The Treasury

Budget 2024 Information Release

September 2024

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

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[31] 9(2)(f)(ii) - to maintain the current constitutional conventions protecting collective and individual ministerial responsibility

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

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Fiscal strategy for Budget 2024 – Surplus target and operating allowances

Date:	4 March 2024	**Report No:**	T2024/475
		File Number:	MC-1-5-2-2024

Action sought

	Action sought	Deadline
Hon Nicola Willis **Minister of Finance**	**agree** your short-term intention for the operating balance is to return to surplus in 2027/28 at the latest. **agree** to leave operating allowances in Budgets 2024-2027 unchanged from HYEFU – unless small reductions are necessary to deliver a surplus in 2027/28 after receiving advice on the preliminary fiscal outlook. **agree** to not make any changes to the OBEGAL indicator to reflect the effects of ACC or other CEs ahead of BPS or BEFU given time constraints and the need to do further work.	7 March 2024 (to reflect approach in BM2 slides)

Contact for telephone discussion (if required)

Name	Position		Telephone	1st Contact
Sam Thornton	Senior Analyst, Macroeconomic and Fiscal Policy	[39]	[35]	✓
Luke Came	Team Leader, Macroeconomic and Fiscal Policy			

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 strategy for Budget 2024 – Surplus target and operating allowances

Executive Summary

The Treasury has recently recommended that you adopt and announce at the Budget Policy Statement (BPS) a target to return to operating surplus in a particular year (T2024/312 refers). This report provides advice on selecting the target year for returning the operating balance before gains and losses (OBEGAL) to surplus, and the recommended operating allowances you should set at Budget 2024. These fiscal strategy decisions involve an on-balance judgement under conditions of significant uncertainty about the fiscal outlook. In particular, there is a trade-off between the need to return to surplus, the macroeconomic benefits of returning to surplus quickly, and the risks associated with committing to the scale of fiscal consolidation that would be required to do so.

Our indicative update on the fiscal outlook suggests a likely further delay in the forecast return to OBEGAL surplus, previously expected in 2026/27 (T2024/443 refers). Our initial estimates suggest that lowering the operating allowances in Budgets 2025 and 2026 by at least $1.6 billion each (to $1.65 billion and $1.4 billion respectively) would be required to show a forecast surplus in 2026/27. With significant demands on the operating allowances expected across the forecast period, reflecting such a significant reduction in operating allowances in the fiscal forecasts would require Cabinet agreement to the additional savings required to deliver the fiscal strategy.

The Treasury's updated advice is that you should target a return to surplus no later than 2027/28. In our view, the risks from implementing a more significant savings and revenue programme within a short timeframe outweigh the macroeconomic and fiscal sustainability benefits from committing now to returning to surplus in 2026/27. The speed and scale of a rebalancing to deliver an earlier surplus carries risk that it is not achievable or sustainable and may undermine broader objectives, including living standards and economic prospects. Further, there is significant uncertainty about the current fiscal outlook, and targeting a return to surplus in 2027/28 will make the strategy more robust to further downward revisions to the fiscal forecasts.

If you agree to the Treasury's recommendations, or decide not to adopt a point target, your communication of the fiscal strategy could emphasise the significant deterioration in the economic and fiscal outlook caused by factors outside of the Government's control. You could reinforce your commitment to achieving medium-term fiscal sustainability by demonstrating fiscal control through your near-term actions by landing Budget 2024 within current operating allowances, emphasising your intention to meet your Budget operating allowances, committing to using upside revenue surprises to support the objective of returning to operating surplus, and setting out the limited and defined circumstances where you expect to consider suspending or deferring any surplus point target.

With Budget 2024 significantly over-subscribed, we recommend you leave the Budget 2024 operating allowance unchanged at $3.5 billion, unless you are willing to scale significant elements of the coalition Government's commitments or implement significant further savings. Similarly, given expected cost pressures and Government priorities beyond Budget 2024, we do not recommend reducing operating allowances in Budget 2025-2027 at this stage. There is a chance the current allowances will be consistent with showing a surplus in 2027/28 by the time we have completed our preliminary fiscal forecasts. If not, we will provide further advice on small reductions in outyear allowances to show a forecast surplus in 2027/28. The recommended fiscal strategy would still require significant savings and/or additional revenue to provide headroom in future allowances and strengthen the OBEGAL

trajectory. We will adjust our forthcoming advice on the design of Phase 2 of the Fiscal Sustainability Programme accordingly.

