The Treasury

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Dealing with Revenue Surprises

Date:	1 November 2013	Report No:	T2013/2568

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** to recommendations **Discuss** at next Fiscal Issues meeting	Tuesday 5th Nov 2013

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Joe Robins	Senior Analyst, Macroeconomic and Fiscal Policy	04 917 6024 (wk)	[3]	✓
Tim Ng	Director, Macroeconomic Policy and Fiscal Policy	04 917 6124 (wk)		

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

Return the signed report to Treasury.

Enclosure: No

Treasury Report: Dealing with Revenue Surprises

Executive Summary

Previous Treasury analysis of options for returning to cash surplus ahead of the forecast trajectory highlighted that positive revenue surprises might help in achieving this target. We committed to undertaking further work on rules for dealing with any revenue surprises in order to support fiscal management, and in light of indications of stronger growth in the near term than previously forecast.

The purpose of any rule or ex-ante commitment for dealing with revenue surprises is to avoid the potential for cyclical increases in revenue to be used to fund tax cuts or spending increases. This helps avoid the risk of running pro-cyclical fiscal policy, as positive revenue surprises typically occur during cyclical upturns. Previous work has found that while New Zealand is not unique in having experienced pro-cyclical fiscal policy in the run-up to the GFC, the adverse implications are likely to be greater, as we are a small open economy with a floating exchange rate and macroeconomic imbalances. Here we consider policy options that would help prevent pro-cyclicality over the current economic cycle.

Defining revenue surprises to be the change in forecast revenue is a simple approach consistent with the current fiscal strategy. We therefore use that definition in this report. However, there is a related issue of how cyclical fluctuations in revenue (even if revenue is correctly forecast) can be identified and handled from a stabilisation policy perspective. We will continue to work on this broader issue.

We identify three broad (not mutually exclusive) policy options for revenue surprises:

- pay down debt;
- commit surprises to one or more existing funds (or ‘jam jars’); and
- create a new form of fund or jam jar (e.g. a stabilisation fund) to commit surprises to.

Given current debt levels, in the short term there is scope to use any revenue surprises to reduce net debt, which would lead to the debt objective being achieved more quickly than was projected in Budget 2013. However, at some point this approach may be difficult to sustain if the political appetite for debt reduction begins to diminish. To manage future political pressures that may limit the attractiveness of further debt repayment, at some point we would recommend committing future revenue surprises to other funds on the balance sheet. How these pressures might play out depends on whether 20% is treated as a cap in future, or as an average around which debt could fluctuate.

In considering the commitment of positive surprises to existing funds there are several possible options, such as the Super Fund (NZSF), the National Disaster Fund (NDF), Government Superannuation Fund (GSF) or the ACC. Of these options, the first two have communications attractions in that either their funding has been explicitly ‘interrupted’ (NZSF), or they have recently been drawn down (NDF). To be consistent with your current policy, the NZSF would be an option once net debt has fallen to 20 per cent of GDP, whereas the NDF could be an earlier option. Of course, all of these funds have specific purposes for future disbursements. This means that any surprises would be effectively ‘locked away’ once committed to the funds.

A new fund would represent an alternative option where 'banked' surprises could be used subsequently and explicitly for macro-stabilisation purposes. The intention of such a 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 a range of options for such a fund, from a notional form managed by the DMO, to a stand-alone entity.

There are many design issues associated with the creation of such a fund, on which further work would be required. One key consideration is pros and cons of independent oversight arrangements for the fund. Such work could be pursued whilst following a commitment to options one or two above.

Recommended Action

We recommend that you:

a **agree** to commit to save positive revenue surprises and to state this commitment in the *Budget Policy Statement*

Agree/disagree
Minister of Finance

b **discuss** the extent and form of such a commitment, considering the options for paying down debt and contributions to existing funds, and

c **note** that we intend to conduct further analysis of options for the creation of a new 'stabilisation fund'.

Tim Ng
Director, Macroeconomic Policy

Hon Bill English
Minister of Finance

Purpose of Report

1. This report provides high level options for the use of stronger than anticipated revenues when these occur during cyclical upturns.

Reasons for Dealing with Revenue Surprises

2. The purpose of any rule or ex-ante commitment for dealing with revenue surprises is to avoid the potential for cyclical increases in revenue to be used to fund tax cuts or spending increases. This helps avoid the risk of running pro-cyclical fiscal policy, as positive revenue surprises typically occur during cyclical upturns. Avoiding spending revenue surprises also helps avoid the need to tighten policy when the cycle reverses.

