The Treasury

Budget 2021 Information Release

August 2021

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Key to sections of the Act under which information has been withheld:

[1] 6(a) - to avoid prejudice to the security or defence of New Zealand or the international relations of the government

[23] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information

[26] 9(2)(ba)(i) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment

[36] 9(2)(h) - to maintain legal professional privilege

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

[40] Not in scope

[42] 18(d) - information is already publicly available or will be publicly available soon.

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [23] appearing where information has been withheld in a release document refers to section 9(2)(a).

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Fiscal Strategy for Budget 2021

Date:	4 March 2021	Report No:	T2021/316
		File Number:	MC-1-5-2

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	Consider recommendations and discuss at Budget Matters	To be discussed at Budget Matters on 9 March 2020

Contact for telephone discussion (if required)

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

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Executive Summary

This report provides advice on setting allowances for Budget 2021 and beyond in order to achieve your fiscal strategy.

Since our post-election advice, the recovery and resilience of the New Zealand economy has surprised on the upside, with strong data across the board. Based on preliminary forecasts we expect this momentum to continue over the course of 2021, albeit at a slower pace. In addition, our current view is the pandemic has caused less economic scarring than expected.

This has resulted in stronger tax forecasts and will likely show in an improved fiscal position. However, this could easily reverse if the Treasury's forecasts prove too optimistic, or in the event of further outbreaks, or a slower recovery. This means a flexible and least regrets approach is advisable.

The current level of fiscal support is likely about right to support the recovery, and we advise a 'watch and wait' approach. If the economy shows signs of deterioration, there remains space to provide further fiscal support. Conversely, if the economy shows signs of overheating, in our view, monetary policy support can be withdrawn before considering any fiscal tightening.

Current allowance levels maintain fiscal sustainability and achieve your fiscal strategy under the central forecast. Levels of debt will likely remain prudent across the forecast period and are not a concern for fiscal sustainability. The reduced scarring has also improved the long-run fiscal position and may reverse much of the structural deficit by the end of the forecast.

However, committing to large increases in allowances risks an unsustainable fiscal position. This risk is greater if the economic and fiscal outlook deteriorate. Frequent increases in allowances can also impact incentives for departments and pose issues for credibility if they set precedents for future years.

Current operating allowances of $2.625 billion will be insufficient to meet cost pressures and manifesto commitments in this and future Budgets. This is particularly the case given forthcoming reforms in welfare and health that have significant costs. In addition, if substantive fiscal risks materialise this will place further pressure on allowances.

We recommend an increase in operating allowances to $3.0 billion in Budgets 2021 to 2024. This is supported by an improved fiscal outlook and provides a buffer against your objective to stabilise net core Crown debt by the mid-2020s. This level of allowances would be enough to fund precommitments and a minimum viable cost-pressure package (together $2.4 billion operating per annum), but only a small number of priority manifesto commitments. This would add approximately 1.4pp of GDP to net core Crown debt and 0.5pp of GDP to the operating deficit by the end of the forecast period.

Alternatively, you could substantially increase allowances at Budget this year and maintain allowances at lower levels in future years. We do not recommend this. You could increase the operating allowance to $4.1 billion this year while meeting your fiscal objectives, as long as operating allowances of $3 billion were maintained in future Budgets. This adds 2.7pp of GDP net core Crown debt by the end of the forecast period, eroding more of your fiscal space.

In the medium term, it is also prudent to consider revenue-raising options. The long-term objectives of your Government may be challenging to achieve within the allowances outlined above. Identifying revenue options in the medium term could allow for increased growth in operating spending while maintaining a sustainable fiscal position.

We recommend a relatively limited capital package in the range of $2 to $4 billion at Budget 2021 with a focus on the achievability of the funded initiatives. This judgement is based on capacity constraints, which have been exacerbated by COVID-19, and delivery of existing capital investment projects is limited.

You will receive an update to this advice incorporating the preliminary fiscal forecasts in late March. We can produce further scenarios of alternative allowance combinations in the meantime if required.

Recommended Action

We recommend that you:

a **note** that the current level of fiscal support is appropriate to support the economic recovery, though there is value in retaining flexibility.

b **note** operating allowances of $2.625 billion will be insufficient to meet all cost pressures, manifesto commitments and expected costs of health and welfare reform in this and upcoming Budgets.

c **note** that the improved economic outlook provides space to increase allowances while still meeting your fiscal objectives.

d **agree** to a provisional operating allowance of $3.0 billion per annum for Budgets 2021 to 2024, subject to the preliminary BEFU fiscal forecasts and confirmation of Budget packages (TR2021/359)

Agree/disagree.

e **note** that the recommended level of allowances would be enough to fund precommitments and a minimum viable cost-pressure package (together $2.4 billion operating per annum), but only a small number of priority manifesto commitments.

f **note**, in light of agency capability and market capacity constraints, we recommend a relatively limited capital package in the range of $2 to $4 billion at Budget 2021 with a focus on the achievability of the funded initiatives.

g **note**, if a significant proportion of the multi-year capital allowance (MYCA) is spent this year, we recommend that you top up the MYCA for future Budgets across the forecast period. This will help to provide a pipeline to plan for future capital investment, and h **indicate**, your preferred multiyear capital allowance, subject to the preliminary BEFU fiscal forecasts and proposed Budget packages (TR2021/359)

Angus Hawkins
Team Leader, Macroeconomic & Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal Strategy for Budget 2021

Purpose of Report

1. At the Budget Policy Statement 2021 (BPS 2021) you set your fiscal short-term intention and long-term objective (fiscal targets hence force) respectively to:

   - *use fiscal policy to secure the economic recovery for New Zealand and reduce deficits over the forecast period as economic conditions allow*

   - *stabilise net core Crown debt as a percentage of GDP by the mid-2020s and then reduce it as conditions permit (subject to any significant shocks)*

2. **This report sets out the Treasury's preliminary advice for Budget 2021 to deliver this fiscal strategy**. The advice is intended to help you take decisions on operating allowances and the multi-year capital allowance (MYCA). This report links closely to the 'Draft package advice for Budget 2021', which you will receive tomorrow (T2021/359).

