The Treasury

Budget 2022 Information Release

August 2022

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

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

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

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

[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] Out of Scope

[41] 18(c)(i) - that the making available of the information requested would be contrary to the provisions of a specified enactment

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

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Fiscal intentions and objectives for Budget 2022

Date:	17 March 2022	**Report No:**	T2022/343
		File Number:	MC-1-5-2-2022

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Consider** the recommendations on the short-term intentions and long-term objectives for Budget 2022 and discuss with officials at the Finance Priorities Meeting on **22 March 2022**.	22 March 2022

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Shefalika	Analyst, Macroeconomic and Fiscal Policy	[39]	N/A (mob)	✓
Renee Philip	Manager, 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

Treasury Report: Fiscal intentions and objectives for Budget 2022

Executive Summary

This report provides advice on options to communicate new fiscal rules in the form of short-term intentions (for a period of at least 3 years) and long-term objectives (which cover a minimum period of 10 years) in the 2022 Fiscal Strategy Report (FSR), as required by the Public Finance Act 1989 (PFA). As previously advised (T2022/37 refers), the new fiscal rules would focus on targeting small surpluses for the operating balance before gains and losses (OBEGAL) as the main fiscal anchor and complement it with a debt ceiling which would provide more flexibility to undertake long-term investments. You recently agreed to a new net debt indicator that includes Crown Entity (CE) borrowings, advances, and all assets and liabilities of the NZ Super Fund (NZSF) (T2022/306 refers).

We recommend revising your short-term intention and long-term objective for debt to maintain net debt below a ceiling of up to 30% of GDP, subject to significant shocks. This approximately corresponds to a ceiling of up to 50% of GDP based on the current net debt measure and balances the objective of long-term debt sustainability while providing more flexibility for capital spending (T2022/37 refers). However, as the NZSF assets grow over time, we would recommend revising this ceiling downwards to avoid borrowing against the growth in NZSF assets. [34] "subject to significant shocks" provides the flexibility to increase debt beyond the ceiling in response to sizeable shocks.

With a comparatively less binding debt ceiling, we strongly recommend strengthening the use of bottom-up tools. We would only recommend such a significant increase in the debt ceiling with a commitment to only fund projects with a positive cost-benefit ratio based on rigorous business cases. Given the current inflationary pressures and low market capacity, we do not recommend any significant increase in capital investments in the short-term (T2022/244 refers). **Your debt intention can reflect this by specifying the forecast values of net debt based on the current pipeline of capital investments**, in addition to maintaining net debt below the recommended ceiling. The preliminary Budget Economic and Fiscal Update (BEFU) 2022 forecasts show the new net debt measure peaking at just below 20% of GDP in 2023/24 and reducing over the forecast period to around 14% of GDP by 2025/26. These forecast values can be revised in future rounds of the FSR/Budget Policy Statement (BPS) to reflect any changes in Government's capital investment commitments. Otherwise, if you think that there is a high risk of projects being funded without a rigorous assessment based on bottom-up tools, or you would like the debt target to provide more of a top-down constraint, you should either set a lower debt ceiling, increase the debt ceiling progressively towards 30% of GDP or adopt a range with a lower bound much closer to the current forecast trajectory for net debt.

The focus of fiscal policy in the short-term should be to return to a sustainable OBEGAL surplus. To ensure that there are fiscal constraints on near-term decision making, we recommend setting the short-term intention to return to an OBEGAL surplus by a specific target year such as 2024/25. This is in line with the preliminary BEFU 2022 forecasts which show an OBEGAL surplus from 2024/25 onwards. Should the first year of surplus change in the final BEFU fiscal forecasts, we would recommend aligning your intention to target that year.

There is, however, some risk that this target is not achieved due to factors such as forecast revisions or volatility in OBEGAL outside of the Government's control, such as, changes in the performance of State Owned Enterprises and Crown Entities, or valuation changes. Ideally, fiscal policy would not respond to such fluctuations, particularly those relating to the economic cycle, to allow the automatic fiscal stabilisers to operate. To reduce the risk of the volatility in OBEGAL leading to adjustments in allowances to meet your fiscal targets, we recommend using a clause such as “subject to economic and fiscal conditions”. The FSR could elaborate on this point and explain the volatility in OBEGAL and its sources. This should also allow the Government to run OBEGAL deficits to support macroeconomic stability in response to future negative shocks.

