increased tax revenue by around 1.1% of GDP since 2011, however, it has also eroded the progressivity of the personal income tax system. New Zealand's tax-to GDP ratio was approximately 30.1% in 2018, slightly below the OECD average (33.9%).

Personal tax is a major part of New Zealand's revenue system (Figure 20) and New Zealand relies more heavily on personal tax compared to most OECD countries[2].

However, there are constraints on our personal tax system which are creating increasing pressures and constraining our options for reform. These constraints arise due to the difference between our personal and company tax rates, and the lack of taxes on capital and capital gains. These limit options to raise revenue, alter the mix of taxes, or make changes that would meet distributional and economic objectives.

Non-alignment

The **difference in rates** between personal and company tax limits the ability to efficiently raise revenue on individuals or reduce the company tax rate, as income can be **sheltered in companies or Portfolio Investment Entities.**

Capital gains taxation

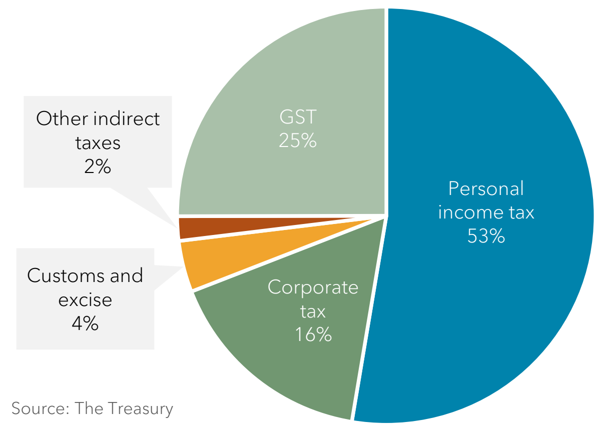
The lack of a comprehensive capital gains tax **restricts the ability to manage gaps** between company rates and personal rates and increases costs of income taxation. It has also contributed to higher house prices.

Based on principles such as sustainability, efficiency and fairness, our first best advice is to address these two structural issues. Major tax changes take time to implement so there is a need to plan for these early.

There are, however, other policy options which could be progressed that raise revenue. However, there are few 'low-hanging fruit' left and many of the options implementable in the short term involve trading off distributional and economic performance objectives.

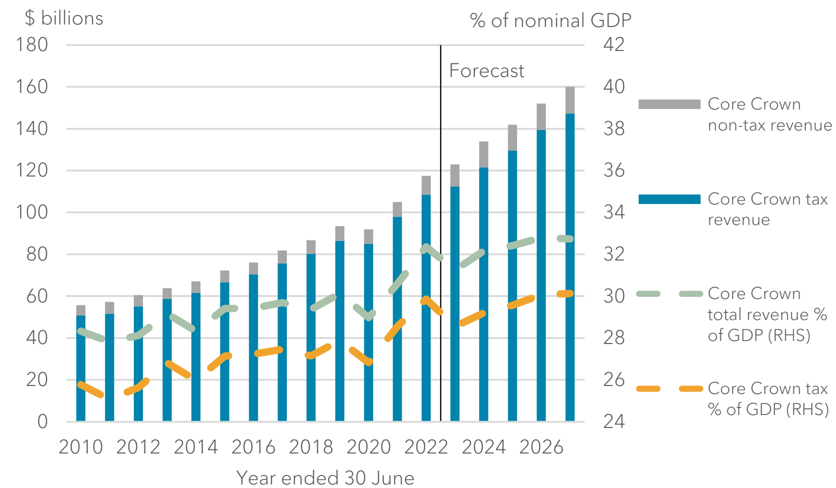
Figure 20: New Zealand relies relatively heavily on personal tax to raise revenue

% of core Crown revenue for year ended 30 June 2023



Source: The Treasury

Figure 21: Revenue has steadily grown over time



Source: The Treasury; Pre-election Economic and Fiscal Update 2023

1. When a greater proportion of income is being taxed at higher personal tax rates, year on year.
2. A major reason we rely more on personal tax is because many other OECD countries have significant social security taxes. As New Zealand does not have social security, we rely more on income tax and GST.

Returning to surplus will require strong prioritisation

Current budget allowances are expected to be sufficient to fund critical cost pressures only, with limited room for new spending in the absence of reprioritisation and savings

The current level of operating allowances should be broadly sufficient to meet critical cost pressures that are not already funded (Figure 22). Prioritisation will be required to fund new initiatives above this, manage pressures within agencies and generate savings to fund new priorities across Government.

Recently, final budget allocations have exceeded the previously signalled allowances and discretionary spending outside of allowances has increased.

Budget allowances play an important role in signalling how much the government plans to spend and staying on track to achieve its fiscal goals. Until recently around 70% of growth in expenditure was through allowances, but since 2019/20 that has been closer to 50% (Figure 23).

This reflects a mix of factors, including the increased cost of indexed benefits which are demand driven, increased finance costs, and funds managed outside the Budget allowances (e.g., the COVID Response and Recovery Fund).

There are also longer-term pressures on the fiscal position

Cumulatively, the fiscal position is likely to face more headwinds in the decade ahead than experienced over the past few. This includes a less benign global backdrop, and the changing nature of shocks.

Moreover, some of the challenges that could impact on public finances highlighted in successive Long Term Fiscal Statements and the Climate Economic and Fiscal Assessment are here now. The impacts are potentially large.

Demographic change and climate change are increasing demand on government expenditures and this will grow over time. Geopolitical tensions and economic fragmentation could increase spending pressures in areas like defence and security. Higher debt and interest rates would see finance costs trend up.

