The Treasury

Budget 2022 Information Release

August 2022

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TE TAI ŌHANGA
THE TREASURY

Reference: T2021/501 MC-1-5-4

Date: 5 March 2021

To: Minister of Finance (Hon Grant Robertson)

Deadline: Thursday 11 March 2021
(if any)

Aide Memoire: Fiscal Indicator Review – Slidepack for Discussion on 11 March 2021

On 11 March you will be meeting Treasury officials on the review of the fiscal indicators. The attached slidepack presents our preliminary judgements on the review.

Our first-principles review has identified several key options to amend the headline flow and stock fiscal indicators (currently OBEGAL and net core Crown debt). The review was progressed according to our initial advice in December [T2020/3488 refers].

We are seeking your feedback on our preliminary judgements. Your feedback will enable us to narrow the range of options we present to you in our final advice at the end of March. Changes are intended to be implemented or signalled at Budget.

We recommend the following discussion points for the meeting:

1. Are there any other policy choices relating to the headline fiscal indicators that we should analyse?

2. Do you agree with the following set of judgements?

   a The headline flow indicator should remain OBEGAL as currently defined.

   b The headline stock indicator should focus on activities that Ministers have decision rights over. This suggests retaining a core Crown net debt measure, with modifications to:

      i Include Crown Entity third party borrowing.

      ii Look through the impacts of RBNZ decisions by presenting a version of net debt both including and excluding the RBNZ.

   c The headline stock indicator should consider only liquid financial assets that the Government can easily access. A broader set of financial assets (i.e. NZSF and potentially some advances) could be brought into the indicator, but this is largely a political judgement.

3. What is your appetite for implementation risk? A trade-off may need to be made between having full implementation by Budget and making preferred changes over a longer timeframe.

Next steps

Following our discussion, we will prepare final advice for you to receive on Thursday 25 March. We require decisions by 31 March to enable implementation in Budget.

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TE TAI ŌHANGA
THE TREASURY

Review of headline fiscal indicators: key policy choices

Macroeconomic and Fiscal Policy team
Fiscal Reporting team

5 March 2021

Context

The Treasury is reviewing the headline flow and stock fiscal indicators (currently OBEGAL and net core Crown debt) ahead of Budget 2021. **Our aim is to ensure the headline fiscal indicators are fit-for-purpose for setting, communicating, and assessing progress against the fiscal strategy**. This includes addressing:

- recent issues with the presentation of alternative monetary policy (AMP) in the fiscal indicators (at HYEFU 2020, this issue was temporarily dealt with through an additional measure of net debt for communication purposes), and
- the increasing prevalence and magnitude of Crown entity (CE) borrowing (which is not captured in net core Crown debt, so the government's fiscal risks appear to be understated).

This slide pack and discussion precedes formal advice to you at the end of March 2021. It follows from initial scoping advice in December 2020 [T2020/3488 refers] where you agreed to progress a first-principles review, and agreed objectives for determining 'good' fiscal indicators (annexed). **No indicator will perfectly meet all of these objectives. You will face trade-offs depending on how you weight different objectives, including timeliness of implementation.**

What do we mean by 'headline' fiscal indicators?

Section 26J of the PFA sets out five indicators the government should focus on when considering their fiscal strategy. Governments have tended to focus on two headline indicators to target (one flow and one stock) and to hold itself accountable for fiscal outcomes. Ideally, the Treasury will publish the same headline fiscal indicators in its regular Economic and Fiscal Updates. Reporting on a suite of indicators helps to put the headline indicators into context by enabling broader analysis of the government's full balance sheet, financial performance, and cash position.

This review is narrowly scoped to identify short-term changes to fiscal indicators, working within the current legislative framework.

COVID-19 and the low interest rate environment have raised fundamental challenges to our macroeconomic framework that go beyond the definition of OBEGAL and net core Crown debt. These may require revisiting the principles of responsible fiscal management and the fiscal indicator requirements in the PFA, as well as the respective roles of monetary and fiscal policy in macroeconomic stabilisation. We intend to address these broader questions as part of a comprehensive review to commence following Budget 2021.

Purpose of this discussion

Our first-principles review has identified a number of policy choices relating to the purpose, design and coverage of the headline fiscal indicators.

- This slide pack provides our current judgements on these choices and some of their practical implications.
- Your feedback on these judgements will allow us to narrow the range of options presented in our final advice.
- Some of these choices are not controversial, but have been analysed for completeness. We now seek your agreement to treat these choices (listed in slide 4) as underlying judgements that further refine the scope of the work, as we focus in on a set of practical recommendations for changes at Budget 2021.
- Other choices are more complex, and detail on the relevant trade-offs is provided in slides 5-9.
- Slide 10 outlines implementation considerations, and slide 11 brings together the judgements in this slide pack to a set of interim recommendations, which we propose focusing on in our final advice to you at the end of March 2021.

