The Treasury

Budget 2017 Information Release

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Fiscal Strategy beyond 2020

Date:	23 March 2017	**Report No:**	T2017/708
		File Number:	MC-1-5

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	**Note** options for the Government's fiscal targets, including the post-2020 debt objective.	Tuesday 28 March 2017

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[34]	[34]	[39]	N/A (mob)	✓
Oscar Parkyn	Principal Advisor, Macroeconomic and Fiscal Policy	[39]	[23]	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Fiscal Strategy beyond 2020

Executive Summary

The Government has a key fiscal target to reduce net debt to around 20 per cent of GDP by 2020. A new fiscal anchor for the post-2020 period may be desirable to support fiscal management in an environment of rising surpluses.

The Government has experience with different fiscal targets: returning to operating surplus by 2014/15 and the net debt target for 2020. These targets have underpinned the fiscal consolidation and the achievement of the surplus target brought credibility. With the fiscal position stabilised, we consider it appropriate that fiscal targets can be more flexible than previously specified and should focus decision making on the medium term.

In designing fiscal targets, a key trade-off that arises is between a target that provides a strong fiscal anchor (thereby supporting prudent fiscal management) and one that avoids pro-cyclical changes in fiscal settings (thereby supporting macroeconomic stability). Fiscal targets need to be sufficiently flexible to allow the automatic fiscal stabilisers to operate (eg, tax revenues automatically rise in an upturn and fall in a downturn). If fiscal targets are too rigid, there is a risk that fiscal targets will induce excessive cuts to spending in a cyclical downturn or conversely excessive increases in spending in a cyclical upturn, thereby exacerbating the economic cycle.

The Government currently has a long-term debt objective to reduce net debt to within a range of 0-20% of GDP. Long-term objectives are required by the Public Finance Act 1989 and must apply for at least 10 years. Given the uncertainty over this time horizon, these objectives need to be flexible. Short-term targets can be used to supplement long-term objectives to help ensure they are achieved.

Any fiscal target cannot take into account all circumstances or be consistent with achieving all objectives, and should provide some room for judgement to be exercised. Although fiscal targets help to communicate your fiscal strategy, they need to be accompanied by a broader explanation of your fiscal strategy that outlines your other long-term and short-term intentions.

There are a number of options for long-term objectives for net debt and the operating balance (before gains and losses) (see tables 1 and 2). Treasury will provide its fiscal strategy advice with updated fiscal forecasts on 30 March.

Table 1: Options for the long-term objective for debt

Option	Potential wording of long-term objective for debt
Option 1: Status quo	Reduce net debt to within a range of 0 per cent to 20 per cent of GDP.
Option 2: Focus on the midpoint of a range	Reduce net debt to around 10 per cent of GDP. Over the economic cycle, maintain net debt within the range of 0 to 20 per cent of GDP.
Option 3: Point target	Reduce net debt to around 10 [or 15] per cent of GDP.
Option 4: Narrower range target	Reduce net debt to within a range of 10 per cent to 15 per cent of GDP.
Option 5: Fixed date target	Reduce net debt to around 15 per cent of GDP by 2025, and maintain it around this level thereafter (subject to economic shocks).

Table 2: Options for the long-term objective for operating balance

Option	Potential wording of long-term objective for the operating balance
Option 1: Status quo	Return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the NZ Superannuation Fund, and ensure consistency with the debt objective.
Option 2: Indicate level of future surpluses	Return to an operating surplus (before gains and losses) of around 2 per cent of GDP, which is sufficient to meet the Government's net capital requirements, including contributions to the NZ Superannuation Fund, and ensure consistency with the debt objective.
Option 3: Indicate range of future surpluses	Return to operating surpluses (before gains and losses) in a range of 1 to 3 per cent of GDP, which is sufficient to meet the Government's net capital requirements, including contributions to the NZ Superannuation Fund, and ensure consistency with the debt objective.

Recommended Action

We recommend that you:

a **note** options for the Government's fiscal targets, including the post-2020 debt objective.

b **note** Treasury will provide its fiscal strategy advice with updated fiscal forecasts on 30 March.