In the long-term, once the OBEGAL has returned to a surplus, we recommend that you run operating surpluses (before gains and losses) that are sufficient to avoid current operating expenses contributing to an increase in net debt as a share of GDP. We estimate an OBEGAL surplus of no less than 0.5% of GDP in each year will be sufficient to achieve this (T2022/37). However, we would not recommend such a precise point target given the volatility in OBEGAL. Instead, we recommend that your OBEGAL objective should provide sufficient flexibility to avoid sub-optimal policy decisions such as pro-cyclical reductions in expenditure during economic downturns.

We have considered two options for achieving flexibility in the long-term objective. One option is to specify the target as an average value within a range, such as maintaining an **average OBEGAL surplus in the range of 0-2% of GDP** over the 10-year period, subject to economic and fiscal conditions. The key trade-off with a range target is making sure that the range is wide enough to provide the flexibility needed to manage cyclical and other fluctuations in OBEGAL, while not being so wide as to provide a lack of clarity about the Government’s intentions. With the volatility in OBEGAL and the potential size of forecast errors, there is still a likelihood that OBEGAL may fall outside of the range, although the average should be more likely to fall within the range. In practice, it may require adjusting allowances in the projection period to keep the average surplus within the target range. **Alternatively, you could avoid specifying the target numerically, and instead aim to target “small surpluses”** (once the OBEGAL has returned to a surplus) along with the same clause “subject to economic and fiscal conditions”. While this option provides more flexibility through a relatively broad target, it can risk credibility by providing less clarity on the definition of small surpluses. **We consider both options to be finely balanced** as they provide some fiscal constraint in the long-term by ensuring surpluses and supporting macroeconomic stability. Your preferred option should be consistent with your intended communication strategy around new fiscal targets.

You have asked for advice on ways to accommodate certain operating expenses that have similarities with capital investments, such as government grants to fund long-term assets that deliver public benefits but are held by third parties. We have looked at a range of options including creating a bespoke new indicator, using a different indicator to OBEGAL, and allowing more flexibility in the OBEGAL target. On balance, our preference is to not make any changes to the fiscal indicators but **identify a few specific projects that fall in this category and acknowledge that the OBEGAL fiscal rule would not be met at times due to the impact of these projects**. You can be transparent in your FSR/BPS that these will be one-offs and looked through for the purpose of fiscal targets by allowing temporary deficits to fund them.

We do not recommend any significant changes to the intentions and objectives for other fiscal aggregates, except for modifying the short-term intention for net worth to align it with the operating balance objective. Annex 1 outlines the suggested wording for the short-term intentions and long-term objectives for Budget 2022.

Recommended Action

We recommend that you:

a **agree** to set the short-term intention and long-term objective for debt to maintain net debt (including the NZSF) below 30% of GDP and include an [34] to allow the ceiling to be exceeded in response to significant shocks.

Agree/disagree.

b **agree** that your short-term intention for debt should specify the forecast values of the new net debt measure including the NZSF based on your current pipeline of capital investments.

Agree/disagree.

c **note** that with a comparatively less binding debt ceiling, we would only recommend a significant increase in the debt ceiling with a commitment to only fund projects with a positive cost-benefit ratio based on rigorous business cases.

d **note** that if you consider that there is a high risk of projects being funded without a rigorous assessment based on bottom up tools, or if you wish the debt target to provide more of a top-down constraint, you should set a lower debt ceiling, increase the debt ceiling progressively towards 30% of GDP or adopt a range with a lower bound closer to the current forecast trajectory for net debt.

e **agree** that your short-term intention for the operating balance (before gains and losses) should target a return to surplus by 2024/25, subject to economic and fiscal conditions.

Agree/disagree.

f **agree** that once the operating position has returned to a surplus, your long-term objective for the operating balance (before gains and losses) should target -

- a surplus in the range of 0-2% of GDP <u>on average</u>, subject to economic and fiscal conditions.

  Agree/disagree.

<u>**OR**</u>

- maintaining a small OBEGAL surplus, subject to economic and fiscal conditions.

  Agree/disagree.

g **indicate** whether you would like to identify specific one-off operating expenses that have investment-like properties and look through the impact of these by allowing temporary departure from short-term intentions and long-term objectives in these circumstances.

Yes/no.

h **agree** to revise your short-term intention for net worth to ensure it consistent with the operating balance objective.

