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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

9 April 2013 MC-1-5-5

To: Mark Blackmore, Renee Philip, John Janssen, Simon McLoughlin

Cc: Peter Mawson, [7] [redacted] Kamlesh Patel

From: Matthew Bell

DETERMINING THE RESUMPTION OF CAPITAL CONTRIBUTIONS TO THE NEW ZEALAND SUPERANNUATION (NZS) FUND

Background

At Budget 2009 the National-led Government postponed capital contributions[1] to the New Zealand Superannuation (NZS) Fund. Since that time, at each Economic and Fiscal Update (EFU), in order to determine the fiscal year[2] in which contributions will resume, Treasury has followed the rationale outlined in the Budget 2009 Minister's Executive Summary, which is:
"...not to make the required contributions to the NZS Fund ***until the operating balance is sufficient in terms of cash flow to meet contributions and other capital spending****."*

This definition is a little ambiguous. Phrases like "operating balance is sufficient in terms of cash flow" and "other capital spending" could be interpreted in more than one way. Furthermore, as the resumption year for contributions has, to date, always fallen in the post-forecast projection period, it has fallen to the Treasury analysts responsible for maintaining and updating the fiscal projection Fiscal Strategy Model (FSM) to determine it at each EFU.

Hence the purpose of this note is **to clarify exactly how, at each EFU round, the fiscal year in which contributions to the Fund are projected to restart is calculated.**

Further sections will:

- provide more detail around the rationale used by the Treasury to determine when contributions to the NZS Fund resume, including an explanation of how each term in the Budget 2009 statement is interpreted;
- clarify that the fiscal year in which contributions are projected to resume is not fixed, explain the main factors that drive changes in this from EFU to EFU, and provide a history of projected resumption years since the original Budget 2009 calculation;
- illustrate, using the 2012 Half Year EFU projections, the sensitivity of the key fiscal indicator, core crown net debt to GDP, and also Fund contribution and asset projections, to scenarios of:
  - restarting one fiscal year either side of the calculated resumption year;
  - restarting only once net debt to GDP reaches the present administration's stated goal of returning net debt to GDP to 20%; and
  - not restarting inside the decade long post-forecast projection period.

This note has been written in response to a request from Cameron Burrows, a current Treasury secondee to the Minister of Finance's office, to better understand this process. It will be sent to him and kept in iManage as a resource for interested Treasury personnel.

[1] Henceforth just referred to in this note as contributions.

[2] A fiscal year in NZ is the year ended 30 June i.e. 1 July through to 30 June of the next calendar year

Current rationale of determining resumption of contributions to the Fund

As outlined in the opening *Background* section of this note, Treasury bases its calculation of when contributions to the Fund resume on the original wording in the Budget 2009 Minister's Executive Summary. That was:
"...not to make the required contributions to the NZS Fund ***until the operating balance is sufficient in terms of cash flow to meet contributions and other capital spending***."

Treasury has interpreted the terms in this phrase in the following ways:

Operating balance
Under the International Financial Reporting Standards (IFRS) used in the Crown accounts, the operating balance is calculated as Revenue (excluding gains) *less* Expenses (excluding losses) *plus* Valuation gains/(losses).
If the Valuation gains/(losses) are left off, the Operating Balance is described as the OBEGAL, or Operating Balance before gains/(losses).
As the description above specifically states *an operating balance sufficient in terms of cash flow* this has been taken, in terms of the Crown accounts measures, as **OBEGAL** rather than Operating Balance. This is because Valuation gains/(losses) are not cash measures.

The Treasury's fiscal projection model, the FSM, uses actual and forecast data from the Crown accounts as its base. As these are stated on an accrual basis, rather than in cash terms, the projections are accrual based. Normally the cash-accrual difference reflects a timing difference between recognising the activity which generated the revenue or expense (accrual measure) and the actual receipt or payment involved (cash measure). While an important difference in historical and even forecast data, the accrual-cash differences in the FSM's projections, which begin five years into the future, can assumed to be insignificant.

In the very first calculation of the resumption of contributions to the Fund, a Total Crown OBEGAL measure was applied. However, advice from Treasury's Fiscal Reporting team suggested that a core Crown OBEGAL measure would be more appropriate. It was pointed out that, for example, the Total Crown OBEGAL might be higher than the core Crown OBEGAL because of something like ACC levy revenue, and this was earmarked for the ACC rather than available to cover the contributions to the Fund. Consequently, a core Crown OBEGAL measure has been used at every subsequent EFU round since Budget 2009.

