THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Balance Sheet Management

Date:	13 March 2009	**Report No:**	T2009/569

Action Sought

	Action Sought	**Deadline**
Minister of Finance (Hon Bill English)	**Discuss** at Fiscal Issues at 4.30pm, Wednesday 18 March	Wednesday 18 March 2009

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
[deleted – privacy]				✓
Mark Sowden	Manager, Macroeconomic Group	[deleted – privacy]		

Minister of Finance's Office Actions (if required)

None.

Enclosure: No

Treasury Report: Balance Sheet Management

Executive Summary

You are currently forming your fiscal strategy. An important element of this strategy is a stronger focus on net worth, the overall balance sheet and risk. Volatility in the value of the Crown's commercial assets is a significant and growing contributor to overall Crown risk. Fiscal policy is only one part of the material that the balance sheet management agenda could potentially cover. However, this note sets out the work programme for strengthening the overall balance sheet approach within the fiscal framework and identifies what is achievable for Budget 2009 and the 2009 Fiscal Strategy Report.

By Budget 2009 we expect to complete a qualitative assessment of Crown Balance Sheet (CBS) management for release in the 2009 Fiscal Strategy Report, a measure of net worth, a rough quantification of risk, and options for full quantification. Full quantification and options for how you could incorporate risk metrics into fiscal strategy will be completed by Budget 2010.

As part of the broader balance sheet work we will be assessing options for creating a new net worth indicator. Part of the work programme will be to assess whether a net worth indicator can be used as a fiscal anchor. At this stage we are not expecting this element of the work to be completed by Budget 09. Previous work in this area has indicated that there are significant practical issues in translating the net worth indicator into a fiscal management tool.

Thus we believe that it would be prudent to retain a debt anchor for Budget 2009. However, we believe there is value in moving from the current gross debt indicator to net debt as the fiscal anchor. The key advantage of net debt is that it more closely reflects the policy decisions of the Government. Gross debt is influenced by a range of operational decisions by the Reserve Bank and New Zealand Debt Management Office (NZDMO) which do not affect the net debt position of the Government.

The move to net debt would require some definitional decisions. At present net debt is shown in the accounts both with and without the New Zealand Superannuation Fund (NZS Fund). The inclusion of NZS Fund would make it difficult to use net debt as a target. For example, the expected growth in the NZS Fund over time would mean the target would have to have a rising profile We also believe the indicator should exclude advances such as student loans as these are not easily turned into cash so would not reflect the Government's short term liquidity position. However, the exclusion of advances would reduce the comparability with other OECD countries.

Only core Crown financial liabilities are currently included in the net debt measure. The credibility of this definitional choice depends on the Crown not using intermediaries to borrow or enter into obligations that a counterparty would not accept on normal commercial conditions. The current policies applying to Crown Entities and SOEs support the use of only core Crown but if any changes were to be made to these policies (e.g. around the use of public-private partnerships) this decision would need to be reviewed.

In addition to these broad definitional issues there are also some specific choices around the level of the debt target, whether it is a point or a range, the timeframe over which it should be achieved etc. We will be talking to you as part of the 3-5 year fiscal strategy about these choices.

To support the debt anchor, we believe there is value in adding an expense rule. In itself a debt objective puts little discipline on the level or quality of government spending as there is an infinite mix of expenditure and revenue levels that would be consistent with delivering a particular debt objective as a share of GDP. While the 2008 Fiscal Strategy Report (FSR) identified specific revenue and spending objectives (i.e. to remain around current levels) these are relatively loose and there has been some confusion about their interpretation. Strengthening these objectives could provide an important signal of the Government's commitment to expenditure control and fiscal consolidation.

While there is a wide range of options for setting a cap, we have examined three broad options: a spending-to-GDP target, a revenue-to-GDP target and a fixed multi-annual spending cap. The revenue target is an indirect mechanism for achieving spending control so we believe one of the two spending options would be better:

- An expense target as a share of GDP could provide a long-term signal of the preferred size of Government.

- A multi-annual spending cap would be seen as a tool for working towards the debt target. It would provide a medium-term signal of the Government's commitment to spending control, though this would be at the cost of some of the flexibility that the current allowance system provides. As a complement to the spending cap consideration would also need to be given to creating a rule for dealing with additional revenue generated by upswings in the terms of trade cycle. This is the type of expenditure rule that has operated successfully in Sweden and The Netherlands and is currently favoured by the OECD.

The exact effects of the target/cap will depend on specification decisions that need to be made e.g. should the cap be nominal or real, applied to all spending or a sub-set, only operating expenditure or capital as well, etc. Subject to these specification decisions, on balance, we believe further exploration of a multi-annual spending cap has merit.