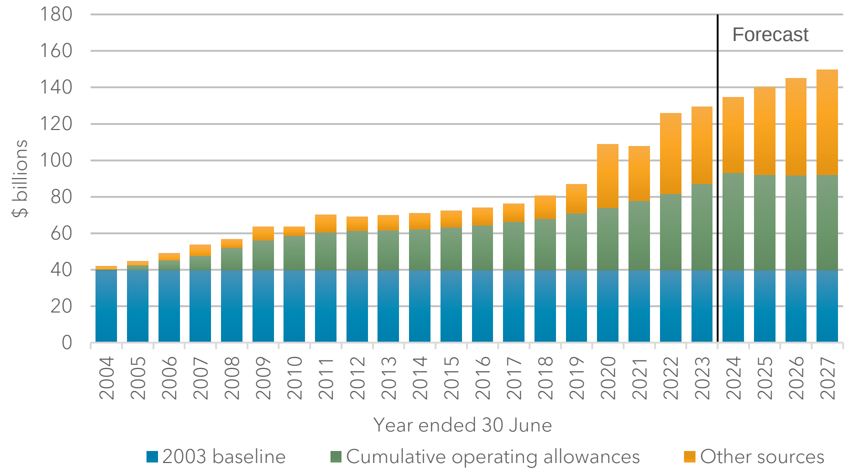
Given these pressures, a programme of work to identify enduring savings options and future policy settings would help support longer-term fiscal sustainability. Increased monitoring is desirable to better understand explicit and implicit risks to the Crown balance sheet.

Figure 22: Current pre-commitments limit room for new initiatives

Year ending 30 June $millions, average per annum	Budget 2024	Budget 2025	Budget 2026
Budget operating allowance – *Pre-election Update*	**3,500**	**3,250**	**3,000**
Less pre-commitments:			
- Multi-year decisions for clusters	(419)	-	-
- Health sector cost pressures	(1,430)	(1,370)	(1,370)
- Transport	(310)	-	-
- Education sector collective bargaining	(102)	-	-
- Digital Services Tax	80	-	-
- Other	(42)	-	-
Remaining Budget operating allowances	**1,277**	**1,880**	**1,630**

Source: The Treasury; Pre-election Economic and Fiscal Update 2023

Figure 23: New expenditure outside of allowances has increased



Source: The Treasury

At a high-level, there are several options to support a return to surplus while delivering your priorities

Ensuring a surplus in 2026/27 while delivering the 100-day plan and wider policy priorities will require departing from existing policy settings

Potential options to achieve this include:

- **Decreasing expenditure** including through centrally directed savings exercises (e.g., identifying specific policies and programmes to stop or scale back, or imposing top-down baseline reductions).
- **Constraining new spending** through carefully sequencing Government commitments across multiple Budgets and applying the Fiscal Management Approach (e.g., reducing allowances to encourage trade-offs, requiring agencies to reprioritise within existing baselines and minimising commitments made to fund initiatives between Budgets).
- **Increasing revenue** through structural reform of the tax system, policy changes to increase revenue, or letting fiscal drag continue to increase revenue raised through personal income tax.
- **More active management of the balance sheet** through greater consideration of capital allocation (including allowing capital to flow to higher priority uses), identifying opportunities to improve performance of assets and liabilities, and better measurement and treatment of risk.

It is likely that using all these levers will be necessary. The trade-offs across them are complex. Decreasing expenditure and constraining new spending risk decline in service quality and/or negative impacts on living standards. Increasing revenue likewise has trade-offs for living standards, including potentially negative impacts on economic performance. All choices involve judgments around fairness and equity. Ultimately, there is a need for robust assessment and disciplined decision-making to drive efficiency, productivity and value-for-money.

Taking a long-term view of potential changes will be important

This can be done by:

- Considering the long-term benefits of particular expenditure items to avoid reductions that may lead to service or regulatory failure or would quickly be reversed.
- Maintaining investment targeted at boosting growth and productivity that will help address longer-term fiscal challenges.
- Using distributional analysis to understand the impacts of any changes on particular groups.

The effectiveness of choices to support a return to surplus is reliant on taking action to mitigate fiscal risks. Some of the most significant fiscal risks that can be managed by Ministers include managing demand for public services, the size of the Government's capital investment programme, public sector pay pressures, and funding pressures generated by policy reviews. Options to manage these risks largely involve challenging policy choices to prevent costs in the short and long term.

A programme of work on fiscal sustainability would allow you to balance short- and medium-term imperatives

You will need to balance acting early to signal strong fiscal discipline, with the need to sequence change across the term

The Treasury recommends a programme of work that:

- Creates fiscal space sufficient to fund your policy priorities and the return to surplus.
- Orients government to prioritise fiscal discipline and continuously improve value for money.

In the short term the Government's focus should be on actions that:

- Free up space to fund 100-day priorities and get the return to surplus on track in a way that is easy to implement, while mitigating the risk that decisions create cost pressures later in the forecast period.
- Send a strong signal that the fiscal programme is a priority for your Government and communicate your expectations that Ministers, and the public sector operate in accordance with your fiscal objectives across the parliamentary term.
- Establish the right governance for the programme, to ensure the decisions you take flow through to implementation and agencies remain focused on results.

In the medium term the Government's focus can shift to actions that:

- Embed a culture of continuously improving value for money through scrutiny of baseline expenditure and holding decision-makers accountable for performance.
- Mitigate fiscal risks that may otherwise defer the return to surplus.
- Progress any priorities that were not possible in the short-term, or where the need for further work is identified as part of short-term work.

