THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Broadening the focus of the fiscal strategy: the role of net worth in Budget 2010

Date:	9 April 2010	**Report No:**	T2010/559

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**agree** to retain net debt as the fiscal anchor and increase the focus on the wider balance sheet (in particular the net worth excluding social assets indicator) and Crown risk in the FSR story around the net debt objective; **note** that we are working with your office to incorporate a stronger balance sheet perspective in the first draft of the 2010 FSR; and **discuss** this report with officials at Fiscal Issues on 14 April 2010.	Wednesday 14 April 2010
Associate Minister of Finance & Minister for State-Owned Enterprises (Hon Simon Power)	**Note** the recommendations	
Associate Minister of Finance (Hon Steven Joyce)	**Note** the recommendations	

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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John Janssen	Acting Manager, Macro Policy	[deleted]	[deleted]	

Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

9 April 2010

Treasury Report: Broadening the focus of the fiscal strategy: the role of net worth in Budget 2010

Executive Summary

You have indicated that Treasury should place more importance on how the Government's balance sheet is performing in the fiscal strategy. Over the past year we have increased our focus on Crown risk management and a broader set of indicators in the fiscal strategy. You have suggested that one way to incorporate the improved risk management work into the fiscal strategy is to change the fiscal anchor from net debt to a net worth variant. The current fiscal anchor is relatively narrow and it may not pick up some shocks to the fiscal situation that the Government might want to react to.

This paper identifies three main options for incorporating risk management and balance sheet issues into the fiscal strategy.

- The first option is the status quo. We do not consider this is a viable option because we agree that more information needs to explicitly feed into the formulation of the fiscal strategy.

- The second option would be to retain net debt as the fiscal anchor, but enhance the section in the Fiscal Strategy Report (FSR) on risk management and provide further balance sheet information (including projections of net worth and net worth excluding social assets). It would also state how this information has been used in setting the net debt objective and judging progress toward that objective.

- The third option would be to move to a net worth type anchor, where changes in the anchor would influence decisions on spending and taxation.

We have assessed the second and third option against a set of criteria for a good fiscal anchor. We have also analysed how each anchor would respond to different shocks to the fiscal position to understand how the fiscal strategy would work in practice.

Our recommendation is formed on the basis of this analysis. The overarching goal of the fiscal strategy is generally taken to be the long-term solvency of the Government. Changes in asset and liability values also matter because they could place a burden on future taxpayers. In this sense a net worth type anchor would be attractive in that it explicitly incorporates the rest of the balance sheet into the fiscal strategy. However, this could come at the cost of transparency and credibility due to the political economy constraints of running a budget process. The same goal can be achieved by retaining net debt as the fiscal anchor, but explicitly stating in each FSR how the extra balance sheet and risk information has fed into decisions around the fiscal strategy. This may result in changes to the net debt objective from time to time.

Recommended Action

We recommend that you:

a **agree** to retain net debt as the fiscal anchor and increase the focus on the wider balance sheet (in particular the net worth excluding social assets indicator) and Crown risk in the FSR story around the net debt objective;

Agree/disagree

b **note** that we are working with your office to incorporate a stronger balance sheet perspective in the first draft of the 2010 FSR; and

c **discuss** this report with officials at Fiscal Issues on 14 April 2010.

John Janssen
Acting Manager
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Treasury Report: Broadening the focus of the fiscal strategy: the role of net worth in Budget 2010

Purpose of Report

1. You indicated that Treasury should place more importance on how the Government's balance sheet is performing in the fiscal strategy. In particular you have mentioned the performance of some SOEs as a concern (e.g. TVNZ and NZ Post), and you have also been concerned about shocks to the Government's assets and liabilities that do not show up in the Government's current main fiscal indicators. The issue of risk to the Crown's financial position also needs to be addressed in the fiscal strategy. If the Government's balance sheet is exposed to a lot of risk then the fiscal strategy may need to be amended to increase resistance to shocks.

