

The Treasury

Budget 2022 Information Release

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Budget Ministers 2

Fiscal Strategy

9 November 2021

Purpose and key questions

The key objectives for this meeting are to:

1. Discuss the broad direction of the **fiscal strategy** for Budget 2022.
2. Make decisions on the level of **new spending to be signalled in the 2022 Budget Policy Statement (BPS)** ahead of the Treasury's finalisation of the Half-Year Economic and Fiscal Update (HYEFU) economic forecasts, including:
 - **Climate spending** – what levels of new operating and capital spending are needed on climate change over the next five years? Over a longer horizon, what level should the Climate Emergency Response Fund (CERF) be set at, and when should it be announced?
 - **Health system reform** – what level of funding is needed for the health sector over the next five years?
 - **Total new spending to signal at the BPS** – what levels of new operating and capital spending are needed for Budgets 2022-2025, including cost pressures and manifesto commitments?

The key decision I am seeking today is to confirm overall new spending of approximately **\$6.0 billion** operating per annum (not including the CERF) at Budget 2022, **\$4.0 billion** operating per annum allocated to Budget 2023, **\$3.0 billion** operating per annum at Budgets 2024 and 2025, and a **\$4.0 billion** increase to the multi-year capital allowance. These figures will be used as inputs to the Treasury's economic forecasts, **which are being finalised later today**. We can decide on how to present new spending in the budget allowance framework at a later date before the BPS is finalised.

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Economic and fiscal context



The economic context

The Treasury's preliminary HYEFU economic and tax forecasts show an economic outlook that is stronger than Budget Economic and Fiscal Update (BEFU) 2021 forecasts

- The domestic economy has proved more adaptable and resilient to the COVID-19 pandemic than previously expected. Tax revenue over the next four years is forecast to be **\$36 billion higher compared to BEFU 2021 forecasts**. This reflects the stronger economy in 2020/21 and higher near-term nominal GDP.
- However, the improved outlook also reflects skills shortages, capacity constraints and supply chain disruptions due to COVID-19. Combined with significantly higher inflation than previously forecast, this will lead to higher cost pressures sought in future Budgets in order to keep delivering the same level of government services.
- Higher inflation is putting upward pressure on the Official Cash Rate and interest rates faced by individuals, businesses, and the government. However, as supply chain disruptions ease and higher interest rates begin to influence activity, the Treasury expects inflationary pressures will also begin to ease off.

Uncertainty around the economic outlook remains higher than usual due to COVID-19

- We should be mindful that, despite the strong economic recovery, extended COVID-19 restrictions in Auckland present an ongoing risk.
- The Treasury's final HYEFU forecasts are likely to reflect a somewhat slower recovery from the Delta-affected September quarter than assumed in the preliminary forecasts. However, inflation is expected to be stronger in the Treasury's final HYEFU forecasts, which will further boost nominal GDP and tax revenue, while also adding to future cost pressures.

The fiscal context

Preliminary HYEFU fiscal forecasts also show an improved fiscal outlook since BEFU forecasts

- The operating balance before gains and losses (OBEGAL) deficit is larger in the current year when compared to Budget 2021, due to higher expenditure – particularly on our response to COVID-19. However, OBEGAL then improves for the remaining forecast period, as COVID-19 expenditure is forecast to unwind, while significantly stronger tax revenue continues.
- **OBEGAL is forecast to return to surplus in 2023/24** (compared to 2026/27 forecast at Budget 2021), before considering my recommended increases in new spending, which are likely to shift this out by one more year, to 2024/25.*
- Net core Crown debt (including Funding for Lending (FLP) assets) is forecast to be lower across the forecast period compared to Budget 2021. It is now forecast to peak as a percentage of GDP at **35.5% of GDP in 2023/24** (before my recommended new spending settings) – a year earlier and around 6 percentage points lower than expected at Budget 2021. With my recommended new spending settings, net core Crown debt including FLP assets is forecast to peak at **38% of GDP in 2023/24**.*

Higher inflation and higher interest rates will have a range of impacts on the fiscal outlook

- Treasury's forecasts show some of the impacts of higher CPI inflation and interest rates flowing through to higher costs over the forecast period, such as ACC claims costs and higher benefit payments. Higher interest rates and inflation have also seen an increase in net core Crown finance costs of \$3.3 billion over the forecast period.
- We can expect to see more funding being sought by agencies over the next few Budgets to meet the likely increased pressure on costs from higher inflation.