These short- and medium-term imperatives can be balanced by progressing the programme in phases. The Treasury can provide more advice on a potential programme at your first convenience.

Phases of a fiscal programme

Phase 1

HYEFU 2023
Budget 2024

Actions to consider for this phase include:

- Implementing a package of key priorities that cannot wait for Budget 2024 through a mini-Budget.
- Setting a strategy for Budget 2024 that operates within allowances consistent with your fiscal strategy.
- Creating fiscal space with targeted policy savings and a reduction in agency baselines implemented through an initial baseline exercise.
- Establishing an appropriate Cabinet committee mechanism and supporting disciplines to steer the fiscal programme.
- Publicly committing to the fiscal programme and its objectives through publications such as the Budget Policy Statement and Fiscal Strategy Report.

Phase 2

Over 2024/25
Budget 2025

Actions to consider for this phase include:

- Requiring all agencies to produce savings and performance plans, setting expectations for how they will deliver priorities and manage within baselines.
- Initiating rolling savings and performance reviews across the public sector, to drive value for money.
- Initiating Treasury-led reviews into areas of fiscal risk.
- Further improvements to institutional settings, with a particular focus on the quality of advice that informs Cabinet decision-making.

Phase 3

Ongoing

Ensuring that change from earlier phases is sufficiently embedded that the public finance system will continue to drive value for money and create fiscal headroom.

SECTION 4

Key policy issue #2: building growth and resilience

A strong and resilient economy will enable New Zealanders to thrive

A growing and resilient economy is critical to addressing domestic challenges and responding to the changing global environment. The private sector ultimately drives growth and resilience through decisions to employ, save, invest and innovate, and taking advantage of opportunities as they arise.

Ensuring fiscal sustainability and improving government performance will support macroeconomic stability, generate the resources to invest in what matters, and lift public sector productivity, directly contributing to achieving a growing and resilient economy.

An economic plan that aligns with the government's objectives for responding to emerging opportunities and challenges such as climate change and global economic fragmentation, has buy in across relevant Ministers, portfolios and the private sector, as well as clear accountabilities and strong governance arrangements for delivery, will be important for driving improvements in New Zealand's economic performance.

Building on existing strengths will be key to future living standards

New Zealand has a number of characteristics that underpins activity in our economy and society. These include:

- strong rule of law and low corruption
- effective government processes relative to many other countries
- high levels of social cohesion
- low public debt by international standards
- flexible labour and product markets that reallocate efficiently
- relatively low barriers to trade and ease of doing business

These have helped us navigate recent shocks and maintain our prosperity.

Maintaining and building on these characteristics will be important for future economic growth and resilience.

We have identified four medium-term priorities to build growth and resilience

Using the analytical prompts of the Living Standards Framework (Productivity, Resilience, Distribution, and Sustainability), we have identified four key areas the Government could focus on over the medium-term to further improve the conditions for the private sector to drive growth and improve the resilience of the New Zealand economy.

Overview of levers for building growth and resilience

Strengthening the business environment	Strengthen the business environment through regulatory settings that enables clear market signals, innovation and investment; housing and infrastructure settings that support growing and more productive cities; and reviewing government settings on industry and Research, Science and Innovation.
Enhancing human capability	Enhance human capability by reversing declining achievement trends in the education system and ensure migration policy helps import the right mix of skills, and factors in infrastructure and housing needs.
Strengthening global connectivity	Strengthen global connectivity and enhance our economic security by continuing to address non-tariff issues, taking a more deliberate approach to attracting foreign investment, and considering new forms of international cooperation to increase our resilience.
Adapting to climate change and enabling transition	Ensure the cost-effectiveness of actions to address climate change through clear incentives and signals from the government so households, businesses, iwi and local authorities are well-placed to manage risk and have the incentive and ability to do so. Take a portfolio approach to climate change, with market mechanisms (such as emissions pricing) at the core.

Strengthening the business environment

The business environment is central to growing productivity…

For New Zealand to grow, clear market signals, well-regulated business activity, and access to open, competitive markets are key prerequisites.

Businesses with higher productivity can pay higher wages and salaries (the key determinants of household incomes, consumption and wealth).

Flexible settings enable businesses to innovate and adapt to change, building their resilience and the resilience of the labour market and incomes. But growth can come at the cost of environmental impacts if these costs are not paid by the firms generating these impacts (e.g. natural resource degradation and emissions).

… and it is important to get the basics right

At the economy-wide level this means maintaining macroeconomic stability and operating a predictable policy environment that allows firms to take long-term decisions. Returning inflation to target and delivering stability in government spending and revenue are two key components of this.

For firms, the basics include policy settings in areas such as tax and competition that support welfare-enhancing economic decisions, alongside ensuring price signals are in place. Strong international connections can help to overcome the constraints of being a small and remote country.

Investment and innovation are essential for productivity growth and improving living standards

New Zealand's capital stock per hour worked has been persistently low compared with OECD comparators (Figure 24), contributing to our low productivity growth. Access to capital is essential to enable business investment, and there is evidence that this has been a constraint, particularly for Māori businesses.

Government can also support business investment and innovation. Despite increasing public spending on innovation and industry support, New Zealand's public and private spending on R&D varies considerably by industry and remains middling compared with other OECD countries.