Renee Philip
Manager, Macroeconomic and Fiscal Policy

Steven Joyce
Minister of Finance

Treasury Report: Fiscal Strategy beyond 2020

Purpose of Report

1. This report outlines some options for the Government's fiscal targets beyond the 2020 debt objective for your consideration. Treasury will provide its fiscal strategy advice with updated fiscal forecasts on 30 March.

2. This paper is based on Treasury's previous advice on fiscal targets in 2015.

3. The report outlines the challenges for fiscal management in the 2020s, objectives for designing fiscal targets, options for new fiscal targets, and fiscal management options to help manage fiscal surpluses in the 2020s.

4. The annexes set out the Government's current fiscal targets and the key design choices involved when formulating fiscal targets.

Background

The fiscal strategy has short-term fiscal intentions and long-term fiscal objectives

5. The Public Finance Act 1989 (PFA) requires the Government to set out long-term objectives ('long-term' defined as a period of no shorter than 10 consecutive financial years) and short-term intentions ('short-term' defined as a period of no shorter than the next two financial years) for:

   - debt
   - operating balance;
   - operating revenues;
   - operating expenses; and
   - net worth.

6. The short-term intentions and long-term objectives must be consistent with the principles of responsible fiscal management in the PFA, including maintaining debt at 'prudent' levels. Annex 1 outlines the current short-term intentions and long-term objectives set out in the 2017 *Budget Policy Statement*.

Large and rising fiscal surpluses are projected beyond 2020

7. Recent advice [T2017/596] noted that there will be a need to reset the fiscal strategy for the post-2020 period given current settings imply an indefinite rise in surpluses and a significant reduction in the level of Government expenditure as a share of GDP.

8. The current outlook implies that future governments will have choices around increasing spending, reducing taxes and/or further strengthening the Crown balance sheet beyond 2020.

9. The projections are based on assumptions of ongoing trend economic growth and all future spending can be managed within operating and capital allowances. Given the many risks to the fiscal outlook, and the likelihood of a shock at some point in the next decade, it is important to focus on strengthening fiscal buffers to support resilience.

A clear fiscal framework can support fiscal management in the post-2020 period

10. Managing surpluses and low debt in the 2020s, particularly in the context of a strong economy and buoyant tax revenues, is likely to create political-economy challenges. These challenges include ensuring that fiscal buffers are strengthened, avoiding pro-cyclical spending, and resisting pressure for increases in low-value expenditure.

11. The fiscal strategy reflects the Government's intentions with regard to revenue, spending, operating balance, debt and net worth. The strategy can be supported by fiscal targets, which are numerical targets for a fiscal indicator.

12. Fiscal targets can support fiscal management by providing an anchor for fiscal decisions. However, fiscal targets are unlikely to be sufficient on their own to maintain broad support for fiscal surpluses. Clear communication to the public and state sector about the benefits of strong fiscal buffers are likely to be critical. Potential institutional mechanisms, such as contributing to funds on the balance sheet once net debt is low, may assist with communicating the rationale for strengthening fiscal buffers.

13. The Government has experience with different fiscal targets: returning to operating surplus by 2014/15 and the net debt target for 2020. The strong political commitment to the surplus target brought considerable credibility to the fiscal consolidation. However, as the date approaches, a fixed date target can risk leading to suboptimal decisions if they are driven by a need to achieve a particular fiscal target in a particular year.

Fiscal targets should support sustainability, stability and accountability

14. Good fiscal targets need to balance the objectives of *fiscal sustainability* (rebuilding fiscal buffers and providing a top-down budget constraint to support decision making) while also supporting *economic stability* by enabling sufficient flexibility for the operating balance and debt to fluctuate over the economic cycle or in response to shocks. Targets should be readily understandable by policymakers and the public to promote *accountability*.

15. In designing fiscal targets, a key trade-off that arises is between a target that provides a strong fiscal anchor (thereby supporting prudent fiscal management) and one that avoids pro-cyclical changes in fiscal settings (thereby supporting macroeconomic stability). Fiscal targets need to be sufficiently flexible to allow the automatic fiscal stabilisers to operate (eg, tax revenues automatically rise in an upturn and fall in a downturn). If fiscal targets are too rigid, there is a risk that fiscal targets will induce excessive cuts to spending in a cyclical downturn or conversely excessive increases in spending in a cyclical upturn.

