BM-2-0-4-3

12 December 2002

Treasury Circular 2002/14

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## THE GOVERNMENT'S FISCAL MANAGEMENT APPROACH

The Government has recently agreed a new fiscal management approach to assist with internal fiscal management (CAB Min (02) 33/4 refers), which replaces the previous fiscal provisions ("counting") framework.

This circular outlines the background to the approach agreed by Cabinet, and replaces Treasury Circular 2000/2.

### Further guidance

Departments requiring further guidance or information on the new fiscal management approach should contact their Treasury Vote Manager for assistance.

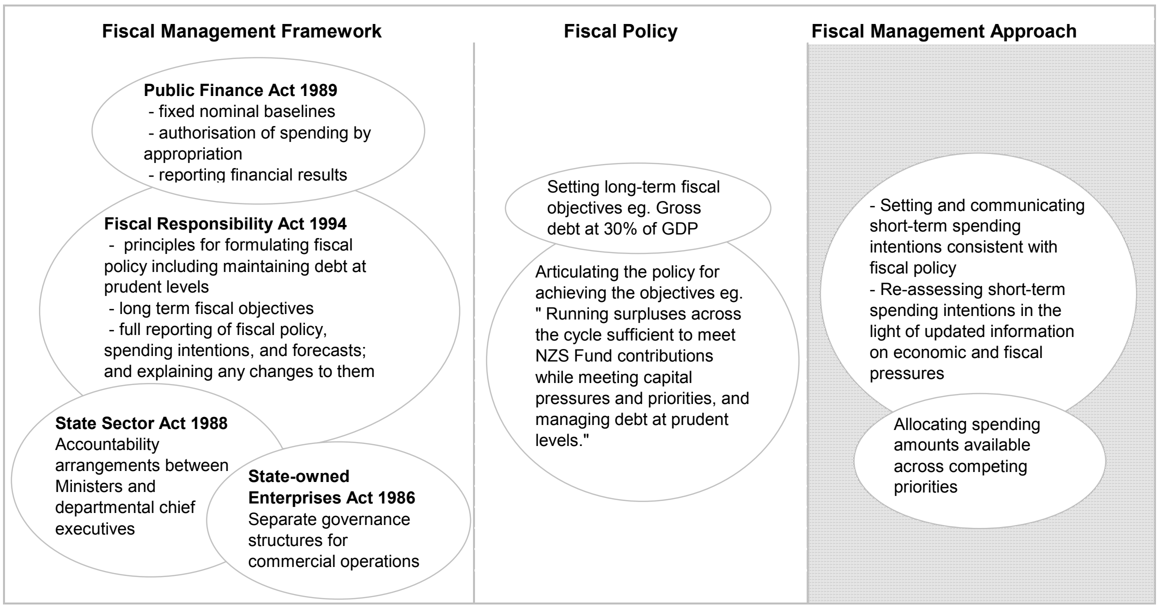
Kirsten Jensen
for Secretary to the Treasury

**EXECUTIVE SUMMARY**

1. The Public Finance Act 1989, and the Fiscal Responsibility Act 1994 set out New Zealand's fiscal framework. The framework, with its focus upon the longer term, and its requirements around transparent fiscal management, establish the context for developing overall fiscal policy and translating that into shorter term spending intentions.

2. This overall fiscal framework remains unchanged, the changes focus more upon the Government's fiscal management approach for setting, communicating and managing short-term spending intentions.

**Figure 1 -** New Zealand's fiscal management approach: the context
(shaded area indicates where the changes have been made)




3. The previous fiscal management approach relied upon the use of three year fixed nominal amounts ("fiscal provisions") for operating and capital spending intentions, which focussed upon spending items deemed "controllable".

4. As with any fiscal management approach, over time a number of issues arose with using a three year fixed nominal spending amount, from both an external communication perspective, and an internal budget management perspective. The two key issues being:

- Too much focus on the three year spending limit amount (which was a tool the Government used to achieve its fiscal objectives), which meant stakeholders sometimes lost sight of the Government's overall fiscal strategy and its progress towards its objectives.
- The "rules" around administering the provisions (deciding which items were "controllable" and which weren't) were becoming increasingly difficult to maintain.

5. An approach that manages more closely to the fiscal aggregates (i.e. the operating balance and debt) is seen as the best way of addressing the identified issues.