3. The preliminary fiscal forecasts will not be finalised until the 23 March. As such, the advice and scenarios in this report are based on:

   a preliminary 2021 Budget Economic and Fiscal Update (BEFU 2021) economic and tax forecasts and,

   b the BPS 2021 version of the fiscal strategy model based on the Half Year 2020 fiscal outlook, with preliminary Budget 2021 economic, tax, and benefit forecasts built in.

Economic and Fiscal Context

The recovery and resilience of the New Zealand economy has surprised on the upside, but risks to the outlook are tilted to the downside

4. **Data across the board has surprised on the upside** since the Half Year Economic and Fiscal Update (HYEFU 2020). The labour market and business investment have held up better than expected, implying less scarring to labour supply and the capital stock. The big question is whether the momentum we've seen in the data will continue.

5. **Based on the BEFU 2021 preliminary economic forecasts we expect nominal GDP to be significantly higher than at HYEFU 2020** (T2021/327)[1]. Despite border restrictions, the Treasury expects growth to continue over the course of 2021, albeit at a slower pace than forecast before COVID-19. Upward historic data revisions and a stronger forecast for potential output, when compared to HYEFU 2020, all contribute to the higher nominal GDP forecast.

6. **The stronger forecast for potential output reflects evidence indicating that the pandemic will cause less severe scarring**. At the Pre-election Economic and Fiscal Update (PREFU 2020), we forecast a significant deterioration in potential output. Our forecasts now reverse around two-thirds of the previous downgrade.

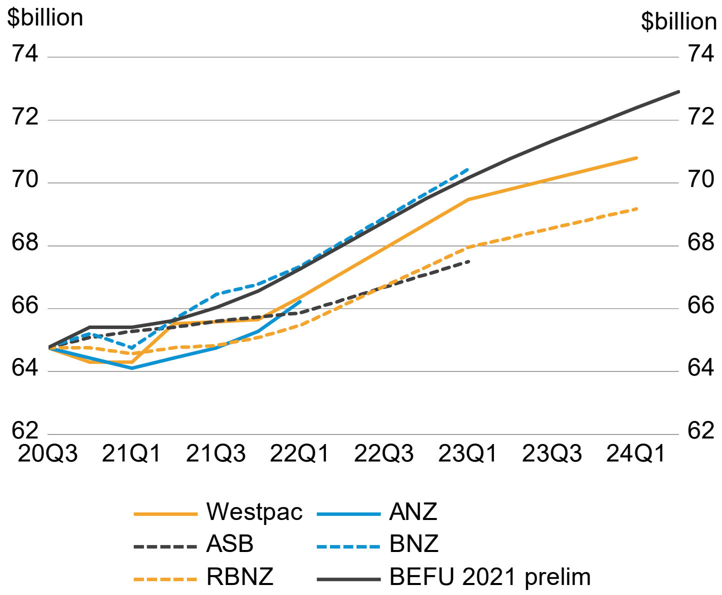
[1] Note these forecasts were finalised before the most recent escalations of the COVID-19 alert levels. The expected cost of short-term heightened alert levels on the macroeconomic outlook is relatively small. Final economic and tax forecasts will be finalised early April, and will therefore account for the recent shift in alert levels.

7. The stronger domestic recovery results in consumer price index inflation being higher across the forecast period compared to HYEFU. We expect this will result in a gradual reduction in monetary policy support. This is consistent with the Reserve Bank's (the Bank) expectations for monetary policy as published in the February Monetary Policy Statement, although the Bank's economic outlook is more pessimistic than ours (see figure 1).

8. **However considerable uncertainty remains,** both in terms of the evolution of COVID-19 and the degree to which pent-up demand may be contributing to the current strength. A number of measurement challenges exacerbate this uncertainty and mean data may exhibit greater volatility than normal.

9. **The Treasury's preliminary BEFU economic forecasts are stronger than the major domestic banks**, who generally expect a slowdown in momentum in the 2020 December and 2021 March quarters, with some forecasting a technical recession (as shown in figure 1).

Figure 1: Real Production GDP forecast (as of 24 February)



The fiscal outlook is also likely to improve but we expect to see larger than normal revisions to this outlook

10. **The Budget 2021 preliminary tax forecasts have significantly revised up the outlook for tax**. Core Crown tax revenue is forecast to be nearly $25 billion higher than HYEFU 2020, across the five years of the forecast period. The higher forecast for nominal GDP is a major driver.

11. The preliminary fiscal forecasts are yet to be finalised. **It is likely both the OBEGAL and net core Crown debt tracks will be better than previously expected** based on recent stronger-than-expected economic growth.

12. **However, the stronger economic outlook is also likely to result in an increase in expense forecasts** (e.g. benefit expenses that are indexed to wage growth). In addition, there is a risk that the drivers of this strength could create significant cost pressures in the future (e.g. wage costs).

13. You will receive advice on suggested modifications to your headline stock and flow fiscal indicators at the end of March 2021. Changes to these indicators could alter the presentation of net core Crown debt and OBEGAL but are unlikely to impact the

trajectory for these variables. As such, this should not impact your fiscal strategy decisions.

We have modelled three indicative scenarios to show the impact of uncertainty on tax revenue (table 1)

a. **Lowest external forecasters** - Scenario A uses an approximation of the nominal GDP track of the lowest external forecaster (ASB) and shows its implications for tax revenue.