Agree/disagree.

i **agree** to keep the intentions and objectives of other fiscal variables in Annex 1 (operating expenses and operating revenues) unchanged for the 2022 Fiscal Strategy Report.

Agree/disagree.

j **note** the proposed narrative in Annex 2 for communicating new fiscal rules with the new net debt indicator in the 2022 Fiscal Strategy Report.

Renee Philip
Manager, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal intentions and objectives for Budget 2022

Purpose of Report

1. This report provides advice on the options to communicate your new fiscal rules in the form of new short-term intentions and long-term objectives for Budget 2022. This builds on our recently provided advice on fiscal rules (T2022/37).

Background

2. The Public Finance Act 1989 (PFA) requires you to outline your fiscal strategy in the FSR by publishing long-term objectives for the years 2022/23 – 2031/32 at least (henceforth objectives) and short-term intentions for the years 2022/23 – 2024/25 (henceforth intentions) for total debt, total operating expenses, total operating revenue, the balance between total operating expenses and total operating revenues, and net worth.

3. This report focuses on formulating your intentions and objectives for net debt and the operating balance before gains and losses (OBEGAL) as they are the primary drivers for guiding your fiscal policy decisions. These fiscal rules are part of New Zealand's broader fiscal management framework which includes thinking about other metrics such as net worth. [36]

You have signalled an intention to announce new fiscal targets at Budget 2022 as the existing targets were designed to be very flexible to respond to COVID-19

4. The current intentions and objectives are relatively broad and flexible which has allowed for the uncertain impacts of the COVID-19 response on the fiscal position. The operating balance intention focused on allowing temporary fiscal support in the short-term and reducing deficits over the forecast period. The debt objective focused on stabilising and reducing debt as conditions permit. Preliminary Budget Economic and Fiscal Update (BEFU) 2022 forecasts show that the Government is on track to meet its current intentions and objectives, as the new net debt measure (which includes core Crown advances, Crown entity borrowings and the NZSF) is expected to peak in 2023/24 at just under 20% of GDP and reduces to around 14% of GDP by the end of the forecast period, and the OBEGAL is in surplus from 2024/25 onwards.

5. As New Zealand moves beyond the immediate shock of COVID-19, it is now the right time to re-calibrate the Government's fiscal rules. Following our initial recommendations for fiscal rules to be introduced at Budget 2022 (T2022/37 refers), you asked for further advice on how the following fiscal rules could be specified and implemented –

    - Adopting an OBEGAL target as the main fiscal rule; and aiming for small surpluses in the long-term.

- Complementing the OBEGAL target with a net debt ceiling of up to 30% of GDP based on the new net debt measure including the NZSF[1].

You recently agreed to a new net debt indicator that includes Crown entity borrowings, advances, and all assets and liabilities of the NZ Super Fund (NZSF)

6. In response to our review of fiscal indicators, you agreed to a new net debt indicator that includes Crown entity borrowings and core Crown advances, and to continue publishing versions of the net debt indicator including and excluding the NZSF (T2021/2416 refers). You asked for further advice on the international comparability of the new net debt indicator and recently agreed to adopt the new net debt measure including the NZSF for use as a new fiscal rule (T2022/306 refers). This was based on a balanced decision on international comparability, ease of communication and a comprehensive reflection of Government's fiscal position.

You can communicate your new fiscal strategy by refreshing your new intentions and objectives for fiscal policy in the FSR.

7. Since HYEFU 2021, the New Zealand economy has performed strongly but the preliminary BEFU 2022 economic forecasts show a slightly weaker economic outlook compared to HYEFU 2021 due to the spread of Omicron. With high inflationary pressures, the optimal Government fiscal policy is to be contractionary in the current macroeconomic context (T2022/244 refers). This means returning OEBGAL to surplus to remove stimulus faster and help cool the economy.

8. Hence, in the short-term, your fiscal strategy should continue to focus on reducing deficits and returning to surplus as we move away from the immediate shock of COVID-19. In the long run, fiscal policy continues to face significant challenges of an infrastructure gap, ageing population, and rising healthcare costs. To maintain the fiscal space for addressing these long-term challenges, we recommend running sufficient surpluses in normal times to offset the deficits during downturns and avoid debt ratcheting up over-time (T2022/37). Therefore, your fiscal strategy should aim for small surpluses in the long-term, so the operating position does not contribute to an increase in debt to GDP. This will also ensure sufficient fiscal space for long-term capital investments.