3. Evidence suggests that the economic impact of pro-cyclical fiscal policies is different for small, open economies such as New Zealand, compared to economies operating under fixed exchange rates or with less exposure to international trade. The interest rate and exchange rate reactions to fiscal shocks tend to be much larger in open economies, indicating a greater sensitivity in the mix of macroeconomic conditions to fiscal shocks.

4. Given concerns about the over-valued exchange rate and external imbalances faced by New Zealand, pro-cyclical fiscal policy that causes interest rate increases is likely to be of greater importance here. The case for making fiscal policy more stabilising during upturns may therefore be stronger.

Defining Revenue Surprises

5. There are several ways to define revenue surprises, which will influence their size and timing. Annex 1 discusses some of the considerations in this process in more detail, but there are effectively two main types of surprise, both defined against forecast tax revenue:

   - ex-post deviations from forecast, which can be thought of as the revenue outturn figure, considered against the most recent forecast; and
   - changes in revenue forecast, which can be thought of as changes in predicted revenue in future years as measured against a specific vintage of forecast.

6. For the purposes of preventing pro-cyclicality it is the second definition that is most important and which we consider in this report. This approach means that revenue surprises are measured by changes in forecast relative to a ‘baseline’ forecast. Implicit in this approach is that operating allowances do not increase from the baseline forecast. To the extent that they do increase they will ‘eat up’ a portion of the revenue surprise. In reporting the scale of surprises it will therefore be necessary to identify the choice of baseline forecast, the size of the deviation in revenue from this baseline in the current forecast for future forecast years, and what this surprise is committed to.

7. Once revenue surprises have been identified the question turns to where they should be committed. With the aim of avoiding revenue surprises being channelled into additional spending or tax cuts (and thus promoting pro-cyclicality), there are three high-level options for 'banking' any additional revenue. These are:

   - pay down debt;
   - commit surprises to existing fund (or 'jam jar'); and
   - create a new form of fund or jam jar (e.g. a stabilisation fund) to commit surprises to.

8. These options are not mutually exclusive and surprises could be split between them. Indeed, it may be that only a portion of any surprise is committed to these options whilst a portion is still spent or used to fund tax cuts, although we view this as a second best option. In this case it would be desirable to design any tax reduction or spending increase to take into account the cyclical position of the economy and attempt to minimise the impact on aggregate demand.

9. **Paying down debt** can be achieved through either reducing gross debt or increasing holdings of financial assets, and thus accelerating progress towards the Government's debt target, as shown in Annex 1. This option would highlight the primacy of the government debt target in the fiscal strategy.

10. However, as progress towards the target is achieved there is likely to be more pressure to loosen the fiscal stance. Several years of revenue surprises and relatively quick convergence to the debt target would likely lead to demand for tax cuts, and after many years of tightly controlled budgets, there may be increasing pressure from government departments to increase spending. Political commitment to the debt target is likely to diminish, as a victim of its own success. This does not negate the justification for such a commitment, but it does possibly make alternative options for dealing with revenue surprises more appealing.[1]

11. Rather than investing in liquid assets held by the DMO to reduce debt there are a number of **existing funds** or asset portfolios ('jam jars') to which contributions could be made. The most obvious of these are the NZSF, the NDF/EQC, the ACC and GSF. From a balance-sheet management perspective there are advantages to prioritising the funding of liabilities for which the likelihood and size are known, which would suggest prioritising the GSF above NZSF and the ACC where size is uncertain and the NDF where size and occurrence are uncertain. However, the NZSF and the NDF would appear to have political economy benefits compared to the ACC and GSF through easier communication.

12. Contributions to the NZSF have been postponed until the 20 per cent debt target is achieved, meaning that it is being 'underfunded' relative to earlier contribution plans. If revenue surprises are committed to reducing debt more quickly, the debt objective may be achieved earlier which would bring forward the resumption of contributions to the NZSF. At this point, subsequent revenue surprises could be committed to making larger contributions to the NZSF to 'correct' some of this underfunding. As the net debt target is stipulated as not including the NZSF then surprises could thus be banked without further reducing (projected) measured net debt.[2]

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[1] It will be important to consider whether the debt level or OBEGAL is likely to be the biggest driver of political traction as certain items, such as the ACC levy, may affect these differently.