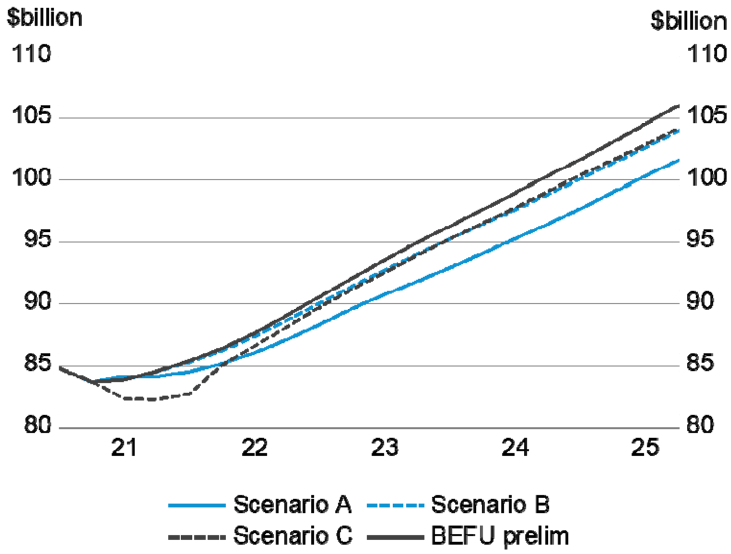
b. **More long-term scarring** - a large proportion of the improved tax outlook results from a judgement of less long-term scarring in the economy. Scenario B shows an estimate of the impact of reversing this judgement.

c. **Sporadic outbreaks of COVID-19 in the community** - as modelled at HYEFU 2020, this has the potential to lower economic activity. This reduces tax revenue as shown in Scenario C.

Table 1: downside alternative nominal GDP and tax scenarios

Scenarios	Description	Estimated cumulative difference in tax revenue to 25Q2 compared with prelim BEFU 2021
A	Lowest external forecasters	-\$13.9 billion
B	More long-term scaring	-\$4.3 billion
C	Sporadic outbreaks of COVID-19 in the community	-\$6.7 billion[2]

Figure 2: alternative nominal GDP scenarios



However, there is some upside risk

14. While the Treasury has upgraded our nominal GDP forecasts significantly, in the near term this still falls short of the underlying strength that would be suggested by tax outturns alone. If the current strength in tax revenue is sustained, it may mean we have underestimated the strength in the economy.

[2] Compared to the main HYEFU 2020 forecast.

15. The Government's fiscal strategy commits to both using fiscal policy to support the recovery, and stabilising net core Crown debt as a share of GDP by the mid-2020s. This requires a fiscal stance stimulatory enough to support the economy in the short-term, without risking overheating the economy or putting the debt on an unsustainable trajectory.

16. In pursing these two objectives, you should place different weight on time-limited compared to permanent spending. Committing to time-limited spending in response to COVID-19 changes the level but not the trajectory of debt. Committing to large increases to allowances risks putting debt on an unsustainable trajectory.

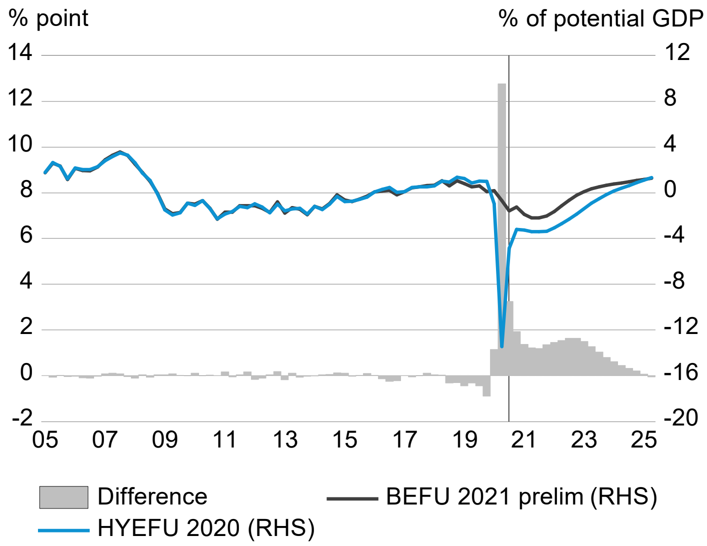
You should continue to 'watch and wait' before increasing or decreasing the level of temporary COVID-19 fiscal support

17. **Fiscal and monetary policy have been effective at supporting the economy through COVID-19 to date**. As of HYEFU 2020, $41.1 billion of support has been allocated to COVID-19 support measures over 2020/21 and 2021/22, of which the Wage Subsidy Scheme makes up a significant percentage. Regarding monetary policy, the Official Cash Rate was reduced 75pp to 0.25%, a Large-Scale Asset Purchases (LSAP) Programme up to the value of $100 billion is underway and a Funding for Lending Programme (FLP) was introduced at the end of last year.

18. **The optimal level of fiscal support going forward requires balancing the risk of providing too much vs too little support**. Too much support risks overheating the economy, while too little risks exacerbating economic scarring. As of HYEFU, fiscal policy remains stimulatory over the forecast period.

19. **The smaller forecast for the output gap compared to HYEFU 2020 supports our view that the current level of fiscal support is adequate.** This gap shown in figure 3 measures the amount of economic slack in the economy and can be used to form a judgment on the amount of support required. However, it is highly uncertain and prone to revision, especially in the current circumstances. We have therefore looked across a broad range of economic indicators to form our view on the appropriate level of support.