2. Over the past year we have increased our focus on Crown risk management and a broader set of indicators in the fiscal strategy. A Treasury Report in March 2009 outlined the potential role of net worth excluding social assets as an indicator, and signalled that it may become a more important indicator in the fiscal strategy (T2009/569 refers). The debt anchor was changed from gross debt to net debt in the *2009 Fiscal Strategy Report (FSR)*.[1] There was also a discussion in the *2009 FSR* on wider balance sheet issues and associated indicators. We discussed at Fiscal Issues in September 2009 the work needed to do to assess the desirability of a net worth type indicator as a fiscal anchor.

3. The *HYEFU 2009* included a brief definition and description of what net worth excluding social assets portrays and historical estimates and projections were provided. Net worth excluding social assets gives a good indication of how the Government's assets that earn a financial rate of return match up to the government's liabilities.

4. You suggested that one way to incorporate the improved risk management work into the fiscal strategy is to change the fiscal anchor from net debt to a net worth variant. The current fiscal anchor is relatively narrow, and it may not pick up some shocks to the fiscal situation that the Government might want to react to.

5. This report outlines our analysis of the value in moving to a net worth type anchor and our recommendation.

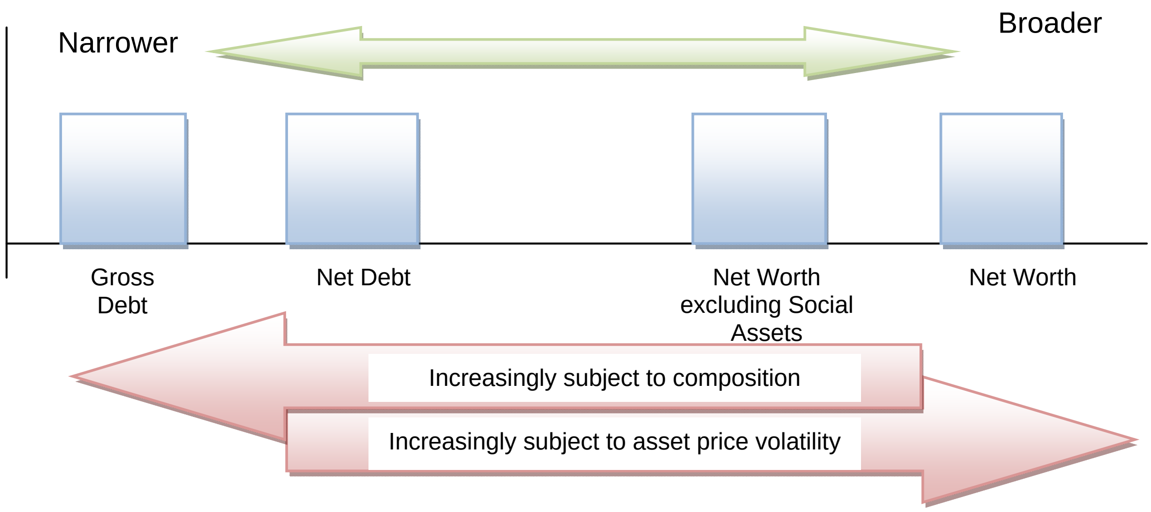
Analysis

Definitions, measurement and projections

6. As shown in Figure 1, there are trade-offs between narrower and broader balance sheet indicators. Narrower indicators can be more subject to compositional changes, where the exclusions can become numerous, thereby making the indicator more complicated. Broader fiscal indicators are increasingly subject to asset price volatility, which means that the measure can be influenced by movements that can be seen as outside the Government's control.

[1] The definition of net debt adopted in the FSR excludes advances and New Zealand Superannuation Fund as financial assets.