Intentions and objectives in the FSR

The intentions and objectives should ensure long-term fiscal sustainability, whilst allowing for flexibility in the short term to respond to shocks.

9. We evaluate the options for intentions and objectives based on the following criteria:

   - **Sustainability**: ensuring long-term fiscal sustainability.
   - **Flexibility**: avoiding pro-cyclical fiscal policy by allowing the flexibility to respond to shocks for example through higher spending and running deficits in downturns. This supports overall macroeconomic stability.
   - **Simplicity:** can be easily communicated and understood by the decision makers and the public.

[1] This is approximately 50% of GDP based on the current net debt measure.

- **Credibility:** are seen as credible and would not be easily abandoned after a shock.

We recommend revising your debt intention and objective to maintain net debt below a ceiling of up to 30% of GDP, subject to significant shocks.

10. We recommend your short-term intention and long-term objective should be to maintain net debt at below 30% of GDP based on the new net debt measure[2] including the NZSF, subject to significant shocks. The level of ceiling is based on our previous advice (T2022/37 refers) and balances the objective of long-term debt sustainability while providing more flexibility for capital investments. It also ensures a backstop against accumulation of deficits in the case that the operating rule is not adhered to. It is worth noting that as NZSF assets grow over time, we recommend periodically revising this ceiling downwards to avoid borrowing against the growth in NZSF assets.

11. **With a comparatively less binding debt ceiling, we strongly recommend using robust bottom-up tools**. [33]

    However, we would only recommend such a significant increase in the debt ceiling with a commitment to only fund projects with a positive cost-benefit ratio based on rigorous business cases. Given the current inflationary pressures and low market capacity, we do not recommend any significant increase in capital investments in the short-term (T2022/244). **Your debt intention can reflect this by specifying the forecast values of net debt based on the current pipeline of capital investments,** in addition to maintaining net debt below the recommended ceiling. The preliminary BEFU 2022 forecasts show the new net debt measure peaking at just below 20% of GDP in 2023/24 and reducing over the forecast period to around 14% of GDP by 2025/26. These forecast values can be revised in future rounds of the FSR/BPS to reflect any changes in Government's capital investment commitments.

12. On the other hand, if you think that there is a high risk of projects being funded without a rigorous assessment based on bottom up tools, or you would like the debt target to provide more of a top-down constraint, you should either set a lower debt ceiling, increase the debt ceiling progressively towards 30% of GDP, or adopt a range for net debt with a lower bound much closer to the current forecast trajectory. All of these options can mitigate some risk of excessive spending on low value-for-money capital projects. However, it can be challenging to determine the right level of ceiling or range that balances an effective top-down constraint for capital investment while avoiding the risk of unnecessarily constraining fiscal space for capital investments due to forecast revisions.

13. We recommend you add [34] as "subject to significant shocks", as it provides the flexibility to increase debt beyond the ceiling in response to sizeable shocks. This supports macroeconomic stability by providing adequate room for fiscal response, and coordination with monetary policy, especially if monetary policy is constrained close to the lower bound on interest rates.

We recommend fiscal policy focus on returning OBEGAL to surplus in the short-term

14. Our previous advice on fiscal rules focused on an OBEGAL surplus position as the main fiscal rule to support intergenerational equity and fiscal sustainability (T2022/37

[2] This is up to approximately 50% of GDP based on the current net debt measure.
[3] This is based on preliminary BEFU 2022 forecast.

refers). There are multiple ways to operationalise this, for example through a point target, a rolling target or a flexible target.

15. You can set your intention to target a year for returning to surplus as it provides an effective constraint for fiscal sustainability, is simple to communicate, and could help to build credibility by giving a clear direction of Government's fiscal strategy in the short-term. **We recommend targeting the year 2024/25 for returning to surplus** based on the preliminary BEFU 2022 forecasts that show an OBEGAL surplus from 2024/25 onwards. Should the first year of surplus change in the final BEFU fiscal forecasts, we would recommend aligning your intention to target that year in the FSR. If you put more weight on having flexibility or want to reduce the risk of not meeting the target year in the next forecast update, you could consider removing the target year or targeting the surplus a year later, such as by 2025/26. The disadvantage of such an option is that it could be interpreted as signalling an intention to loosen fiscal policy in the future, although this risk could be mitigated with clear communication around your intentions.