Questions for you:

1. Are there any other policy choices relating to the headline fiscal indicators that are **not included in this slide pack but that should be analysed**?
2. Do you **disagree with any of our judgements**? (This will inform the scope of final advice)
3. What is your appetite for **implementation risk**? How important is it that any changes to the indicators are announced and fully delivered for Budget 2021?

Further scope refinements

OBEGAL and net core Crown debt have not changed substantially for over a decade. There remains a strong case for retaining much of the current approach. We have reviewed the basic design features of both of these fiscal indicators (discussed below), and concluded there is no strong justification to change our judgements on these issues. **Unless you indicate otherwise, we will not prepare further analysis on these issues.**

Treasury judgements	
Accrual/Cash: **Accrual-based headline indicators are preferred** over cash-based measures (OBEGAL and net core Crown debt are accrual-based). They are more transparent and reflect transactions when decisions are made. However, it is more common internationally to use cash-based measures.	Removing volatility: The headline flow indicator should continue to **look through market movements** (such as revaluations) **but include the impacts of business cycle movements** (such as those driven by tax and transfer settings and other policy decisions). Further (non-urgent) work could consider whether our current judgments on the kinds of market volatility that are looked through remain appropriate.
Operating/Capital: The headline flow indicator should **continue to exclude capital items**. This provides a better measure of year-on-year fiscal performance as ‘lumpy’ items such as capital are excluded. The ongoing cost of capital would somewhat still be reflected via depreciation costs captured as operating expenditure.	Audited financial statements: The fiscal indicators themselves **do not need to be audited**. However, it is important for credibility that these indicators clearly and simply reconcile to audited figures and can be understood in the context of the Government’s financial statements.
Stock/flow consistency: The set of equations that link the current headline fiscal indicators (total Crown OBEGAL and net core Crown debt) is relatively complex, because the two indicators are targeted for different purposes and measure different segments of the government. As such, we consider that **better stock/flow consistency should not be prioritised ahead of other objectives if this would compromise the usefulness of either of these indicators**.	International comparability: New Zealand’s approach to public finance is unusual internationally, but we believe it has many significant strengths. Prioritising international comparability of our headline fiscal indicators would likely require fundamental changes to our legislative frameworks and could compromise the usefulness of the indicators in other ways. **We do not view achieving international comparability as sufficiently high priority to justify changes.**

Remaining key policy choices

A number of policy choices do not have a clear judgement. These choices and their practical implications are discussed in the following slides. Your feedback on our judgements will be reflected in our final advice in late March, which will present fully-built options for new or modified headline fiscal indicators.

Policy choices	Examples of practical implications	
	If yes…	**If no…**
1. Should the **headline flow indicator** focus only on the financial impacts of activities that Ministers have decision-rights over? (**slide 6**)	**Consider excluding SOEs and/or CEs from OBEGAL.** The flow indicator becomes a less comprehensive measure of financial performance.	**Retain OBEGAL as is.** The headline flow measure will continue to be impacted by decisions of entities outside short-term control of Ministers.
2. Should the **headline stock indicator** focus only on the financial impacts of activities that Ministers have decision-rights over? (**slide 7**)	**Amend net core Crown debt to include some CE borrowing**, and present net debt both including and excluding the RBNZ.	**Widen coverage of net debt to include total Crown.** Measure would move closer to net worth, and exhibit greater volatility.
3. Should the **headline stock indicator** include only financial assets that can be liquidated in the very short term? (**slides 8 and 9**)	**Retain the current set of assets included in net core Crown debt**. Continues to measure narrowly defined 'financial resilience', but excludes substantial Crown assets (e.g. NZSF assets) that could be drawn on in a crisis.	**Consider inclusion of NZSF assets and/or advances in net core Crown debt.** Would present a wider picture of the balance sheet, but raises challenges to determine consistent treatment across different assets.

Question for MOF: Are there any other policy choices relating to the headline fiscal indicators that are **not included in this slide pack and should be discussed or analysed further**?

1. Should the headline flow indicator focus only on the financial impacts of activities that Ministers have decision-rights over?

Pros of a narrow indicator	Cons
It provides a more direct link between fiscal policy decisions and the headline flow indicator.	It would provide only a partial view of the Government’s financial performance (e.g. the performance from investments in entities like SOEs would be excluded).
Decisions are reflected more quickly in the flow indicator.	
There would be a clearer link to decisions that Ministers have accountability over.	It could lead to a narrower focus for fiscal management of the Government’s balance sheet (e.g. resulting in less focus on management of long-term liabilities and poor performing entities).
It would remove some volatility from the flow indicator that is outside Ministers’ control (e.g. performance of SOEs).	
It would provide a clearer picture on how fiscal policy impacts the economy.	It requires some judgement about what activities Ministers have decision-rights over.
Movements in the headline flow indicator would more closely align to movements in the current headline stock indicator (if it remains unchanged).	It is not well-established and may have some communication challenges.