Recommended Action

We recommend that you:

a **note** that we have begun a work programme looking at Crown Balance Sheet issues including developing appropriate indicators and risk management;

b **note** that we are preparing a qualitative assessment of net worth and risk on the Crown balance sheet for inclusion in the upcoming Fiscal Strategy Report;

c **note** that the remainder of the Crown Balance Sheet work will be completed after Budget 2009;

d **note** that we believe there is value in shifting from the gross debt indicator to a net debt indicator as the fiscal anchor;

e **note** that we believe a spending rule should be introduced as a signal to the government's commitment to spending control;

f **discuss** the fiscal element of the Crown Balance Sheet work and the choice of fiscal indicators with Treasury staff at Fiscal Issues

Yes / No.

Mark Sowden
Manager, Macro Pol 1
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Treasury Report: Balance Sheet Management

Purpose of Report

1. You have indicated that you would like to give net worth and the Crown balance sheet (CBS) greater prominence in the formation of your fiscal strategy. Work on the Crown balance sheet has potentially wide ranging implications for government policy and Treasury's work programme. We are discussing this wider scope with your office. This report focuses only on the elements of Crown balance sheet work that impact on fiscal policy and the way your fiscal strategy is represented. This report provides:
   - information on our proposed work agenda for the CBS work;
   - information on net debt as a potential fiscal target; and
   - a discussion of revenue/spending targets.

Crown Balance Sheet (CBS) Analysis

2. Volatility in the value of the Crown's commercial assets is a significant and growing contributor to overall Crown risk. By Budget 2009 we expect to complete a qualitative assessment of CBS management for release in the 2009 Fiscal Strategy Report, a rough quantification of risk, and options for full quantification. Full quantification and options for how to use risk metrics in fiscal strategy will be completed by Budget 2010.

Crown Balance Sheet Work Agenda
1. Qualitative assessment of Crown Balance Sheet management for inclusion in Financial Strategy Report
Budget 2009 A qualitative assessment of CBS risk will be included in the upcoming FSR that discusses: • how to measure total vs. commercial net worth; • why net worth and risk are important concepts; • the structure of the New Zealand balance sheet and how this affects net worth and risk; • a qualitative assessment of where is risk concentrated on the balance sheet; and • how wider CBS management might improve fiscal performance over time.
2. Measurement and quantification of risk
Budget 2009 • A preliminary or rough quantification of risk (may not reach a publishable state) • options for different risk measures *Budget 2010* • Full quantification and publication of risk measures;
3. Determine how risk management could inform decision making
Budget 2010 • Investigate how measures of CBS risk could be included in fiscal strategy and decision making • Specify what constitutes an acceptable amount of risk • Investigate potential risk policy targets
4. CFI and SOE investment strategy
Budget 2010 • Investigate whether a more centralised approach to risk management would improve the Crown's aggregate risk profile • Determine how centralised risk management can complement governance arrangements

Fiscal indicators, targets and anchors

3. The current economic environment has increased the focus on balance sheet risk and associated measures. For instance Moody's recently announced that information on government net worth "is generally unavailable" but should form a "focus of analysis" for ratings agencies.[1]

4. An increased emphasis on risk and the net worth measure in the Fiscal Strategy Report (FSR) will be timely. However, we believe further work is needed before that focus on risk can be translated into a fiscal management tool.

5. Net worth is currently one of five long-term objectives the Government sets in line with the Public Finance Act (PFA) (Debt, Net Worth, Operating Balance, Revenue and Expenses). Each of these objectives is measured using an indicator. Other indicators are also published as part of the financial accounts. Each of the indicators tells a different story about the progress of the Government towards its overall objectives.

6. However, none of the indicators currently accurately capture the impact of the volatility in the value of the Crown's commercial assets on the Government's future "financial health". Swings in the value of these commercial assets could ultimately have a significant impact on the Government's fiscal position. Losses represent a future liability that would need to be met out of tax revenue, thereby potentially reducing the range of other goods and services that the Government could spend its revenue on.

7. To get a better handle on the future impact of these commercial risks on the Government's financial health over the medium term, a new indicator may need to be created. The current net worth indicator includes all of the Government's assets and liabilities irrespective of either the volatility in the value of that asset or the true realisable value. So, social assets whose value is unlikely to change from one year to the next and are unlikely to be ever sold are included alongside commercial assets whose value will change depending on the latest movements in the market.

8. As part of the pre-Budget 2009 work we will be investigating the concept of "commercial net worth" which would strip out these social assets to get a better measure of liquidity/vulnerability.

9. The commercial net worth measure could be seen as part of the spectrum which represents the degree to which various assets (and liabilities) are included in the various measures. At one end of the spectrum is core crown gross debt (with no assets) and at the other end is net worth (with all financial and physical assets and all liabilities of both core crown and SOEs and Crown Entities). In between are the core crown net debt definition and the proposed commercial net worth indicator.

