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IN CONFIDENCE

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Chair
CABINET POLICY COMMITTEE

PRE-FUNDING NEW ZEALAND SUPERANNUATION:
BUDGET IMPLICATIONS

Executive Summary

1. This paper is one in a suite of papers on pre-funding New Zealand Superannuation (NZS). Decisions on the funding of NZS need to be made in the context of the Government's overall fiscal objectives and capital spending plans.

2. In the 2000 Budget Policy Statement and in more detail in the 2000 Fiscal Strategy Report, we set out the key elements of our overall fiscal policy. These included assumptions about the extra amounts that would be set aside for pre-funding New Zealand Superannuation, as well as provisions for future spending decisions and capital investment decisions. A balance was struck to ensure that net debt is brought to below 20% of GDP in the short-term while increasing operating and capital spending. This was illustrated in the 2000 Fiscal Strategy Report.

3. The analysis for the 2000 Budget was based on a "technical assumption" that the contributions retained in the Fund would be $600m, $1,200m and $1,800m in the first three years, giving a transition to the full rate of contribution by the 2004 Budget. These amounts will need to be reassessed during the forthcoming 2001 Budget decision-making process. However, I do not anticipate that the contributions in those years would be any less than these amounts because, at these levels, our debt objectives are still forecast to be met comfortably.

4. Future Budgets will also need to weigh our obligation to provide for future New Zealand Superannuation along with other priorities for current and capital

spending. Making these decisions in the lead up to the Budget Policy Statement will ensure that an ordered approach is taken to the relative fiscal priorities of debt repayment, spending and NZS funding objectives. This process will facilitate an on-going review of relative priorities that can be integrated into our longer-term goals for current and capital spending.

5. Any adjustments to policy should be made with reference to the long term fiscal objectives. In the exceptional event of a departure from the required level of contribution to pre-funding, the Government would be required to explain the reasons for the departure and its implications for future contribution levels.

Fiscal Policy Approach

6. Our policy programme will only be sustainable if it is grounded in sound fiscal policy. In the Budget Policy Statement and the Fiscal Strategy Report we set out the key elements of our fiscal policy approach. These elements include:

- As a general rule, keeping revenues and expenses in at least broad balance on average (excluding the allowance for pre-funding future NZS costs).

- Reducing gross Crown debt to below 30% of GDP and net Crown debt to below 20% of GDP – levels that are relatively low in historical and international terms.

- Keeping expenses at around current levels of about 35% of GDP.

7. Sound fiscal policy should also take a longer view and recognise the emergence of spending pressures before they impact. New Zealand's population is ageing. By setting aside some resources toward future retirement income costs now we will be able to smooth out the cost over time. One of the key objectives of pre-funding NZS is to ensure that future costs of NZS entitlements are linked to how they are to be financed. Governments need to be able to demonstrate how the NZS entitlements they support can be afforded in the context of overall fiscal objectives.

8. The Government's formal long-term fiscal objectives reflect our views about the appropriate size and role of government and about sound, forward-looking fiscal policy.

Balancing Pre-funding and Other Fiscal Objectives: In Principle

9. It is important that we have the opportunity to weigh the relative fiscal priorities from different areas of government activity and translate these into Budget decisions that reflect our overall priorities and are consistent with our long-term fiscal objectives. As a new fiscal objective, making contributions to pre-funding must be weighed against our existing fiscal objectives.

10. Contributions to pre-funding would be capital contributions and therefore would not directly impact on the operating balance, as they would not be current expenses. However, the contributions would affect the level of indebtedness in the rest of the Crown. Achievement of the debt objectives, as a share of GDP is the overarching fiscal constraint for assessing the Government's overall funding requirements because it ensures that both expense *and* capital investment requirements are taken into account.

11. The Government's debt objectives are defined as a percentage of GDP in order to retain relativity to the size of the economy and, hence, to the tax base. In any particular year, nominal debt may increase, yet the Government's percent of GDP debt objectives could still be met. The Government has set long-term objectives for gross and net debt at 30% and 20% of GDP respectively.

12. For example, all things being equal, any decision to increase the capital provisions would increase debt. The decision would therefore need to be considered in relation to the Crown's capacity to fund spending and NZS pre-funding objectives, while still being capable of meeting its debt objectives.

Balancing Pre-funding and Other Fiscal Objectives: in Practice

13. The interrelationships between the Government's fiscal objectives were considered in the 2000 Fiscal Strategy Report and Budget Economic and Fiscal Update (the 2000 Budget). The 2000 Budget adopted technical assumptions on transitional contributions to the Fund of $600 million in 2001/02, $1,200 million in 2002/03 and $1,800 million in 2003/04 before the full contribution rate is paid in 2004/05. These remain our working assumptions, however they will need to be reviewed carefully as part of the 2001 Budget process. I do not anticipate that the contributions in those years would be any less than these amounts because, at these levels, our debt objectives are still forecast to be met comfortably.