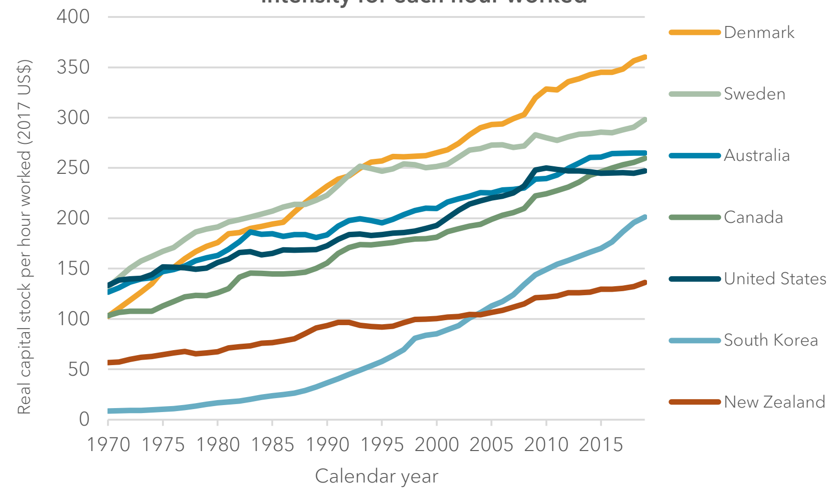
Regulatory systems should also incorporate market mechanisms that support investment and economic transition, including in areas such as competition, renewable energy, and the adoption of emerging technologies. There is also scope to ensure that any public spending is targeted towards priority areas and complements private sector activity.

Unaffordable housing and a significant infrastructure gap are contributing to our low productivity

New Zealand's provision of housing and infrastructure has not kept pace with the needs of our growing population. This has resulted in unaffordable housing and a significant infrastructure gap – where the infrastructure available to us does not meet our economic and social needs.

Creating a responsive urban development and infrastructure system will require significant change. This will include successful implementation of changes to the resource management system to ensure that the system delivers environmental outcomes, whilst enabling development across essential areas such as energy generation and transmission, transport networks and urban expansion and intensification.

Figure 24: New Zealand has had persistently low capital intensity for each hour worked



Source: New Zealand Productivity Commission

Enhancing human capability

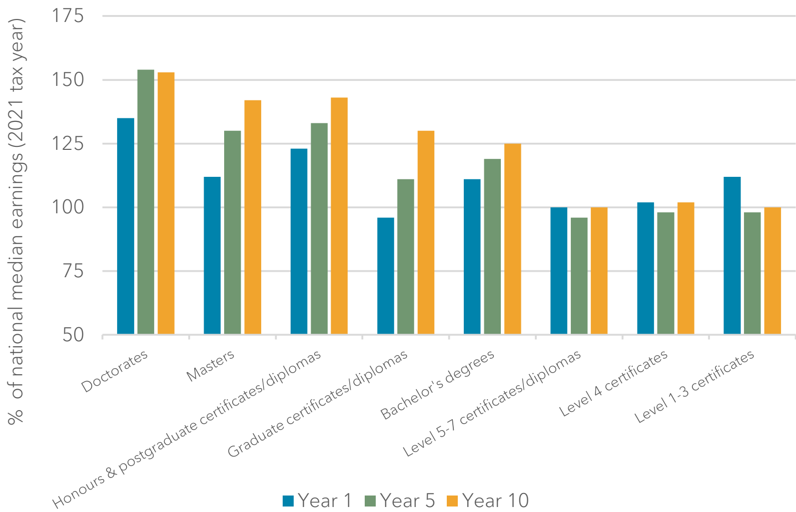
Human capability is central to economic performance

High levels of human capability (including knowledge and skills) are linked to better economic outcomes and better non-material outcomes such as health, cultural identity, social cohesion and trust, safety, and engagement in society.

Human capability will become increasingly important as technological change provides opportunities for New Zealanders to move into higher-skilled jobs in the service sector. New Zealand's economic performance will depend on the extent to which it can grow, attract and match skills in the economy.

As higher skilled people add to the future tax revenue base, investing in human capability tends to have net positive fiscal impacts. In 2021, New Zealanders who had completed a Bachelor's degree earned 19% more than the national median earnings five years after graduation in 2021 (Figure 25).

Figure 25: New Zealanders with a Bachelor's degree earned 19% more than the median five years after graduating



Source: Ministry of Education

School performance – particularly in literacy, mathematics, and science – is critical to human capability

While New Zealand's compulsory schooling system is strong by international standards, student achievement has been declining.

To support necessary improvements to educational outcomes, additional focus should be placed on proven programmes to improve literacy, maths, and science outcomes, alongside supports to improve attendance. Ensuring these improvements are realised will require close monitoring of key strategies, in particular curriculum reforms.

The effectiveness of our teaching profession is a key lever for improving school performance. Work to maximise the profession's impact should focus in the first instance on ensuring that the structures to support a strong teaching workforce, including our systems for Initial Teacher Education and Professional Learning and Development, are operating as effectively as possible.

Well-planned migration will help provide the skills needed to grow the economy

Migration will continue to play a role in filling short-term skills gaps in New Zealand's labour market, and providing the capability needed to support longer-term investment and growth.

It is vital that migration settings prioritise the right mix of skills, while stability in these settings will assist with New Zealand being an attractive destination for skilled migrants.

Migration will contribute to New Zealand if migration policy is firmly aligned with the Government's medium term economic performance objectives, including in areas such as infrastructure and housing. A Government Policy Statement could be developed to set out the Government's strategic intentions on relevant issues.

Maintaining a well-functioning labour market will be important for high-quality job creation

A well-functioning labour market incentivises strong worker participation and matching of skills with businesses' needs. It also balances worker protections with flexibility for employers. Recent minimum wages increases have been absorbed through a period of high employment and wage growth. New Zealand has among the highest ratio of minimum-to-median wages in the OECD. Further increases around or above wage growth are more likely to increase unemployment, especially for youth and other disadvantaged workers.