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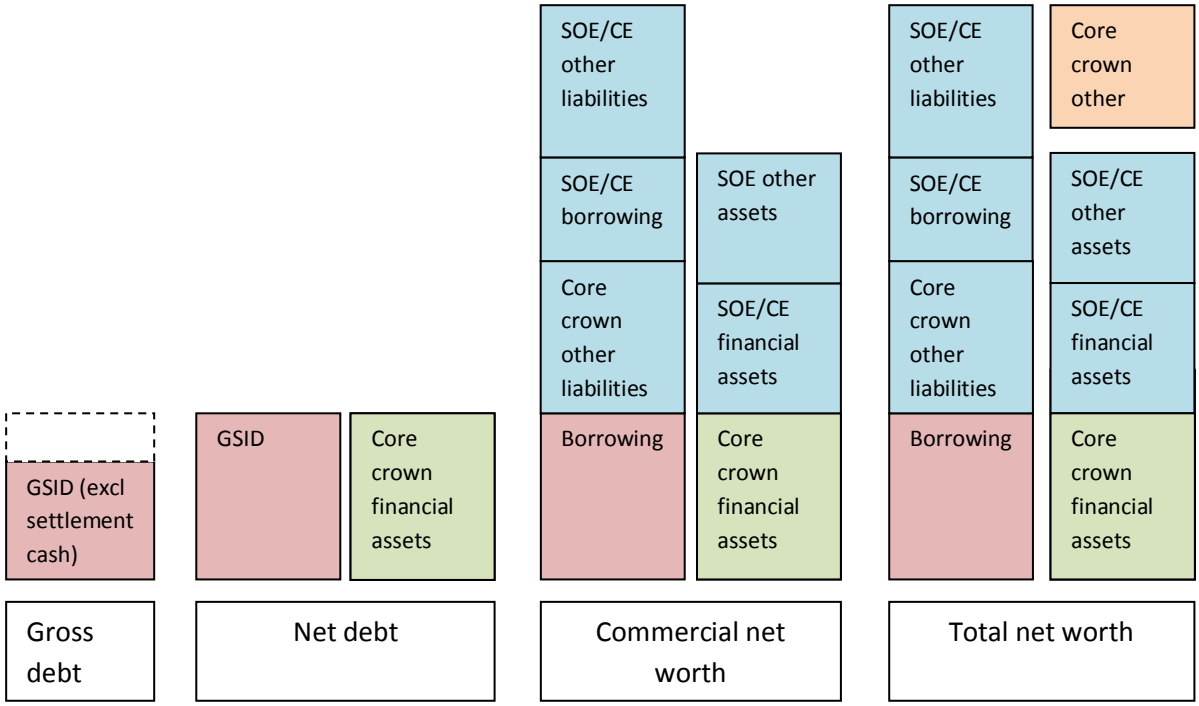
[1] Moody's Investor Service (2009) "Not All Public Debt is the Same: Navigating the Public Accounts Maze", February 2009.

Figure 1: Measure of the Crown Financial Position



SOE – State Owned Enterprises CE – Crown Entities

10. An indicator such as commercial net worth, once it is finalised, would probably form the focus of risk management. However, whether it could then be used to drive fiscal management decisions by replacing debt as the fiscal anchor is something we would investigate after Budget 2009.

Net debt as a Fiscal Anchor

11. The debt indicator used in the 2008 Fiscal Strategy Report is described in terms of gross debt[2]. The main reason for the choice of gross debt for the indicator was that it was seen as a reflection of the Government's priority of continuing to reduce gross debt relative to GDP so as to strengthen its fiscal position. It was also a transparent and easily understood indicator of the strength of the Government's fiscal position; and generally comparable to gross debt definitions in other countries.

12. There are some weaknesses in gross debt as a fiscal indicator. It does not accurately describe the "fiscal headroom" available to the Government and may not be consistent with changes in the residual cash.

13. In this report we show that net debt is a more appropriate fiscal indicator.

[2] Technically the gross debt measure is Gross Issued Sovereign Debt (GSID) excluding Reserve Bank settlement cash.

Advantages of net debt v gross debt

Transparency	Net debt is more transparent in terms of its role in presenting information on available "fiscal headroom". The fiscal constraint is determined not only by the level of debt but also the level of financial assets held. Net debt includes financial assets held by the New Zealand Debt Management Office (NZDMO) and therefore changes in these assets are reflected in the measure.
Consistency	Movements in net debt are more consistent with residual cash compared to gross debt. Residual cash typically initially flows through to changes in holdings of NZDMO financial assets which are included in net debt and not in gross debt.
Reflects primarily fiscal policy decisions	The debt indicator should primarily reflect fiscal policy decisions. Net debt is not impacted by decisions such as the change to the Reserve Bank's holdings of settlement cash. The level of settlement cash reported in financial statements is determined by Reserve Bank operational decisions and varies. This influences the level of gross debt. Would allow the Reserve Bank and other core-Crown entities to structure their balance sheets without unnecessary regard for the impact such decisions have on the Government's debt objective. Such decisions could involve wider considerations such as the overall level of risk rather than just the level of debt. In recent months, issuance of Treasury bills has increased in response to demand for relatively liquid assets from banks. In addition, RBNZ has issued Reserve Bank bills to sterilise increased cash in the system as a result of the Term Auction Facility (TAF) programme. Both of these changes are seen in a gross debt increase but are not reflected in net debt (See Figure 2 on page 11).
Communication	Net debt would provide the best information on the short term solvency of the Government.