14. In the short term the Government has committed to a $5.9 billion fiscal provision, and is finalising its capital provision on the basis of expected capital project requirements. Over this period, I believe we have struck a balance that sees us making good progress on debt objectives, increasing capital and current spending and building up the contribution rate. The 2000 Fiscal Strategy Report and Budget Economic and Fiscal Update demonstrates that the pre-funding proposal is fiscally affordable while fully meeting all our other fiscal objectives (see technical annex) and taking into account the need to finalise the capital provision.

15. Furthermore, I am suggesting a process that both in the short term and medium term would allow us to check our progress towards all our fiscal objectives and, if necessary, make adjustments, including on changing the contribution rate in the short term. However, given our debt objectives are

forecast to be comfortably met, I believe it is unlikely we would need to adjust the transitional funding arrangements.

Budget Process and the Proposed Scheme

16. Decisions on the Government's overall budget strategy are usually made in October/November preceding the Budget, and these decisions form the basis of the Budget Policy Statement. It is at this point in the Budget cycle that we would make overall decisions about the relative fiscal priorities of debt repayment, current and capital spending and Fund objectives.

17. The budget strategy decision-making process starts with the preparation of revised macroeconomic and fiscal forecasts. These fiscal forecasts would incorporate some view on resources for the next Budget, and hence indicate the amount of flexibility the government has in considering its spending intentions.

18. Because budget strategy decisions are taken in the context of our long-term fiscal objectives, I would see us also making use of revised ten-year fiscal projections (Progress Outlooks). In this way we can monitor developments and make adjustments around a rolling ten-year fiscal horizon to ensure that our long-term fiscal objectives are met.

19. Adjustments to policy settings would be made if the longer-term fiscal projections suggested a sustained departure from our long-term fiscal objectives. Given expected revenues, we would effectively be trading off between spending levels, contributions to the Fund and debt repayment. It is at this stage of the process that we would review our general approach to the fiscal and capital allowances.

20. We would not, however, change policy settings or long-term fiscal objectives in response to a short-term fiscal shock. In that case we would generally maintain both projected spending levels and the existing contribution rate, and use debt repayment as a buffer. This approach provides some flexibility to adjust to changes in both the economic environment and to our priorities. At the same time it builds credibility in the pre-funding approach as decisions are made in the context of the Government's overall fiscal objectives and departures from the contribution rate would need to be explained.

Budget Documents

21. The Budget Policy Statement would specify the Government's long-term objectives for fiscal policy, including the desired contribution rate for pre-funding of New Zealand Superannuation. If there was to be any departure from the long-term contribution policy, this would be agreed as part of the budget strategy discussions, and the amount and reason behind any departure from the long-term policy would need to be explained.

22. The Budget Economic and Fiscal Update prepared by Treasury would be required to include a statement of the required level of contribution to the Fund. In the Budget, the amount to be provided to the Fund would be appropriated, as a capital contribution. Payments to the Fund would be disclosed in the Statement of Cashflows and a separate line included in the Statement of Financial Position (balance sheet) to indicate growth in Fund assets.

23. It is unlikely that the intended contribution rate would change between publication of the Budget Policy Statement and the Fiscal Strategy Report. In the case of an unexpected movement in the amount of the contribution, the Government would maintain its existing policy settings with regard to the rate, and compensate for the change in the forecast fiscal position by altering debt repayment.

24. Should the Government decide not to contribute at the "required" level reported in the Budget Economic and Fiscal Update, the Government would be required to include in the Fiscal Strategy Report an explanation for the departure, an assessment of its implications for future required contribution levels, and (if less than the required level) the action that the Government plans to take to return to the path of required rates of contribution expected for the future as a result of this departure. This process of specifying an objective, complying with it in the normal course of events, and disclosing and justifying departures is consistent with the approach taken to other fiscal objectives in the Fiscal Responsibility Act 1994.

Comment

25. The implications of pre-funding for legislation, the Treaty of Waitangi, the Human Rights Act and publicity are addressed in the associated Cabinet paper on funding arrangements, as is a statement of the consultation undertaken in developing this policy. A Regulatory Impact Statement is also attached to that paper.

Recommendations

I recommend that the Cabinet Policy Committee:

a **agree** that decisions on pre-funding be made in the context of the Government's broader fiscal objectives;

b **agree** that beyond the transitional funding period, the Government set its fiscal and capital objectives in light of the pre-funding contribution rate and debt objectives; and

c **agree** that the Government use the revised ten year fiscal projections to monitor developments and make adjustments around a rolling ten-year fiscal horizon to ensure long term fiscal objectives are being met.