16. There are a number of key design choices for fiscal targets, including the time horizon, which indicator to target, whether to specify the target as a range or a point, and the level of the target (which should reflect the Government's fiscal strategy).

17. Annex 2 provides further information about the design of fiscal targets, based on the Treasury's review of fiscal targets in 2015 [T2015/2225 refers].

Options for change

The fiscal strategy includes short-term intentions and long-term objectives

18. The Government's fiscal strategy includes short-term intentions and long-term fiscal objectives, as required by the Public Finance Act. Further information is in Annex 1.

19. The key short-term intentions include:

- Reducing net debt to around 20% of GDP by 2020;
- Maintaining rising OBEGAL surpluses over the forecast period so that cash surpluses are generated and net debt begins to reduce in dollar terms; and
- Reducing expenses below 30% of GDP, which has already been achieved.

20. The long-term objectives are to have core Crown net debt between 0-20% of GDP, maintain core Crown expenses below 30% of GDP and to have operating balances sufficient to meet capital requirements, including NZ Super Fund (NZSF) contributions.

21. The current fiscal targets provide a sound basis for Budget 2017 decisions, including reducing net debt to around 20% of GDP by 2020 for reasons of credibility and prudence. However, you may wish to consider modifications to the long-term fiscal objectives to provide a stronger fiscal anchor for future Budgets, combined with a narrative in the Fiscal Strategy Report about the fiscal strategy beyond 2020.

22. We provide options for the long-term objectives for net debt and OBEGAL. We chose these indicators as there is greatest familiarity with these indicators. These would augment, not replace, the current net debt target for 2020.

Options for post-2020 objective for net debt

23. The 0-20% of GDP range in the current long-term net debt objective reflects the significant uncertainty about the debt trajectory and that debt is a “shock absorber” that should fluctuate over the economic cycle. Net debt increased from 5% of GDP in 2007 to a peak of 26% of GDP in 2013. Historically, net debt has risen by an average of 10 percentage points of GDP following recessions in New Zealand.

24. The 0-20% of GDP range may not provide a strong anchor to communicate decisions, although the allowance framework and a commitment to save revenue surprises is intended to constrain spending within the current range target. You could therefore choose a smaller range, a point target or a point target within a range. With each of these you could choose to have a fixed date target (eg, reach a level of net debt by 2025) or for the target to cover the next 10 years, which would roll forward over time.

25. The fiscal strategy is focussed on reducing net debt below 20% of GDP. This level reflects a judgement about what is ‘prudent’ based on a range of considerations relating to exposure to risks, credit ratings, liquidity, stability of fiscal settings, demographic pressures and capital investment opportunities. There are choices about the pace of debt reduction and which level to target in the long run.

26. Maintaining net debt below 20% of GDP in the 2020s implies a focus on reducing it to a level below 20% of GDP to provide a buffer. This could be around 10% of GDP or somewhat higher (eg, 15% of GDP). A 10% of GDP target would bring net debt closer to around its pre-GFC level and is the midpoint of the 0 to 20% of GDP range in the current long-term objective for debt. It would also mean debt is likely to stay below 20% of GDP if New Zealand faced a typical recession.

27. We have set out options in Table 3 with a preliminary assessment with regard to criteria of providing a strong fiscal anchor and supporting macroeconomic stability. We provide a high level subjective assessment of the options with the following 0-3 scale:

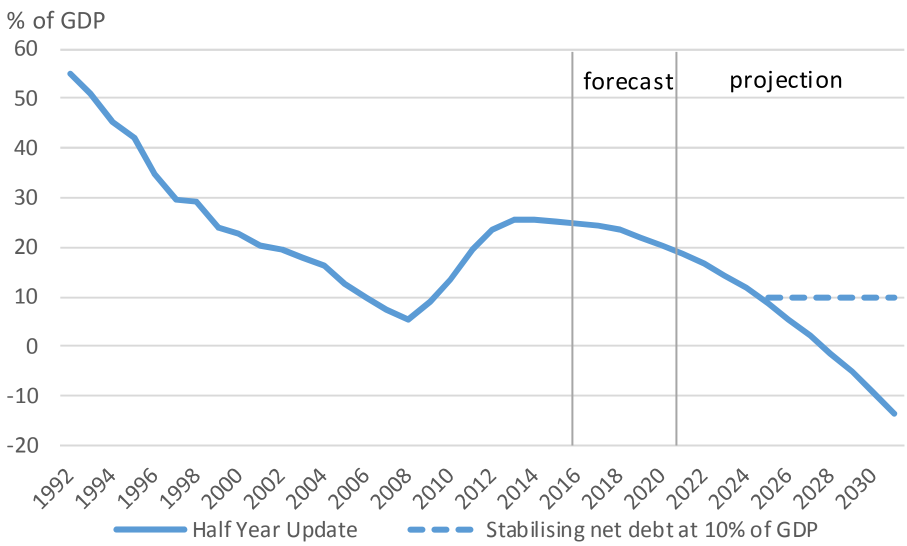
- [no tick] = does not support objective
- ✓ = somewhat supports objective
- ✓✓ = supports objective
- ✓✓✓ = strongly supports objective

Table 3: Options for the long-term objective for debt

Option	Potential wording of long-term objective for debt	Strong fiscal anchor?	Supports macroeconomic stability?
Option 1: Status quo	Reduce net debt to within a range of 0 per cent to 20 per cent of GDP.	✓	✓✓
Option 2: Focus on the midpoint of a range	Reduce net debt to around 10 per cent of GDP. Over the economic cycle, maintain net debt within the range of 0 to 20 per cent of GDP.	✓✓	✓✓
Option 3: Point target	Reduce net debt to around 10 [or 15] per cent of GDP.	✓✓	✓
Option 4: Narrower range target	Reduce net debt to within a range of 10 per cent to 15 per cent of GDP.	✓	✓
Option 5: Fixed date target	Reduce net debt to around 15 per cent of GDP by 2025, and maintain it around this level thereafter (subject to economic shocks).	✓✓✓	

28. The outlook for net debt (based on forecasts and projections at HYEFU 2016) is shown in Figure 1. Fiscal surpluses imply a downward trajectory for net debt. Net debt was projected to reach 10% of GDP in 2024/25 in the *Half Year Update*.

Figure 1: Net debt



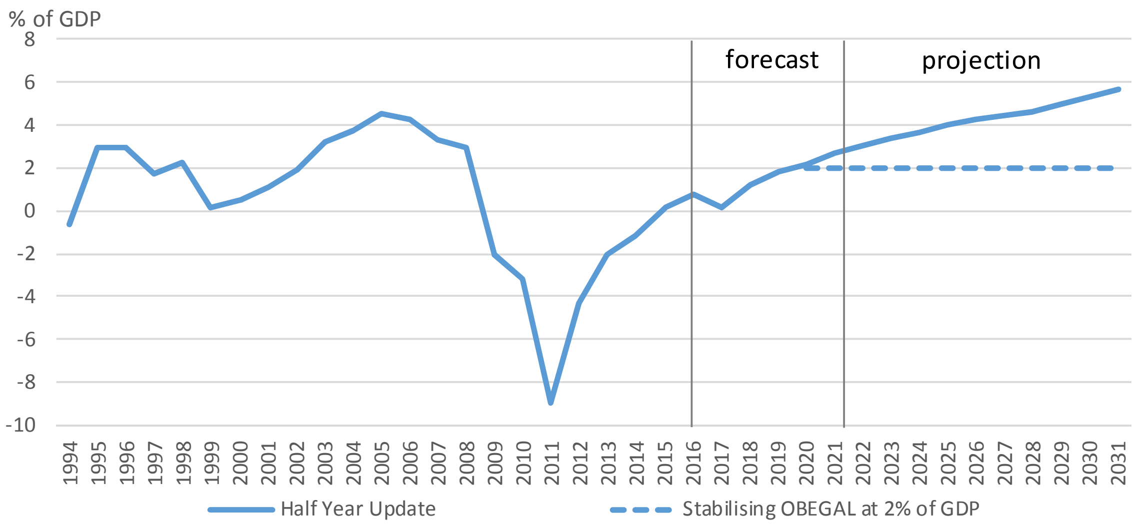
Options for post-2020 objective for the operating balance

29. The current fiscal strategy is to return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the NZ Superannuation Fund, and ensure consistency with the debt objective.

