THE TREASURY
Kaitohutohu Kaupapa Rawa

An Overview of New Zealand's Fiscal Framework

Oscar Parkyn
New Zealand Treasury

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Disclaimer

- Views should be attributed to the author and not the New Zealand Government or New Zealand Treasury.

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- Purpose:
  - Discuss New Zealand’s experience with its fiscal framework.

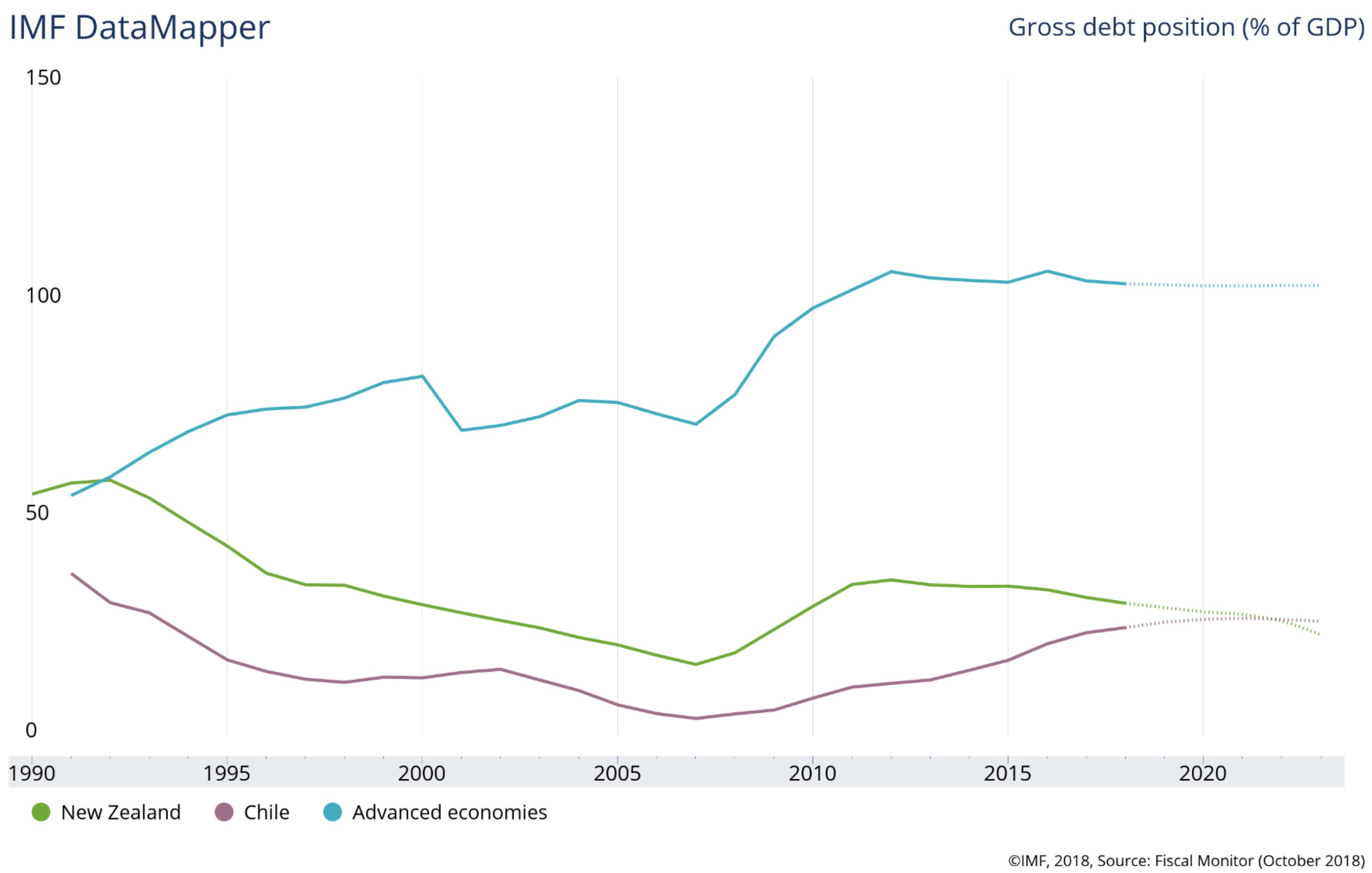
- Outline:
  - New Zealand economy and public finances
  - New Zealand’s fiscal framework
  - New Zealand’s experience with a debt objective
  - Designing a debt objective
  - Specific challenges as a commodity exporter
  - Conclusion