In summary, when determining the fiscal year in which contributions to the Fund resume in projections or in forecasts (although the latter is yet to occur since the contribution holiday began), the ***operating balance is sufficient in terms of cash flow*** is measured using **core Crown OBEGAL**.

Other capital spending
The phrase "*... and other capital spending*" is ambiguous. Capital covers more than physical assets. There are financial assets, cash holdings, inventory etc on the Crown balance sheet, as well as physical assets, and growth in all of these is not all due to valuation changes. Consequently it would be inappropriate, considering the reference to having sufficient cash flow, to measure *other capital spending* as the annual change in core Crown assets, or even in property, plant and equipment, as this would certainly not reflect a cash change.

However, there is a *Forecast for new capital spending* in the Crown accounts, often referred to as the Capital Allowance. Being a component of assets this is a stock measure, not a flow, meaning it is the annual increment to the Capital Allowance that represents an annual sum set aside for new capital spending. Furthermore, this Capital Allowance is purely a core Crown variable – it is not put aside to aid Crown Entities or SOEs to add to their capital.

In summary, the measure used as the representative of ***other capital spending***, when calculating the year of resumption for contributions to the Fund, is **the annual increment to the Capital Allowance**.

Capital contributions to the Fund

The capital contribution to the Fund in any year is another variable in the year of resumption calculation, as it is not a constant amount. It is derived from a relatively complex calculation which involves the previous year's Fund balance and projected nominal GDP and net (of tax) NZS expense tracks, going out at least 40 years. (For more detail see the modelling guide at the bottom of the NZS Fund Contribution Rate Model site on the Treasury website.)

For the purposes of this note it is sufficient to state that, for a given set of projected nominal GDP and net NZS expense tracks, the larger the Fund balance in the year before contributions restart, the smaller will be the contribution at resumption.

Consequently, there is a certain amount of trial and error in working out in which fiscal year contributions should resume. The process involves running the NZS Fund model for a potential year that might meet the criteria:

Core Crown OBEGAL – Fund capital contribution – Capital Allowance annual increment > 0

and then slotting in the resulting contribution calculated by the model to see if it satisfies this.

If not, the following year is trialled. The process usually only requires two consecutive years to be checked, as the OBEGAL is normally lifting quickly enough in this future period to ensure that if the criteria is narrowly missed in year *t*, it will be satisfied in year *t+1*. Also the nature of the contribution calculation ensures that it is constrained to generally be between 4% and 5% of nominal GDP, or roughly $2 billion to $2.5 billion during this decade.

The changing resumption date from Budget to Budget

The calculated resumption year for contributions to the Fund has varied at subsequent EFU rounds since first being calculated at Budget 2009. It has ranged between as late as 2020/21, in the original calculation, to as early as 2016/17 at Budget 2011. The latest official projection, for the 2012 Half Year EFU (HYEFU), had the resumption fiscal year at 2018/19.

While the size of the Fund contribution does depend on the year in which it is calculated, and the annual increment to the Capital Allowance also grows annually in projected years, neither of these generally determine the year in which contributions to the Fund resume. Rather it is the core Crown OBEGAL measure that usually determines the degree of shift, from EFU round to EFU round, in the calculated resumption year.

This is because the calculated Fund contribution and, to an even greater extent, the annual Capital Allowance increment have greater constraints on the degree to which they can alter from year to year than the core Crown OBEGAL has. As indicated in the last section, the annual contribution to the Fund normally falls between $2 billion and $2.5 billion. Annual growth in the Capital Allowance is restricted to amounts closer to $20 million.

Core Crown OBEGAL, which is influenced most by tax on the revenue side and Operating Allowance decisions on the expense side, can range from EFU to EFU by considerably more than half a billion. In regards to revenue, a better economic outlook generally translates to stronger tax forecasts, which can grow to quite large annual differences from the previous projection. On the expenditure side, a major reason for doing projections is to give the government of the day an indication of how their current policy settings stack up against their future fiscal goals. If things are not on track, reining back forecast spending via reducing Operating Allowances is a powerful tool for improving both OBEGAL and debt tracks.