Budget 2022 context



Budget 2022 Context

Budget 2022 Priorities

- Budget 2022 will continue to make **progress against the Government's goals** for this term.
- To do this, Budget 2022 will focus on:
 - addressing long-term challenges through multi-year funding arrangements, including **health reforms** and the establishment of a **Climate Emergency Response Fund (CERF)**
 - Public Finance System modernisation, through the establishment of **Justice and Natural Resources clusters**
 - meeting our **manifesto commitments**, and
 - funding **critical cost pressures**.

Budget 2022 Invitations

- We are facing **significant bottom-up pressure on the Budget allowances**. Through the Budget invitation process, Ministers sought funding for **over 560 initiatives**:

Total operating sought over forecast period (\$ billion)	63.9
Average per annum operating sought (\$ billion)	16.0
Total capital sought over ten years (\$ billion)	9.3

- In addition to the multi-year packages already invited to be submitted by Justice and Natural Resources cluster Ministers, **I have invited the Health and Education Ministers to prioritise their new spending initiatives within funding envelopes**, which will be the starting point for Budget decision-making. Of the remaining initiatives, I have excluded over 110 through the invitation process and added conditions to the submission of nearly 150 others.

Table includes CERF initiatives, which totalled \$11.9 billion sought. Does not include funding sought for the Justice and Natural Resources clusters. Includes initiatives later identified for the COVID-19 omnibus funding process/CRRF.

Budget 2022 Context

- But we need to make further, tough, prioritisation decisions.** Funding invited for consideration through Budget 2022 outstrips our available allowances. The economy is also unlikely to have the **capacity to absorb** a large amount of additional spending through Budget 2022 and funding a large number of initiatives would create **challenges for delivery.**

Summary of funding sought, post-invitations (excludes initiatives that were not invited)

Funding sought by track*	Opex avg (\$b)	Opex total (\$b)	Capex total (\$b)
Cost pressure	1.588	6.351	1.001
Manifesto commitments	2.728	10.911	0.938
Health (medium)	3.225	12.900	TBC
Education	0.750	3.000	TBC
Sub-total – Budget 2022 allowances – invitation process	8.291	33.162	1.938
Justice cluster envelope (medium envelope)	0.665	2.660	TBC
Natural Resources cluster envelope (medium envelope)	0.260	1.040	TBC
Budget 2022 precommitments	0.789	3.155	2.292
Sub-total – Budget 2022 allowances	10.005	40.017	4.230
Climate Emergency Response Fund	2.303	9.210	1.329
Total	12.308	49.227	5.560

*Excludes COVID-19 omnibus process/CRRF initiatives. Invited Education envelope excludes invited funding for teacher and principal collective agreement bargaining. Budget 2022 precommitments figure includes the Budget 2022 Between-Budget Contingency. **As at 8am, Friday 5 November.**

Budget 2022 Context: Health

- Investment in the health system will be one of the centrepieces of this Budget. With Health New Zealand and the Māori Health Authority operational from 1 July next year, Budget 2022 is our opportunity to **set them up for success and support our desired refresh** – with revenue uplifts sufficient to meet pressures over coming years without incurring deficits, and to begin investing in our envisaged system shifts.
- However, the system is facing **significant capacity constraints** – especially workforce – and delivery of new investment is my major concern. I have asked the Minister of Health to prioritise new investments within three envelope scenarios to illustrate interdependencies and trade-offs.
- Cabinet recently agreed to move to multi-year funding for Vote Health from Budget 2024. The Budget 2022 two-year **health transitional funding package** will set the stage for this shift as a two-year Budget (covering Budgets 2022 and 2023), with indicative costs as follows