Disadvantages of net debt v gross debt

Familiarity	The public is familiar with a gross debt indicator, less so with a net debt indicator.
Definitional Issues	There is no consistent international definition of net debt making it difficult to do international comparisons. Some financial assets are not liquid in the short term (e.g. student loans), thereby providing a misleading indicator of the government's ability to meet obligations.

14. However, we believe these definitional disadvantages can be minimised by targeting a relatively narrow definition of net debt which includes financial assets such as cash, cash equivalents and marketable securities but excludes student loan advances and the New Zealand Super Fund.

15. On balance, we now believe net debt would be a more appropriate debt indicator. The key advantage of the net debt indicator is that it more accurately reflects the "fiscal headroom" available to the Government.

Definition of net debt

16. If the decision to move to a net debt target is made, there are several definitional options around both financial assets and financial liabilities to explore.

Measure of financial assets

17. A question has been raised about whether the Crown financial institutions (CFIs) and their derivative positions are included in the net debt measure.

    - Net debt is a core Crown measure and therefore includes RBNZ and NZDMO. The CFI's ACC and EQC are not included because they are Crown entities which are not included in core Crown.

    - GSF, while part of core Crown, is not included because its net pension liability is classified as an "other liability" and not a financial liability.

    - Derivatives held by the core Crown (departments, NZDMO, RBNZ) are included in the net debt calculation (derivatives in gain are included in financial assets while derivatives in loss are included in financial liabilities). Derivatives are often used to hedge against changes in the value (e.g., resulting from changes in interest rates of exchange rates) in underlying financial assets and financial liabilities and should therefore be viewed in conjunction with these assets and liabilities. Due to this we believe it is appropriate to include these derivatives in the measure.

18. One of the main reasons for shifting to net debt is that it is a better representation of the government's short term liquidity. However, not all of the government's financial assets can be easily liquidated. The New Zealand Superannuation Fund is a long-term asset designed to partially pre-fund the increase in New Zealand Superannuation expected when the future demographic pressures eventuate. The current definition also includes student loans and other advances (in particular, loans to DHBs) which would be difficult to make liquid. There is thus a question as to whether these two elements should be included in a measure of net debt.

Should the NZS Fund be included in the calculation of net debt?

19. The Budget documentation also publishes an indicator of net debt that includes NZS Fund assets as it is a useful indicator of the overall progress towards prefunding future liabilities. However, we do not believe this indicator is appropriate as a target because:

    - if the NZS Fund grows over time, the inclusion of it in the net debt measure would mean that the target would have to show an increasing profile over time. This makes communication of the target more difficult;

    - there may be increased focus on accumulating assets in the NZS Fund. This might mean a greater weight is put on the pre-funding aspect of the strategy at the expense of not taking appropriate actions in the interests of macro stability;

- significant movements in the indicator may be seen from factors that are not the direct result of fiscal policy – specifically, movements in the valuation of the Fund's assets; and

- the pre-funding aspect of the fiscal strategy can be captured through the operating balance objective (to run surpluses sufficient to meet requirements for contributions to the NZS Fund), reporting on the Fund separately and through balance sheet management.

Should advances be included in the net debt calculation?

20. Advances are not liquid in the short term so their inclusion in the net debt indicator may provide a misleading indicator of the government's ability to meet obligations. This is because in the New Zealand context, advances are mostly student loans which are particularly illiquid and their valuation may differ from their actual market value. However, their inclusion would allow greater international comparability as the OECD generally includes advances its definition of net debt.

21. We believe the arguments for excluding advances outweigh the benefit from possible international comparability so propose to use a net debt measure excluding advances.