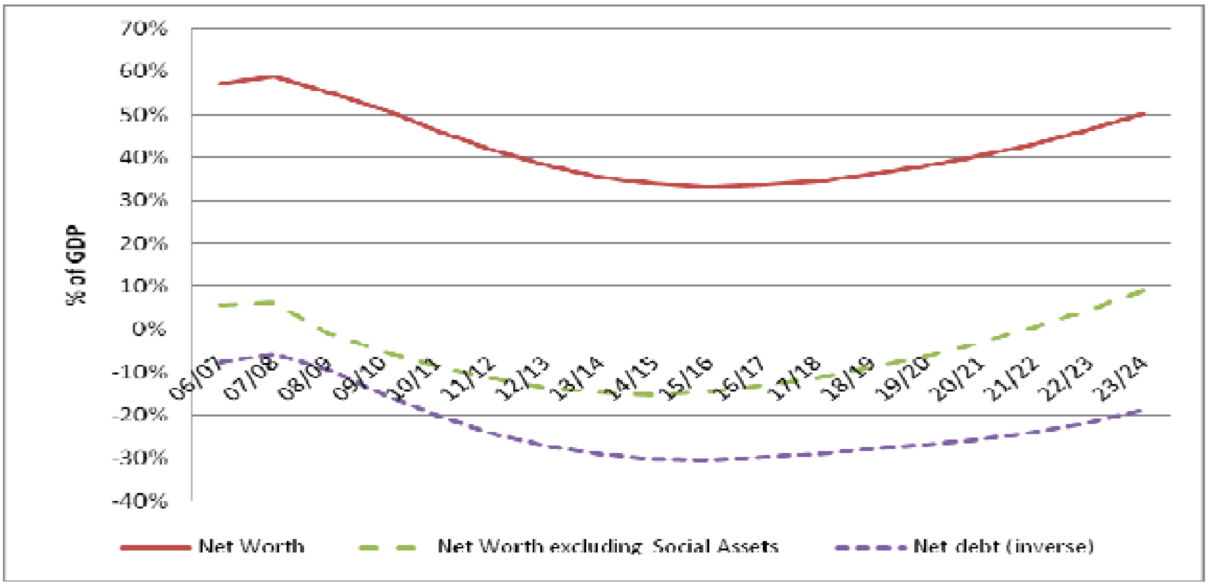
Figure 1: Spectrum of fiscal indicators (Source: Paul Dyer, 'Comments on net debt report' April 2009)



7. Further to the indicators in Figure 1, there are also other indicators in this spectrum: net debt including the NZS Fund assets; net financial worth; comprehensive net worth (i.e. including the present value of future liabilities and assets, including tax). The choice of fiscal anchor depends on the objectives for that anchor, and how it performs against criteria for a good fiscal anchor.

8. The trajectory of the net worth excluding social assets indicator closely follows those of net debt and net worth in the projection period. There is only really a level difference (reflecting social assets when compared to net worth, and Crown entity and KiwiRail financial assets, and SOE assets and liabilities when compared to net debt). We do not project changes in asset prices beyond simple growth rates linked to inflation and GDP, and therefore all three tracks are largely driven by sustained operating deficits.[2]

Figure 2: Net debt (inverse), net worth excluding social assets[3] and net worth to GDP (*HYEFU 2009* data)



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2 The growing wedge between net worth excluding social assets and net debt is largely due to the New Zealand Superannuation Fund as it is included in the net worth excluding social assets measure but not the net debt measure.

3 Subsequent to the initial modelling presented in the *HYEFU 2009*, a review of the assumptions has not yielded any changes to the projection methodology.

Options for increasing the focus on risk management in the fiscal strategy

9. Work is underway on improving Crown risk management and methods to quantify Crown risk. Treasury will report to you on its analysis of Crown risk in the coming weeks. There is also work underway on ways to help communicate how the SOE balance sheet is performing, including a new market-value based indicator of SOE net worth. This is discussed in the accompanying report titled, 'SOE net worth – applications and considerations'. We can also draw on further information from the financial statements to feed more explicitly into the fiscal strategy.

10. Our analysis has identified three options:

- Retain the status quo. This would involve keeping net debt as the fiscal anchor and continuing to *implicitly* consider the wider balance sheet and information on Crown risk when setting the fiscal strategy. We do not consider that the status quo is a viable option because we recognise the need to tell a richer story around the fiscal strategy.