Recommended Action

We recommend that you:

a **note** the Treasury recently advised you on options for setting short-term intentions (STIs) and long-term objectives (LTOs) to express your fiscal strategy in the Budget Policy Statement (BPS) 2024, as required by the Public Finance Act 1989 (T2024/312).

b **note** the Treasury recommended LTOs to achieve and maintain small surpluses and maintain prudent levels of net debt, complemented by an STI to return OBEGAL to surplus by a specific year.

c **note** our indicative update on the fiscal outlook as at 4 March 2024 suggests the return to OBEGAL surplus, previously expected in the 2026/27 year, will be pushed out (T2024/443 refers).

d **note** that the updated fiscal outlook suggests there would be risks to a realistic and enduring structured fiscal consolidation, if you were to commit to the level of savings required to return to surplus in 2026/27.

e **agree** to leave the Budget 2024 operating allowance unchanged at $3.5 billion (unless you are willing to scale significant elements of the coalition Government's commitments or implement significant further savings).

Agree/disagree.

f **note** that, given existing demands on the operating allowances, we do not recommend significantly reducing operating allowances for Budgets 2025-2027 from the current levels without a Cabinet agreed process for identifying and implementing savings and revenue initiatives.

EITHER

g **agree** to option 1 (return to surplus in **<u>2026/27</u>**):

- state your intention to return to surplus in 2026/27 at the latest, subject to exit clauses for departing from this intention as advised in T2024/312, at the BPS, and

- reduce the operating allowance in Budgets 2025 and 2026 by $1.6 billion each, to $1.65 billion and $1.4 billion respectively, subject to further updates to the fiscal outlook, and

- seek Cabinet agreement in the April Budget Cabinet paper to deliver sufficient savings or revenue to offset the reduction in the operating allowances.

Agree/disagree.

OR

h **agree** to option 2 (return to surplus in **2027/28 at the latest**) (**Treasury recommended**):

- state your intention to return to surplus in 2027/28 at the latest, subject to exit clauses for departing from this intention as advised in T2024/312, at the BPS, and

- leave operating allowances in Budgets 2024-2027 unchanged from HYEFU ($3.5 billion, $3.25 billion, $3.0 billion, $3.0 billion) unless small changes are required to deliver a forecast surplus in 2027/28 pending further updates to the fiscal outlook.

Agree/disagree.

OR

i **agree** to option 3 (**no target** for returning surplus):

- state your intention to return to surplus via a steadily improving OBEGAL trajectory as your short-term intention for the operating balance in the BPS, and

- leave operating allowances in Budgets 2024-2027 unchanged from HYEFU ($3.5 billion, $3.25 billion, $3.0 billion, $3.0 billion) pending further updates to the fiscal outlook.

Agree/disagree.

j **note** that you can further signal your commitment to medium-term fiscal sustainability by:

- demonstrating fiscal control through your near-term actions by landing Budget 2024 within current operating allowances, and

- continuing to communicate your intention that future operating allowances are an enduring commitment, and

- committing at the BPS to using any upside revenue surprises to improve the surplus trajectory, and setting out the limited and defined circumstances where you expect to consider suspending or deferring any surplus point target (as advised in T2024/312) k **agree** not to pre-commit new initiatives against Budget 2025 and Budget 2026 operating allowances as part of Budget 2024, other than as part of a multi-year funding strategy (e.g. Health sector cost pressures).

Agree/disagree.

l **note** we will provide you with advice in June on the design and savings target for Phase 2 of the Fiscal Sustainability Programme, including to provide more headroom in future allowances and increase the likelihood of achieving any surplus target.

m **agree** not make any changes to the OBEGAL indicator to reflect the effects of ACC or other CEs ahead of BPS or BEFU given time constraints and the need to do further work.

Agree/disagree.

n **indicate** whether you would like to receive advice on extending the exit clauses for any surplus point target announced at BPS to cover a scenario where there are large temporary deficits caused by entities that are intended to be self-funded (such as ACC).

Yes/No.