Judgement: No – a wide coverage is preferred. This suggests retaining a total Crown OBEGAL measure. OBEGAL would continue to capture some financial activity within Government that is outside the control of Ministers, but would provide a full picture of the Government’s financial performance, with some volatility removed.

Ease of implementation		**No change.** LSAP repurchase price effects (assuming no changes to items excluded from OBEGAL) would continue to be presented below-the-line, and OBEGAL would sit outside the audited financial statements.

2. Should the headline stock indicator focus only on the financial impacts of activities that Ministers have decision-rights over?

Pros of a narrow indicator	Cons
There would be a more direct link to how fiscal policy decisions impact the stock indicator.	Measures that are narrower than total Crown provide only a partial view of the Government's financial position.
There would be a clearer link to decisions that Ministers have accountability over.	May require judgement about what activities Ministers have decision-rights over.
This would capture entities that the Government implicitly guarantees. This ensures that the indicator accurately reflects the Government's fiscal risk with respect to these entities.	This could lead to a narrower focus for fiscal management of the Government's balance sheet (e.g., management of long-term liabilities and poor performing entities).

Judgement: Yes – the headline stock indicator should focus on activities that Ministers have decision rights over. This suggests retaining a core Crown net debt measure, with modifications to:

- **include Crown entity third party borrowing**, as this debt is approved by Ministers and is viewed as being guaranteed by the Government. We suggest making this change now before the levels of Crown entity debt increase any further.
- **Look through the impacts of RBNZ decisions** by presenting a version of net debt that removes the RBNZ. We would look to continue presenting the headline stock indicator both including and excluding the RBNZ.

Ease of implementation		
		Challenging – Removing the RBNZ and including parts of the Crown Entity segment would involve complex manual changes and may not be fully implementable by Budget 2021.

3. Should the headline stock indicator only include financial assets that can be liquidated in the very short term?

Net debt is focused on measuring the ability of the Crown to access cash easily in a crisis. As a result, it only covers highly liquid assets Ministers can access without needing policy changes, but excludes other non-financial or less liquid assets that may still be important for longer-term solvency of the Crown. Broader measures of balance-sheet solvency, such as net worth, are not used to set fiscal targets but are reported in the suite of fiscal indicators to enable a fuller assessment of fiscal sustainability.

Pros of including only liquid financial assets	Cons
As some financial assets are held for public policy reasons (e.g., student loans) it could be misleading to consider these assets available to use for Government funding purposes as they cannot feasibly be liquidated or securitised in the short term.	Some judgement is required to determine what a 'liquid' financial asset is (e.g., some assets may be liquid but are ring-fenced for specific purposes, such as the NZSF portfolio). Both debt maturing in the short-term and long-term are included in the current net debt indicator, but only assets with very short term maturity are included.
Including only liquid financial assets provides a good sense of the Government's ability to sustain current policy settings and respond to shocks.	Incentivises a greater focus on expenditure management and budget allocations at the expense of wider balance sheet considerations.
Liquid financial are akin to cash and are therefore less likely to be volatile, which makes the indicator more useful for fiscal strategy purposes.	In practice, the Crown's liquidity would be constrained only if new debt could no longer be issued. The liquidity of assets would only be relevant in this extreme case, so may not be a useful guide for day-to-day fiscal management

Judgement: Assuming a liquidity-based measure is preferred, the headline stock indicator should only consider **liquid financial assets** that the Government can easily access (and should exclude other financial assets, such as advances). **If more of a cash solvency measure is preferred, a broader set financial assets (i.e. NZSF and potentially some advances) could be brought into the indicator**. The exclusion or inclusion of NZSF assets in the headline indicator is largely a political judgement – the status quo reflects that these assets are legislatively ring-fenced to fund future expenses, but otherwise would be classified as liquid assets in the net debt indicator.

Other practical implications	If a NZSF-inclusive measure is targeted for the fiscal strategy, the target may need to reflect a changing profile over time, which could be confusing to communicate. If Crown entities were included in the headline stock indicator in future, **we would not consider Crown entity financial assets to be liquid** as they are largely held for public policy reasons and are not easily available to fund the Government's fiscal policy decisions.
Ease of implementation	**No change / Easy** if net debt is retained – the current net debt indicator includes only liquid financial assets, but including advances (if desired) would be a minor change to the existing measure. Additionally, net debt is already published both including and excluding the NZSF.

Options for addressing the Funding for Lending Programme (FLP) presentation issue in the headline stock indicator

Assuming net debt is retained as the headline stock indicator, the policy choices and judgements in this slide pack suggest three discrete options for addressing the mismatch in assets and liabilities relating to the Reserve Bank (RBNZ)'s Funding for Lending Programme (FLP).