[2] There may still be some difficulties associated with this approach as net debt including the NZSF will clearly still be reported, and will be shown to fall proportionately with the increased contributions to the NZSF. Conversely it may be argued that this approach is not consistent with previous government policy putting net debt as the primary target. However, this is relatively easy to justify given progress towards the target would still be on the planned trajectory.

13. The NDF/EQC has similar political economy advantages of having been recently drawn down significantly, and therefore any commitment is likely to have broader public understanding. Current direction to the EQC is to invest in government stock. From a consolidated Total Crown perspective this is economically equivalent to paying down net debt, but as the EQC is a Crown Entity it is excluded from the core Crown target measure (as for the NZSF).

14. For these reasons it appears that the NZSF and NDF have notable political economy advantages largely stemming from public recognition and understanding that they may need 'topping up'. However, the recognition of these funds as enabling a specific disbursement purpose can also be a possible drawback in that they effectively 'lock away' revenue surprises, limiting the possibility of discretionary use (for example in a downturn).

15. If your main concern is preventing the possibility of current pro-cyclicality in the use of revenue surprises over the next few years (or avoiding pro-cyclicality in upturns rather than downturns more generally), then this commitment is less of an issue. However, if there is appetite for a wider promotion of symmetric stabilisation then this form of banking revenue surprises may be less well accepted.

16. The third option outlined above, **a new fund** or jam jar, can address this problem by being explicitly committed to macro-stabilisation purposes – a 'stabilisation fund' designed to be drawn against in cyclical downturns.

17. Such a fund could also improve the liquidity of the balance sheet. The locked-in nature of funds in existing jam jars means there is not much flexibility in the face of large downturns that require immediate action. The design of any stabilisation fund could allow holding of more liquid assets and freer disbursement criteria that would mean that the fund could be used as an initial 'stabilisation' tool against adverse economic shocks. The fund would not be intended to act as a defence against major events such as a financial crises or foot and mouth outbreak; it would lack the scale required, and in such emergency conditions access to other funds and debt is likely to be easier. However, the fund could still potentially offer a first and accessible source to tap.

18. The analysis, design and implementation of a stabilisation fund would take some time. There are always costs associated with creation of any new fund which would have to be considered. Other important considerations concern:

    - *the criteria for making draw downs*: in addition to considerations about the ease of access to funds for shocks like those outlined above, funds could potentially be committed for specific purposes, such as tax cuts, or for specific spending areas such as health or education (as in the Australian Future Fund);
    - *the criteria to be met before a withdrawal could be made*: this could be based on specific economic or fiscal triggers;
    - *the legal standing of such a fund*: whether it is notional run as 'tagged' items on the balance sheet or whether a more free-standing entity is created, and also whether this would be included in the target net debt measure;
    - *who would run the fund*: whether run by Government or an independent body or fiscal council which could administer the fund or judge the criteria on which it is accessed; and
    - *whether other types of revenue (i.e. in addition to revenue surprises) might also be directed to the fund*: for example, it has been suggested that the revenues from a capital gains tax – if one were to be introduced – could be directed into a stabilisation fund, to assist with managing capital gains tax revenue volatility.

19. Further advice on the different design options can be provided if you are interested in further considering the creation of such a fund. Even if such a fund is envisaged as being most useful at a further point in the future, the design of the fund could be developed whilst following plans for debt repayment or commitments to the NZSF or NDF in the near term. The choice of mix between them is likely to be largely influenced by timing considerations, which are addressed in the next section.

20. A related consideration for the choice of strategy here is a consideration of how the debt target should be specified post-2020. To date there has been no strategy statement as to whether the 20 per cent net debt target represents an intermediate step to a lower debt target, a desired cap on future debt, or an average around which cyclical variation can be managed.

21. If 20 per cent net debt is intended as a steady-state target, then alternative policy options for revenue surprises should be considered at the point at which political traction might be lost, as discussed above. If the target represents a future cap, then the best strategy would probably be to continue to pay down debt once the target is reached, with the trajectory dependent on what is considered the prudent final target level. There is a question as to whether (and to what extent) this would lower the net debt level at which traction might be lost.