Luke Came
Team Leader Macroeconomic and Fiscal Policy

Hon Nicola Willis
Minister of Finance

_____/_____/_______

Treasury Report: Fiscal strategy for Budget 2024 - Surplus target and operating allowances

Purpose of Report

1. The purpose of this report is to provide advice and seek your decisions on:

   a the target for any commitment to return to OBEGAL surplus in a particular year, intended for publication in the Budget Policy Statement (BPS) 2024, and

   b the operating allowances for Budget 2024 and outyears (Budgets 2025-2027).

Background

2. The Treasury recently advised you on options for setting short-term intentions (STIs) and long-term objectives (LTOs) to express your fiscal strategy in the BPS 2024, as required by the Public Finance Act 1989 (T2024/312). We recommended LTOs to achieve and maintain small surpluses and maintain prudent levels of net debt, complemented by an STI to return OBEGAL to surplus by a specific year. This report provides advice on selecting the specific target year for returning to surplus, if you choose to commit to a surplus target year in the BPS 2024, and the recommended operating allowances to support the delivery of your fiscal strategy.

3. In November 2023 Treasury advised you that, in the absence of any unexpected events or significant negative economic shocks, there is an on-balance case for the Government committing to a return to surplus in 2026/27 at the latest (Economic and Fiscal Context Slide Pack). This report reassesses the recommended target for returning to surplus given the latest preliminary Budget Fiscal and Economic Update (BEFU) 2024 economic and tax forecasts, and our updated view of the fiscal outlook.

4. Treasury previously recommended you keep the Budget 2024-2027 operating allowances unchanged at the Mini Budget (as per the operating allowances in the Pre-election Fiscal and Economic Update 2023) and make decisions on changing them as part of the Budget Policy Statement or Budget 2024 decision-making processes (T2023/1953). This approach aimed to minimise the risk of needing to increase the Budget 2024 operating allowance later, and means that decisions on allowances can now be informed by savings and new spending you want to progress at Budget 2024.

5. You recently agreed to increase the multi-year capital allowance by $7 billion, largely to fund capital decisions in Budget 2024, with further headroom provided by reprioritisation (T2024/327 refers). As the level of the multi-year capital allowance (MYCA) and the Budget 2024 capital package affect your fiscal strategy, this report takes them into account.

You face competing objectives when setting your fiscal strategy

6. You face competing objectives when setting your fiscal strategy, including any surplus target year and operating allowances, including:

   a supporting macroeconomic stability and having regard to the interaction between fiscal policy and monetary policy

   b supporting fiscal sustainability, including managing prudently fiscal risks, building buffers on debt and net worth against economic shocks, and having regard to the likely impact of the fiscal strategy on present and future generations

   c progressing your Government's objectives including the sufficiency of the allowances to deliver on your new policy priorities and fund cost pressures, and improving management and discipline applied to fiscal expenditure

   d deliverability of new spending and investment in the context of economic capacity constraints, including in the public and private sectors, and

   e providing a realistic and accurate outlook for allowances that will prove to be enduring over time.

Macroeconomic considerations support tight fiscal policy

7. The preliminary BEFU 2024 economic forecasts indicate a significant macroeconomic adjustment is underway as high interest rates dampen demand (T2024/341 refers). Economic growth is slow, inflation continues to fall, the labour market is cooling, and the current account deficit is expected to narrow as past demand shocks fade, domestic demand slows, and international tourism recovers. Uncertainty about the economic outlook remains high, and there are significant risks to the downside from global trends including the slowdown in the Chinese economy, and conflicts in Ukraine and the Middle East.

8. Past monetary policy tightening is reducing domestic household spending more than expected, as illustrated by September's unexpectedly sharp slowdown in GDP growth. However, while inflation has fallen from its peak, this has been driven by tradables (e.g. imported goods), with non-tradeable inflation which is domestically generated remaining elevated. Similarly, while unemployment has increased, it remains at historic lows contributing to wage growth remaining slightly above levels compatible with inflation returning to target.

9. In its recent meeting on 28 February 2024, the Monetary Policy Committee (MPC) held the Official Cash Rate (OCR) at 5.5% and noted that monetary policy needs to remain at a restrictive level for a sustained period of time to ensure headline inflation returns to target. The MPC takes fiscal policy into account when setting monetary policy, and any changes to the forecast tightening of fiscal policy will have implications for interest rates.