6. The main changes in the new fiscal management approach are:

- Spending intentions will focus upon what the operating balance and debt over a longer time frame (five and ten year horizons) could accommodate, while still achieving the Government's overall fiscal objectives.
- Spending intentions will be regularly re-assessed in light of changes in the Government's fiscal position.
- Spending intentions will still be incorporated into the Government's overall fiscal forecasts, and these amounts will still form the basis of a fiscal constraint for developing budget packages. However, these intentions will not be translated into a fixed three-year spending amount.
- The spending intentions will be more encompassing than the previous "provisions" approach. All impacts upon the operating balance and debt will affect either the available operating or capital spending amounts - with the exception of a few pre-specified items.

7. These changes to the fiscal management approach do not represent a change in overall fiscal policy. In particular the existing policy of not adjusting spending intentions in response to economic cyclical variations is a central theme in the approach.[1] Annex 1 compares the previous fiscal provisions with the fiscal management approach.

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1 Changes in the economic and fiscal outlook reflect a mix of cyclical and longer lasting (structural) factors. Keeping spending and tax plans unchanged during upswings and downswings allows for the operation of automatic fiscal stabilisers.

## HOW THE NEW FISCAL MANAGEMENT APPROACH OPERATES

### Setting spending intentions for the parliamentary term and beyond

*Overall fiscal objectives and policy settings provide the context*

8. At the start of the parliamentary term the Government settles upon its overall fiscal policy approach and long-term fiscal objectives. Articulating how the Government will achieve its fiscal objectives (and remain consistent with fiscal policy) will involve considering medium term forecasts for the operating balance and debt consistent with these ends. This will provide the context for establishing short term spending intentions.

*Communication on spending intentions will reflect the focus upon overall fiscal tracks, and ongoing process of reassessment*

9. Similar to the previous fiscal management approach, spending intention amounts will be entered into the Government's forecast financial statements. However these amounts will not be translated into a fixed three year dollar amount for the purposes of signalling spending intentions. Instead, the focus will be upon the operating balance and debt over the forecast (five year) and longer term period.

10. Spending intentions will have a different "certainty" status depending on the time period referred to. The further ahead in time the intentions are, the less certain they are, as there are greater uncertainties around the various factors influencing the fiscal position.

11. For example, the spending intention for the next Budget will be very certain and unlikely to change, while the spending intention for the Budget in three years time will have a greater level of uncertainty, and a greater likelihood of changing.

*Fiscal policy remains the same*

12. Expressing spending intentions in this way does not represent a change in fiscal policy. Rather, the aim is to communicate spending intentions as part of the overall fiscal policy picture, and to reflect the need for regular re-assessment.

*Fiscal Responsibility Act principles of accountability and transparency maintained*

13. Clear definition of spending intentions at the outset provides a transparent base for explaining and assessing forecasts of progress towards long term fiscal objectives, and any variations from the original track (be it due to volatilities or changes in spending intentions).

## Deciding the strategy for annual budgets

*Budget strategy process will involve re-assessing spending intentions*

14. The annual budget strategy will assess spending intentions in light of progress of the fiscal aggregates against the Government's objectives. This regular (re-)assessment reinforces the link between the annual budget process, and the Government's fiscal strategy. It will take a medium term focus, and consider factors such as:

- the current macro-economic outlook, including the estimated impact of cyclical factors
- New Zealand Superannuation Fund pre-funding requirements
- operating and capital spending proposals, and the relative priorities between operating and capital spending proposals
- progress of the operating balance and debt towards objectives for the five-year forecast period and the 10 year outlook period.

15. This information will inform budget strategy decisions about the overall spending intentions for the upcoming budget and the high level trade-offs (operating versus capital investments).

*Bias to no change will be maintained*

16. As part of these regular re-assessments, the Government's spending intentions may be fine-tuned for various factors (eg. relative priorities between capital and operating considerations). However, the need to achieve the operating balance and debt levels over the medium term will constrain the potential for significant changes in the Government's spending intentions.

17. Changes in the economic and fiscal outlook reflect a mix of cyclical and longer lasting factors. Keeping spending and tax plans unchanged during upswings and downswings allows for the operation of automatic fiscal stabilisers. In practice it is difficult to distinguish between cyclical movements and a change in the medium term economic outlook. The re-assessments will need to allow for this uncertainty, by adopting a cautious approach of not changing spending intentions unless there is strong evidence that any change in the fiscal position (in either direction) is structural rather than cyclical. In this sense, the current fiscal policy of a bias to no change will be maintained.