- Retain net debt as the fiscal anchor, but enhance the section in the FSR on risk management and provide further balance sheet information. The FSR would then state how this information has been used in setting the net debt objective and judging progress toward that objective. It would also include projections of net worth or net worth excluding social assets alongside the projections of the net debt anchor to aid decision making.

- Move to a net worth type anchor (net worth or net worth excluding social assets). This option would mean changes in net worth would drive decisions around taxes and spending, unless the changes in net worth were looked through (e.g. if the changes were seen as temporary).

Criteria for a good fiscal anchor

11. In determining which option is preferred it is important to understand how each indicator would perform as the fiscal anchor. Over recent years Treasury has identified criteria for what makes a good fiscal anchor. The table below outlines how the three stock indicators, net debt, net worth excluding social assets and net worth match up to the criteria.

Table 1: Criteria for a good fiscal anchor

Criteria	Net Debt	Net Worth excluding Social Assets	Net Worth
Transparency – The public, financial markets and credit rating agencies clearly understand that making progress toward, and achieving the objective contributes to a prudent fiscal position.	Excellent – well understood.	Average – once the indicator is established it will be simple enough to understand, however, the indicator may be volatile ex post which will reduce transparency.	Average – the extra volatility associated with net worth will mean it is subject to further ex-post volatility. This may cause level shifts in the indicator which may be difficult to understand.
Timeliness – Decisions made by the Government are reflected in changes in the indicator within a reasonable period of time.	Good – these decisions will mostly be through tax and spending.	Good – these decisions will mostly be through tax and spending, but may be hidden by changes in asset values.	Good – these decisions will mostly be through tax and spending, but may be hidden by changes in asset values.
Consistency – Movements in the measure are consistent with changes in other indicators.	More consistent with residual cash than the operating balance.	Consistent with the operating balance.	Consistent with the operating balance.
Communication of the fiscal strategy	Good – movements in the anchor would generally be reflected in Government decisions.	Average – movements in the anchor would not always be responded to which may hinder communication.	Average – movements in the anchor would not always be responded to which may hinder communication.
Primarily reflects direct fiscal policy decisions – rather than the operational decisions of independent Government agencies.	Good – the measure only captures the core Crown.	Average – the indicator is also affected by changes in SOEs assets and liabilities and Crown Entity financial assets.	Average – the indicator is also affected by SOE and Crown Entity assets and liabilities.
International comparability	Average – net debt is widely used internationally, though definitions can differ.	Poor – we are not aware of any country that uses this indicator.	Average – net worth has a standard definition, but not many countries report on it.
Clear reaction function/policy (credibility)	Good – includes tax and spending. Changes in the indicator are largely considered when setting the fiscal strategy. Still faces cyclical/structural identification around taxes and spending.	Poor/uncertain – includes tax and spending. *Plus changes to SOEs and Crown Entity financial assets.* Changes in the indicator would not necessarily require an immediate response as the Government may want to look through short-term movements in asset values. Still faces cyclical/structural identification around taxes and spending.	Poor/uncertain – includes tax and spending. *Includes the rest of the balance she*et. Changes in the indicator would not necessarily require an immediate response as the Government may want to look through short-term movements in asset values. Still faces cyclical/structural identification around taxes and spending.
Uncertainty around projections	Good/average – implicit probability bands given cyclical/structural issues.	Average – wide probability bands and subject to year-on year-volatility.	Average – wide probability bands and subject to year-on-year volatility.

Effect of shocks and policy decisions

12. A key issue highlighted by the above table is that different anchors would potentially alter how the Government reacts to shocks or how the Government might treat some categories of spending. For example:

- If there was a sizeable impairment of the student loan portfolio in one year, a net debt anchor in isolation would suggest not to react, because student loan assets are not included in the indicator. A net worth anchor would inform the Government that net worth has decreased and therefore changes might need to be made to restore net worth. To make a decision, further information would be needed to understand the causes of the impairment and whether it was likely to be a permanent or temporary change.