10. While our preliminary economic forecasts reflect a central track of balanced risks, from a macroeconomic perspective a least regrets approach favours maintaining tighter fiscal policy into a more-severe-than-expected downturn in the economy, helping support the MPC in tackling inflation (as opposed to not sufficiently tightening fiscal policy if inflation remains high):

    a Fiscal deficits are currently contributing to inflationary pressures, and tightening fiscal policy will reduce upward pressure on interest rates.

b There is a risk that domestic demand and inflationary pressures prove to be more persistent than expected, and maintaining tight fiscal policy mitigates against this scenario by signalling the Government is supportive of price stability.

c Elevated current account deficits reinforce the desirability of a tightening fiscal stance, which would reduce the Governments' contribution to external imbalances that could make debt increasingly costly to finance.

d If a more significant economic downturn occurs, there is room for monetary policy to respond to quickly stabilise the economy, with fiscal policy potentially also adjusting as counter-cyclical automatic stabilisers kick in.

11. The overall macroeconomic stance of fiscal policy is also affected by the composition and timing of expenditure in the Budget 2024 package, both operating and capital. To increase the support that fiscal policy provides to monetary policy objectives, expenditure in the Budget 2024 operating and capital packages could be backloaded, with most expenditure occurring towards the latter half of the forecast period (i.e. in 2026/27 and 2027/28).

12. The Treasury is preparing advice and modelling the impact of Budget 2024 (including the tax package) on inflation and interest rates, including the impact of any increase in labour supply due to lower personal income tax rates.

Fiscal sustainability considerations support tighter fiscal policy

13. There is considerable uncertainty involved in forecasting government revenue, driven mainly by difficulty in forecasting growth in nominal GDP, itself a function of inflation and real GDP growth. Forecasts for total taxation revenue four years ahead – the current horizon for 2027/28 – can vary substantially.

14. As advised in a separate report today, our indicative update on the fiscal outlook as at 4 March 2024 suggests the return to OBEGAL surplus previously expected in 2026/27 will be pushed out. The revised OBEGAL track shows an approximately $3.2 billion deficit in 2026/27 and a $0.9 billion deficit in 2027/28 (T2024/443 refers). However, there is a chance OBEGAL in 2027/28 may end up being a small surplus by the time we have completed our preliminary fiscal forecasts. The main driver of the deterioration in the fiscal outlook is lower tax revenue, which is indicated to be cumulatively $12.7 billion lower in the five years to 2027/28 and $3.5 billion lower in 2027/28, compared to HYEFU. Weaker growth in nominal GDP is the main contributor to the change in tax forecasts, with initial estimates of the net impact of the new tax policies that have been included reducing tax by $1.7 billion overall.

15. There remains substantial uncertainty about the outlook for revenue, and how much of the recent deterioration will turn out to be temporary (i.e. cyclical) or permanent (i.e. structural). Changes to the revenue forecasts between HYEFU 2022 and HYEFU 2023 appear to have been primarily driven by structural factors. In particular, there were large downward adjustments to corporate tax and GST, as judgements about how COVID-era policy support, elevated inflation, and the changing composition of output would affect revenue forecasts were revised in light of new data. More recently, downward revisions to the preliminary revenue forecasts reflect a mix of structural and cyclical factors.

16. We expect the lower indicative OBEGAL track, along with the top up to the MYCA associated with the additional forecast year, will contribute to a higher net debt track than previously forecast. As a rough estimate, we now anticipate net debt to be $15 billion higher by the end of the forecast period, compared to 2023 HYEFU. Debt

headroom for shocks is still available (based on a net debt ceiling of 30%), but has significantly narrowed over recent years.

17. These recent revisions to the fiscal forecasts have reinforced challenges to medium-term sustainability over the short- and medium-term. There has been structural growth in expenditure in recent years without a commensurate change in structural revenue, and a substantial fiscal consolidation is required to bring revenue and expenses back into balance. Medium-term factors such the aging population and climate change are increasingly putting pressure on the fiscal position, and finance costs have increased from both higher interest rates and the increased stock of net debt. The Treasury estimates that OBEGAL has on average been in structural deficit since 2020.