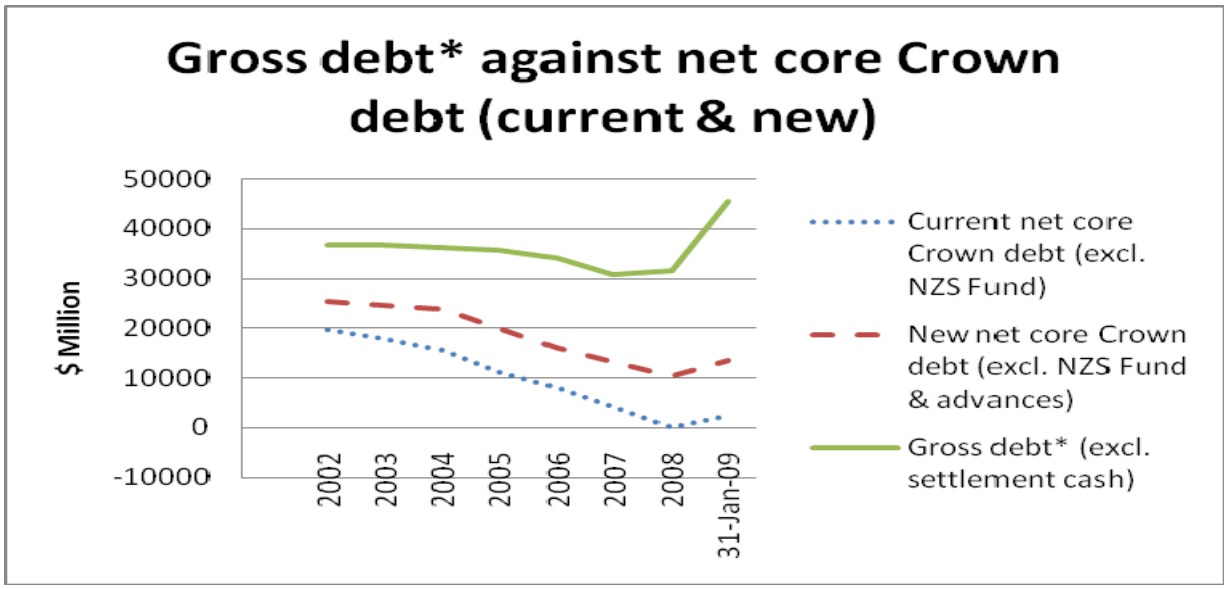
22. Table 1 below sets out the differences between the current gross debt indicator, the current net debt indicator (including advances) and the proposed net debt indicator (excluding advances). Figure 2 shows the changes over time in those three measures.

Table 1 – Components of debt indicators

For year to June 2008	**Gross debt* indicator** **($ million)**	**Current net debt indicator** **($ million)**	**Proposed net debt indicator** **($ million)**
GSID	37745	37745	37745
Less RB settlement cash	7955		
Add back NZDMO borrowing due to settlement cash	1600		
GSID excl set. cash	**31390**		
Less core Crown Financial assets		50698	50698
Net core Crown debt (incl NZS)		**(12953)**	**(12953)**
Add back NZS Fund		12934	12934
Net core Crown debt (excl NZS Fund)		**(19)**	**(19)**
Add back advances			10465
Net core Crown debt (excl advances)			**10446**

Source: Treasury Financial Statements 30 June 2008
* Gross debt indicator is GSID less Reserve Bank settlement cash

Figure 2: Historical Comparison



*Technically the gross debt measure is Gross Issued Sovereign Debt (GSID) excluding Reserve Bank settlement cash.

Measure of financial liabilities

23. The debt measure being proposed is a core Crown debt measure only; that is it excludes debt or obligations entered into by State-owned enterprises and Crown entities (see Annex 1 for more detail on total versus core Crown indicators).

24. State-owned enterprises (SOEs) can and do borrow to support their commercial investments and operations. These borrowings are negotiated and entered into on commercial terms and it is Government policy to be explicit that such borrowings are not guaranteed by the Crown. Also, it is Government policy that non-commercial activity (and financing) should not be carried out by SOEs. Therefore, as SOE borrowings are for commercial rather than fiscal purposes and are supported by the commercial operations of State-owned enterprises, it would not be appropriate to include State-owned enterprise borrowing in a measure of debt for fiscal management purposes. However, State-owned enterprise borrowing is important in terms of a wider balance sheet and would be captured in a net worth or crown balance sheet risk indicator.

25. Crown entities are restricted from borrowing under s.162 of the Crown Entities Act, although it is possible for Crown entities to borrow under some circumstances. It is generally now Government policy that any Crown entity borrowing will be from the Crown alone, and that private sector sourced debt of non-commercial Crown entities be run down.

26. Currently it is not Government policy to engage in structured finance transactions (e.g., through a guaranteed special purpose vehicle to support a public-private-partnership). If these were to be used in the future, it would be necessary to reassess the scope of the financial liability measure.

27. If any of the policies described above should be changed, then the credibility of using a core Crown debt target only, and hence the credibility of the Government's fiscal policy itself, would be called into question. The use of a core Crown-only debt target should therefore be revisited should any of the policies outlined above change.

Further decisions

28. There are specification decisions that will need to be made regarding the level of the net debt target, whether this is a point or a range, and the timeframe of the target.

These will need to be discussed in together and will therefore be considered in the 3-5 year fiscal plan.