- If the Government chose to invest in an SOE, net debt would increase. However the net worth anchors would show that the fiscal position is unchanged. In this situation, if net debt was the fiscal anchor the Government would be prompted to cut spending or raise revenue to keep net debt under control. If net worth was the anchor then no change to the fiscal strategy would be prompted.

13. It is important to note that despite having an anchor as the face of the fiscal strategy; it is not the only indicator that is taken into consideration. In previous years the rest of the balance sheet has been implicitly taken into consideration, and therefore we would not have advised making decisions based on only one set of information.

14. The table below considers a range of shocks across the three stock indicators.

Table 2: How different shocks and policy decisions would show up in the different indicators

	Arrows indicate the communication of a worsening or improving **fiscal position** given the choice of anchor:		
Fiscal Anchor	**Net Debt**	**Net Worth excluding Social Assets**	**Net Worth**
Higher unemployment spending	↓	↓	↓
Leaky school buildings resulting in a need to rebuild of hundreds of schools	–	–	↓
Government investment in housing	↓	↓	–
Positive revaluation of SOE assets	–	↑	↑
Big impairment of student loan portfolio	–	↓	↓
Negative shock to the NZS Fund value	↓(will cause a change to the contribution rate)	↓	↓
Reserve Bank sells foreign reserves	–	–	–
Government invests in the physical assets of KiwiRail	↓	↓	–
Government invests in SoEs	↓	–	–

15. Ultimately, the main role of a fiscal anchor is to communicate and quantify the Government's fiscal strategy. It also needs to play a key role in short-term fiscal management by providing a top-down anchor for fiscal policy. Finally, it should support broader economic objectives through providing information to households, firms, rating agencies and others about the Government's fiscal position/strength of the balance sheet and liquidity. No one measure can achieve all of these goals.

16. Given multiple roles for a fiscal anchor, trade-offs have to be made in choosing the best option. For example, **the best indicator of overall fiscal sustainability may not be the best indicator to guide decisions around short-term fiscal management**. The cost of this trade-off is reduced as a suite of fiscal indicators are produced and published (e.g. gross debt, net debt, net debt including NZS Fund assets, net worth), together with other information (e.g. estimates of the structural fiscal balance, medium and long-term fiscal projections).

Assessing the options

17. We do not recommend the status quo, as we recognise the need to tell a richer story around the fiscal strategy.

18. A second option is to retain net debt as the fiscal anchor, but enhance the section in the FSR on risk management and provide further balance sheet information. It would also state how this information has been used in setting the net debt objective. This option would include projections of net worth or net worth excluding social assets alongside the projections of the net debt anchor to aid decision making.

19. This option would be in line with using a suite of indicators and extra information to guide the fiscal strategy. It would be a way of uniting and formalising the work we have been doing in the risk management space, and providing a clear method of how it fits into the fiscal strategy.

20. A section in the FSR would outline the relevant information on risk, and wider balance sheet measures such as net worth excluding social assets and net worth, and explicitly state how this information has fed into the decision around the net debt objective. This may result in changes to the net debt objective from time to time. It would include net worth tracks and a discussion of any changes to the path of net worth and how the Government is responding to that. It is possible that if net worth shows signs of serious deterioration, building up net worth would become more of a focus in the fiscal strategy.

21. This option would retain the transparency and simplicity of the current system. It would also help to more explicitly bring the information on Crown risk into the fiscal strategy by aiding in the setting of the debt objective and helping to tell a richer story about the Government's finances.

22. There is a risk that by not changing the anchor to a net worth type anchor the extra information on Crown risk will be treated with less importance. We think that risk can be avoided once the focus in the FSR on the balance sheet becomes standard practice.