18. In this context, there is a need for a disciplined approach to Government expenditure to support fiscal sustainability. Constraining new expenditure through tight allowances across the forecast period will be an important lever for delivering a credible trajectory towards improving the medium-term fiscal outlook. Moreover, the challenging medium-term outlook highlights the importance of savings programmes having an enduring and sustainable impact, broader reforms to promote medium-term fiscal sustainability including reviewing revenue and expenditure policies.

19. A tightening of fiscal policy will also be supportive of New Zealand's sovereign credit rating. Although New Zealand's rating remains in a strong position on most of the metrics that credit rating agencies assess, recent statements have noted downside risks to the rating if there is a failure to return to surplus, put net debt on a sustained downward path (as a % of GDP), or to reduce elevated current account deficits.

Setting your fiscal strategy given the impact of Crown entities on OBEGAL

20. OBEGAL provides a comprehensive measure of the Government's finances and is the primary indicator of short-term fiscal sustainability. As it is a total Crown measure, it includes the operating balances of CEs and State-Owned Enterprises (SOEs). Our previous advice recommended retaining OBEGAL as a key fiscal strategy indicator (T2024/312 refers).

21. Over the forecast period, Crown entities (CEs) are expected to make a significant negative contribution to OBEGAL. The Accident Compensation Commission (ACC) is currently the main contributor to the aggregate CE deficits, with the preliminary BEFU 2024 forecasts showing ACC generating OBEGAL deficits of $3.3 billion per annum on average over the 2024-28 period. In contrast, some other Crown entities are forecast to contribute positively to the OBEGAL trajectory over the forecast period. [33]

22. We do not recommend making any changes to the treatment of ACC or other CE impacts in the fiscal strategy ahead of BEFU. This will provide time for the Treasury to undertake further work over the following months to ensure that any changes are enduring and preserve credibility. This work will include reviewing the appropriate treatment of other entities that are intended to be self-funded to ensure a consistent approach (particularly those with an insurance focus, such as the Earthquake Commission and the Depositor Compensation Scheme).

23. In the short-term, we intend to provide more transparency on the effects of CEs on total Crown OBEGAL in the BEFU. You also have options to ensure flexibility within your fiscal strategy to adjust your surplus point target in response to temporary deficits caused by entities that are intended to be self-funded (where those deficits are not expected to impact on medium-term sustainability). For example, you could acknowledge at BPS that the Treasury is providing you with the advice described

above, which may result in changes to the treatment of self-funded entities within the fiscal strategy. Alternatively, the Treasury can provide short-term advice on a new exit clause to be announced at BPS which would enable suspension or deferral of any surplus point target in this circumstance.

You are likely to face significant demands on operating allowances

24. The current Budget 2024 operating allowance of $3.5 billion (on average per annum) is significantly oversubscribed relative to the agency submissions for invited cost pressures and Government priorities.

25. You are also likely to face significant demands on your operating allowances in future Budgets. If these pressures are funded, you would need to increase expenditure, increase the scale of savings programmes, or raise additional revenue. In addition to the revenue forecast uncertainty noted at above, the additional significant demands include:

    a **Ongoing significant cost pressures from price and volume increases** – the current assumed Budget operating allowances should be broadly sufficient to meet remaining critical cost pressures not already funded, however, significant trade-offs would be required. While the preliminary BEFU 23 forecasts show slightly lower inflation compared to HYEFU, higher than expected population growth may offset this. Further, the experience of past Budgets with significantly scaled cost pressure funding is cost pressures accumulate at subsequent Budgets. Health (covered below) and Education are the two largest areas of Government spending. In Education, we anticipate ongoing cost pressures in future Budgets, including to support the real value of operations funding (which has declined over recent years), ongoing school property maintenance and compliance costs, and costs associated with collective bargaining rounds for the education workforce.

    b **Health sector cost pressures are expected to continue to take up a large proportion of the operating allowances** – Budgets 2025 and 2026 include significant pre-commitments for Health New Zealand cost pressures. These represent Treasury's view of the minimum viable funding for core health volume, remuneration and inflationary pressures, after accounting for all viable efficiencies and reprioritisation options. Whilst we anticipate these precommitments being sufficient to enable Health New Zealand to plan for and deliver a break-even position within current policy settings, it will require Health New Zealand to deliver a range of efficiencies and reprioritisation and hold cost growth down (including wage and FTE growth). Treasury's health Budget bilateral briefing will provide further advice on Health New Zealand cost pressures, including risks of managing within Treasury's recommended funding level.