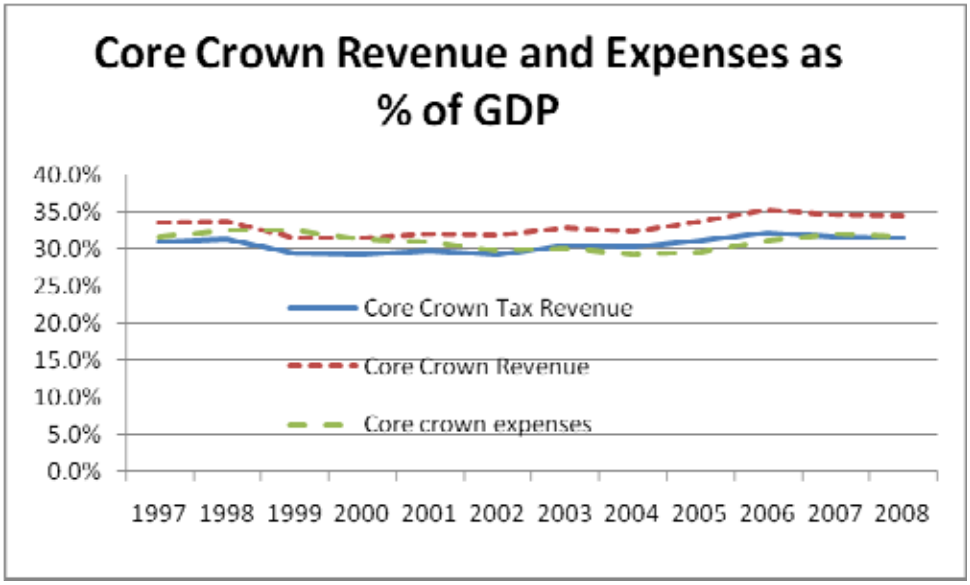
Introducing a Revenue or Spending Anchor

29. The debt objective discussed above is just one of five long-term fiscal objectives the Government sets in line with the PFA. In addition to debt there are objectives relating to the operating balance, revenue, expenses, and net worth (see Annex 2). Of these, the fiscal strategy of the 2008 FSR largely operates to one fiscal "anchor", the long-term debt objective. While the 2008 FSR refers to a suite of measures, these other objectives are subsidiary in practice. The focus on the debt objective has been successful in reducing gross debt to the target levels. However, there have been two main criticisms of the current set of fiscal objectives:

    i the increase in revenue identified as structural over recent years has resulted in increases in spending which have been seen by many as pro-cyclical (i.e. spending has increased at a time when the economy is growing strongly) leading to a potential conflict with macro stability; and

    ii in itself a debt objective puts little discipline on the level or quality of government spending as there is an infinite mix of expenditure and revenue levels that would be consistent with delivering a particular debt objective as a share of GDP. While there are specific revenue and spending objectives (i.e. to remain around current levels) these are relatively loose and there has been some confusion about their interpretation. They did not feature strongly in fiscal decision-making.

30. So even though the debt and operating balance objective have been met, the level of revenue and expenditure (as a proportion of GDP) has been drifting up in recent years. Core crown expenses increased from a recent low of 29.3% in 2004 to a high in 2007 of 32%. The total crown figures (which include crown entities and SOEs) show more dramatic growth from 37.5% in 2004 to 42.1% in 2008, though this is to be expected given that the total crown measure includes the commercial SOEs whose expenses would have risen in line with their increases in revenue during the upswing in the economic cycle.



31. Similarly, core crown tax revenue increased from a low of 29.3% in 2002 to a high of 32.2% though has since fallen to 31.5% in 2008. Again the total crown revenue showed a greater increase from a low of 37.5% in 2000 to 45.2% in 2008. On the revenue side this was partly the result of the unusual strength of the recent cycle (including the rise in the terms-of-trade and the unwinding of loss utilisation for company taxes) and the consequence of a progressive tax system. Once debt reached its target level, expenses tended to drift up with in line with revenue.

32. In the current economic environment the focus will once again be on fiscal consolidation. The recent literature suggests that an additional fiscal rule or anchor based on either revenue or expenditure could support a debt target in focussing on fiscal consolidation. Such rules may also assist with macro-stability objectives, though this will depend on the exact specification.

Is an additional anchor necessary?

33. Arguments for an additional anchor:

- complement the debt anchor by disciplining a different element of fiscal policy;
- provide an important signal to international investors, the wider public, ministerial colleagues and the public sector about the Government's commitment to expenditure control;
- provide a signal that the government is committed to improving the fiscal position over the medium term; and
- provide a mechanism for focusing on value-for-money of Government spending by constraining the availability of "new" money.

34. Arguments against adopting an additional fiscal anchor:

- could potentially undermine the fiscal framework if the Government is not committed to achieving the specified target i.e. if a target is set but not achieved;
- may not provide sufficient flexibility to deal with rapidly changing economic circumstances – depending on the specification of the rule; and
- while we would expect a debt and a revenue/expense anchor to be consistent most of the time, there may be occasions where there is a conflict between them. For example, should a positive revenue surprise be used to reduce debt or to meet a revenue-to-GDP target? Any such conflict would need to be explained and the Government would need to be transparent about the priority it has given to the particular anchor. Such clarity around the priority of objectives may be useful but may constrain the flexibility the Government currently has in such circumstances.

35. Given the Government's commitment to achieving expenditure control and improving value for money of government spending, we believe the signalling value of an additional anchor would be helpful.

What are the options for an additional fiscal anchor?