Figure 3: Output Gap at HYEFU 2020 vs preliminary BEFU 2021



20. **Our view is also supported by the strong outturn data and evidence of capacity constraints.** Although unemployment is expected to rise slightly over the coming year to 5.4%, it is then expected to fall relatively quickly. Capacity constraints are also becoming more prevalent. The recent Quarterly Survey of Business Opinion shows capacity and cost pressures are becoming a worry for firms, particularly in the construction sector.

21. **In this context, further large-scale fiscal support risks overheating the economy**, increasing inflation and exacerbating capacity constraints. If inflationary pressures arise, in our view monetary policy should be withdrawn first before considering fiscal tightening. Monetary tightening would likely lead to an appreciation in the exchange rate, with impacts on global competitiveness. However, tighter monetary policy might offset concerns about the effect of the current monetary policy stance on house prices.

22. **You could alternatively withdraw fiscal support sooner, but we do not recommend this**. Given downside risks, this could result in providing too little support and exacerbating scarring, particularly if the outlook weakens further. This also risks further use of alternative monetary policy tools.

23. **Overall, we are of the view that you should continue to 'watch and wait' before changing the level of fiscal support**. We continue to closely monitor the economy and will provide further advice if there is evidence of a deterioration or further strong improvement to the outlook.

Central forecasts suggest your spending plans are fiscally sustainable in the short-term

24. **We do not see a case for a major structural consolidation in the short run,** if current allowances are maintained**.** This judgement reflects:

    a **the expected structural improvement to the fiscal outlook** - we anticipate that a significant proportion of the structural deficit forecast at HYEFU 2020 could reverse in BEFU 2021 by the end of the forecast period. This is one of the most important measures of fiscal sustainability. It shows how far expenditure exceeds revenue on an ongoing basis, after excluding temporary spending and accounting for the economic cycle.

    b **that expected forecast levels of net core Crown debt** are prudent with space for debt to rise further than forecast while maintaining debt sustainability and market access. New Zealand's strong starting point means at its peak, debt will still be significantly lower than many other countries had before COVID-19. Interest rates, and hence debt servicing costs, are historically low and expected to stay low in the medium-term.

25. **In the case of a further resurgence there remains fiscal space for temporary support.** The unallocated balance of the CRRF is $9.8 billion, with $800 million in upcoming funding requests. This provides some space to respond to small scale resurgences. However, in the case of repeated or large-scale national resurgence, further support will likely be needed. For example, as of 31 December 2020, $13 billion of support had been provided through the Wage Subsidy Scheme. There also remains further fiscal space to increase spending beyond the CRRF on a temporary basis. There are options to explore reprioritisation of CRRF spending towards higher value spend. The scale of the savings involved are unlikely to have a macroeconomic impact (TR2021/200).

There is some space to increase allowances but given the high level of uncertainty, you should take a flexible and iterative approach

26. This means avoiding substantial repeated increases in allowances that risk:

a **Putting debt on an unsustainable trajectory** in the case of a deterioration in the outlook.

b **A downgrade to New Zealand's credit rating**. This was recently upgraded by S&P. The rating is 'stable' and seen as robust to some weakening in the fiscal position, but is conditioned on the expectation that the deficit will decline over the next few years. Hence, large commitments to ongoing spending that reverse this position could have risks for New Zealand's rating.

c **Reducing credibility and incentives for high value spending**. Frequent increases in allowances impact incentives for departments and can create credibility issues, with large increases to allowances setting a precedent for future year allowances.

To keep in line with your policy ambitions and to help ensure long-term fiscal sustainability, revenue strategies should be considered

27. **Achieving your fiscal targets in the long-term relies on constraining spending growth, low interest rates and economic growth**. The long-term fiscal projections released at BPS 2021 assume a return to $2.3 billion in allowances. There is a minimal explicit role for increasing revenue as a share of the economy. This approach carries risks, particularly as the intended level of spending constraint may be challenging to achieve given long-run cost pressures of an ageing population and rising healthcare costs common to many developed economies.

28. **Funding historic levels of spending, with no change in revenue policy, would result in a persistent and worsening deficit**. We estimate that if expenses grow in line with historic rates, allowances will need to be in the range of $3.3 to $3.8 billion over the next four years. Taking a relatively conservative assumption of $3.5 billion, leads to debt rising to 48% of GDP and a persistent and increasing OBEGAL deficit increasing to 1.9% of GDP by 2034 (under our current scenarios see paragraph 36).

29. Officials briefed you on key matters to be considered in developing the Government's revenue strategy, including the need for the revenue strategy to be consistent with the Government's overall fiscal strategy (refer T2021/85 & IR2021/052). Consistent with our earlier advice, **given the fiscal challenges it would be prudent to prepare revenue options to support fiscal sustainability in the event of slower growth or higher expenditure requirements than currently forecas**t. Officials have now prepared a draft revenue strategy for you to consider which acknowledges this challenge (refer T2021/314 & IR2021/080).

Operating Allowances

Budget allowances are oversubscribed and will most likely continue to be so

30. **Despite running an invitation-only process operating allowances are heavily oversubscribed for Budget 2021**. Bids received from departments for operating funding average $7.2 billion per annum. Of this, $3.4 billion was submitted as cost pressures, $3.8 billion was submitted as manifesto commitments initiatives. Of submitted operating bids, Treasury Vote Analysts support an average of $4.7 billion per annuum. You will receive advice tomorrow on a draft package for Budget 2021.

31. **We expect this trend of oversubscription to continue given underlying cost pressures** are expected to take up a substantive portion of allowances. This year, non-discretionary cost pressures around public services and precommitments amount to $2.4 billion of the operating allowance.