Priority	Operating (\$m)					Capital (\$m)
	2021/22	2022/23	2023/24	2024/25	2025/26	
Vote Health cost pressures	-	1,000	2,100	2,100	2,100	TBD
Health System Rebase to remove deficits (note that the Treasury's ^[33] p.a. forecast provision and associated confidential cash contingency will be removed at HYEPU, offsetting the OBEGAL impact)	[33]					
New investment (Medium envelope) (note that the small and large scenarios of \$300m p.a. and \$900m p.a. have also been requested)	-	600	600	600	600	TBD
Capital investment	[33]					
Total						

- The significant fiscal impacts of this package raise questions about whether components should be treated inside or outside of the Budget 2022 and Budget 2023 operating allowances. Any of the fiscal management choices will have communications implications, including for the visibility of potential health system funding uplifts at HYEPU. I am receiving further advice on options available.

Budget 2022 Context: Clusters

- Clusters for the Justice and Natural Resources sectors are being piloted for Budget 2022. The aim is to **enhance collaboration on collective priorities** and agree a **three-year funding path** for the agencies in these clusters (informed by spending reviews).
- The clusters are currently developing joint packages to deliver on their priorities within **indicative operating envelopes** (although some initiatives will be submitted through the main Budget process, eg, capital).
- Final cluster packages with an overall spending proposal are due to me on **Friday 4 February**. This process will then merge into the main Budget process for the decision-making phase in March.
- The clusters are on track to deliver packages. However, even with priorities now set, significant prioritisation will be needed to manage within an affordable final package.

Justice Cluster priorities:

- Better outcomes for victims
- Improving access to justice
- Addressing issues with remand
- Better enabled organisations and workforce

Justice (\$m)	2022/23	2023/24	2024/25 & outyears
Low	140	300	475
Medium	280	580	900
High	370	770	1,200

Natural Resources Cluster priorities:

- Improving biodiversity and biosecurity
- Improving marine system resilience
- Implementing natural resource system reform
- Building a more inclusive and sustainable economy
- Enabling climate resilience

Natural Resources (\$m)	2022/23	2023/24	2024/25 & outyears
Low	55	120	195
Medium	100	220	360
High	160	350	570

Budget 2022 Context: Next Steps

Initiative Submission

- I have communicated to Ministers that I expect the number of initiatives submitted in December across all portfolios to be **less than** the number invited.
- As Budget Ministers, we should only consider funding those initiatives that are our **highest priority**, represent **high value for money**, and are **implementation ready**.
- To aid decision making, I have asked Ministers to **clearly articulate their relative priorities** when submitting initiatives in December.

Package Development

- In February and March 2022, I will provide you with draft, revised and final Budget packages for your consideration.
- When considering these packages, **we will need to carefully consider where there is more discretion around the timing and quantum of funding**, including whether an initiative may be deferred to Budget 2023.
- It is also important that we consider the **delivery risk** associated with each initiative. **Labour shortages, higher-than-expected inflation** and other **supply constraints** are already impacting on deliverability, so we must be careful not to crowd out existing investments and reform programmes.
- As such, value-for-money analysis of Budget initiatives will comprise three elements: **value** (wellbeing impacts), **alignment** (with Government goals and strategies) and **delivery** (assurance of effective delivery).
- When making funding decisions, we should consider how robust the value-for-money case for an initiative is, and **prioritise funding those initiatives** supported by clear economic rationale and **stronger value-for-money analysis**.