## Agreeing annual budget packages

18. The nominal dollar amounts entered into the Government's overall fiscal forecasts will form the new spending amount for capital and operating for the purposes of facilitating internal trade-offs during the Budget process - similar to the fiscal provisions.

19. As noted earlier, the old fiscal provisions were focussed only upon "controllable" items, and had a complex (and sometimes controversial) set of rules to determine which items "counted" against them. Separate recommendations had to be made in Cabinet papers in order to indicate to ministers the "counting" impact of initiatives. One criticism made of the old approach was a perception that "if it doesn't count its free."

20. The new approach adopts a simpler and more encompassing spending amount: **all** issues that impact upon the Government's operating balance and gross debt position also impact upon either the available operating or capital spending amounts. The concept of "count/does not count" is therefore eliminated from all decisions presented to Ministers.

21. The new approach introduces a qualitative assessment at the end of the Budget. This will allow more of an opportunity to consider the aggregate of all decisions (or potential decisions) with the latest available information on the Government's fiscal position.

22. How these concepts are built into the fiscal management approach is outlined in more detail below. Annex 2 sets out technical issues and examples.

*Some pre-specified volatilities "looked through"*

23. Under the proposed approach, everything that impacts against the fiscal aggregates now matters in a budget management sense. However, some pre-specified items (major volatilities expected to largely net out over the forecast period) arising during the Budget process that are expected to be largely "looked through" – meaning that spending intentions are not automatically adjusted to take account of these factors; instead they are left until an overall assessment at the end of the process.

**Table 1** – Managing the forecast new operating spending amount

| *Impacts directly*<br><br>*Items that impact directly on the forecast new operating spending amount throughout the budget process (and during the year, ie. regular updates to Ministers will take account of these items)* | *High level assessment*<br><br>*Pre-specified items that may be taken into account in the qualitative assessments (but generally will not impact on the forecast new operating spending amount)* |
|---|---|
| • Policy decisions, including those over State owned enterprises/ Crown Entities (SOE/CEs)<br>• Operating balance and debt impacts of the baseline updates.<br>• Demographic changes (normally picked up in a baseline update)<br>• Changes in forecasts, except those listed in the right hand column under "high level assessment"<br>• Non-controllable (eg. legal claims)<br>• Any other impact on the operating balance and debt not in the high-level assessment | • Tax re-forecasts<br>• Changes in net finance costs (interest costs on debt and interest income on marketable securities and deposits (MSDs))<br>• Benefit re-forecasting changes (including indexation changes)<br>• Re-forecasts of SOE/CE retained surpluses<br>• Revaluations of assets and liabilities (excluding provisions). This includes gains/ losses on MSDs<br>• Gains/ losses on sale of assets |

**Table 2** – Managing the forecast new capital spending amount

| *Consider items directly*<br><br>*Items that impact directly on the forecast new capital spending amount throughout the budget process (and during the year, ie. regular updates to Ministers would take account of these items)* | *High level assessment*<br><br>*Pre-specified items that may be taken into account in the qualitative assessments (but generally will not impact on the forecast new capital spending amount)* |
|---|---|
| • All non-depreciation funded capital decisions<br>• Equity injections into SOEs and CEs, and other capital purchases made by SOE/CEs resulting from a policy decision (eg changes in housing stocks)<br>• Movements in advances, including Student loan receipts, payments and movements<br>• Any other impact on debt not in the high-level assessment | • All debt impacts driven by the operating balance (already picked up by the operating framework – includes revaluations)<br>• Shifts in MSDs and shareholdings associated with Reserve Bank activities (neutral from a total Crown debt perspective)<br>• Changes in super pre-funding rates (volatile)<br>• Changes in SOE/CE dividend flows (volatile)<br>• Autonomous self financed SOE/CE capital decisions (only impact on total debt, not core Crown gross debt)<br>• International capital subscriptions (significant and unpredictable)<br>• Refinancing of existing Crown entity debt (neutral from a total Crown debt perspective) |

24. As noted earlier, items impacting directly (see list above) upon the new spending amount cover everything that goes to Ministers on a regular basis. Financial recommendations in Cabinet papers will show the operating and debt impacts of any proposed decision (rather than the counting implications). A revised circular on financial recommendations will be issued in January 2003.

*Final assessment just a "road-check"*

25. At the assessment phase towards the end of the Budget process the Minister of Finance will also take account of the pre-specified volatilities that were "looked through" during the Budget process.