16. **Alternatively, you can set a rolling-horizon target to provide more flexibility**. This could target the Government's intention to return to a surplus by the fourth year of the rolling forecast period (i.e., this would be 2024/25 for FSR 2022 but would roll-out in the subsequent years) and specify the forecast values to support this intention. This option provides some constraint for fiscal sustainability by signalling Government's intention to return to a surplus in the forecast period along with some flexibility if the year of achieving surplus is delayed due to forecast revisions[4]. However, it can be regarded less credible if the intended year of achieving surplus keeps rolling forward without actually returning to a surplus.

17. In both of the above options that outline a specific or rolling target, there is some risk that future forecast updates could show the target not being achieved, for example, due to changes in economic indicators that underpin the forecasts for tax revenue, benefit expenses and finance costs, or due to volatility in OBEGAL from factors outside of Government's control such as performance of State-Owned Enterprises and Crown Entities. In addition, although the gains or losses on the valuation of the ACC outstanding claims liability is not captured within OBEGAL, some consequential impacts from these valuations can impact on OBEGAL[5]. Ideally, fiscal policy would not respond to such fluctuations, particularly those relating to the economic cycle, to allow the automatic fiscal stabilisers to operate.

18. To reduce the risk of the volatility in OBEGAL leading to adjustments in allowances to meet your fiscal targets, **we recommend using a clause such as "subject to economic and fiscal conditions".** The FSR could elaborate on this point and explain the volatility in OBEGAL and its sources. This should also allow the Government to run OBEGAL deficits to support macroeconomic stability in response to future shocks. However, we note that this escape clause is relatively broad and therefore it is unclear in which specific circumstances it would be triggered, which may reduce credibility. You could consider tightening the escape clause by referring only to significant shocks.

19. We do not recommend changing OBEGAL as the preferred fiscal indicator to address the issue of volatility in the operating position. This is because we have reviewed a range of indicators such as the operating balance and still consider OBEGAL as the

[4] For example, the preliminary BEFU 2022 forecasts suggest that an OEBGAL surplus will be achieved a year later than expected at HYEFU 2021 due to revisions in the forecast base.
[5] In the preliminary BEFU 2022 fiscal forecasts, expenses have roughly increased on average by around $750 million from 2022/23 because of the most recent valuation of the ACC outstanding claims liability. The upcoming advice on the preliminary fiscal forecasts on 22 March provides more details on the sources and magnitude of volatility in OBEGAL.

most suitable measure given it is less volatile and is comparably under more direct control of the government of the day (T2021/2416 refers).

20. Given the primary focus on the OBEGAL rule as the main anchor for fiscal sustainability, we recommend putting greater weight on having a binding and credible target that is simple to communicate through a specific year for returning to a surplus, as opposed to a broad intention without a target year or a rolling target horizon. On balance, we recommend revising your OBEGAL intention to **return to surplus by a specific year such as 2024/25, subject to economic and fiscal conditions.**

In the long-term, once the economy returns to a surplus, we recommend that you maintain surpluses sufficient to avoid current operating expenses contributing to an increase in net debt to GDP.

21. In our previous advice we estimated that an OBEGAL surplus of no less than 0.5% of GDP in each year would be sufficient to ensure that the operating balance does not contribute to net debt as a share of GDP over time (T2022/37 refers), including an adjustment to allow for occasional shocks. However, given the volatility in OBEGAL, we consider that any recommended long-term objective should provide sufficient flexibility to avoid sub-optimal policy decisions.

22. Once the economy has returned to a surplus, we have considered two options for achieving flexibility in the long-term objective. One option is to target an average value within a range. For example, targeting an **average surplus in the range of 0-2% of GDP over a 10-year period**. This means that in the long-term, OBEGAL can be in deficit at times, but the surpluses in normal times should result in an overall average surplus in the range of 0-2% of GDP over a ten-year horizon. The key trade-off with a range target is ensuring that the range is wide enough to provide the flexibility needed to manage cyclical and other fluctuations in OBEGAL, while not being so wide as to provide a lack of clarity about the Government's intentions. With the volatility in OBEGAL and the potential size of forecast errors, there is still a likelihood that OBEGAL may fall outside of the range, although the average should be more likely to fall within the range[6]. In practice, this may require adjusting allowances in the projection period to keep the average surplus within the target range. We also recommend adding a caveat "subject to economic and fiscal conditions" to support macroeconomic stability by allowing to run deficits in response to shocks or significant volatility.