Climate Emergency Response Fund (CERF)



The cost of climate change mitigation

- We are embarking on an ambitious programme of climate action. **This is a long-term programme** that will reach across many portfolios, sectors and across time. As a result, **the total cost is uncertain**. However, in achieving its objectives the Government is likely to incur significant costs.
- **Potential mitigation costs are presently much clearer than adaptation costs**, although the role of government and mix of policy interventions across either are yet to be fully determined.
- The Treasury has prepared indicative scenarios based on potential mitigation costs that bring together Climate Change Commission modelling, proposed Emissions Reduction Plan initiatives, transportation mode shift, offshore mitigation purchases and international climate finance. These scenarios are illustrative only and are based on a number of assumptions.

[33]

This excludes potential adaptation costs.

[33]

Setting the size of the CERF

- **Cabinet has already committed to establishing a Climate Emergency Response Fund** as a multi-year mechanism to address both climate change mitigation and adaptation costs. However, we have **not yet agreed to the size of the CERF.**
- I have publicly announced that we will be recycling revenue from the Emissions Trading Scheme toward climate mitigation from Budget 2022 onwards. On this basis, Treasury has included climate mitigation spending in HYEFU forecasts, proportional to ETS cash proceeds.
- ETS cash proceeds amount to \$4.5 billion over the forecast period. I recommend that **we announce the CERF in the BPS** and announce **\$4.5 billion as a 'down payment' for our climate spending.**
- I recommend that we signal that we will top this up ^[33]

• [33]

Overall levels of new spending



New spending to signal in the BPS

In this meeting, **I would like to seek your agreement to higher levels of new operating spending over the forecast period.** This will inform the allowances we communicate in the BPS for the next four Budgets.

I recommend new operating spending of \$6 billion p.a. for Budget 2022, \$4 billion p.a. for Budget 2023, and \$3 billion p.a. for Budgets 2024 and 2025. The higher spending in Budgets 2022 and 2023 intends to capture cost pressures and new investments associated with the health system transition.

My recommended new spending package also provides an increase in the multi-year capital allowance of \$4 billion, to fund **\$9.8 billion total new capital (excluding the CERF) over the next 10 years.**

\$ billions	Budget 2022	Budget 2023	Budget 2024	Budget 2025
Health two-year transitional package, allocated in Budget 2022 (rebase and cost pressures only)	2	1	n.a.	n.a.
New operating spending p.a. (excludes CERF, includes health new spending envelope and initiatives already pre-committed to Budget 2022)	4	3	3	3
Total new operating expenditure p.a. (excl CERF)	6	4	3	3
CERF total capital / time-limited operating	←————— 4.5 —————→			
Multi-year capital allowance (after pre-commitments)	←————— 9.8 —————→			

Note: ‘Total new operating expenditure’ is likely to line up closely with the Budget allowances to be announced at the BPS, but there are options to exclude some health transition spending from allowances. I intend to seek Budget Ministers’ decisions on fiscal management options for presenting new spending in the coming weeks. **For now, I suggest we instead focus on the overall level of spending and its impacts on the headline fiscal indicators, as these decisions are required as inputs to Treasury forecasts on 9 November.**

Impacts on the fiscal indicators

My recommended operating and capital spending settings (including health, climate change and all other new spending) will see **net core Crown debt (including FLP assets) peak in 2023/24 at 38%, and OBEGAL return to surplus in 2024/25** (shown in Figures 1 and 2).

Figures 1 and 2 present the fiscal impacts of the following operating allowance settings:

- My recommended operating spending of **\$6 billion p.a. at Budget 2022, \$4 billion p.a. for Budget 2023, and \$3 billion p.a. for Budgets 2024 to 2025.**
- The Treasury's recommended operating spending of \$4 billion at Budget 2022 and \$3 billion for Budgets 2023 to 2025.
- An illustrative higher spending scenario of \$7 billion at Budget 2022 and \$4 billion for Budgets 2023 to 2025.

Figures 1 and 2 also include the **Budget 2021 forecasts** for net core Crown debt (including FLP assets) and OBEGAL, to allow for comparison. Budget 2021 set lower operating allowances of \$2.7 billion p.a. for Budgets 2022 to 2024, \$2 billion p.a. for Budget 2025 onwards.