36. There is a wide spectrum of options for a revenue and/or expenditure cap. It can be something as simple as a limit on the allowances each year through to a strict cap as suggested by the ACT Party's Taxpayer Rights Bill, or something in between.

37. The choice will in part be determined by the degree of fiscal consolidation required. A cap on the allowances may not be sufficient if the Government's objective is to significantly reduce the size of Government expenditure. However, an ambitious long-term target will not aid decision-making if there isn't the political will to take the steps necessary to achieve it.

38. Broadly, revenue or expenditure growth rules can be divided into two types:

- those that limit revenue/spending relative to GDP e.g., Hong Kong has a general principle that over time expenditure growth should not exceed the growth rate of the economy; this is equivalent to a maximum expenditure/GDP ratio; and

- those that seek to limit the absolute level of spending/revenue, either on certain items or in aggregate. The Netherlands and Sweden are the most commonly cited examples of countries where a multi-annual expenditure limit has been used successfully. Some US states use a non-income based formula (such as population growth and inflation) as the basis of the cap on revenue and expenditure – this is the basis of the ACT Party's Taxpayer Rights Bill.

39. However, within these broad categories there is a wide range of specific approaches created from decisions made about the variables e.g., a nominal versus real spending cap, limiting growth or levels of expenditure, applied to all expenditure or a sub-set, etc. The exact specification can create significant differences in terms of the impact of the target.

40. The following analysis compares a target based on:

- revenue as a percentage of GDP;

- expenditure as a percentage of GDP; and

- a multi-annual expenditure limit e.g. a fixed cap on the amount the government can spend which is set for 3-4 years and cannot be revised (this is similar to the current allowance system except the allowances could not be revised).

41. We do not propose to analyse a target based on population growth and inflation (the ACT proposal). We do not believe such a proposal is a viable option for a cap for introduction in the 2009 Fiscal Strategy Report. If you want further information on this option, we can provide that at a later date.

Analysis of options

42. Table 2 below compares the three options.

Table 2: Summary of characteristics of the three options.

	Expense as a % of GDP	Revenue as % of GDP	Multi-annual expenditure limit
Timeframe	Long-term	Long-term	Short-term
Implementation	Change in fiscal objectives	Change in fiscal objectives	Change in how the objectives are translated into the fiscal strategy
Value for money	Will focus on getting value from operating expenditure though specification over the cycle may loosen the constraint. May encourage capital spending or over-achievement of the debt objective if revenue increases.	May not be sufficient to constrain operating expenditure if government reduces capital expenditure to stay within limit. May encourage tax expenditure initiatives	Will focus on getting value from operating expenditure though may encourage capital spending or over-achievement of the debt objective if revenue increases.
Consistency with macro-stability	Strictly targeting a spending-to-GDP ratio could lead to pro-cyclical fiscal policy (i.e. as GDP increases, spending can increase), although this could be reduced by specifying the target over a longer time period	May be pro-cyclical due to the progressivity of the tax system	A multi-annual expenditure target allows the automatic stabilisers to operate (provided cyclical expenditures are excluded) but precludes any additional fiscal stimulus during downturns.
Signal of commitment to expenditure control	Good provided the target is credible	Indirect	Good short term restraint. Quality of longer term signal will depend on how credible continued restraint is.
Communication	Maybe more difficult to communicate as constraining spending is seen as reducing public services.	May be easier to communicate as it focuses on constraining taxes, though the link to public services is likely to be made.	Maybe more difficult to communicate as constraining spending is seen as reducing public services.
Complexity	May be complex if allowance needs to be made for fluctuations due to prefunding of some expenses. However, this doesn't apply until around 2023 so wouldn't impact on a 10 year target for a few years.	Simple % GDP but a progressive tax system means that the proportion will continue to increase unless thresholds are indexed and/or tax changes are made regularly.	Would be a simple $ figure.
Boundary issues	Need to decide whether to apply to core or to total Crown.	Need to consider what is a tax, and whether objective should apply to core or total Crown	Need to decide whether to apply to core or to total Crown and what cyclical expenditure to exclude.
Constraint on policy choices	If a positive revenue surprise occurs, the Government couldn't increase operating spending unless it also resulted from an increase in GDP. Tax cuts or paying down debt remain options.	If a positive revenue surprise occurs, the Government would be expected to either pay down debt or reduce taxes. The Government would have to clarify the hierarchy between the two objectives.	If a positive revenue surprise occurs, the Government couldn't increase operating spending though may increase capital spending. Tax cuts or paying down debt remain options.

43. We believe there is value in adding an expense anchor. A revenue target is an indirect mechanism for focussing on the variable of interest – operating expenses. The progressivity of the tax system would mean the target would require a rising profile and may introduce additional pro-cyclicality given the correlation between revenue and GDP.