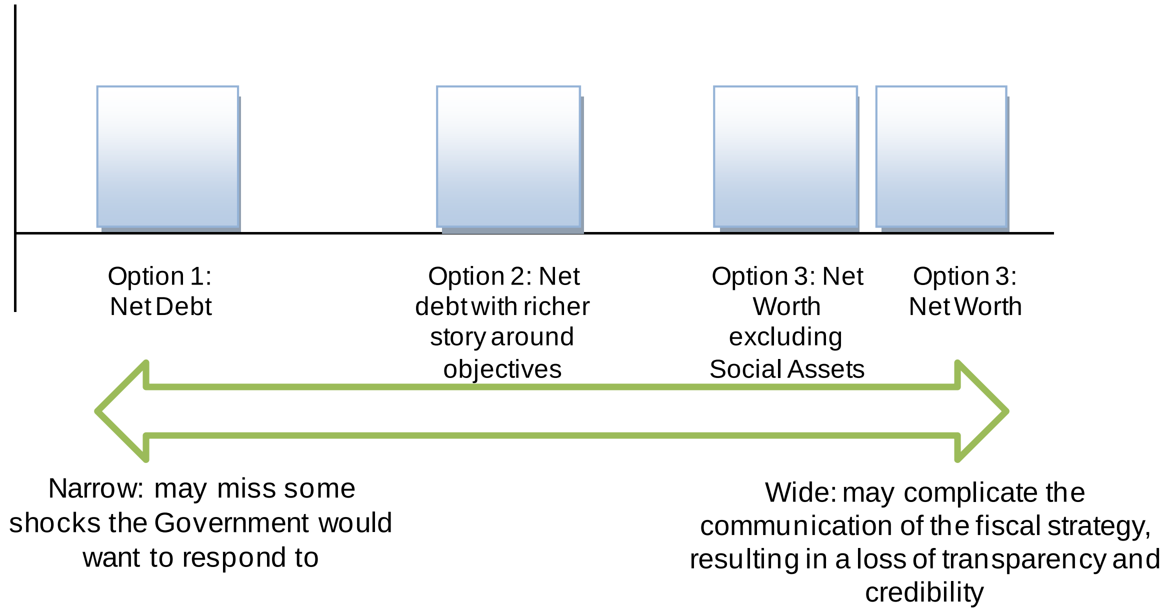
23. A third option involving a move to a net worth type anchor would be a move away from using fiscal anchors in the traditional sense. It would be wider than just a fiscal anchor, and would therefore serve more roles (e.g., an indication of the performance and composition of the whole balance sheet). Under this option, projections of net worth or net worth excluding social assets would be treated in the same respect as net debt is now. We are not in a position to rely upon probability projections around the central track of net worth for fiscal decision making due to modelling limitations (T2009/2710 refers). This will mean that while we could set a target for net worth based on a net debt track; the path of the projections, how they changed year-on-year and whether the Government change policy would be more important than the end result. It may be difficult to communicate this.

24. However, by changing the anchor the fiscal strategy would directly incorporate the extra information on Crown risk. This would mean the headline indicator of the fiscal strategy would be more comprehensive and therefore give a better indication of the Government's finances. Changes in asset values would be highlighted at each projection round and explicit decisions would need to be made about how to react to these. But, this could require a lot of explanation each projection round because the Government might be deviating away from their target but could choose not to react.

Recommendation

25. The overarching goal of the fiscal strategy is generally taken to be the long-term solvency of the Government. Swings in asset and liability values may burden future taxpayers and therefore need to be taken into account. Both options 2 and 3 would aide in communicating the Government's increased focus on the wider balance sheet and risk management in the fiscal strategy. While we do not recommend the status quo, at the other end of this spectrum, net worth as a fiscal anchor would create complications as outlined above. Figure 3 below illustrates this point.

Figure 3: Options under consideration for the fiscal anchor



26. On balance, Treasury recommends Option 2 (at least for FSR 2010), which will achieve the goal of an increased focus on the wider balance sheet and risk management in the fiscal strategy, without losing any potential credibility and transparency. This recognises the need for the fiscal anchor to play a key role in the budgetary process. This is also due to the modelling limitations of projecting net worth type indicators, and the difficulties in setting a target level. We see net debt as more of an intermediate anchor that would be set consistent with the overarching goal of the Government's long-term solvency. Therefore, we would be moving to an option that sits in the middle of the spectrum outlined directly above.

27. We recommend that a net worth excluding social assets indicator be produced alongside the net debt anchor in the FSR, but that no target level is identified.