    c **Funding for Government policy priorities may be deferred from Budget 2024 and phased over Budget 2025 and Budget 2026** – You invited new non-tax Government policy commitments into the Budget 2024 process, with agency submissions totalling around $1.6 billion per annum on average. Budget 2024 may include limited funding for non-tax policies meaning these policies may be deferred for consideration at Budgets 2025 and 2026. [33]

    d **Some significant specific fiscal risks (SFRs) may materialise** – The number and complexity of SFRs has increased in recent years. As directed by you, the Treasury is improving the information we collect and publish on SFRs in BEFU

2024. This improved information will not be available to inform your fiscal strategy for the BPS as agency submissions will not be available until late March, and not assessed by Treasury until mid-April. This information will, however, be useful for future consideration of your fiscal strategy.

e **Time-limited funding expiring in 2025/26 are considered for funding** – Most time-limited funding identified at HYEFU 2023 was invited into the Budget 2024 process. [33]

f **Increased capital investment will require operating funding** – Your Government's intentions for capital investment may also increase demands on future operating allowances as approximately every $3 of capital expenditure requires $1 of operating expenditure to support it.

Implications for your fiscal strategy

To achieve surplus within the forecast period, the operating allowances would likely need to be reduced

26. As noted above, the fiscal outlook has deteriorated since HYEFU 2023. As the primary lever for fiscal control and delivering your fiscal strategy, you could reduce your operating allowances so that an operating surplus is still forecast in 2026/27. Based on the indicative fiscal outlook, lowering the operating allowances in Budgets 2025 and 2026 by at least $1.6 billion each would be required to show a small forecast surplus in 2026/27 in BEFU 2024. Such allowances would be significantly lower than in the National Party Fiscal Plan, and would require structural changes to policy settings in order to enable cost pressures to be funded from savings.

27. Alternatively, you could delay the forecast return to surplus to 2027/28. Achieving this would require reducing allowances in Budgets 2026 and 2027 by at least $0.45 billion (or a $0.3 billion reduction if phased across Budgets 2025-2027). However, there is a chance OBEGAL may end up being a small surplus in 2027/28 by the time we have completed our preliminary fiscal forecasts, meaning no reduction in operating allowances would be necessary to show a forecast surplus in 2027/28.

	2023/24	**2024/25**	**2025/26**	**2026/27**	**2027/28**
	Budget 2023	**Budget 2024**	**Budget 2025**	**Budget 2026**	**Budget 2027**
OBEGAL ($, billions)					
At HYEFU	(9.3)	(6.1)	(3.5)	0.1	3.4
Indicative as at 1 March 2024	(10.2)	(8.7)	(6.2)	(3.0)	(0.5)
Operating allowances ($, billions)					
Current and HYEFU		3.5	3.25	3	3
National Party Fiscal Plan		3.2	2.85	2.85	2.7
Consistent with surplus in 2026/27		3.5	1.65	1.4	1.4
Consistent with surplus in 2027/28		3.5	3.25	2.55	2.55

Substantial reductions in forecast operating allowances should be supported by a Cabinet agreed process for achieving additional savings or raising revenue

28. With significant demands on the operating allowances expected across the forecast period, we recommend that significant reductions in operating allowances required to support your fiscal strategy are supported by a clear and effective plan that supports their delivery. This would reduce risks that your fiscal strategy is not implemented effectively, leading to further slippage in achieving a return to surplus and impacting on the credibility of the fiscal strategy.

29. Given Budget 2024 is significantly over-subscribed, we do not consider it realistic to reduce the Budget 2024 operating allowance unless you are willing to scale significant elements of the coalition Government's commitments (both tax- and non-tax) or implement significant further savings. Similarly, given expected cost pressures and Government priorities beyond Budget 2024, we do not recommend substantially reducing operating allowances in Budget 2025-2027 from the current levels without a Cabinet agreed process for identifying and implementing additional savings or revenue initiatives because it risks being seen as not credible.