All scenarios assume the CERF is funding using expected \$4.5 billion Emissions Trading Scheme (ETS) proceeds in the forecast period, and that \$4.0 billion is added to the multi-year capital allowance for the HYEPU forecast period.*

*Treasury has assumed all CERF expenditure over this time period will be operating expenditure. I expect some of the CERF will be capital expenditure (increasing over the medium term), so the impact on OBEGAL in these scenarios may be slightly overstated.

Figure 1: Impact of my recommended spending settings on net core Crown debt (including FLP assets)

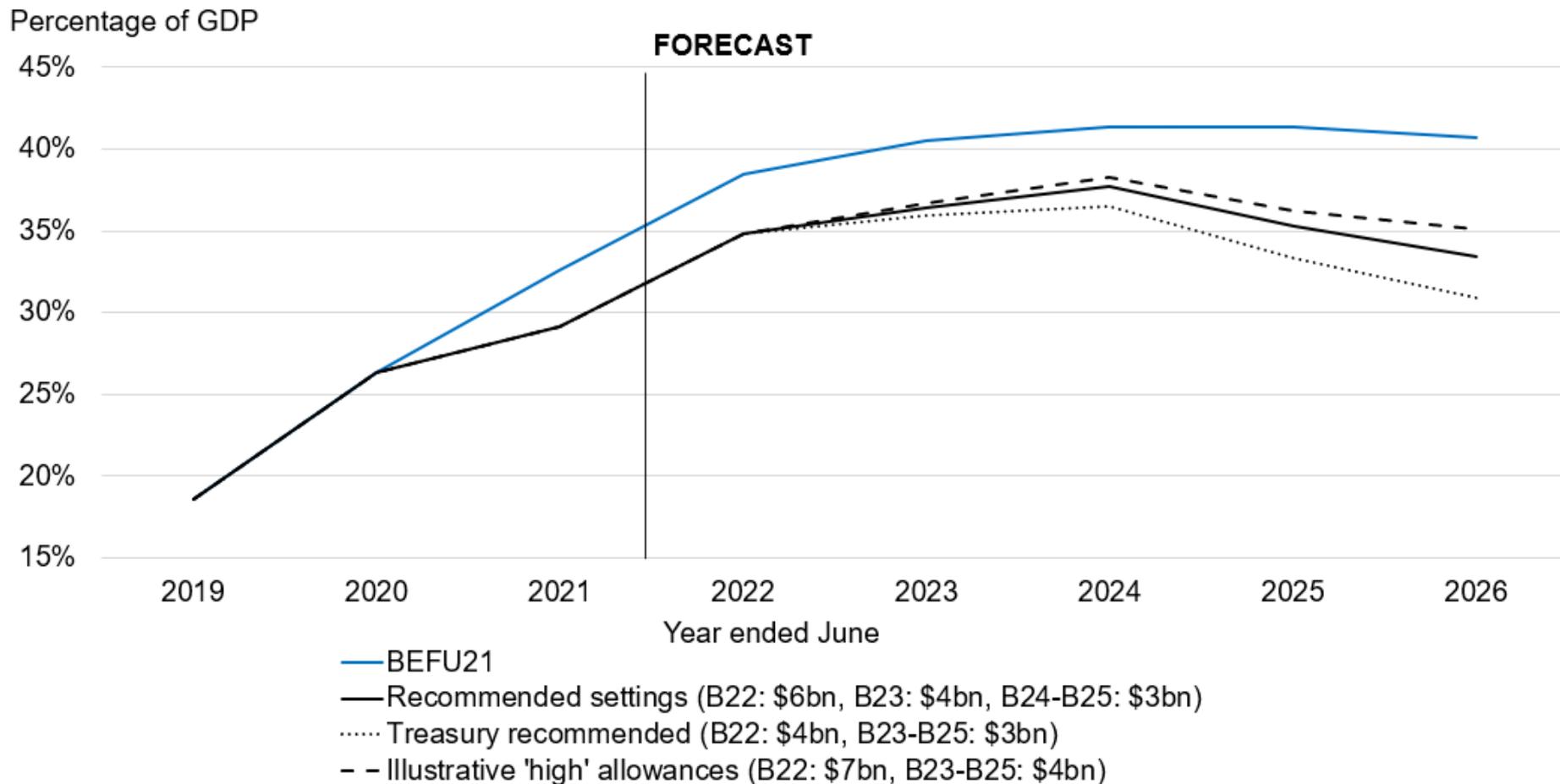
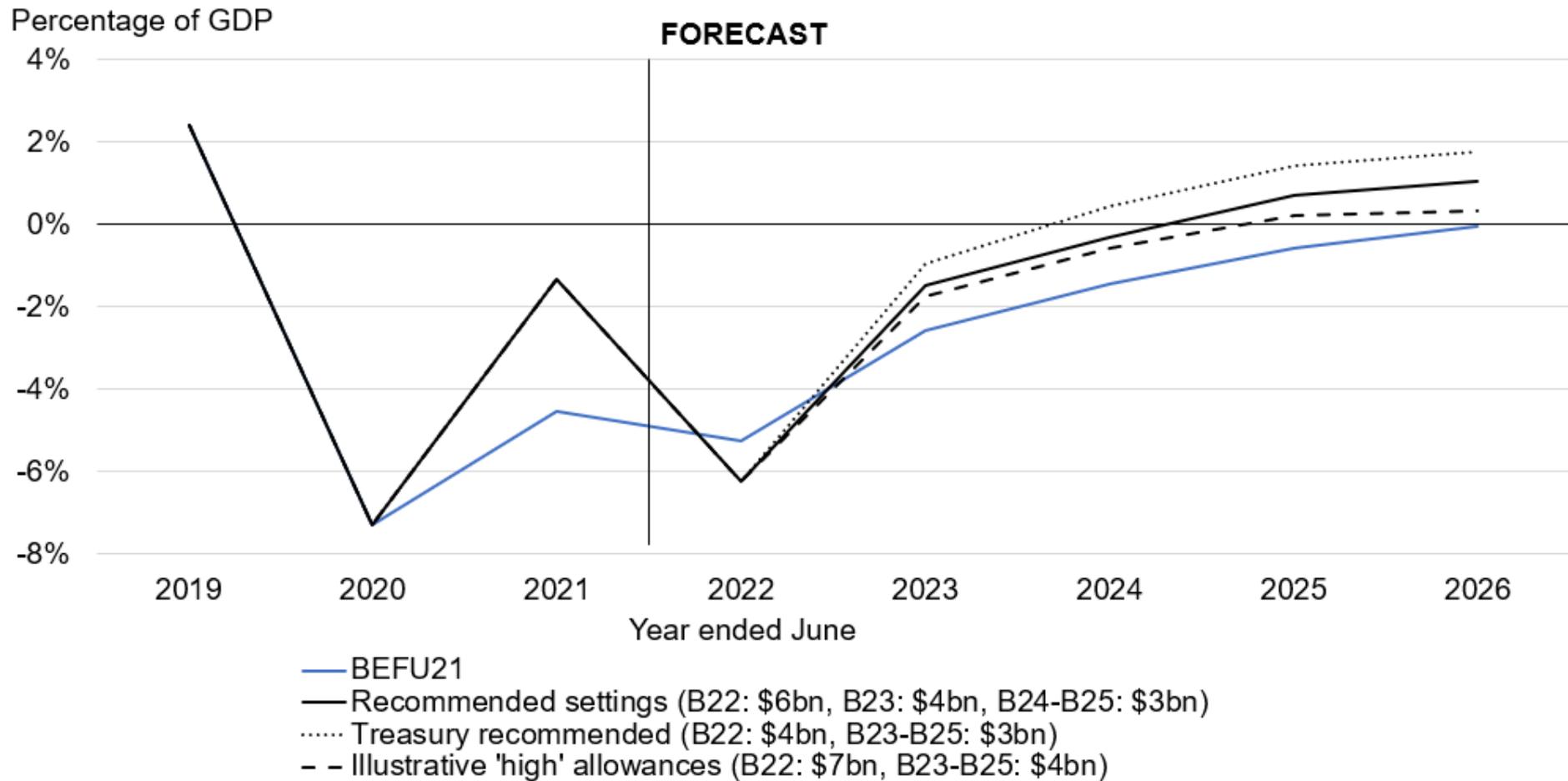