Strengthening global connectivity

Strong international connections are important to overcome the constraints of New Zealand's small size and remoteness

Low export intensity, low foreign direct investment and persistent current account deficit are longstanding features of the New Zealand economy. Over recent decades these have played out in a benign global environment of strongly growing trade and investment flows. This is no longer the case and heightened global tensions and geopolitical change are making the relationship between trade and investment policies and foreign and defence policies more complex.

Continuing to grow and diversify exports and investment, while navigating these complexities, will build resilience and create new economic opportunities.

Completing the coverage of New Zealand's free trade agreements will be challenging

Over the last two decades, New Zealand has improved market access for our exporters and our ability to import goods and services by securing a series of free trade agreements (FTAs). Once the EU FTA comes into force, FTAs will cover 73% of New Zealand's exports of goods and services. At this point, achieving additional FTAs that provide increased market access will be very difficult due to entrenched protectionism and differences in potential net gains, or be of only marginal benefit because the markets are smaller and/or less developed. The United States and India are the two major gaps amongst New Zealand's FTAs.

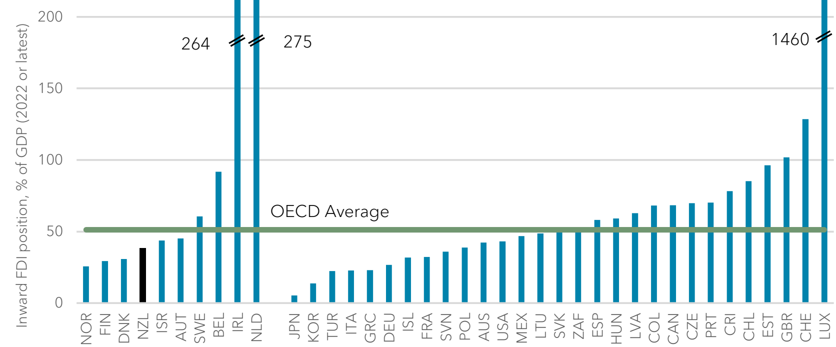
There are significant barriers to realising greater value from exports even where we have free trade agreements. New Zealand exports face more Non-Tariff Measures (NTMs) than the global average, which inhibit growth and profitability. Options to better address NTMs include strengthening coordination between government agencies, further international regulatory co-operation, and stronger implementation of the relevant provisions of existing trade agreements. In addition, the institutional footprint and priorities of NZ Inc agencies should also be aligned with supporting exporters to build commercially beneficial relationships in new and high value markets.

New Zealand needs to attract high quality foreign investment

New Zealand's inward foreign direct investment (FDI) stock is low compared to other small open economies (Figure 26), and FDI has not contributed much to the creation of new, innovative exports. It will be important to continue improving New Zealand's investment brand and fostering a welcoming environment for high quality foreign investors.

There are opportunities to further liberalise the Overseas Investment Act. Streamlining consent pathways and lifting the screening thresholds will improve our attractiveness to high quality foreign investment. The monetary threshold for screening business assets has not been raised since it was introduced in 2005, except for some subsequent FTA partners. On the other hand, investment screening for certain sectors is becoming an increasingly important tool for economic security purposes.

Figure 26: Our inward FDI stock is lower than other small open economies



Source: OECD. KOR data is for 2021. Small advanced economies are defined as the OECD countries with populations of 1-20 million people and with per capita incomes above USD $30,000.

Geopolitical change presents particular risk for New Zealand

As a small, open trading economy that has benefited substantially from the international rules-based order, New Zealand is particularly exposed to the impact of geopolitical shocks and any global fragmentation of the international trading system.

An ongoing focus in building strong relationships with counterparts, multilateral institutions, and groupings like the Five Finance Ministers should be on how these arrangements enhance New Zealand's resilience against economic shocks, including by strengthening the multilateral system.

It is critical for New Zealand to strike the right balance between openness and security, so that New Zealand can reap the benefits of strong international connections while protecting its core national interests.

Adapting to climate change and enabling the low emissions transition

New Zealand is already experiencing the effects of climate change

Climate change poses one of the greatest risks to New Zealand's future living standards.

Higher temperatures, more frequent droughts and extreme storms, and rising sea levels are already being experienced in New Zealand. These trends are expected to grow over time and are already having a significant impact on the economy, society and government's financial position (Figure 27). Treasury scenario modelling reported in the Climate Economic and Fiscal Assessment 2023 shows that net core Crown debt could be higher by 4% of GDP in 2061 due to increased storms and droughts.

These potential costs heighten the importance of understanding how best to adapt to and mitigate climate change in a manner consistent with a sustainable fiscal trajectory and future economic growth and resilience.

While climate change presents risks, there will also be opportunities for New Zealand including the potential benefits associated with a warmer climate and co-benefits of decarbonisation (for example, improved health outcomes).

International emissions reduction efforts are crucial to avoid the worst potential scenarios and preserve our living standards

New Zealand's economy is relatively small, and New Zealand contributes only 0.17% of global emissions. Success in constraining average global temperature rises will rely heavily on large emitters making meaningful reductions. However, New Zealand can influence global efforts by achieving its own long-term net-zero targets and through international cooperation to prove the workability of key global policies and actions that will meaningfully incentivise large emitters to reduce emissions.

How New Zealand achieves any emissions targets has significant implications for living standards

Enduring economic growth, productivity and resilience will require efficient re-allocation of resources and adoption of productivity-enhancing technologies and practices.