26. The underlying rationale here is to "quarantine" the few major items in the forecasts that tend to fluctuate significantly, but are expected to largely net out over-time. Some of the fluctuations also involve an automatic fiscal stabiliser component eg. unemployment spending. Therefore changes in these items should not automatically affect the new spending amount available for the budget.

27. As part of the assessment, the Minister of Finance will make a decision around whether to continue to "look through" these items, or whether to adjust the new spending amount to accommodate them.

28. Bilateral agreements with Ministers during the Budget process will need to be qualified to reflect the potential for the new spending amount to change in this final assessment. However, it is important to note that this qualitative assessment stage at the end of the Budget process is expected to be a "road-check" only with a bias towards not changing the spending intentions.

## Annex 1: Fiscal Provisions and Fiscal Management Approach: a Comparison

| | **Fiscal provisions** | **Fiscal management approach** |
|---|---|---|
| *When is the Government's fiscal policy, including long-term fiscal objectives, set?* | At the start of each parliamentary term. | No change. |
| *What factors are taken into account when setting short-term spending intentions?* | • The current macro economic outlook, including the estimated impact of cyclical factors.<br>• NZS Fund pre-funding requirements.<br>• Bottom-up pressures on operating and capital baselines.<br>• Relative priorities between operating and capital considerations.<br>• Progress of the operating and debt tracks towards objectives for the forecast period.<br>• Progress of the operating and debt tracks towards objectives for the 10-year progress outlook tracks. | No change. |
| *How often are short term spending intentions set?* | Once at the start of each parliamentary term. However, in practice they were changed from time to time on the basis of bottom-up spending pressures, or reflecting a significant economic shock. | Formal re-assessments at the start of each annual Budget process around September, with a "road-check" against the latest fiscal information before each Budget is finalised.<br>Greater use of top-down information than previously. |
| *Is an operating and capital spending amount entered into the forecasts?* | Yes, provision focused only upon "controllable spending" (i.e. discretionary initiatives and cost pressures). | Yes, the forecast new operating spending amounts encompass all impacts on the operating balance with the exception of a few pre-specified volatile items. The forecast new capital spending amount focuses on other core Crown gross debt impacts. |
| *How are spending intentions expressed?* | Spending intentions were communicated via a fixed three-year aggregate fiscal provision in nominal dollars.<br>Provision focuses only upon "controllable spending" (ie discretionary initiatives and cost pressures). | Spending intentions are communicated via a desired operating balance and debt track consistent with overall fiscal policy. While the nominal amount will be communicated, the focus on this will be lower than with the fiscal provisions.<br>Spending intentions will:<br>• cover a wider range of impacts than previously<br>• be subject to re-assessment<br>• have a different status depending upon the time period referred to – the closer the time horizon, the firmer the intentions. |
| *Is there an "amount" for new spending for internal budget management?* | Yes, on the basis of provision in forecasts. | Yes, on the basis of the amount in forecasts. However:<br>• the amount must manage more impacts.<br>• budget processes will more explicitly accommodate the potential for changes to the size of the amount at the end of the Budget process (for example, final numbers are not agreed in bilaterals). |

## Annex 2: Technical issues and examples

### *GST on appropriations*

29. Although GST on appropriations does not affect on the operating balance, impacts on the spending intentions will be measured on a GST-inclusive basis (where GST is applicable). This is so that impacts on the spending intentions match with appropriation changes, and also to retain continuity with the old "counting" framework.

### *Capital charge*

30. Capital charge is fiscally neutral (it is an internal charge and therefore has no effect on the operating balance). Therefore changes in capital charge do not impact on the spending intentions.

### *Returns on capital investments*

31. Any financial returns on capital will now be treated as a saving against the forecast new operating spending amounts. This is a change to the previous approach.

32. When a capital spending amount is settled upon, the associated finance costs are factored into the government's fiscal forecasts, assuming a zero financial return on any capital spending (in line with the majority of capital spending proposals considered by the Government, which are for social investments such as schools and hospitals, rather than investments which generate a return).

33. This means that any capital investment which does have a financial return will increase the operating balance - and therefore should impact on the Government's operating spending intentions.

34. One risk with taking into account returns on capital is that it may be difficult to estimate them, particularly returns of a "second round" nature. For example increased taxes from higher economic activity associated with building a new power station. As with any initiative, these "second round" returns will not be taken into account unless they are tangible enough to impact upon the Government's fiscal forecasts and can be reliably estimated.