32. **Furthermore, we expect large reforms to carry significant fiscal costs for future budgets**, specifically in welfare and health [33] In the medium-term, the health reforms should be beneficial to your fiscal strategy and allow you to regain greater control over health spending. But in the short-term, health costs are expected to total [33] in funding from operating allowances across Budgets 2021 – 2023, subject to Cabinet decisions on health and disability system reform. Further to this, as noted in TR2021/371, your commitment to overhaul the welfare system could have significant fiscal costs. Introducing both the main benefit increases and Working for Families reform could cost [33] pa for Budgets 2021 – 2024.

[33]

33. **There also remains substantive specific fiscal risks (SFRs) that would place significant further pressure on allowances if they materialised.** The number of SFRs has increased compared to Budget 2020, due both to COVID-19 and the inclusion of unfunded manifesto commitments. SFRs from HYEFU 2020 total an expected fiscal cost of $2.0 billion in cost pressures and $2.7 billion in policy changes across the forecast period. This compares to $430 million in cost pressures and $2.6 billion in policy changes at HYEFU 2019[3]. The figures are estimates based on data submitted by departments with limited scrutiny from the Treasury. Therefore, the data may be incomplete, and some entries may be inaccurate, meaning that the expected costs presented should be treated as highly uncertain.

A wide range of expenditure strategies can be set to achieve your fiscal strategy over your parliamentary term

34. **You have several options for operating allowance settings while meeting your fiscal objectives**, as outlined in table 2. These scenarios have implications for your fiscal indicators as outlined in table 4 and figure 5 and 6. These should be considered alongside your draft package advice for Budget 2021.

35. **A number of caveats should be considered alongside these scenarios**. The analysis is based on the BEFU 2021 economic and tax update and the HYEFU 2020 fiscal update. As such these numbers will be revised and should be used for a sense of scale of the impact rather than for absolute values. The preliminary fiscal forecast will provide greater clarity on your expected fiscal track. Furthermore, these scenarios are based on the central forecast and there is a large range of uncertainty around these central tracks. We can provide further analysis for a high and low scenario as required.

[3] SFR figures presented for HYEFU 2020 and HYEFU 2019 exclude the health portfolio and the welfare reform costs discussed in paragraph 39. 'Expected fiscal cost' is the estimate of the value of the risk, multiplied by the probability of occurrence, taken from the midpoint of the range stated by the agency.

Table 2: Operating allowance scenarios[4]

<table>
<tr><th>Recommendation</th><th>Description</th><th>Budget Package</th><th>Allowance per year ($bn)</th></tr>
<tr><td>Not recommended to fund new initiatives</td><td>Baseline: substantive fall in debt and return to OBEGAL surplus</td><td>Non-discretionary cost pressures and precommitments, plus $0.2 billion of priority spending.</td><td>$2.625 in forecast period, $2.3 in projection period</td></tr>
<tr><td>Recommended to address cost pressures and high value spend</td><td>Low ongoing: debt falling and small OBEGAL deficit</td><td>As above, plus $0.6 billion of priority spending.</td><td>$3.0 in forecast and projection period</td></tr>
<tr><td>Feasible but not our preferred option due to uncertainty</td><td>Medium ongoing: debt stabilising and medium OBEGAL deficit</td><td>As above, plus $0.9 billion of priority spending.</td><td>$3.3 in forecast and projection period</td></tr>
<tr><td rowspan="2">Not recommended given the impact on the fiscal position if ongoing</td><td>High one off: debt falling and small OBEGAL deficit</td><td rowspan="2">Non-discretionary cost pressures, precommitments, high priority packages and other manifesto.</td><td>$4.1 in 2021/22, with $3.0 for the rest of the forecast and projection period.</td></tr>
<tr><td>High ongoing – debt rising unsustainability and large OBEGAL deficit</td><td>$4.1 in forecast and projection period</td></tr>
</table>

Table 3: Fiscal indicators under the baseline scenario

Description	Net core Crown Debt		OBEGAL	
	2024/25	**2034/35**	**2024/25**	**2034/35**
Baseline	41.0%	25.8%	-0.1%	1.3%

Table 4: Impact of alternative operating allowances settings on fiscal indicators

Description	Impact on net core Crown Debt (% of GDP) by:		Impact on OBEGAL (% of GDP) by:	
	2024/25	**2034/35**	**2024/25**	**2034/35**
Low ongoing	1.4pp	11.4pp	-0.5pp	-1.7pp
Medium ongoing	2.5pp	17.9pp	-0.8pp	-2.6pp
High one off	2.7pp	14.4pp	-0.7pp	-2.0pp
High ongoing	5.4pp	35.3pp	-1.8pp	-5.0pp

[4] Forecast allowances are nominal figures. Projection allowances are in 2024/25 prices and grow with CPI through the ten years of the projection.

Figure 5: Impact of budget allowances on OBEGAL (% of GDP)