23. Another option would be to avoid specifying the target numerically, and instead, once the economy has returned to a surplus, aim to **maintain small surpluses in the long-term** along with the same clause "subject to economic and fiscal conditions". While this option provides more flexibility through a relatively broad target, it can risk credibility by providing less clarity on the definition of small surpluses.

24. **We consider both options to be finely balanced** as they provide some fiscal constraint in the long-term by targeting surpluses and supporting macroeconomic stability. Ultimately, which option you prefer may depend on your intended communication strategy around new fiscal targets.

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[6] The preliminary BEFU 2022 forecast and projections indicate that once the economy returns to a surplus in 2024/25, the average surplus from 2024/25 to 2031/32 is 1% of GDP. Historically, the average OBEGAL surplus forecast and projection for a period of 10 years in each iteration of Economic and Fiscal Update (EFU) since 2015, has been in the range of -3.5% to +2.6% of GDP.

For operating expenses which have similarities with capital investments, we recommend being transparent about their impact on fiscal rules.

25. **You have asked for advice on ways to accommodate operating expenses which have some similarities with capital investments,** such as government grants to fund assets held by third parties rather than capital investments where the government owns the asset directly. We have looked at a range of options including creating a bespoke new indicator, using a different indicator to OBEGAL, allowing more flexibility in your OBEGAL objective, or not making any changes but communicating its impact on fiscal rules for transparency.

26. We do not recommend creating a bespoke indicator or changing the definition of operating expenses for the calculation of OBEGAL, as it could create misaligned incentives to exclude an increasing amount of operating expenses from the operating target over time. We also do not recommend using a different indicator to OBEGAL as we have reviewed other indicators such as operating balance (T2021/2416 refers), and continue to prefer OBEGAL as the main fiscal indicator for communicating fiscal policy targets and decisions.

27. **On balance, our preference is to not make any changes to the fiscal indicators but to identify a few specific projects that fall in this category** and broadly acknowledge that the OBEGAL fiscal rule would not be met at times due to the impact of these projects. You can be transparent in your FSR/BPS that these will be one-offs and looked through for the purpose of fiscal targets by allowing temporary deficits to fund them. While this approach can avoid disincentivising spending on such operating expenses, it can still create some fiscal risks as the cost of depreciation will not be included in our fiscal forecasts and projections. Therefore, we do not recommend creating a permanent specification to allow departure from the OBEGAL intentions and objectives as it could create an increasing list of exemptions. We strongly recommend keeping this rule strict by accommodating for only a few specific projects identified in advance.

We do not recommend any significant changes to the intentions and objectives of other fiscal aggregates.

28. The current intentions and objectives for operating expenses and revenues are consistent with the new fiscal rules. We recommend amending the intention for net worth to align it with the operating balance objective, as aiming for OBEGAL surpluses would also be consistent with maintaining net worth as a share of GDP. The objectives for operating expenses, revenue and net worth were unchanged in response to COVID-19 and continue to reflect your long-term strategy. Refer to Annex 1 for the suggested wording on the short-term intentions and long-term objectives for 2022 FSR.

Communication of new intentions and objectives

Shifting to an increased focus on the OBEGAL target for short-term decision-making, coupled with a relatively less binding debt ceiling will require careful communication.

29. We sought feedback from the IMF about the new net debt indicator and the new fiscal rules, including the proposed short-term intentions and long-term objectives. The IMF did not raise any significant concerns with adopting the new net debt measure including the NZSF. [34]

They had no concerns with

adopting a net debt ceiling of up to 30% of GDP based on the new net debt measure, and strongly recommended to set the same debt ceiling for both the short-term intention and the long-term objective to avoid communication challenges.

30. Overall, the IMF places greater weight on ensuring that fiscal rules are enduring and achievable. They have a preference for adopting intentions and objectives that allow sufficient flexibility to accommodate normal shocks or adjustments, and limit the use of escape clauses to accommodating significant shocks. They do not recommend frequently revising fiscal targets or having permissive escape clauses, and had some concerns about our suggested escape clauses for the debt and OBEGAL rules being too permissive and not clearly defined.

