NZ Insight: New Government, new fiscal strategy

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A new strategy

Summary

- The new Government has just released its first Budget Policy Statement (BPS), including its fiscal strategy.
- The BPS noted that the operating allowance for Budget 2024 will be less than the $3.5bn signalled at the Half-year Update, but they didn't get specific (note, this captures the net impact of the Government's tax and spending cuts, but does not incorporate the fiscal impacts of a weaker economy). Operating allowances for Budget 2025 onwards will be announced alongside May's Budget. Meanwhile, the multi-year capital allowance has been boosted by around $4bn compared to the Half-Year Update, to $7bn.
- Overall, while the fiscal policy mix has certainly changed (ie tax and spending cuts), we'd say the signal today is that *discretionary* fiscal policy settings (capex + opex) will be about par or perhaps mildly less expansionary than that baked into the Half-Year Update outlook over the next four years. But this all comes down to how much the operating allowance is reduced from Budget 2024 onwards (we estimate this could be cut by as much as $5-7bn over 4 years). But the economic drivers of fiscal outcomes are likely to more than offset that.
- The Budget Policy Statement also included an interim update to the Treasury's economic outlook. This points to a much smaller nominal economy over the next four years and a lot less tax revenue as a result (around $14bn less).
- Our attempts to net out the weak economic signal with today's signal on discretionary policy suggests bond issuance could be upgraded by around $10-12bn over the next four years come Budget. But we will refine that estimate closer to the time to reflect the latest monthly financial statements and any other pre-Budget announcements.
- Turning to the fiscal strategy, the Government has gone back to the old measure of debt (core Crown net debt), which we think is sensible, as it makes the debt target a little more relevant to discretionary policy choices. The Government intends to get net core Crown debt down to 40% of GDP (at the Half-year Update, it was forecast to reach this level in the year to June 2027). OBEGAL surpluses are certainly a target, but the wording here is a little vague (but will possibly get updated at Budget). Compared to the previous Government's strategy, this looks a touch tighter, but we were expecting something a little tighter still (which still may happen).
- All in all, the info we got today was only partial. The Treasury's tax outlook is much weaker, capex is going to be higher, but in terms of what that all means for bond issuance, we don't know how much changes to future operating allowances will offset this. There is also scope for the Treasury's updated forecast to change a bit from here, and for further policy decisions to move the dial. Bring on Budget 2024.

Highlights of the Budget Policy Statement

Tax and spending cuts will proceed, and based on the signalled operating allowance it looks likely they will be "fiscally neutral". Whether they are "economically neutral" is a question the RBNZ will need to think about. A fiscally neutral package could still become a small net drag on economic activity if a large enough share of the tax relief is saved or spent on imports, and public sector redundancies from spending cuts outweigh the positive indirect employment impact from slightly higher-than-otherwise household demand. Estimating fiscal multipliers is difficult, but if this is the way it pans out, a "fiscally neutral" package could mean the RBNZ is in a position to ease monetary conditions a little sooner than currently expected (albeit only marginally).

If, in time, the Government decided to respond to weaker revenue by making deeper spending cuts, pressure on CPI inflation from fiscal settings could go into reverse very dramatically. At the other extreme, tax cuts funded by more debt would be inflationary, as the IMF pointed out last week, but the Government has indicated they will not follow this path, and their signalled operating allowance for Budget 2024 is comforting on that front.

Turning to spending allowances, the Government has signalled that the operating allowance for Budget 2024 will be less than the $3.5b signalled at the Half-Year Update (but that the exact number will be confirmed at the Budget). The operating allowance captures how much discretionary policy wiggle room the Government is giving itself for its policy agenda at the upcoming Budget. This number is net of spending and revenue initiatives (ie it nets out the Government's plans to cut taxes and spending).

Operating allowances for Budgets 2025 to 2027 will be set out in the Fiscal Strategy Report (alongside Budget). At the Half-Year Update these were $3.25bn for Budget 2025, and $3.0bn for Budgets 2026 and 2027. Without knowing the Government's plans here, we cannot say much about how discretionary fiscal policy choices are likely to impact NZDM's four-year bond issuance guidance come Budget.

Meanwhile, the multi-year capital allowance is getting a top-up to $7bn (vs around $3bn that was available for allocation at the Half-Year Update). This higher capex is for the next four years, but we will have to wait and see whether it is more than, or partially offsets, the lower operating allowance signalled.

Overall, we'd say the signal today is that *discretionary* fiscal policy (opex + capex) could end up around par with what was baked into the Half-Year Update outlook, or possibly a little less expansionary (depending on how much operating allowances are lowered vs the Half-Year Update).

It's also worth noting that some changes to operational expenses and revenues fall outside the operating allowance, such as those driven by economic impacts: changes to the cost of debt servicing when interest rates surprise, changes to benefit payments when unemployment surprises, or changes to tax revenue when the taxable parts of the economy surprise.