Option	Pros	Cons	Depends on…
Present a version of net debt excluding the RBNZ (assets and liabilities of FLP both excluded) - **our preferred option**	Likely to be an enduring change if other monetary policy interventions are introduced in the future that would otherwise have significant impacts on the fiscal indicators.	Complex and high risk to implement by Budget 2021. Transactions with the RBNZ that are currently eliminated on consolidation would impact the fiscal indicator if the RBNZ was excluded.	Whether you agree with our judgement on presenting net debt both including and excluding the RBNZ (slide 7)
Change the definition of net debt to include all advances (assets and liabilities of FLP both included) - **our second-best option**	Less ad hoc than just including FLP advances (status quo), but would still be relatively easy to implement. More internationally comparable. Would shift net debt away from liquidity towards more of a solvency measure (if desired).	We already said in HYEFU 2020 that advances (due to their relative illiquidity) "should not be considered when assessing the sustainability of the Government's finances" so this change may seem inconsistent and could be challenging to communicate.	Whether your judgement is to include in net debt only those assets that are liquid in the very short term (slide 8)
Present a version of net debt including FLP advances but continuing to exclude other advances – **our third-best option**	This measure was already produced and communicated at HYEFU so would be simple to retain (in the absence of other substantive changes to the indicator)	This is a relatively ad hoc solution and would not be an enduring change if further alternative monetary policy (AMP) interventions necessitated additional changes to the indicator.	Both of the above judgements.

Judgement: We recommend exploring longer-term options for addressing AMP presentation issues in the indicators, such as looking through the RBNZ entity, and considering ad hoc solutions if enduring options are not preferred.

Implementation considerations

The options outlined here present varying timing and implementation risks. Your preferred options for changes to the indicators may depend on when they need to be implemented.

- **Minor adjustments** to the indicators may pose little implementation risk, for example, including advances in net core Crown debt.
- **Substantive changes** to the structure of an indicator may take more time to implement, require new processes, and/or require manual manipulation of current processes. This would create additional risk in the construction of the indicators ahead of Budget 2021. Including the Crown Entity segment in net debt, or excluding the RBNZ from OBEGAL are both examples of substantive changes as they would affect the underlying structure of the indicator.
- Substantive changes may not be fully implementable at Budget 2021. There are a number of ways to communicate a substantive change. For example, you could announce the change at Budget 2021 for implementation at HYEFU in December 2021.
- We can provide more specific advice on implementation as part of our final advice. **Please indicate if you would like us to consider *only* options that are fully implementable for Budget 2021. This could mean taking a number of first-best options off the table**, which we would recommend against if you would like changes to the indicators to be enduring.

If you agree with our judgements, we will focus on a narrower set of issues over the coming weeks

Our final advice will consider the interdependencies between the discrete policy choices presented in this slide pack, and will provide advice on options for presenting new or modified indicators.

Our judgements on the key policy choices lead to some interim conclusions:

Headline flow indicator	Headline stock indicator
Retain a net debt measure and an OBEGAL measure as the headline fiscal indicators	
Do no further work on possible modifications to OBEGAL, **unless improving stock/flow consistency is a high priority** for you (this includes consistency with any changes to the headline stock indicator, such as removing the RBNZ).	Broaden the coverage of net core Crown debt to include CE third party borrowings (**slide 7**)
	Explore options for presenting a net debt measure that excludes the RBNZ, or that looks through RBNZ decisions in a more enduring way than the current FLP solution (**slides 7 and 9**)
	Provide further advice depending on your preference for including or excluding illiquid assets such as advances and NZSF in the net debt measure (**slide 8**). If further work indicates that removing the RBNZ is not a pragmatic option to address the FLP presentation issue, we would recommend including some or all advances to address this instead (**slide 9**).

As noted in T2020/3488, we will advise on broader questions about the evolution of New Zealand's fiscal and macroeconomic frameworks over a longer timeframe.

Annex: Objectives for a ‘good’ fiscal indicator [T2020/3488 refers]

We proposed that the review ahead of Budget 2021 focus on identifying measures of debt and the operating balance that best meet our objectives of a ‘good’ fiscal indicator. We considered these to be, in order of priority:

- **Policy intent** – the indicator reflects the policy decisions of the Government.
- **Fiscal position** – the indicator is an accurate reflection of the financial position of the Crown.
- **Integrity** – the definition and measurement of the indicator is clear and consistent, for example, through adherence to a recognised accounting standard.
- **Neutrality** – the indicator’s definition does not influence policy decisions and does not incentivise ‘gaming’.
- **Communication** – the indicator can be easily communicated to the public and other stakeholders.
- **Comparability** – the indicator can be easily compared to other countries’ data and can be understood in the context of historic New Zealand data.