New Zealand economy and public finances

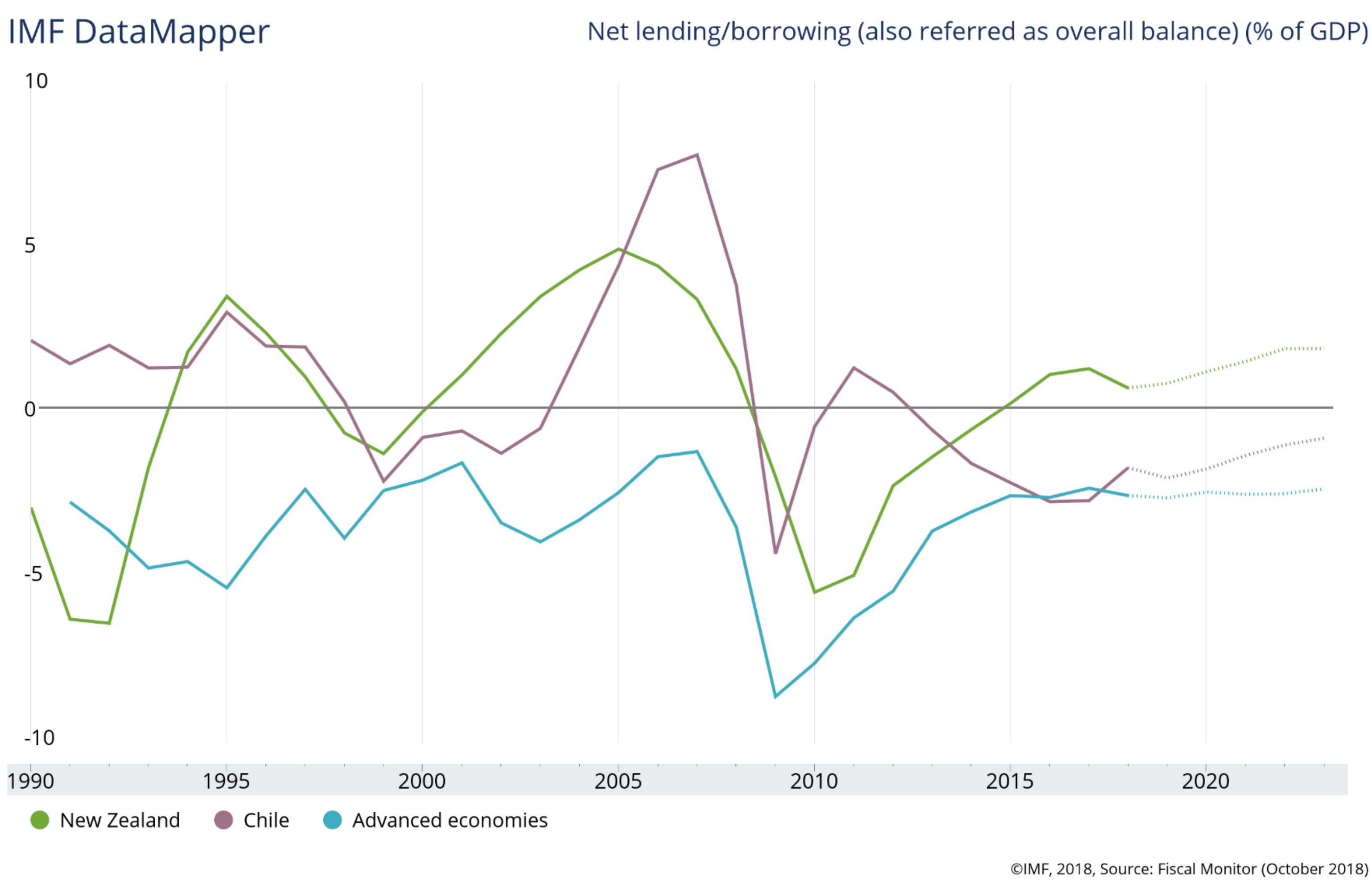
New Zealand economy

- Small, open economy (2017 GDP of $200 billion USD)
- Exports (30% of GDP) include agricultural commodities
- Inflation targeting monetary policy with independent central bank (since 1989)
- Free floating exchange rate (since 1985)