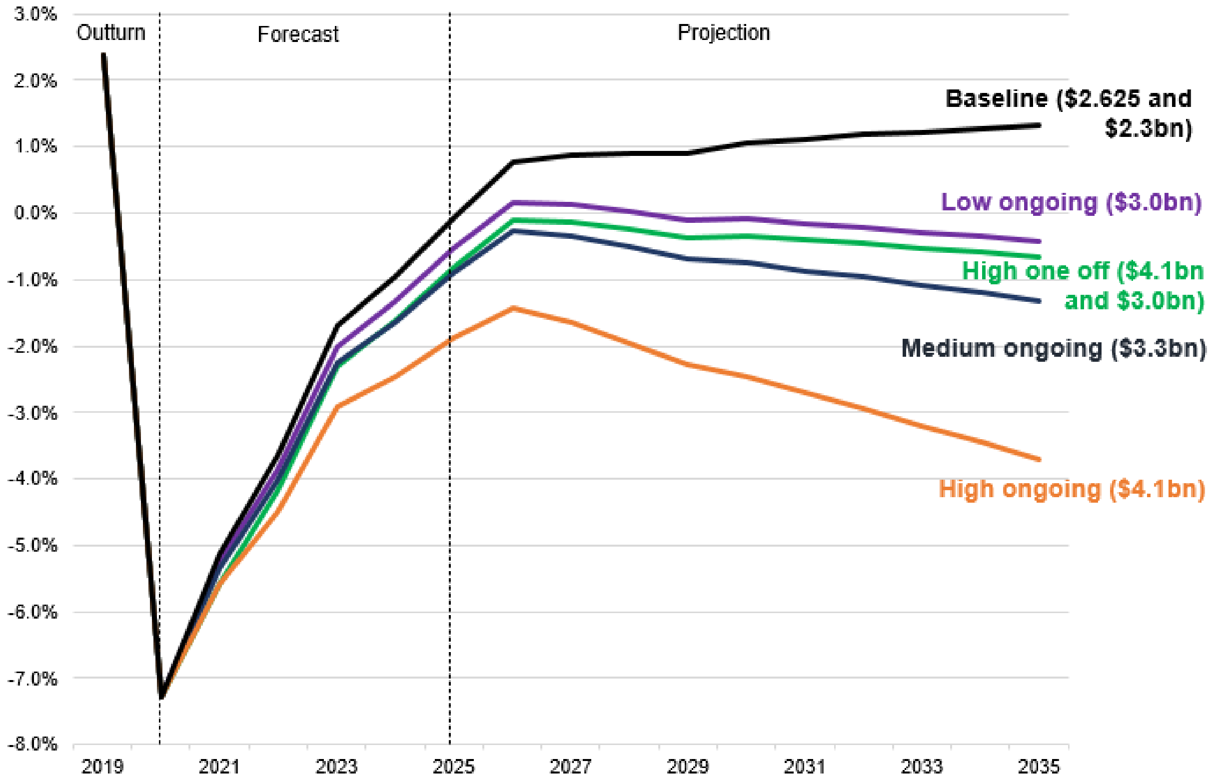
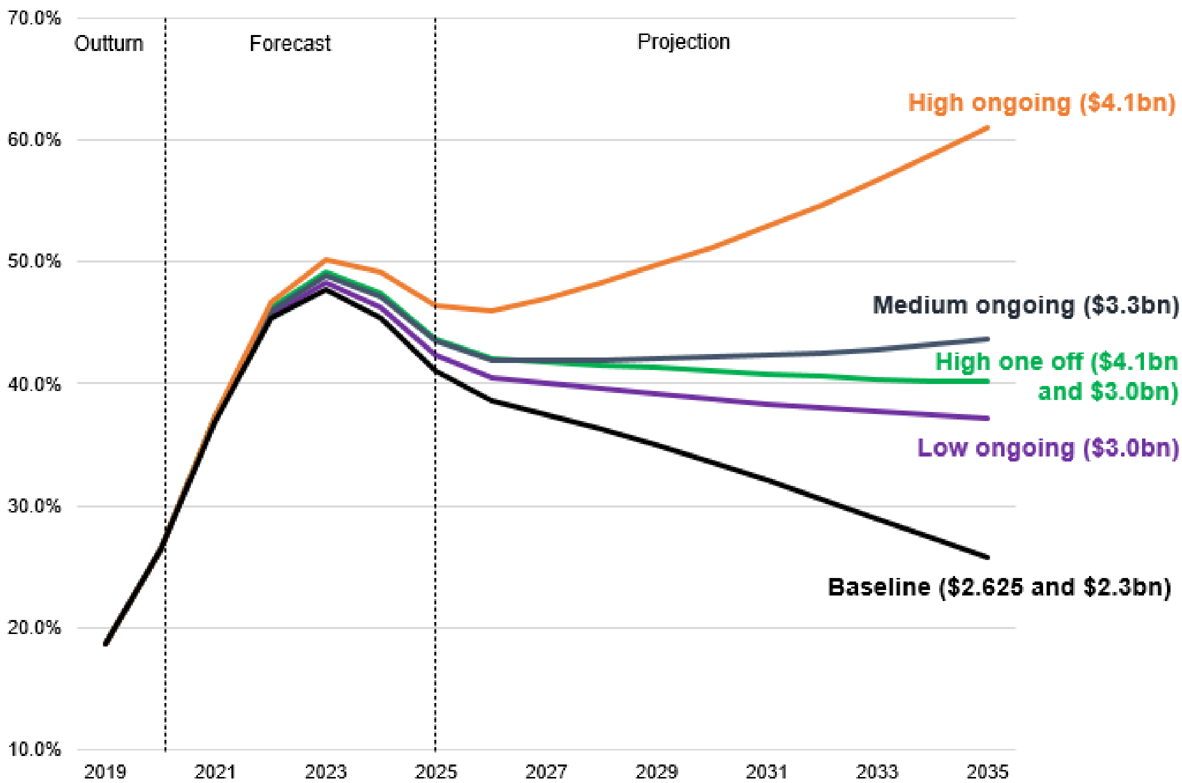


Figure 6: Impact of budget allowances on net core Crown debt (% of GDP)



Baseline

36. **We do not recommend this option to fund new spending** as we consider it unlikely to be feasible and risks pushing cost pressures into future years.

37. **Sticking to the current operating allowance in Budget 2021 will help build back fiscal buffers** that have been used to respond to COVID-19. This will create greater fiscal space to increase allowances in future years of the parliamentary term. Sticking to allowances may also signal to departments a commitment to fiscal restraint and incentivise greater prioritisation of funding requests, therefore minimising low value budget bids.