As an example, at Budget 2009 the projected core Crown OBEGAL was –$3.3 billion in the fiscal year 2015/16. A year later, at Budget 2010, this had improved to –$0.4 billion, chiefly due to an improved economic outlook flowing through to more tax dollars forecast and projected. Move forward a further year to Budget 2011 and projected OBEGAL in this year was positive at $1.3 billion, with reduced spending plans being a major driver of the improvement. This represented an increase in projected core Crown OBEGAL in 2015/16 of over four and a half billion dollars across two Budget updates.

The table below illustrates the calculated fiscal year for resuming contributions to the Fund for every Budget EFU since Budget 2009, as well as the latest estimate for the 2012 HYEFU.

Budget EFU	**Fiscal year contributions resume**	**Core Crown OBEGAL ($m)**	**Capital Allowance annual increment ($m)**	**NZS Fund capital contribution ($m)**
Budget 2009	2020/21	2.639*	1,034	2,780
Budget 2010	2018/19	3.975**	993	3,013
Budget 2011	2016/17	3.719	828	2,671
Budget 2012	2017/18	4.148	821	2,528
HYEFU 2012	2018/19	2.822**	748	2,116

* Clearly $2,639 million does not even cover the calculated NZS Fund contribution for this year of $2,780 million, let alone that plus another $1,034 million of "other capital spending". However, as has been explained earlier, Total Crown OBEGAL was used in this initial calculation and it was projected to be $3,754 million in the Budget 2009 FSM. Even this is not quite enough but was deemed within acceptable error bounds and the net debt to GDP track was declining by this year.

** Core Crown OBEGAL did not cover the combined Capital Allowance annual increment and Fund contribution in these years. However, in both cases, the "under $50 million" deficit was considered within acceptable error bounds and net debt to GDP was declining by this year.

The sensitivity of core Crown net debt and NZS Fund variables to the resumption year

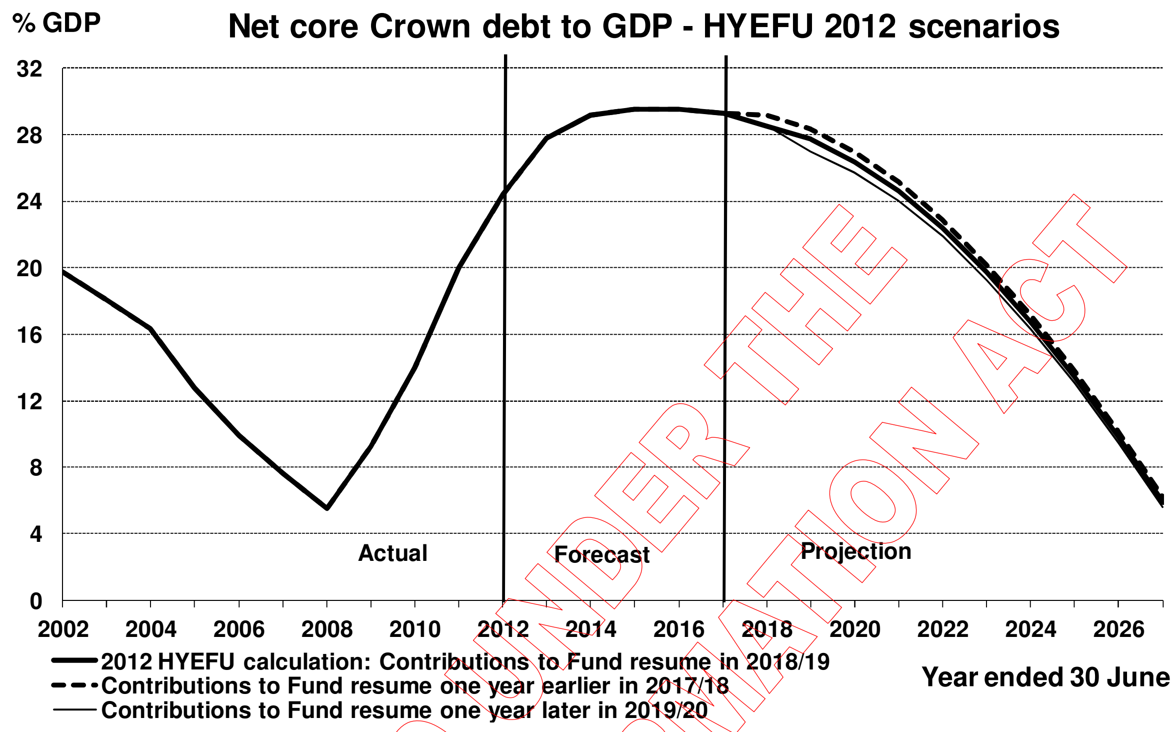
The following graphs use 2012 HYEFU forecasts and projections to illustrate three different scenarios involving the resumption year for contributions to the Fund, relative to the fiscal year that was calculated in the official projection (2018/19). The scenarios are:

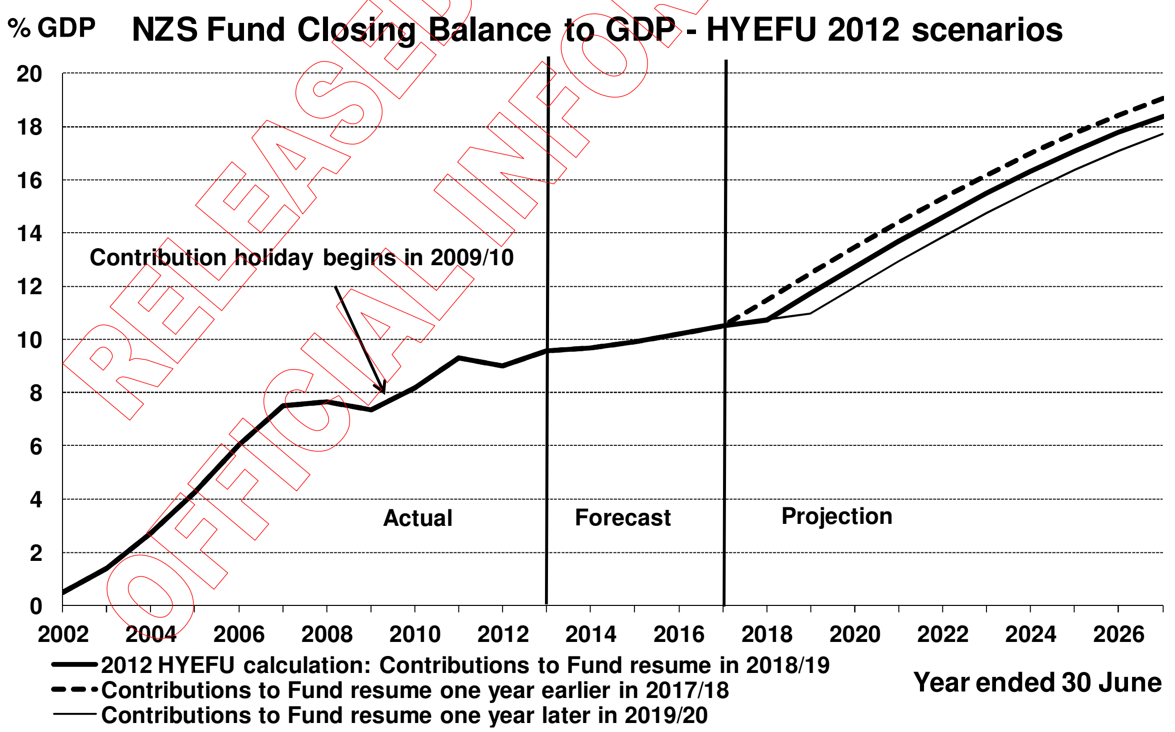
- restarting one fiscal year either side of 2018/19;
- restarting only once net debt to GDP reaches 20% of nominal GDP; and
- not restarting inside the decade long post-forecast projection period to 2026/27.

In all scenarios graphs are shown of both the impacts on core Crown net debt tracks, a key fiscal indicator in Crown documents, and on the size of Fund assets over time.

Core Crown OBEGAL is another key fiscal indicator but, as Fund contributions are capital rather than operating spending, the resumption year for contributions has little impact on OBEGAL tracks. There is some flow through via changed debt-financing costs, resulting from lower or higher debt stocks, but this is fairly small over this horizon.

Scenario One – Contributions resume a year either side of the calculated 2018/19





Scenarios Two & Three – Contributions resume once core Crown net debt reaches 20% of GDP & contributions do not resume at all inside the decade-long projection