30. Our experience from the rapid savings exercises over the past 12 months is that, while substantial savings have been identified, further broad savings processes would involve sharper trade-offs for existing government services. Following savings exercises at Budget 2023, PREFU 2023 and the current savings process, generating further substantial savings or revenue will likely require more significant policy changes to stop or scale government programmes.

We recommend no further pre-commitments against future Budget operating allowances

31. On 21 February 2024 you requested advice on making pre-commitments against future operating allowances. In most cases, the Treasury recommends the Government makes all decisions with significant fiscal impacts together as part of a single, annual Budget process. This approach supports the Government to consider trade-offs between competing demands on the operating allowances and the broader fiscal strategy. However, in some circumstances, pre-commitments are appropriate as part of a multi-year Budget strategy to improve funding certainty and planning, for example for the Health sector cost pressures.

32. With limited fiscal space in Budget 2024 for non-tax Government priorities, we acknowledge the appeal from pre-committing new initiatives against future Budget operating allowances. However, we recommend against this approach because it would mean taking decisions in the absence of knowing your strategy and the trade-offs for Budgets 2025 and 2026, and future Budget allowances are also expected to be under significant pressure. As pre-committing new policies against future operating allowances would be equivalent to reducing outyear allowances, we recommend against doing so to without an agreed process for identifying and implementing savings and revenue initiatives to ensure the allowances are realistic and achievable.

Weighing up a 2026/27 or 2027/28 surplus target is an on-balance judgement under conditions of uncertainty

33. Treasury recently recommended setting a point-target to return to surplus at BPS. While there are risks to this approach, which you have noted, a point-target is easy to communicate and provides a clear direction for the Government's fiscal strategy which supports medium-term fiscal sustainability (T2024/312 refers). Treasury has previously advised that a return to surplus in 2026/27 is desirable (T2023/1992 refers), however the change in the economic and fiscal outlook means re-evaluating our recommendation.

34. Deciding between targeting a return to surplus in 2026/27 or 2027/28 is an on-balance judgement requiring a trade-off between the fiscal and macroeconomic benefits of returning to surplus in 2026/27 (relative to a year later), and the risks from committing to the fiscal consolidation required to achieve surplus in 2026/27. Your fiscal strategy decisions will also be made under conditions of uncertainty about the economic outlook, the amount of revenue that will be collected in coming years, and the outcomes of savings programmes to support fiscal consolidation.

35. As noted above, a tightening of fiscal policy is needed to achieve a credible commitment to medium-term fiscal sustainability. This reflects the deterioration in the outlook for tax revenue over successive budgets, the repeated deferrals of the forecast timeframe for returning to operating surplus, and the pressures on expenditure associated with an ageing population. Current macroeconomic imbalances also support a tightening of fiscal policy during the next 1-2 years while monetary policy is restrictive to bring (and maintain) inflation within the target. You should note there is scope for monetary policy to be adjusted if the economic outlook deteriorates more significantly than anticipated.

36. While short- and medium-term fiscal sustainability challenges highlight the need for a substantial rebalancing of revenue and expenses, the speed and scale of this rebalancing needs to be achievable and sustainable. Moreover, committing to significantly reduced allowances without a good understanding of the trade-offs could risk undermining broader objectives (including living standards and economic prospects). The HYEFU forecasts already showed an extended period of tight fiscal management that would see a substantial decline in real government consumption, similar in size to the decrease of the early 1990s but over a shorter timeframe.

The scale and pace of savings required to deliver surplus in 2026/27 create risks

37. As noted above, high level indicative analysis suggests that returning to surplus in 2026/27 would mean a reduction in Budget 2025 and 2026 allowances of at least $1.6 billion each.

38. The Treasury supports continued work on efficiencies, savings, and reprioritisation of low-value-for-money expenditure, and we are currently preparing advice on the design of Phase 2 of the Fiscal Sustainability Programme. However, the options for identifying further savings needed to support your fiscal strategy are likely to become more complex. Beyond specific targeted policy changes previously recommended, it will take time to identify substantial savings and revenue that best balance your broader objectives, including for living standards, more efficient public services, long-term economic prospects, and the durability of spending reductions.