44. The two expense options have different strengths:

- an expense target as a share of GDP could provide a long-term signal of the preferred size of Government. The value of the target as a signal would depend on how credible it is that the Government could meet the target. Within 3-4 years any 10-year spending target would need to introduce a rising profile to reflect the higher demographic related spending; and

- a multi-annual spending cap would be seen as a tool for working towards the debt target. It would provide a medium-term signal of the Government's commitment to spending control, though this would be at the cost of some of the flexibility that the current allowance system provides. As a complement to the spending cap consideration would also need to be given to creating a rule for dealing with additional revenue generated by upswings in the terms of trade cycle.

45. The OECD currently favours a multi-annual expenditure cap because of the way it has successfully operated in a number of countries, especially Sweden and The Netherlands. In Sweden, the expenditure ceiling applies to central government budget expenditure and expenditure for the extra-budgetary public pension system; interest on government debt or local government expenditures are not covered. The expenditure ceiling is set for three years (every year a new third year is added). The ceiling is nominal and it contains a contingency margin. In The Netherlands, the expenditure ceilings are established at the start of any new coalition government for the entire term of government (four years). No explicit corrections are made for business cycle fluctuations, though the automatic stabilisers operate freely.

46. The exact effects of the target/cap will depend on specification decisions that need to be made e.g. should the cap be nominal or real, applied to all spending or a sub-set, applied to operating expenditure only or include capital as well, etc.

47. Subject to these specification decisions, on balance, we believe further investigation of a multi-annual spending cap has merit.

Annex 1: Core vs Total Crown fiscal objectives

The long-term fiscal objectives required by the PFA are required to be specified in terms of the total Crown for specific variables (operating expenses, operating revenues, the operating balance, total debt and total net worth). However, for some fiscal variables these objectives are supplemented by an additional focus on a supplementary indicator. The previous government stated that its fiscal objectives were operationalised through a focus on:

- total Crown OBEGAL (excluding NZS Fund retained revenue);
- core Crown expenses-to-GDP;
- tax-to-GDP; and
- gross sovereign-issued debt (excluding RB settlement cash) as a % of GDP.

The expense, tax, and GSID objectives are all aiming to capture some measure of the core Crown. Some of the reasons for this narrower focus include:

- SOEs/CEs are generally managed at arm's length from the government and outside of the government's direct control, so government would not be able to be held directly accountable for achieving fiscal objectives that include these entities;
- expenses of SOEs, and to some extent CEs, are funded by commercial revenue rather than tax revenue and therefore do not reflect the burden of taxation;
- an increase in SOE expenses that generates increased revenue could signal good performance under strong governance, and should not necessarily require a reduction in core Crown spending in order to achieve an expense objective; and
- including SOEs and CEs could be perceived as government wanting to gain increased control of these entities, or could affect SOE or CE decision making.

Whether any numerical objectives should be set for core or total Crown is not clear cut. Some of the arguments for setting numerical objectives for the total Crown include:

- better reflect Crown's ownership, and encourage Ministers to focus on the appropriateness of retaining public ownership;
- make SOE debt more transparent (although SOE debt is already included in the financial statements);
- make transparent the potential risk facing the Crown if it were to bail out an SOE or CE (again SOEs and CEs are already reported in the financial statements); and
- reduce the potential for the government to change institutional structures in order to meet fiscal objectives.

Fiscal indicators relating to total Crown will continue to be an important part of fiscal reporting.

Annex 2: Long-term fiscal objectives

Long-term fiscal objectives	To achieve the objectives, the Government's high-level focus is on:
Operating balance Operating surpluses on average over the economic cycle sufficient to meet the requirements for contributions to the NZS Fund and ensure consistency with the debt objective.	• Operating surpluses during the build-up phase of the NZS Fund. Our focus is on maintaining the OBEGAL excluding NZS Fund revenue at a level sufficient, on average, to meet the requirements for contributions to the NZS Fund. • Our focus in meeting this objective is on core Crown revenues and expenses, maintaining tax-to-GDP and core Crown expenses-to-GDP around current levels. • As set out in our revenue strategy, we will ensure tax policy decisions are consistent with the overall fiscal strategy including the Government's long-term revenue objective. • SOEs and Crown entities contributing to surpluses, consistent with their legislation and Government policy.
Revenue Ensure sufficient revenue to meet the operating balance objective.	
Expenses Ensure expenses are consistent with the operating balance objective.	
Debt Manage total debt at prudent levels. Gross sovereign-issued debt broadly stable at around 20% of GDP over the next 10 years.	• Gross sovereign-issued debt-to-GDP will be broadly stable over the period ahead of the major demographic changes associated with population ageing. • The Government is effectively targeting a level of gross sovereign-issued debt excluding the increase in debt on the Reserve Bank balance sheet as a result of the change in the liquidity management regime. • SOEs will have debt structures that reflect best commercial practice. Changes in the level of debt will reflect specific circumstances.
Net worth Increase net worth consistent with the operating balance objective.	• The NZS Fund will continue to accumulate assets through its retained earnings and Crown contributions. • Consistent with the net worth objective, there will also be a focus on quality investment.