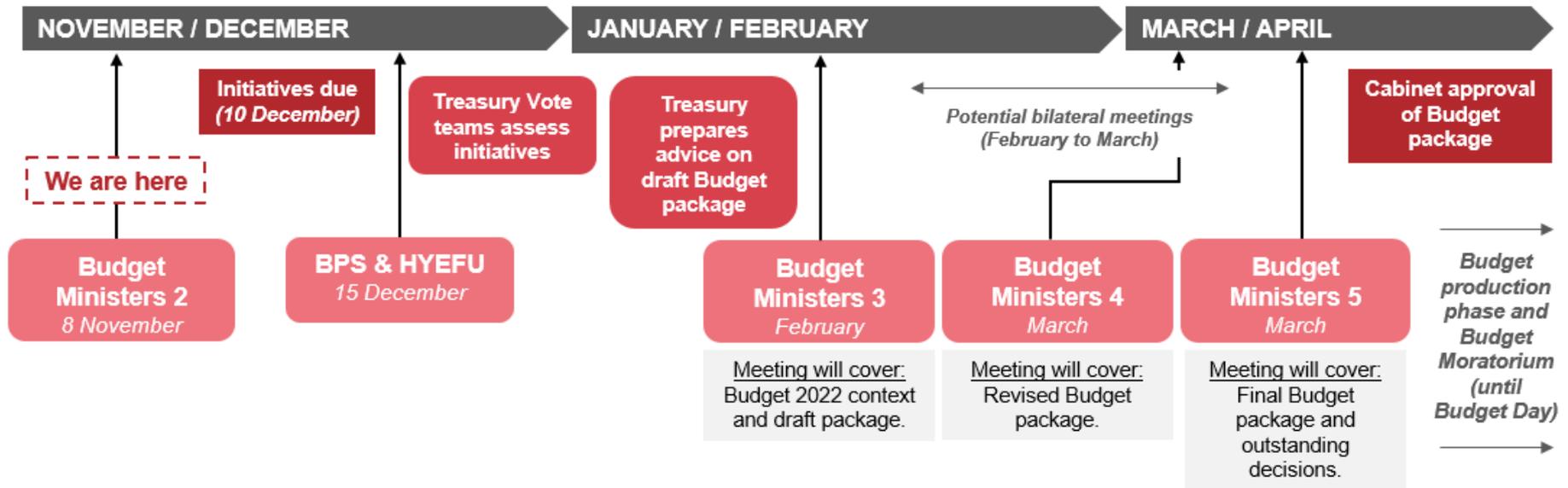
Figure 2: Impact of my recommended spending settings on the operating balance before gains and losses (OBEGAL)



Next Steps



Next Steps



- It is important that **the Budget 2022 process remains flexible to account for the uncertainty of COVID-19**, and I will keep you updated of any changes to our decision-making approach.
- On **Monday 15 November**, the Minister for COVID-19 Response and I will be taking a paper to Cabinet that seeks agreement to a range of proposals as part of our ongoing COVID-19 response. In addition, some initiatives that progress through the Budget 2022 process will be **funded through the CRRF**, where they meet the strict criteria for this fund.
- Ahead of the publication of the BPS in December, I will seek your views on how the Health package is treated in relation to Budget allowances, and subsequently take to Cabinet our proposed Budget allowances to be communicated in the BPS.

I will inform you of the key dates for 2022 once I consider these in early December.