### *Process for seeking changes to baselines*

35. A wider range of items will now impact against spending intentions, including items that are progressed through the baseline update process, and where departments "automatically" receive changes in baseline funding (for example demographic adjustments).

36. The process for seeking changes to baselines is unaffected by the new fiscal management framework. Cabinet Office Circular CO(02)17 sets out which changes can be approved by joint Ministers or through the baseline update process, and which changes require Cabinet approval.

37. There is a question around whether individual votes should get to keep any positive gains from these changes, or be required to fund the impact of any negative changes (eg demographic pressures).

38. In general, departments will not be able to keep savings from "automatic" changes to baselines; on the other hand they will not be penalised for "automatic" increases in funding. While these changes will impact the government's spending intentions, the Minister of Finance will manage the aggregate impact of these changes across the whole of Government.

39. However, similar to the provisions framework, the option is still available for individual votes to apply for savings from wider impacts they are able to generate. In addition, the Minister of Finance also has an option to specifically ask for increased costs to be managed from within the vote.

***Funding allocations in the Budget process***

40. During the Budget process allocations of new funding are sometimes agreed for sectors. Previously, these allocations managed only "controllable" items (i.e. items that impacted on the fiscal provisions).

41. Under the new fiscal management approach if a funding allocation is provided, then the allocation is expected to manage all items that impact on the Government's spending intentions (i.e. all items in the first column of the tables above), not just "controllable" items.

42. So for example an allocation would be expected to manage any funding changes as a result of demographic adjustments, or any changes progressed through baseline updates. This means that a funding allocation could (for example) keep any savings from a demographically driven reduction in a baseline, but would also need to meet any costs from a demographically-driven baseline increase.

43. In some cases, the impact of these "non-controllable" funding changes may be very significant (either positive or negative) and would have a major impact on the funding allocation. In this case, the Minister responsible for the allocation and the Minister of Finance would need to discuss how to handle the change (e.g. the Minister of Finance may agree to increase the allocation to help offset any increased costs, or may reduce the allocation to "claim back" some or all of any savings).

**Some examples**

44. The table below provides examples of items and their potential treatment under the old "fiscal provisions" approach compared to the new fiscal management approach.

| *Item* | *Old system (impact on fiscal provisions?)* | *New system (impact on spending intentions?)* |
|---|---|---|
| Legal aid given extra funding due to "demand driven" factors. | No impact | Impact |
| Early childhood education given extra funding due to "demand driven" factors. | No impact | Impact |
| Maori reserve land leases – compensation | No impact (concluded an existing liability) | Impact |
| Government loses court case and has to pay compensation | No impact (not a Government decision) | Impact |
| Hospital deficits increase from $100m to $200m | No impact (until financed by government) | May impact as part of the qualitative re-assessment (financing impacts) |
| Student loan debt provisioning changes | No impact | Impact |
| Police fines are forecast to increase due to higher road traffic | No impact | Impact |
| MAF fines policy introduced at an expected gain of $10 million (and counted) subsequently turns out to be an $20 million gain | No impact | Impact |
| Demographic increase to Health or Education baselines | No impact | Impact |
| Benefit payments in Vote Social Development are reforecast | No impact | No impact |
| Tax/benefit amnesty | Unclear? | Impact, to the extent it can be costed |
| Tax base maintenance | No impact | Impact, to the extent it changes the fiscal forecasts |
| SOE or CE borrows from private sector to finance investment project | No impact | No impact (doesn't affect core Crown debt) |
| Government decides to join a new international organisation | Impact | Impact |
| Fiscally neutral adjustment to baselines | No impact | No impact (no change to operating balance) |
| Expense or capital transfer | No impact | No impact (no change to operating balance over time) |
| Turning an annual appropriation into a multi-year appropriation (eg $100m annual appropriation turned into $400m MYA over 4 years) | No impact | No impact (no change to operating balance over time) |

| *Item* | *Old system (impact on fiscal provisions?)* | *New system (impact on spending intentions?)* |
|---|---|---|
| A surplus/deficit in a memorandum account | No impact | No impact (no change to operating balance over time) |
| A capital contribution to a memorandum account, in excess of previous surpluses in the account | Impact (on capital) | No impact, on the assumption that the capital contribution will be repaid through a capital withdrawal from future surpluses |