30. The operating balance (before gains and losses) is projected to continue to rise (Figure 2). The OBEGAL was projected to reach 5% of GDP or $15 billion in 2024/25 in the Half Year Update.

31. Based on current projections, an OBEGAL surplus of around 1.5-2% of GDP in the 2020s is consistent with a residual cash balance of zero (ie, operating revenues are sufficient to meet capital spending and capital contributions to NZSF). This level of cash balance is sufficient to reduce net debt as a proportion of GDP, but insufficient to pay down net debt in nominal dollar terms. Aiming for an OBEGAL surplus of around 2-3% of GDP may be prudent to ensure surpluses are sufficient to reduce net debt in dollar terms, rebuild fiscal buffers more rapidly, and provide a margin for risk.

Figure 2 – OBEGAL



32. Providing a clear numerical guide for the OBEGAL surplus could help anchor fiscal decisions. It would provide a signal about the degree and timing of headroom for higher spending or reduced taxes, but equally express a credible commitment to running surpluses at a higher level than at present.

33. We have suggested options for a point target ("around 2% of GDP") or range ("1 to 3% of GDP"). We provide a preliminary assessment with regard to criteria of providing a strong fiscal anchor and supporting macroeconomic stability on a 0-3 scale as above.

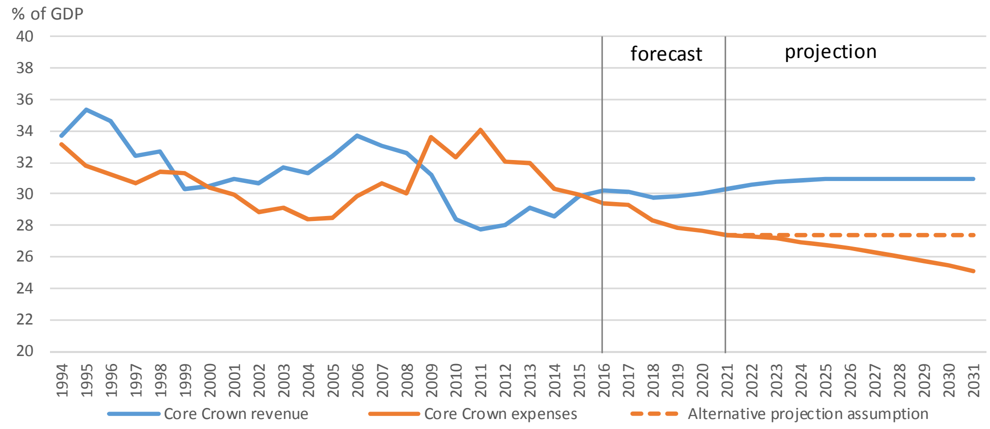
Table 4: Options for the long-term objective for operating balance

Option	Potential wording of long-term objective for the operating balance	Strong fiscal anchor?	Supports macroeconomic stability?
Option 1: Status quo	Return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the NZ Superannuation Fund, and ensure consistency with the debt objective.	✓	✓✓
Option 2: Indicate level of future surpluses	Return to an operating surplus (before gains and losses) of around 2 per cent of GDP, which is sufficient to meet the Government's net capital requirements, including contributions to the NZ Superannuation Fund, and ensure consistency with the debt objective.	✓✓	✓
Option 3: Indicate range of future surpluses	Return to operating surpluses (before gains and losses) in the range of 1 to 3 per cent of GDP, which is sufficient to meet the Government's net capital requirements, including contributions to the NZ Superannuation Fund, and ensure consistency with the debt objective.	✓	✓✓

34. Indicating a long-term level for the OBEGAL surplus implies some adjustment in either revenue or expenses beyond 2020. Current fiscal projections are based on a stable tax-to-GDP ratio, while the expenses-to-GDP ratio declines over time reflecting an assumption that operating allowances continue to constrain growth in spending. Future Governments will have choices to either cut taxes or increases spending.

35. A stable level of OBEGAL would be consistent with a stable expenses-to-GDP ratio for the projection period (ie, beyond a five year horizon), as depicted in Figure 3. This level could be around 28% of GDP and could be reflected in an updated fiscal objective for expenses as the current fiscal intention to reduce expenses below 30% of GDP has already been achieved. Alternatively, the Government could signal a more ambitious reduction in government expenses to provide greater scope for reductions in taxes.