38. **However, fully meeting cost pressures in Budget 2021 with current allowances only leaves $0.2 billion for additional operating funding**. It therefore requires tough trade-offs between cost pressures and manifesto commitments. We would expect many cost pressures not funded in Budget 2021 to flow through to Budget 2022 as well as further bids for new cost pressures, representing a significant portion of any future increases in allowances. It may also compromise your wider economic and policy objectives.

Low to medium

39. **Given the high level of uncertainty in both the outlook and these scenarios, our recommended option is to increase allowances only to $3.0 billion**. This leaves a buffer against your fiscal targets. However, if these scenarios hold, there is space to increase allowances by up to $3.3 billion across the forecast and projection period while meeting your objective to stabilise debt by the mid-2020s.

40. Note that we have maintained the scenario level of allowances across the forecast and projection period to ensure the scenarios reflect an accurate picture of the long-term fiscal position. There is value in updating the Fiscal Strategy Model that is published alongside the Budget to reflect this long-term pressure. We will provide you further advice on this closer to the Budget.

41. **The value of additional spending should be traded off against the impact on your fiscal metrics**. Even with increased operating allowances, you will still have to make trade-offs between priorities for funding:

    - Increasing operating allowances to $3.0 to $3.3 billion over the forecast period adds 1.4pp to 2.5pp to net core Crown debt and 0.5pp to 0.8pp to the operating deficit respectively by the end of the forecast period.
    - If you increase allowances to $3.0 billion, this will allow you to either focus on one large priority area, deferring your other priorities to future Budgets, or several small packages across your priority areas. This is in addition to non-discretionary cost pressures outlined above.
    - Increasing allowances to $3.3 billion would allow you spend an additional $0.3 billion on priority packages.

42. **Any increase to allowances should only be considered if there are sufficient ‘high value’ initiatives** that are welfare improving or address critical and long-term cost pressures, as advised in TR2021/359. Increasing allowances to fund ‘low value’ initiatives will produce little benefits while using up finite fiscal headroom.

43. **Additional operating spending should also avoid impeding the delivery of existing or already funded initiatives**. Data on the delivery of COVID-19 initiatives shows that after ignoring ‘non-delivery initiatives’ (eg Wage Subsidy Scheme, cash injections, tax changes), for the $41.1 billion funding allocated to 2019/2020 and

2020/21, only $21.9 billion (53% of allocated funding) has been spent as of 31 December 2020. These ‘delivery initiatives’ report that they only expect to spend 66% of the funding that has been allocated for 2020/21 (AM2021/264).

44. **Increasing allowances may not result in further spending being delivered under certain initiatives or portfolios.** This data indicates that underspending of COVID-19 initiatives has occurred. The reasons for these underspends have not been thoroughly investigated, but it does indicate that constraints on delivering operating spending may be present.

High (not recommended)

45. **We do not recommend substantially increasing allowances at Budget this year since this option risks committing to an unsustainable structural position if the outlook worsens, or spending continues at this level**. This judgement reflects our advice to take a flexible and iterative approach to your fiscal strategy in light of heightened uncertainty.

46. **Based on these scenarios, you could do a one-off increase of operating allowances for Budget 2021 to $4.1 billion**, while meeting your fiscal objectives. This would allow you to fund non-discretionary cost pressures plus high priority packages and other manifesto priorities (see T2021/359). Under current forecasts this scenario increases the OBEGAL deficit by of 0.7pp of GDP and net core Crown debt by 2.7pp of GDP by the end of the forecast period.

47. **However, there are risks associated with such a substantive increase to allowances at Budget this year.** [33]

If allowances are increased to $4.1 billion in each of the following year, this adds 5.4pp of GDP and 1.8pp to the operating deficit and net core Crown debt by the end of the forecast period respectively.

48. **This approach also risks running tighter fiscal policy in the future**. Returning to surplus within the projection period would require operating allowances of $2.1 billion as opposed to the currently signalled $2.3 billion. Both of these are significantly below historic levels of spending.

MYCA for Budgets 2021 to 2024

Capacity constraints have been exacerbated by COVID-19 and delivery of existing capital investment projects is limited

49. **Continued border closures in response to COVID-19 have created significant supply chain constraints**, as well as exacerbating existing capacity and capability constraints in the construction sector. These will significantly impede the deliverability of capital projects and will likely continue to do so at least until ‘normal’ border movements of goods and people resume. Despite additional labour in the construction sector, we are already seeing constraints result in pricing pressure. This is reducing the value for money of capital projects.

50. **The level of actual spending on the NZ Upgrade Programme (NZUP) accounts for approximately only 1.0% of the $8 billion of funding allocated,** as of October 2020. In December 2019 you announced $12 billion of capital investment. $8 billion of this was allocated before Budget 2020. As of October 2020, the NZUP has delivered $79

million of capital spending, materially less than the approximately $300 million allocated to be spent over that time period[5].

51. **The continued 'frontloading' of funding sought through the MYCA also contributes to implementation issues** and does not support proper planning and sequencing of capital investment projects. These increase the risk to delivering projects on time, to budget and to the scope originally specified. This significantly impacts the achievability of outcomes expected. These in turn do not support a reliable and continuous pipeline of capital investment projects. This further contributes to on-going capacity and capability constraints in the construction sector.

52. **Allocated funding for existing capital projects is significant in scale**. $7.0 billion of allocated funding remains as part of the NZUP, with a further $1.0 billion of capital funding allocated to be spent across 2021/22 and 2022/23 under the CRRF.

53. **Delivering currently planned capital spending projects may not be possible within the timeframes and costs expected**. This judgement is indicated by available information on the progress of investments. Funding further capital projects will add additional pressure on the delivery of existing projects. This will impact the achievability of both new and current projects. However, capital spending on smaller maintenance projects of existing assets (e.g. schools and hospitals) are likely to be deliverable, as these don't face the same constraints as larger, more complex capital projects.