39. Given the scale of the savings or revenue required to achieve surplus in 2026/27, a specific and Cabinet agreed plan for identifying and implementing additional savings and revenue would be needed to be reflected in our fiscal forecasts. At a minimum, this would require a numerical savings target and timeframe, and identification of the policy areas under consideration for scaling or stopping to generate savings or new revenue initiatives. Because you are required to set your fiscal strategy before understanding

the trade-offs required, you would in effect be locking the Government into a set of difficult policy choices with limited information. Showing a forecast surplus in 2027/28 may also require a small reduction in operating allowances in Budgets 2026 and 2027, however there is a chance we may end up showing a small forecast surplus in 2027/28 under current allowances by the time we have completed our preliminary fiscal forecasts.

On balance we recommend a return to surplus no later than 2027/28

40. The indicative deterioration in the fiscal outlook flowing from the preliminary BEFU 2024 economic and tax forecasts has shifted our on-balance recommendation to target a return to surplus no later than 2027/28. While it remains important to promptly return OBEGAL to surplus to support fiscal sustainability and the rebuilding of fiscal buffers for shocks, on-balance we judge the risks from implementing a larger savings and reprioritisation programme within a short timeframe to outweigh the benefits from returning to surplus a year earlier. A careful and structured fiscal consolidation that is enduring, more realistic, and balances broader objectives, is preferrable to returning to surplus a year faster, in 2026/27.

41. If you commit to returning to surplus in 2027/28, delivering an earlier return to surplus would be better than committing to 2026/27 and needing to delay. A strategy that commits to returning to surplus in 2027/28 will be more robust to any further negative surprises to the economic and fiscal outlook. In the event that there are upside revenue surprises and/or substantial savings were found, you would be able to bolster the credibility of your fiscal strategy by delivering an earlier return to surplus. The recommended approach to communicating your fiscal strategy at BPS includes committing to using upside revenue surprises to support returning to operating surplus, and to the limited and defined circumstances where you expect to consider suspending or deferring any surplus point target.

42. A target to return to OBEGAL surplus in 2027/28 would strengthen the current high-level fiscal strategy agreed by Cabinet in December 2023 to "focus on returning to surplus via a steadily improving OBEGAL trajectory" [CAB-23-MIN-0490]. While the status quo provides a relatively high degree of flexibility, including to manage OBEGAL volatility, it would be a lessening of fiscal discipline relative to STIs of recent Governments. The lack of a salient and comprehensive Budget constraint could create risks to your ability to exercise fiscal control and achieve your fiscal sustainability objectives.

43. For these reasons, the Treasury recommends you adopt a surplus point target of returning to operating surplus in 2027/28. The recommended approach could be communicated as a realistic and credible strategy in light of the significant deterioration in the economic and fiscal outlook since HYEFU. While credit rating agencies have publicly raised concerns about further slippage in returning to surplus, we believe these concerns can be mitigated through:

    a delivering Budget 2024 within the current operating allowance, showing your ability to make the necessary difficult trade-offs

    b restating your intention to meet your future Budget operating allowances and to achieving a steadily improving OBEGAL trajectory.

    c committing in the BPS to use any upside revenue surprises to improve the surplus trajectory, rather than increasing operating allowances,

    d committing to a more tightly defined set of exit clauses for any surplus point target.

44. These options could also be used to support the credibility of your fiscal strategy if you would prefer not to adopt a surplus point target at BPS. In this case, your communications approach could also involve stating your intention to seek Treasury advice on an expenditure rule to be put in place at BPS 2025 (see TR2024/312 for further details).

Next Steps

45. The Treasury is available to discuss the recommendations in their report with you at Budget Matters on 6 March 2024.

46. We recommend you discuss your preferences for your fiscal strategy, including LTOs and STIs, any surplus target date, the operating allowances and the increase to the MYCA with at the Budget Ministers 2 meeting on 11 March 2024.

47. Subject to any decisions on the fiscal strategy at the Budget Ministers 2 meeting, we will include decisions on your fiscal strategy in the Cabinet paper seeking early decisions, due for consideration at Cabinet on 18 March.

48. Publication of BPS, including your fiscal strategy is scheduled for 27 March 2024, with a near-final version to you on 12 March 2024. The Treasury will also work with your office on how to communicate your fiscal strategy at BPS, including the significant deterioration in the economic and fiscal outlook reflected in the preliminary forecasts, and any decisions on your operating allowances.