31. [34]

32. We propose to continue our engagement with a limited number of trusted stakeholders before announcing the new fiscal rules. This could include stakeholders in New Zealand or organisations such as the OECD. [34]

33. **We suggest using the FSR to explain the key changes in fiscal rules, including some of the more nuanced points.** For example, you can reinforce that a ceiling is not the same as a point target by providing fiscal projections which show that debt levels are forecast to remain well below the ceiling. To support transparency, we will also continue publishing the current net debt indicator (excluding the NZSF) in addition to the new net debt indicator both including and excluding the NZSF[7].

34. You may also want to deliver a speech on the new fiscal rules, either shortly before or after the FSR is released. We can assist with preparing this speech.

35. We propose that the Treasury publishes an analytical note at the same time as the Budget which set out the analytical approach underlying the new fiscal rules. This would, for example, include Treasury's analysis of debt sustainability, and the methodology used for setting the debt ceiling and OBEGAL fiscal rules.

36. Following the announcement of the new fiscal rules at Budget 2022, we suggest that the Treasury meets with key stakeholders to communicate the changes in fiscal rules, and how they support long-term fiscal sustainability. Things we would suggest highlighting in these discussions include:

- the government is introducing clear numerical targets with a demonstrated commitment to those targets;
- the operating rule acts as a constraint to support prioritisation and long-term sustainability of operating expenses;
- net debt continues to be low compared to peers;

[7] These indicators will be published in some capacity, though the exact presentation of the indicators (whether through a full time series or just the forecast period data) is still being decided.

- high-quality investments can support some underlying vulnerabilities such as long-term challenges in the housing market;
- the credibility of the new fiscal rules is supported by the fiscal outlook.

37. Annex 2 provides a possible narrative which could support announcement of the new fiscal rules at Budget 2022. We would welcome your feedback on this and the broader communications approach.

Next Steps

38. We will discuss this advice with you at the Finance Priorities Meeting on Tuesday 22 March. We will continue working your office to ensure that the final wording of the short-term intentions and long-term objectives in the FSR is consistent with the PFA requirements.

39. Following that, we propose that you take your preferred options for the new short-term intentions and the long-term objectives to the Budget Ministers 6 meeting on 1 April. We will then provide a Cabinet paper for you on the new intentions and objectives in mid-April.

40. You will receive the detailed preliminary BEFU 2022 fiscal forecasts on Monday 21 March that will show the initial track for the new net debt measure including the NZSF. This will be followed by the first draft of the FSR in early April that includes the communication of new fiscal rules, new fiscal indicators, and the new intentions and objectives for Budget 2022. You will receive the final fiscal forecasts and the advice on the long-term allowance assumptions for projection tracks of fiscal variables in the first week of May.

Annex 1 – Suggested short-term intentions and long-term objectives for FSR 2022

Fiscal variable	BPS 2021 STIs	Suggested STIs for FSR 2022	BPS 2021 LTOs	Suggested LTOs for FSR 2022
Debt	Our intention is to allow the level of net core Crown debt to rise in the short term to fight COVID-19, cushion its impact and position New Zealand for recovery.	Maintain net debt at below 30% of GDP based on new net debt measure including the NZSF, subject to significant shocks. Net debt is forecast to peak at just below 20% of GDP in 2023/24 and reduces over the forecast period to 14% of GDP in 2025/26[8]. This corresponds to maintaining total borrowings[9] at below 65% of GDP, subject to significant shocks. Total borrowings is forecast to be 52% of GDP at the end of the forecast period.	The Government will 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).	Maintain net debt at below 30% of GDP based on new net debt measure including the NZSF, subject to significant shocks. This corresponds to maintaining total borrowings at below 65% of GDP, subject to significant shocks.
Operating balance	The Government will use fiscal policy to secure the economic recovery for New Zealand and reduce deficits over the forecast period as economic conditions allow.	Our short-term intention is to return to an operating surplus (before gains and losses) by 2024/25, subject to economic and fiscal conditions. The operating balance is forecast to be 3% of GDP at the end of the forecast period is a surplus of [10].	The Government will run an operating balance consistent with meeting the long-term debt objective.	Once the economy has returned to a surplus, our long-term objective is to maintain an operating surplus (before gains and losses) in the range of 0-2% of GDP on

[8] This is based on the preliminary fiscal forecasts for BEFU 2022.

[9] [36]

The intentions and objectives can be translated to a total borrowing indicator by stating after the net debt target (as reflected in the table) that, "this corresponds to maintaining total borrowings at below 65% of GDP, subject to significant shocks." Given the new net debt measure including the NZSF is lower than the total borrowings indicator by approximately 35% of GDP on average, it translates to a debt ceiling of up to 65% of GDP using the total borrowings indicator.