Timing Considerations and Sequential Strategy

22. Timing considerations concern both when policy options are intended to be implemented, and when they are signalled. The *Budget Policy Statement* provides the next opportunity to indicate government priorities and any plans for revenue surprises. However, the detail of these plans is likely to be better suited to the *Fiscal Strategy Report*.

23. There appears to be a natural progression to the policy options that is in line with stated government strategy. Delaying contributions to the NZSF shows the primacy of the debt target, and consistent with that, we think that positive revenue surprises should be used initially to reduce net debt. Upon reaching the target the focus could then shift to the NZSF, or as discussed, the NDF.

24. However, as noted, it is likely that political traction for this course will diminish as the target is approached. The key question is at what proximity to the current debt target this might occur, and whether an alternative pro-cyclical policy path might then emerge. At this point the commitment to alternative jam jars may be favourable, dependent on the likelihood of these being viewed as a distinctly different approach than debt repayment.

25. However, there are risks in putting all future revenue surprises into funds which are locked away. For this reason we recommend giving serious considerations to some type of stabilisation fund that could be implemented once future debt levels are lower.

26. As noted, there are a range of options for this fund, including whether it is a stand-alone entity. Further design work would be needed before any decision could be made whether to proceed, but there is time before any decision would be needed. We intend to begin work looking at some of the design details.

27. There are several ways to define revenue surprises, which will influence their size and timing. Many countries that run stabilisation funds do so due to the volatility in revenue from natural resources. In these cases revenue surprises or commitments to such a fund may be defined as all revenue from these sources.

28. For the purposes of this report we have chosen to define a surprise as the **deviation from forecast** – i.e. the core Crown revenue forecast contained in the *Budget Economic and Fiscal Update* (BEFU) or *Half-Year Economic and Fiscal Update* (HYEFU). Conceptually this allows the surprise to be defined in relation to the current fiscal strategy and provides a simple and "objective" numerical figure. This simplicity allows greater focus on the potential use and impact of such unanticipated income, and reduces arguments about (for example) whether the extra income is cyclical or structural.

29. The identification of structural and cyclical components of revenue (and therefore also revenue shocks) is important in the prevention of pro-cyclical fiscal policy, which requires that cyclical revenue increases are not committed to additional spending or tax cuts. The identification of the output gap and structural changes in the economy means that such analysis is inherently uncertain, particularly in real time, as recent experience in re-assessing structural revenue in the wake of the GFC demonstrates. The definition of revenue surprise as used in this report does not depend on a structural/cyclical identification. Rather, the Treasury will continue to perform separate analysis to identify these components, and the results will continue to inform fiscal policy advice in future.

30. However, conceptually there is still the distinction between ex-post forecast errors and the change in the forecast. Ex-post errors come from outturns coming in higher than expected, and can be thought of as the difference between forecast and the monthly statements. This is largely committed to debt repayment as a matter of course due to the timing effects. The volatility of this outturn data also complicates its use.

31. The change in the revenue forecast represents the change in economic conditions and policy settings between forecasts.[3] The revenue surprise can be identified for any of the forecast years against a given baseline. This baseline also contains a default baseline operating allowances assumption. In subsequent forecasts, revenue surprises that are allocated towards increased spending will not alter the position of the surplus or the debt trajectory, whereas surpluses will appear larger if spending remains unchanged.[4] This also highlights that expense surprises are important and may offset any revenue surprise allocations or commitments, although we do not consider these in detail here.

32. Therefore if wishing to identify revenue surprises and outline a commitment to one or more options included in this report, it will be necessary to explicitly state the baseline, the size of the surprises in each year as measured against this baseline, and where (i.e. in what proportions) these have been allocated between different policy options. The identification of the baseline forecast may appear somewhat arbitrary, but is necessary for this approach. It may be desirable to update the baseline from time to time, such as following an election.