Figure 3 – Core Crown revenue and expenses



Managing surpluses

36. To manage future political pressures that may limit the attractiveness of further debt repayment, the Government could consider committing future surpluses, or positive revenue surprises, to other funds on the balance sheet.

[33]

38. Once net debt is below 20% of GDP beyond 2020, there are several possible other options for strengthening the balance sheet ('jam jars'), such as additional contributions to the NZSF, the National Disaster Fund (NDF) or Government Superannuation Fund (GSF). Of course, all of these funds have specific purposes for future disbursements. This means that any contributions would be effectively 'locked away' once committed to the funds.

39. A further possible option would be an 'economic stabilisation fund', although this would require much more detailed consideration of the costs and benefits. The purpose of a stabilisation fund would be to avoid political pressures associated with reducing debt, as achieved with the existing NZSF and NDF options. However, the contributions and disbursements would be symmetric (over the cycle) and associated with the objective of counteracting the economic cycle. They could thus act as a complement or alternative to using changes in debt as a buffer to manage volatility in revenues. There are many institutional design considerations associated with a fund, including the pros and cons of independent oversight arrangements for the fund.

Next steps

40. Treasury will provide its fiscal strategy advice with updated fiscal forecasts on 30 March.

41. An updated fiscal strategy should be outlined in the Budget Cabinet paper (lodged on 12 April) and incorporated into the 2017 *Fiscal Strategy Report*, which Treasury will draft in conjunction with your Office in April. You will need to sign off the *Fiscal Strategy Report* in May.

Annex 1: Current fiscal intentions and objectives in *Budget Policy Statement*

The fiscal strategy has short-term intentions and long-term objectives

42. The Public Finance Act 1989 (PFA) requires the Government to set out long-term objectives ('long-term' defined as a period of no shorter than 10 consecutive financial years) and short-term ('short-term' defined as a period of no shorter than the next two financial years) intentions for:

- debt
- operating balance;
- operating revenues;
- operating expenses; and
- net worth.

43. The short-term intentions and long-term objective must be consistent with the principles of responsible fiscal management in the PFA, including maintaining debt at 'prudent' levels.

Table 1: Short-term fiscal intentions and long-term objectives in Budget Policy Statement 2017

	Short-term intention *The Government's short-term intentions must relate to at least the next 2 years.*	**Long-term objective** *The Government's long-term objectives relate to at least the next 10 years.*
Net debt	Our intention is to reduce net debt to around 20 per cent of GDP in 2020.	Reduce net debt to within a range of 0 per cent to 20 per cent of GDP.
Operating balance	Our intention is to maintain rising operating surpluses (before gains and losses) so that net core Crown debt begins to reduce in dollar terms (subject to any significant shocks to the economy).	Return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the NZ Superannuation Fund, and ensure consistency with the debt objective.

Expenses	Our intention is to support fiscal surpluses by restraining the growth in core Crown expenses and reducing these to below 30 per cent of GDP.	To meet the operating balance objective, the Government will control the growth in government spending so that, over time, core Crown expenses are reduced to below 30 per cent of GDP.
Revenue	Our intention is to support fiscal surpluses by growing revenue in dollar terms, although maintaining it at broadly the same proportion of GDP.	Ensure sufficient operating revenue to meet the operating balance objective.
Net worth	Our intention is to strengthen the Crown's balance sheet as a buffer against future adverse shocks.	Ensure net worth remains at a level sufficient to act as a buffer to economic shocks. Consistent with the debt and operating balance objectives, we will start building up net worth ahead of the full fiscal impact of the demographic change expected in the mid-2020s.

Annex 2: Principles for designing fiscal targets

Fiscal targets should support sustainability, stability and accountability

44. Fiscal targets can help manage the multiple objectives for fiscal policy that underlie the principles of responsible fiscal management in the Public Finance Act 1989 (PFA).