Regarding the Treasury's interim economic outlook, the table below says it all:

Table 1. Treasury's interim forecast update

June years	2023 Actual	2024 Forecast	2025 Forecast	2026 Forecast	2027 Forecast	2028 Forecast
Real production GDP (annual average % change)						
Budget Policy Statement	3.0	0.1	2.1	3.1	2.8	2.5
Half Year Update 2023	3.2	1.5	1.5	2.8	3.0	2.7
Unemployment rate (June quarter)						
Budget Policy Statement	3.6	4.6	4.9	4.5	4.4	4.4
Half Year Update 2023	3.6	4.5	5.2	4.8	4.6	4.4
CPI inflation (annual % change)						
Budget Policy Statement	6.0	3.3	2.2	2.1	2.0	2.0
Half Year Update 2023	6.0	4.1	2.5	2.2	2.0	2.0
Nominal GDP ($ billion)						
Budget Policy Statement	395.5	414.6	432.6	455.6	478.4	500.9
change from Half Year Update	-0.5	-5.4	-7.1	-8.0	-10.2	-12.1
Core Crown tax revenue ($ billion)						
Budget Policy Statement	112.4	120.8	127.1	135.5	143.0	149.8
change from Half Year Update	0.0	-1.2	-2.6	-2.6	-3.2	-4.2

Sources: Stats NZ, the Treasury

Putting it all together, the weaker tax outlook and higher capital spending look like they will add around $18bn to NZDM's funding requirement over the next four years. However, this will be partially offset by the "less than $3.5bn" operating allowance in Budget 2024, and possibly a downgrade to the operating allowance from Budget 2025 onwards. It's very loose, but we'd say we're steering down the barrel of a $10-12bn upgrade to issuance guidance come Budget (at this stage).

That said, there's further information to come before May's Budget: two more sets of monthly fiscal statements (February statements due next Thursday), and possibly further government decisions/announcements.

To get a feel for the risks to fiscal settings over the next few years, let's turn to the fiscal strategy.

Introduction to the fiscal strategy

Fiscal indicators and the Government's fiscal strategy are relatively fluid in New Zealand. The Public Finance Act (PFA) requires both indicators and a strategy, but allows the Government of the day to choose the specific definition of key indicators, such as net debt (eg what assets and liabilities to include/exclude), and what targets it considers appropriate to aim for over time. At the same time, the PFA requires that the Government's objectives are set in accordance with the principles of responsible fiscal management. And of course, the NZ Treasury provides advice on all of this.

The Government uses its fiscal strategy to communicate how it intends to manage the books provided a nasty shock doesn't come along that requires a significant fiscal response (when temporarily deviating from the fiscal strategy would be appropriate). It is also quite wide-ranging, covering debt, the operating balance, expenses, revenues, and net wealth.

There is also a balance to strike between building flexibility into the strategy and making it binding. For example, it might not be optimal for the Government to respond to a slightly weaker economic outlook (that pushes out the timing of a return to surplus by one year) by cutting its spending plans (particularly if the stuff the Government is spending money on is delivering results, which is, and always should be, robustly debated). But at the same time, the strategy needs to be binding enough to ensure that the

Government sticks to it and doesn't keep pushing out the projected day it plans to get the books to where they probably should be (which again, is subject to debate). In practice, forecasting a surplus is pretty straightforward: just tell the Treasury you won't increase spending by as much from next year onwards, no matter how unrealistic that prospect actually is, when you drill down to the details. But achieving surplus is much harder. That requires actually sticking to what you said you'd do (tax and spend) a year ago, and the year before that, and possibly the year before that.

In an ideal world, the self-imposed (PFA-consistent) fiscal rules the Government adopts would also ensure that the resources the Government is using on behalf of the taxpayer are delivering results. But that's not a guarantee. More (or less) government spending doesn't automatically transfer into better (or worse) outcomes, as poor policy-making, planning, measurement, and delivery can get in the way. But one thing's for sure, when the Government sets limits and makes funding "contestable" across different portfolios, it will have to think a lot harder about which policies deserve funding. Economists tend to be relatively agnostic when it comes to the philosophical question about the "optimal size of Government". Rather, size should depend on the net benefits of government activity, while also maintaining a sustainable fiscal stance through economic cycles. A good fiscal strategy certainly helps achieve the latter, but not always the former.

A little fiscal strategy history for context

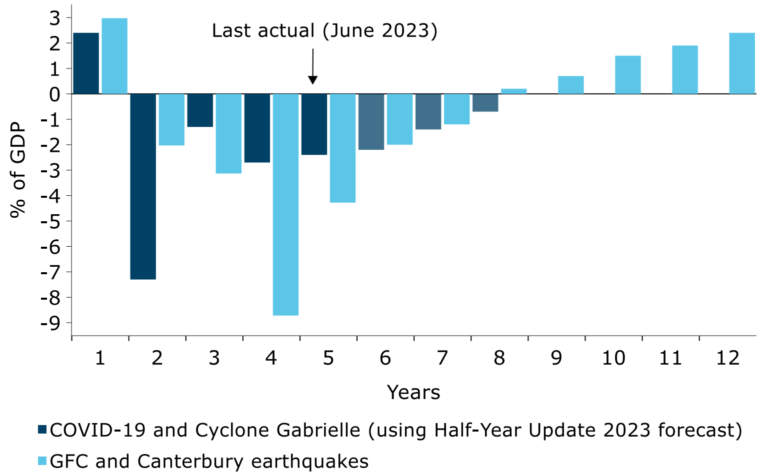
When Labour was elected in 2017, it had campaigned on a relatively prudent fiscal strategy, which involved delivering surpluses, reducing net core Crown debt, and taking a prudent approach to ensure expenditure is phased, controlled, and directed to maximise its benefits. It also noted that the Government would maintain its expenditure to within the recent historical range of spending as a share of GDP. Then COVID-19 happened, and it demanded a big fiscal response, requiring a deviation from the fiscal strategy at the time.