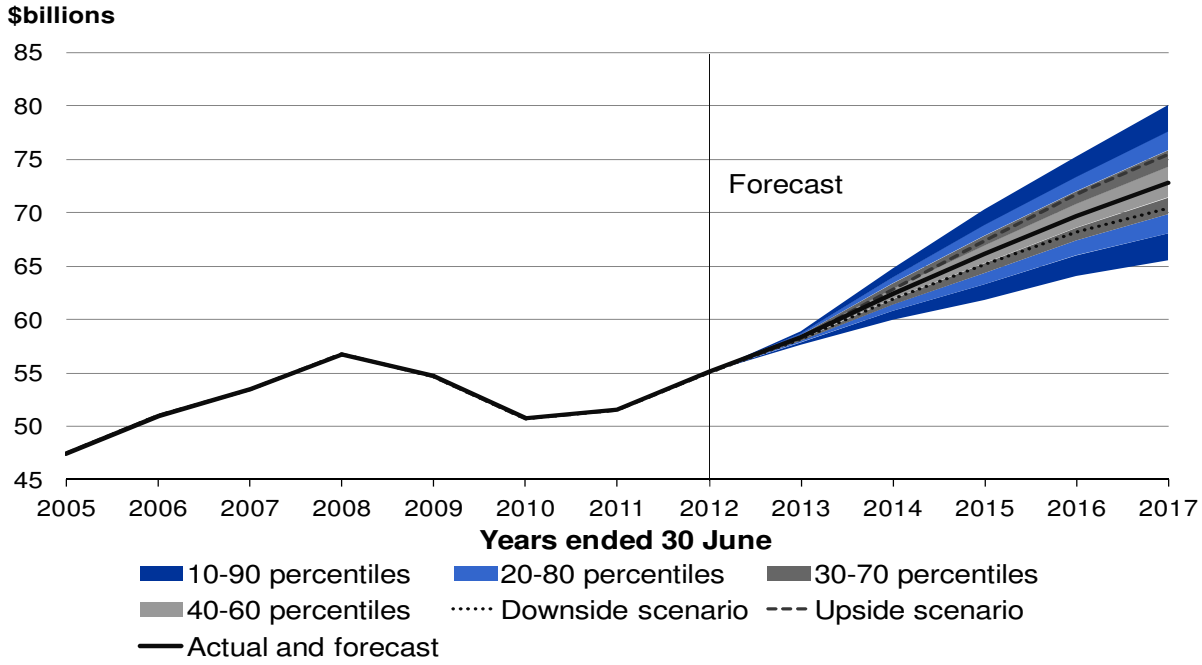
33. Charts 1 and 2 show an application of this approach to defining surprises. Chart 1 shows a fan chart of core Crown tax revenue published in BEFU 2013 in order to

[3] The policy change element represents a structural change, whilst the economic variables represent the cyclical elements that it is most important not be committed to spending, but these elements remain combined in this identification. It is this total change in forecast for which alternative policy options may be considered.

[4] This assumes that spending is committed to operating allowances; there are options for changing the distribution of cash flows, such as through capital expenditure.

highlight revenue uncertainty. The confidence intervals shown here are based on previous Treasury forecast errors, with additional economic scenarios also shown.[5] The confidence intervals diverge, meaning that the forecast errors tend to be bigger with more distant forecast horizons. This will tend to mean the identification of larger surprises the further we are from the baseline forecast.

Chart 1: Core Crown tax revenue uncertainty in BEFU 2013



34. Chart 2 (next page) shows the impact on the projected debt trajectory of two scenarios related to potential positive revenue surprises if these were committed to paying down debt; firstly, if forecast tax revenue were replaced with the 'upside scenario' revenue series from 2013/14 to 2016/17, holding economic performance constant; secondly, if both tax revenue and economic forecasts from the 'upside scenario' were used.[6]

35. If the forecast in all subsequent years were to be the same as the BEFU 2013 'upside scenario' forecast this would indicate revenue surprises (against the BEFU 2013 central forecast baseline) of $400 million in 2014, $1.3 billion in 2015, $2.1 billion in 2016 and $2.7 billion in 2017. Assuming unchanged expenditure forecasts this would lower debt by around $7 billion by 2017. In both scenarios there is an accelerated path to the 20 per cent net debt target, which is achieved a year earlier than currently forecast.[7]

[5] The chart illustrates that negative revenue shocks are also an important consideration, but for the analysis that follows we will confine discussion to higher-than-anticipated revenues.

[6] In both the scenarios shown above, the taxation-to-GDP ratio returns to the level of the central projection by 2019/20. This is because the 'upside scenario' is not meant to represent an ongoing, upward structural change in economic performance. As noted previously, this structural component is not material to the definition we are using.

[7] It should be noted that this is against the BEFU 2013 forecast; successive HYEFU and BEFU would update the baseline and show a faster trajectory towards the debt target also.

Chart 2: Net core Crown debt (excluding NZSF and advances)