45. Good fiscal targets need to balance the objectives of **fiscal sustainability** (rebuilding fiscal buffers and providing a top-down budget constraint to support decision making) while also supporting **economic stability** by enabling sufficient flexibility for the operating balance and debt to fluctuate over the economic cycle. Targets should be readily understandable by policymakers and the public to promote **accountability**. In the short-term, there can be trade-offs between sustainability and stability following an economic shock, since achieving fiscal balance too quickly could result in pro-cyclical fiscal tightening or easing (eg, increasing spending in a boom or cutting spending in a recession). In the medium-term, there is less likely to be a conflict as sustainable public finances support stability by providing headroom for the automatic fiscal stabilisers to operate.

46. Treasury last reviewed the fiscal targets in 2015. Our advice focused on encouraging a medium-term focus to fiscal policy, supporting macro stability and increasing the focus on the broader balance sheet.

47. The benefits of a medium-term focus to fiscal policy is that it allows the Government to look beyond the current fiscal year in order to reallocate and prioritise spending.

Design choices for fiscal targets

48. There are a number of key design choices for fiscal targets, including the **time horizon**, which **indicator** to target, whether to specify the target as a **range or a point**, and the **level** of the target (which should reflect the Government's fiscal strategy).

Time horizon

49. There are choices about the number of years ahead for a target, and whether to have a 'rolling horizon' or 'fixed date' target. A rolling horizon means ensuring forecasts are consistent with the target, similar to how inflation targeting operates for monetary policy. A fixed date target means achieving a fiscal target in a particular year.

50. The appropriate length of the horizon needs to balance a number of factors:

    - *Macroeconomic considerations* - ideally the horizon would be longer than the typical length of the business cycle, in order to avoid discretionary responses to cyclical fluctuations in the economy (e.g. to avoid tightening fiscal policy to correct a cyclical deficit driven by automatic stabilisers). Monetary policy is the primary macro stabilisation tool, and so the horizon for the target should exceed the Reserve Bank's policy horizon. In New Zealand, this suggests a minimum horizon of 3-5 years.

    - *Uncertainty around the forecasts and projections* - uncertainty increases significantly as the time horizon is increased. Treasury only forecasts 5 financial years out from the current financial year, the remaining estimates are projections.

- *PFA requirements* – the PFA requires long-term objectives to be set for a minimum of 10 years (this implicitly suggests a default rolling target) and objectives need to be relevant over that timeframe (even if the numerical target applies to a shorter period). This avoids being required to frequently refresh long term targets, the process of which can be influenced by sentiment derived from which point in the cycle the target is being made

51. For a budget balance target (e.g. OBEGAL), a 3-5 year time horizon is considered appropriate taking into account the length of the business cycle. This also fits with the five-year forecasting and budgeting framework.

52. A stock variable (e.g. net debt) should adjust quite slowly back to its target level in response to shocks according to standard economic theory. Although there are no clear guidelines on length of time horizon for a net debt target, we consider a 5-10 year horizon to be appropriate in the New Zealand context. Adopting a budget surplus target in conjunction with a stock target would automatically set net debt on the path to the target following a shock, without inducing pro-cyclical fiscal policy.

Which indicator to target?

53. There is a choice about whether to keep the main fiscal targets based on total Crown OBEGAL and net core Crown debt. Given that these variables are now reasonably familiar to many stakeholders, this report provides options around OBEGAL and net debt.

54. Headline OBEGAL and net debt do create some communications challenges, as they cover different entities, OBEGAL includes movements in non-cash items that are excluded from net debt, and OBEGAL covers the total Crown whereas net debt covers the core Crown. In addition, whenever there are two targets there is the potential for the targets to conflict – for example one could suggest a tightening while the other could suggest a loosening.

Range or point target?

55. A target can be specified as a point (e.g. 20% of GDP for net debt), or a range (e.g. 0-20% of GDP). A point target has some advantages of simplicity of communication and providing a clear focus. However, there is much uncertainty around the economic and fiscal outlook, and the degree of uncertainty increases significantly as the time horizon increases.

56. It is appropriate for fiscal variables to fluctuate within a range over the economic cycle in order to support stability. Range targets can more explicitly allow for these fluctuations.

Level of targets

57. The discussion above relates to the specification of fiscal targets, independent of the fiscal strategy. However, in practice changing fiscal targets does have implications for the fiscal strategy itself.