The Treasury supports a portfolio approach to climate policy with market mechanisms (such as emissions pricing) at its core, and public spending constrained to where the case is clear for additional intervention. The emissions price required will depend on several factors, including the degree to which governments wish to leverage relatively low-cost forestry offsets to achieve targets. It will be important that the direction of travel is clearly communicated to support market confidence to invest.

Where public funds are used, we recommend targeting them towards investments with long-term returns (financial or non-financial) that support and maintain productivity growth and enhance living standards.

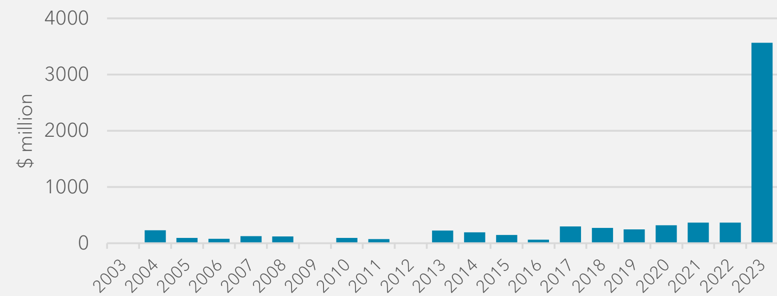
Adapting to global temperature increases is a necessity

Clear incentives and signals from the Government are required on New Zealand's direction of travel to ensure actors like businesses, iwi and local authorities are well-placed to manage risks, have the incentive and ability to do so and that investments can be made with confidence.

Effective adaptation action will involve getting better information on climate-related risks; a planning system that supports risk mitigation; a clear articulation of how costs will be shared across central and local governments, communities, businesses and asset owners; and statutory frameworks that enable a range of options for how communities adapt. Establishing clear roles and responsibilities for an enduring approach to severe extreme weather events can also ensure the economy is more resilient and prepared for shocks.

Enabling the Crown to respond to pressures from climate change, while ensuring that risks to the balance sheet and long-term fiscal sustainability are managed effectively, will require integrated fiscal and climate change strategies.

Figure 27: New Zealand's insured weather-related losses have been rising over time



Source: Insurance Council of New Zealand. Values in 2023 dollars. Excludes non-weather events such as earthquakes.

SECTION 5

Key policy issue #3: improving government performance

Improving government performance will be key to achieving better fiscal and economic outcomes

Strong institutions are crucial to ensure the public sector supports economic growth, fiscal sustainability, and living standards

Much of the lift in New Zealanders' living standards over the past 30 years has been underpinned by stable, open and transparent institutions that have been put in place by successive governments.

The Treasury plays a role in many institutional systems, with oversight responsibility for two:

Public Finance System

The Public Finance System (PFS) is the laws, regulations and practices that govern how the Government collects and spends money – underpinned by the PFA.

The PFS is a complex system, incorporating and interacting with other systems such as:

- the **Investment Management System** (IMS) which helps government plan, deliver and realise the value of capital investments.
- the **Fiscal Management Approach** (FMA) which is a set of budgetary rules and practices the Government uses to give effect to its fiscal strategy.

Regulatory Management System

The Regulatory Management System (RMS) comprises the policies, tools, and processes employed by central government to help it develop, deliver, and maintain high quality regulatory systems.

These systems intersect with others that the Treasury works on jointly with other central agencies and the wider public sector. The most significant of these is the **public sector management system**, which focuses on allocating resources and responsibility for pursuing government priorities, establishing monitoring and reporting to ensure delivery, and managing performance.

Aspects of this system are articulated in the PFS, meaning the Treasury has oversight of them. This is most notable for the **performance reporting system** through which government is accountable to Parliament and the public.

Though generally strong, these systems face challenges

New Zealand's institutions are sound by international standards. We rank highly amongst advanced economies in indices of trust in public services, perceptions of corruption, rule of law, and ease of doing business.

However, as incomes have risen and technology has advanced, New Zealanders' expectations for key public services (such as healthcare and infrastructure) have grown. Pressure has increased on these systems to enable government to meet those expectations.

Meeting these challenges will require change

While each of these systems has unique characteristics, there are themes and potential shifts in approach that overlap.

These include moving from:

- a focus on defining performance purely in terms of expenditure and outputs to one that incorporates quality of delivery and results.
- a focus on managing incremental change to one focused on dealing with the stock (e.g. of spending or regulation).
- a tendency to prioritise the short-term to factoring in long-term considerations.
- agency 'silos' to joined up approaches when this can deliver better results.

The Public Finance System is under strain, requiring changes to ensure resources are targeted to priority areas…

An effective Public Finance System is critical to delivering on government priorities.

The PFS fulfils critical roles in:

- **Fiscal management**: requiring a fiscal strategy to be set that adheres to the principles of responsible fiscal management, then operationalising it through the budget cycle.
- **Public sector management**: aligning the public sector to deliver on government priorities, with a focus on effective governance, ensuring value for money, and clear accountability.
- **Public accountability**: requiring the public service to articulate what it will do with public resources and provide an account of what has been achieved.

Each of these roles is under strain to one degree or another, reflecting increased public expectations of government in the context of a constrained fiscal outlook.

Fiscal management rules are sound, but could be more effective

The Fiscal Management Approach's (FMA) key components include the annual Budget; fixed nominal baselines to hold agency funding steady so that the government has control of the fiscal position; and allowances, to signal the available fiscal headroom.

The FMA operates in a different context to when it was designed, with increased expectations, current fiscal pressures and high inflation, all putting pressure on the approach. Combined with the FMA's flexibility, this has contributed to new spending being increasingly outside allowances. Between Budget spending has grown significantly, which in turn contributes to heavily pre-committed allowances.