Hon Dr Michael Cullen
Minister of Finance

TECHNICAL ANNEX: DEBT OBJECTIVES, FISCAL AND CAPITAL ALLOWANCES

The transition period

At the start of the transition period, net and gross debt-to-GDP are above the Government's long-term objectives and the operating position is in broad structural (cyclically-adjusted) balance. In order to meet the debt objectives and make contributions to the Fund, the Government needs to increase the level of the structural surplus. In order to make progress toward the fiscal objectives, the Government has set:

- A fiscal provision of $5.9 billion over 1999/2000 to 2002/03. The fiscal forecasts in the Budget Economic and Fiscal Update include a technical assumption for a provision of $800 million in 2003/04.

- Capital provisions (including student loans) of around $800 million each year from 2000/01 to 2002/03. This provision will be reviewed once the Government has considered its capital spending priorities in more detail, and the extent to which capital can be withdrawn from State-Owned Enterprises becomes clearer.

During the transition period the Government builds up the contributions to the Fund, with assumed contributions of $600 million in 2001/02, $1.2 billion in 2002/03, and $1.8 billion in 2003/04. Any increases in these capital contributions (all other things being equal) do not directly impact on the operating balance, though they impact on both Gross and Net debt.[1]

Beyond the transition period

The 10-year fiscal projections in the Fiscal Strategy Report illustrate how the fiscal constraints interact with the Fund beyond the transition period. (The projections assume that the rate of return on Fund assets is equivalent to the long-term Government stock rate).

Until 2003/04, the projections are the fiscal forecasts in the Budget Economic and Fiscal Update. They include the fiscal provision of $5.9 billion over 1999/2000 to 2002/03, a technical assumption of $800 million in 2003/04 and capital provisions (excluding student loans) of around $400 million each year from 2000/01 to 2002/03.

Beyond 2003/04, the projections include a "fiscal allowance" of $1.2 billion a year. The fiscal allowance indicates the fiscal flexibility that the Government

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[1] Government payments into the Fund to build up assets to meet future (rather than current) New Zealand Superannuation expenses are treated as capital contributions. *Capital contributions* do not impact on the operating balance, as they are not current *expenses*. Reporting an expense in the year that money is set aside, rather than the year in which the money is spent, would not provide a true measure of the Government's annual expenses.

has for expense and revenue initiatives, accelerating contributions to the Fund, and responding to developments in the economic and fiscal position that differ from the projections. The fiscal allowance would be reviewed as part of the budget strategy process, taking into account likely progress toward agreed long-term fiscal objectives (e.g., debt).

Beyond 2003/04 the projections include a capital allowance of $400 million per year to cover increased Government investment in departments (over and above depreciation funding for asset purchases), and State-Owned Enterprises and Crown Entities. It is assumed that the net surplus of State-Owned Enterprises and Crown Entities is reinvested back into the Crown's SOE/CE asset. This is assumed to average around $900 million over the projection period. As part of the annual budget strategy process, the capital allowance would be reviewed in the context of longer-term capital spending demands.

If the projections prove accurate, operating surpluses will build to just over 3.5% of GDP by 2009/10.

The table below summarises the key fiscal aggregates using Treasury's Long Term Fiscal Model on the basis of the assumptions used in the 2000 Fiscal Strategy Report (see pages 34- 36). These aggregates will change as the Model is updated for revisions to economic and demographic data, financial data, and other modelling assumptions.

Table- Key Fiscal Aggregates 1999/2000 to 2009/10 ($ billions and % of GDP)

	99/00	00/01	01/02	02/03	03/04	
Operating balance	0.763	1.012	2.091	2.733	3.222	
Closing Net Debt	21.819	22.282	21.796	21.265	20.963	
Gross Debt	36.337	36.092	35.561	35.442	35.558	
NZS fund			0.620	1.910	3.910	
GDP	105.411	110.897	116.492	121.624	126.959	
Net Debt	20.7%	20.1%	18.7%	17.5%	16.5%	
Gross Debt	34.5%	32.5%	30.5%	29.1%	28.0%	
	04/05	**05/06**	**06/07**	**07/08**	**08/09**	**09/10**
Operating balance	3.678	4.005	4.346	4.850	5.331	5.836
Closing Net Debt	20.940	20.817	20.646	20.340	19.860	19.196
Gross Debt	36.458	37.203	37.880	38.377	38.668	38.760
NZS fund	6.811	10.014	13.473	17.245	21.298	25.628
GDP	131.985	137.304	142.676	148.207	153.671	159.264
Net Debt	15.9%	15.2%	14.5%	13.7%	12.9%	12.1%
Gross Debt	27.6%	27.1%	26.5%	25.9%	25.2%	24.3%