However, that big fiscal response was never really unwound, despite the economy becoming overheated. And when the Government refreshed its fiscal strategy on the other side of the COVID response (in 2022), it was quite a bit looser:

- The debt "target" became a 30% of GDP "ceiling", but under a new debt measure that included NZ Super Fund (NZSF) assets. The inclusion of NZSF assets meant the new 30% was closer to 50% of GDP under the old measure. In reality, treating debt as a ceiling (with a Victorian villa stud height) meant the hurdle was very high for debt to actually become a binding constraint on discretionary fiscal policy. That's not necessarily a bad thing, as debt is a function of both capex and opex: and with plenty of need for infrastructure, the last thing NZ needs is a Government that's not willing to invest. But it does up the ante on the quality of spending.
- The most binding part of the last Government's post-COVID strategy was that OBEGAL 'surpluses will be kept within a band of 0 to 2 percent of GDP to ensure new day-to-day spending is not adding to debt'. This was certainly flexible, but the lack of specifics (eg timeframe) meant it wasn't overly binding in practice.
- Further, there was no mention in the prior Government's strategy about what they'd do with positive revenue surprises. This added to the risks that fiscal policy would be pro-cyclical on the way up, adding stimulus into an already-hot economy, boosting inflation pressures and delivering poor bang-for-buck for taxpayers due to limited resources.

Under the last Government, the forecast return to surplus was repeatedly pushed out as big spending increases became commonplace. The first post-pandemic forecast surplus was in the 2021 Half-Year Update, and it was forecast for the current fiscal year (2023/24). As at the Half-Year Update in December 2023 (where the forecasts maintained the policy settings of the prior Government), the forecast return to surplus was for the 2026/27 fiscal year, and it was wafer thin at just $0.1bn. we wouldn't be surprised if the weaker economic outlook causes the return to surplus to be pushed out another year at the upcoming Budget. If so, that would mark 8 years of consecutive deficit following the pandemic and cyclone Gabrielle, two years more than following the Global Financial Crisis and Canterbury earthquakes (figure 1).

Figure 1. OBEGAL following crises



Source: New Zealand Treasury, Macrobond, ANZ Research

So is the new fiscal strategy a game changer?

The key parts of the new Government's fiscal strategy are as follows:

- An OBEGAL surplus is certainly the goal, but the wording around this is still a little vague: "An operating surplus will be achieved via a steadily improving OBEGAL trajectory. A specific timeframe for returning to surplus will be set out in the FSR, when a complete set of updated fiscal forecasts and projections will be available. It would be premature to identify a surplus date now, based on incomplete information." Forecasting a surplus is one thing, but we're not sure if this means the Government will announce a *target* surplus date in May or not.

- The Government has gone back to the old measure of net debt. And we think that's a good thing. Yes, it's not quite as comparable to some key international measures, but stripping out NZSF assets will mean less volatility, and ultimately an indicator that better reflects the Government's policy choices. This will make it a lot more binding than previously. In terms of the new debt "ceiling": "the Government intends to put net core Crown debt on a downward trajectory. Once it is below 40 per cent of GDP, the Government intends to maintain net core Crown debt within a band of 20 to 40 per cent of GDP".

The big missing piece for us was any comment about what the Government might do if the economy and revenues surprise on the upside, as that would have added a new symmetry around debt risks, and possibly help avoid pro-cyclical fiscal settings in the future. But overall, today's strategy is a notch higher on the prudent-o-meter, with perhaps a little headroom to go higher still? Time will tell.

Summary

All in all, the writing is on the wall. Pressure on bond issuance is building, but today's information is only partial in terms of what we're likely to see in the May Budget. Indeed, the upcoming Budget Economic and Fiscal Update will be the first update provided by the Treasury that fully incorporates the new Government's policy agenda. How this nets out with their updated economic outlook (which will probably undergo further tweaks versus that presented today) is still an unknown.

Through a macroeconomic lens, the faster the Government consolidates the fiscal position, the sooner the RBNZ will be able to ease monetary conditions (all else equal). And that's an important consideration: there are (always) many households that would benefit from more fiscal support, but there are currently also many struggling in the face of higher interest rates. You'll get better overall outcomes if monetary and fiscal policy work together rather than against each other.

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