Improvements to support greater fiscal restraint and value for money include:

- Enabling allowances to link spending intentions to government priorities, through thematic envelopes and incorporating funds within allowances;
- Controlling spending between Budgets by restricting pre-commitments and reducing incentives to bypass Budget.

Such changes to the FMA, alongside introducing savings and performance plans (refer slide 21), will set expectations for how agencies deliver priorities and manage within existing funding, and maximise Ministers' choices for directing limited funds to where they are best deployed.

Public sector management arrangements impede cross-agency efforts to address complex issues

The public sector management system places responsibilities on departmental Chief Executives. This vertical accountability enables efficiency through specialisation, but it can also impede progress on cross-sectoral and complex issues. Other issues include:

- Devolution of detailed resource allocation choices to departments making it difficult for Ministers to undertake centralised management;
- Limited incentives to reallocate resources between departments and achieve cross-agency efficiencies and therefore value for money; and
- Annual budgetary and reporting cycles don't meet Ministers' need for real-time information or recognise the longer-term nature of public sector delivery.

Attempts to address these issues include Public Service Commission led work on specified agencies (new types of entities to co-ordinate multiple department's work), and system leads (Chief Executives designated to provide system leadership) and initiatives, and Treasury-led work on agency clusters for multi-year budgeting. It is not clear yet how effective these models are, but the Treasury will contribute to further advice in the coming year.

Targets are one way to drive performance

Setting a limited number of targets to galvanise action is another public management tool. Targets can be used to signal priority goals to the public and create a sense of shared purpose between agencies – especially when a collaborative approach is needed to achieve the objective.

They are effective at creating a sense of urgency and spurring action amongst agencies but need to be designed carefully to avoid unintended results through gaming and goal displacement.

The Treasury is working with the Department of Prime Minister and Cabinet, and the Public Services Commission to provide advice on how to effectively use targets to drive performance.

…and focused on driving performance by improving value for money and reporting publicly on what has been achieved

Value for money analysis is a critical tool to prioritise spending in a fiscally constrained environment

Government finances will be under sustained pressure across the course of this term, with difficult choices required to balance trade-offs between living standards, quality of public services, fiscal goals, and economic performance. VFM analysis is a key tool for weighing up these factors to maximise impact within a given budgetary constraint.

The Treasury's understanding of VFM is broad, capturing human, social, environmental and other living standard impacts:

Value for Money	Government expenditure achieves value for money if its benefits outweigh its costs (relative to other options), it is deliverable, and it aligns with the Government's priorities.

This approach is applied when analysing and advising on both new spending proposals and on savings both through the annual Budget and to proposals considered by Cabinet throughout the year.

Better embedding VFM analysis throughout the public sector requires changes to rules, tools and guidance. The Treasury is working on improvements to Cost Benefit Analysis practice and tools such as placing appropriate value on the longer-term impacts in VFM analysis. This includes reviewing the public sector discount rate (i.e., the rate at which government values impacts that occur in the future relative to those that occur in the present).

Performance reporting supports public accountability and management of public sector resources

The Public Finance System is not adequately delivering the performance information expected. Effective performance reporting is necessary for both *Public Accountability* (by informing the public how government delivery is progressing and enabling Parliament and the public to scrutinise the use of public funds) and *Public Sector Management* (by providing information required for Ministers to inform their decisions, monitor delivery, and maintain fiscal discipline).

Improving public accountability performance reporting will require a focus on continuous improvement and consideration of changes to system settings

The current public accountability reporting structure is based around agencies and appropriations and provides a large amount of information. However, this information is often not relevant or meaningful for the user. It can be difficult to trace funding decisions over time and assess whether these represent value for money. The level of detail provided can make it hard to understand how the range of government interventions is combining to make a difference.

The Standing Orders Review 2023 highlighted the desire of Parliament to improve scrutiny over the use of public funds. A recommendation was made that an inquiry into performance reporting be established.

The Treasury is making on short-term improvements to performance reporting for public accountability within current legislative settings. This includes setting clearer requirements and expectations and building agency capability.

Existing public accountability performance reporting arrangements do not support the Government to report on what has been delivered and achieved with its major spending decisions. Once the Government has identified its spending priorities, the Treasury will provide support to establish monitoring and reporting systems.

Options for longer-term reform will require consultation with Parliament and the public. The proposed parliamentary inquiry into performance reporting provides an opportunity for such a process. The Treasury recommends that you support the establishment of this inquiry and ensure that sufficient time is provided to develop the Terms of Reference for the inquiry.

Actions to improve performance reporting to support public sector management include:

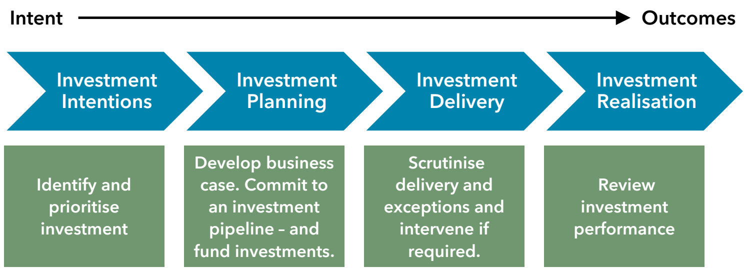
- introducing savings and performance plans (refer slide 21), and
- improving visibility of the investment pipeline through the Treasury Quarterly Investment Reporting (QIR) process on the Government investment portfolio (refer slide 32).
- Providing more in-depth performance reporting for selected, high priority areas of government spending.