[10] [36]

The operating balance measure is expected to be approximately 1.6% stronger than

				average, subject to economic and fiscal conditions. OR Once the economy has returned to a surplus, our long-term objective is to maintain small operating surpluses (before gains and losses), subject to economic and fiscal conditions.
Operating expenses	Our intention is to ensure expenses are consistent with the operating balance objective.	Keep unchanged	The Government will ensure operating expenses support a responsible and proportionate role for the Government in maintaining a productive, sustainable and inclusive economy, consistent with the debt and operating balance objectives.	Keep unchanged
Operating revenues	Our intention is to ensure revenue is consistent with the operating balance objective.	Keep unchanged	The Government will ensure a progressive taxation system that is fair, balanced and promotes the long-term sustainability and productivity of the economy, consistent with the debt and operating balance objectives.	Keep unchanged
Net worth	Our intention is to use the Crown's net worth to fight COVID-19, cushion its impact and position New Zealand for recovery. Significant risks will be transferred onto the Crown's balance sheet through the response period.	Our intention is to maintain net worth consistent with the operating balance objective.	The Government will use the Crown's net worth to maintain a productive, sustainable and inclusive economy, consistent with the debt and operating balance objectives.	Keep unchanged

the OBEGAL balance measure on average over the period 2022/23 to 2031/32 (based on preliminary BEFU 2022 Fiscal Strategy Model). Therefore, we can reasonably expect operating balance surpluses of approximately 2.2% from 2022/23 to 2031/32 based on preliminary BEFU 2022 Fiscal Strategy Model (gains and losses will vary but this is our central estimate). This ensures that the objective of targeting OBEGAL surpluses over the next 10 years should be commensurate with targeting operating balance surpluses on average over time, as per the principles of responsible fiscal management.

Annex 2 – Possible narrative for announcement of the new fiscal rules

The government borrowed to support the economy in response to COVID-19, helping to prevent long-term scarring.

- The Government responded to the COVID-19 pandemic with significant fiscal stimulus. This led to higher net debt and a period of OBEGAL deficits.
- But this fiscal response has helped prevent a deeper and longer lasting recession, which could have had long-term impacts on New Zealand's living standards.

Our short-term intention is to return to an operating surplus (before gains and losses) by 2024/25, subject to economic and fiscal conditions.

- Because the fiscal response to COVID-19 is largely temporary, deficits will shrink as temporary support measures end.
- We will therefore reduce our operating deficits over the forecast period and return to an operating surplus (before gains and losses).
- Current forecasts indicate that we will have an operating surplus (before gains and losses) from 2024/25 onwards.

In the long-term, we will ensure debt is prudent by maintaining a small operating surplus (before gains and losses).

- We will ensure intergenerational wellbeing by balancing ongoing spending and revenues over time, so today's day-to-day spending is paid for by today's taxes.
- Aiming for a small operating surplus allows us to build a buffer to respond to economic shocks. This helps us maintain a healthy balance sheet and ensures that debt is on a sustainable path.

We will make high-quality investments to boost wellbeing, living standards and the capacity of the economy.

- We will continue to borrow to invest in the wellbeing of future generations. Capital investments can boost productivity and therefore long-term fiscal sustainability. It is appropriate for the cost of these long-term capital investments to be spread across generations. Future generations will receive both an asset and a liability.
- We will use robust value for money assessments to make sure we are only funding good quality investment, which will support a long-term trend of increasing net worth, as well as other wellbeing and living standards indicators.

And we will maintain net debt below 30% of GDP based on the new net debt measure including the NZSF, subject to significant shocks.

- Current debt levels remain low relative to our peers and are unlikely to limit our ability to borrow further if required. In part this is due to favourable debt dynamics where interest rates are lower than the economic growth rate.
- Treasury's debt sustainability analysis shows that even with conservative assumptions where growth rates are substantially lower than interest rates, we can tolerate debt levels of up to 70% of GDP (new net debt measure). Building in a large fiscal buffer, we consider that a debt ceiling of up to 30% of GDP (new net debt measure) is sustainable and prudent.
- This means that we have fiscal space to borrow for investments which boost intergenerational wellbeing, while maintaining prudent debt. We will only use fiscal space if we are confident in the quality of the investment pipeline supported by rigorous value-for-money assessments and there is sufficient market capacity.