However, the MYCA is significantly oversubscribed

54. Submitted Budget bids for capital total $13.2 billion across Budgets 2021 – 2024. Of this, $6.1 billion is sought for cost pressures, with the remaining $7.1 billion submitted as manifesto commitment initiatives. This compares to $7.8 billion in the MYCA for Budgets 2021 – 2024, which is meant to cover all new capital spending over the period. Of submitted capital bids, Treasury Vote Analysts supported $6.7 billion.

A wide range of capital expenditure settings could achieve your fiscal strategy over your parliamentary term

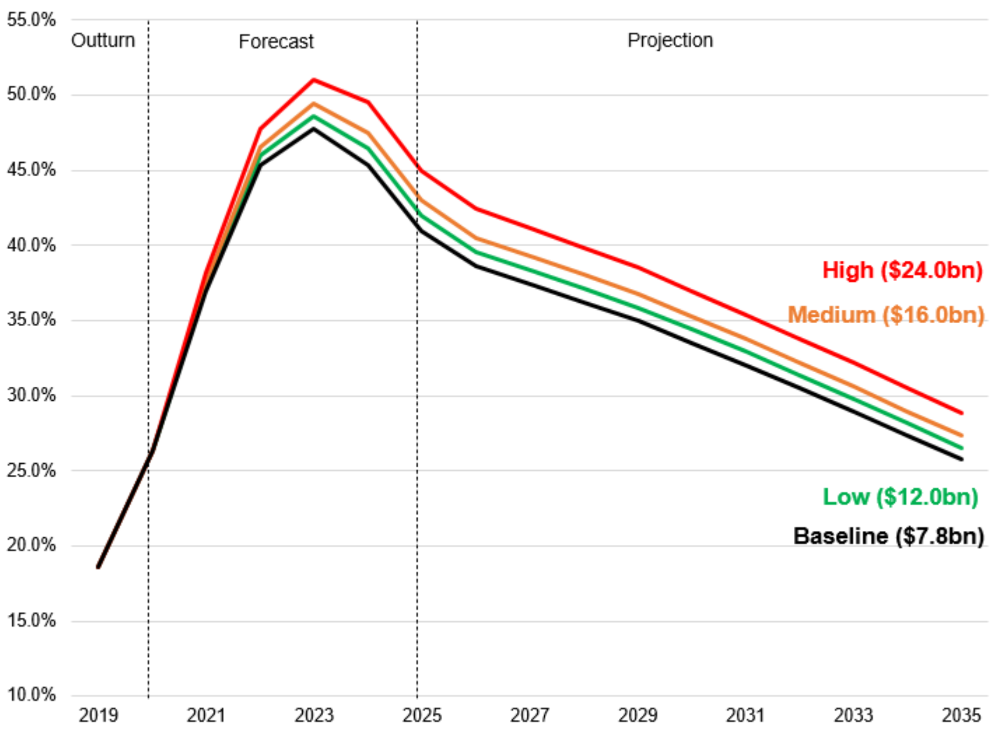
55. The follow scenarios should be considered alongside your draft package advice for Budget 2021. Any of these packages can be introduced while aligning with your fiscal objective to stabilise debt by the mid-2020s and then reduced as conditions permit.

Table 5: MYCA packages

Description	**MYCA ($bn)**	**Equivalent annual spend ($bn)**	**Impact on net core Crown debt (% of GDP) by:**	
			2025	**2035**
Baseline	7.8	1.95	N/A	N/A
Small increase	12	3	1.0pp	0.8pp
Medium increase	16	4	2.0pp	1.6pp
Large increase	24	6	4.0pp	3.1pp

[5] The estimate of $300 million allocated for this period is based off the NZUP funding profile presented in HYEFU 2019, at which time little information about what initiatives were being funded through the NZUP was known.

Figure 7: Net core Crown debt (% of GDP)



56. **The Treasury advises against a significant capital package at Budget this year**. This judgement is predominantly based on the significant capacity constraints of delivering a MYCA of this scale, particularly if it is front loaded. It also has a relatively significant impact on the net debt position, increasing net core Crown debt by 4.0pp of GDP by the end of the forecast period.

57. **The Treasury recommend that you either**:

a. **Stick to the currently signalled MYCA and fund a package of around $2 billion this year**, with a focus on delivering capital cost pressures. This option sticks to an even spread of capital funding across the forecast period. Not 'frontloading' capital funding through the MYCA will encourage better planning of future capital projects and contribute to a sustainable pipeline, while leaving enough funding in the MYCA to act as a more realistic constraint on future capital spending.

OR

b. **Fund a small to medium increase capital package of around $3 to 4 billion.** Beyond cost pressures, this package should focus on high value and deliverable capital spending initiatives in your priority areas. If this option is chosen, we recommend that you top up the MYCA for future Budgets across the forecast period to ensure allowances are set at realistic levels, which would increase the MYCA to between $12 to 16 billion. This option should consider what types of initiatives are being funded, so as to not threaten the deliverability of existing capital projects. Funding a package of this scale would increase net core Crown debt by 1.0pp to 2.0pp by the end of the forecast period.

58. **The scenarios above have a very limited impact on OBEGAL**, since the operating position largely excludes capital spending. The distinction between operating and capital was made in the fiscal targets due to differing impacts these types of spending have on the fiscal strategy. This only holds if for short-term temporary capital

expenditure, rather than using capital to top up operating expenditure, such as DHB deficits.

Next Steps

59. We will discuss this advice with you at Budget Matters on 9 March.

60. We will provide your further fiscal strategy advice following the finalisation of the preliminary fiscal forecasts on the 23 March.