Lifting investment and infrastructure performance and planning

The Investment Management System (IMS) supports Cabinet to govern the investment portfolio effectively

The IMS helps plan, deliver and fully realise the value of our investments. Cabinet's expectations for investment management and asset performance are set out in Cabinet Office circular (23) 9. These support your fiscal objectives by outlining the investment disciplines necessary to ensure investments deliver value for money.

The IMS is designed to provide Ministers and Cabinet with information and decision points through the investment lifecycle:



There are challenges with how to manage investment

While the foundations of the IMS are sound, current settings and practices are no longer fit for purpose and do not meet Ministers' needs.

- **System settings do not support Cabinet to govern effectively:** Cabinet is often asked to make decisions on investments in isolation, too late in the planning process, and without an understanding of agency asset management plans.
- **Limited visibility of the investment pipeline:** there are large data gaps (especially in investment intentions), with disparities in agencies' data capability.
- **Inefficient planning and assurance processes:** business cases take too long, cost too much and don't provide Ministers with the right information or assurance.

These issues have contributed to ongoing challenges affecting the pipeline's delivery. This is set against **market capacity constraints,** and the challenging fiscal context of limiting operating funding to deliver, service and maintain investments.

Recent changes to the system will enable better informed, more responsive decision-making that supports value for money

- **Improving assurance and planning** through revisions to the Cabinet Office circular to clarify Cabinet's expectations for agencies in their asset management and planning, with a greater focus on Chief Executive accountability and transparency.
- **Improving visibility** through the Treasury Quarterly Investment Reporting (QIR) process on the Government investment portfolio.
- **Strengthening governance** through introducing a Cabinet decision point earlier in the planning process to enable greater oversight and direction.

Our focus is on making further improvements to planning…

Further improvements to IMS settings to ensure these are fit for purpose and delivering what Ministers and Cabinet need to make timely, well-informed investment decisions.

- Reporting on agency adherence to Cabinet's expectations for investment management.
- Supporting you to put in place strong Cabinet governance of the investment portfolio.
- Updating the core planning and assurance frameworks (Better Business Case and Gateway)

…and addressing the pipeline of investments

There has been a significant allocation of capital and related operating funding in recent years. While increased investment is needed the investment pipeline is oversubscribed – it is far larger than the agency or market capacity to deliver.

As much of this funding was allocated in pressured timeframes, we do not have full confidence that the highest value for money investments have been prioritised.

We will support you to undertake a reprioritisation and reduction of the investment pipeline to better match with market and agency capacity and capability, and to focus on the highest priority, highest value for money investments, and drive improved visibility of the investment pipeline.

There is room to improve the performance of our regulatory systems

Regulatory quality appears good by international standards, but there are areas of underperformance

New Zealand ranked in the 99th percentile for regulatory quality in the 2022 World Bank Worldwide Governance Indicator, and better than the OECD country average in the latest OECD Product Market Regulation survey.

However, over the years we have experienced some costly regulatory failures, as well as many instances of persistent regulatory underperformance.

There are some persistent barriers to good regulatory performance, including over-use of legislative responses; patchy quality of departmental regulatory impact assessment (RIA) processes; poor design and implementation of regulatory reform; lack of review, evaluation, and monitoring of regulatory performance; and widespread capability and capacity issues. In addition, work on maintaining, updating or improving existing regulatory systems is generally afforded a lower priority than introducing new reforms.

Where regulation fails to achieve its objectives, or the costs exceed benefits, there can be significant impacts on individuals, communities, and businesses.

Ongoing governance, monitoring and care of our regulatory systems is required to maintain and lift their performance over time and ensure value for money.

New Zealand faces particular challenges

New Zealand seeks to develop, monitor and maintain a full suite of regulatory systems, like other developed countries. But it must do so off a smaller tax and economic base, making value for money particularly important in the design and operation of each regulatory system.

Making this more difficult is the limited attention devoted to regulatory oversight – including the operation of our **Regulatory Management System (RMS)** – particularly when compared with fiscal management.

The RMS plays a key role in regulatory quality

New Zealand's 180-200 **regulatory systems** each comprise a linked set of rules, organisations, and activities that share a common policy objective (e.g. food safety). The RMS is made up of the policies, tools, and processes employed by central government to help it develop, deliver, and maintain high quality regulatory systems. The RMS helps ensure that agencies govern, maintain and care for the regulatory systems they are responsible for.

Key RMS roles include:

- impact analysis to support robust proposals for regulatory system change
- monitoring and periodic review of existing regulatory system performance
- support for good regulator practice.

The Public Finance System also influences the performance of regulatory systems.

New Zealand's institutional arrangements for regulatory oversight are comparatively under-developed:

- While the RMS sets out expectations and guidance for agencies, there is very limited central monitoring and assurance.
- There is limited data available on overall system performance, or overall impacts on regulated parties.
- There are relatively few RMS levers focused on implementation of regulatory proposals and the ongoing performance of regulatory systems.

Options to strengthen regulatory oversight to lift regulatory system performance include:

- setting higher standards and requirements for new regulatory proposals, for instance through strengthened RIA requirements
- identifying and addressing issues in existing regulatory systems, for instance, through more systematic reviews
- building a better shared central picture of performance, costs and impacts, for instance through work to better identify impacts and costs on regulated parties
- introducing or augmenting tools and structures to support an increased focus on regulatory quality, for instance, an enhanced regulatory oversight body.

A key consideration in each of these areas is how to balance the benefits of greater centralisation with the need to maintain departmental capability and accountability for good regulatory management.

End

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THE TREASURY