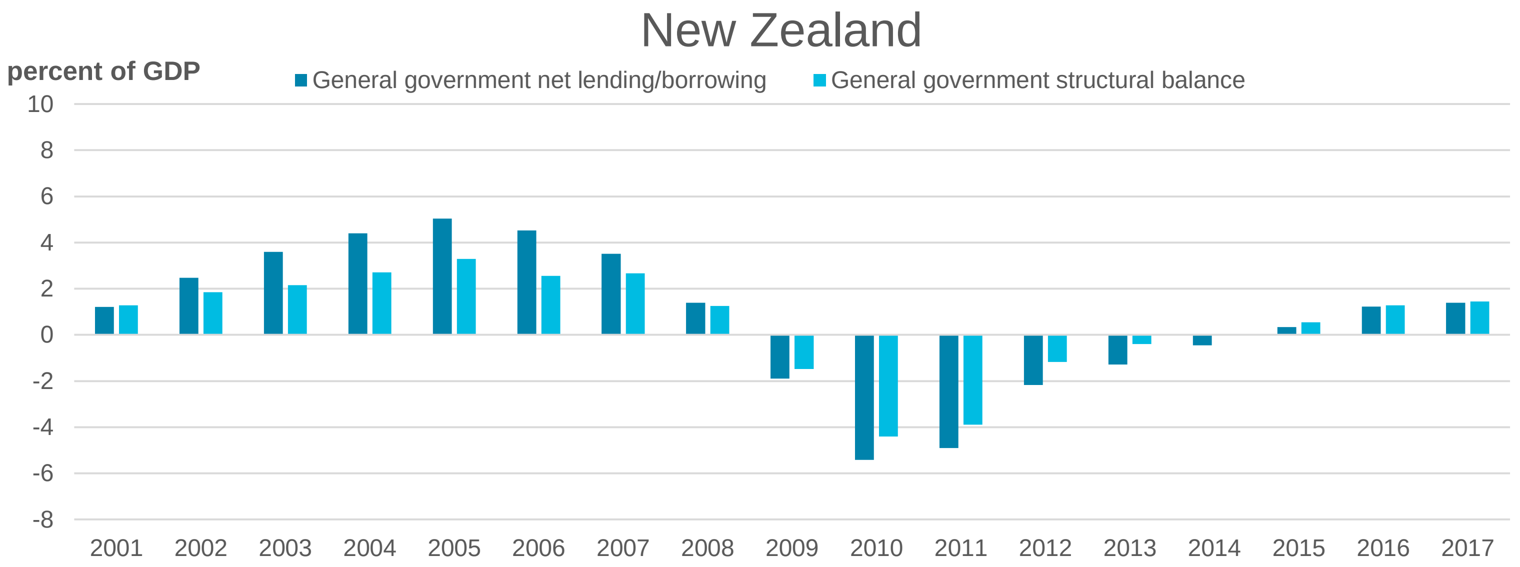
Government debt

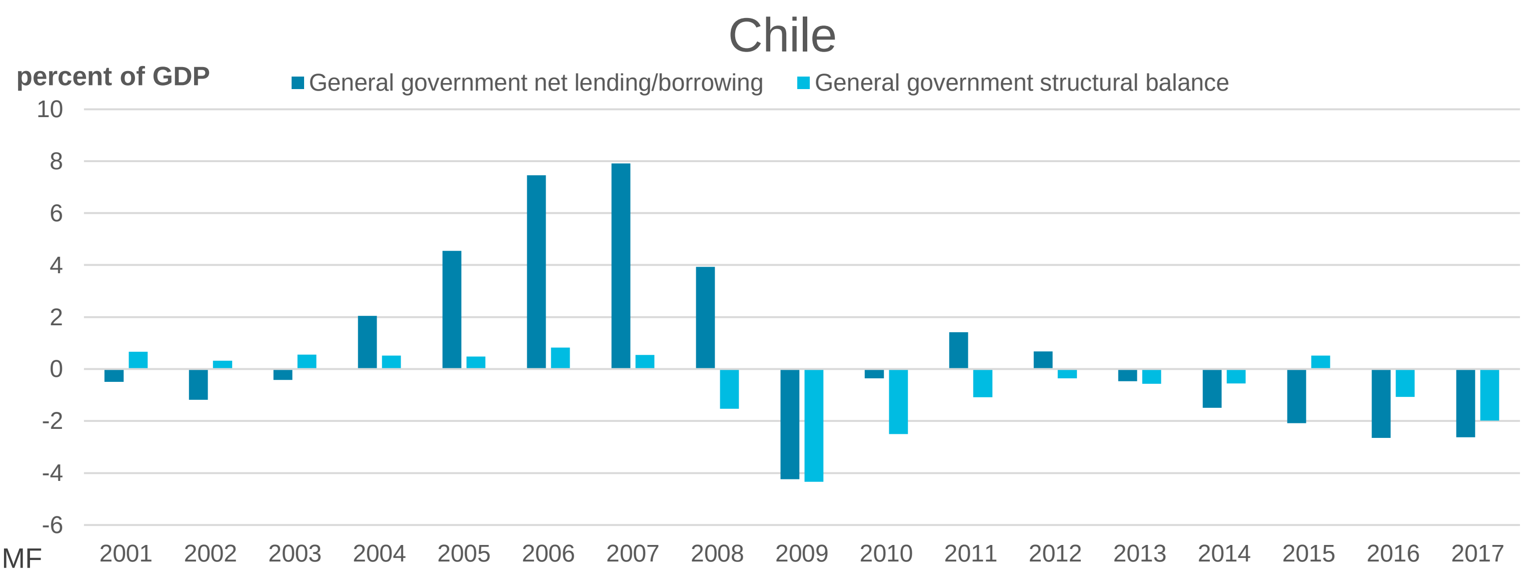


Fiscal balance



Structural budget balance





Source: IMF

New Zealand's fiscal framework

New Zealand's fiscal reforms

- New Zealand's fiscal policy during the 1970s and 1980s included extensive use of fiscal policy in a demand management role that had not contributed to sustainable growth.
- Expansionary fiscal policy had led to a deterioration in the net debt position.
- Although some fiscal consolidation was achieved during the 1980s, it was not sustained into the early 1990s.
- In order to safeguard improvements in government finances and increase policy credibility, the *Fiscal Responsibility Act (FRA)* was introduced in 1994.
- As a result, fiscal policy in New Zealand has to comply with <u>principles</u> of responsible fiscal management. The principles include requirements to run operating balances sufficient to achieve and maintain <u>prudent</u> levels of public debt.
- The FRA was subsequently incorporated into the Public Finance Act and additional principles were added. The framework has endured across governments.

New Zealand fiscal framework

- Principles of responsible fiscal management
- Transparency
  - Budget Policy Statement
  - Fiscal Strategy Report
  - Economic and Fiscal Updates
  - Audited financial statements
  - Statement of Long-term Fiscal Position
  - Investment Statement
- Independence: preparation, standards, audit

Fiscal responsibility

- Principles that set out, at a general level, what good fiscal policy means.
- Each Government must articulate how its fiscal strategy is consistent with these principles
- In contrast to legislated numerical fiscal rules that exist in many countries.

Principles of responsible fiscal management

- **To address fiscal sustainability:**

1. reducing public debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of debt in the future
2. Then maintain debt at prudent levels by balancing operating revenue and operating expenses on average over time
3. Achieve and maintain net worth as a buffer
4. Manage prudently fiscal risks
5. Have regard to the likely impact of fiscal strategy on present and future generations

Principles of responsible fiscal management

- **To address fiscal structure:**

6. Revenue should be raised with regard to efficiency and fairness, reasonable predictability about the level and stability of tax rates
7. Resources are managed effectively and efficiently

- **To address stabilisation:**

8. when formulating fiscal strategy, have regard to the interaction between fiscal policy and monetary policy

Fiscal Strategy Report

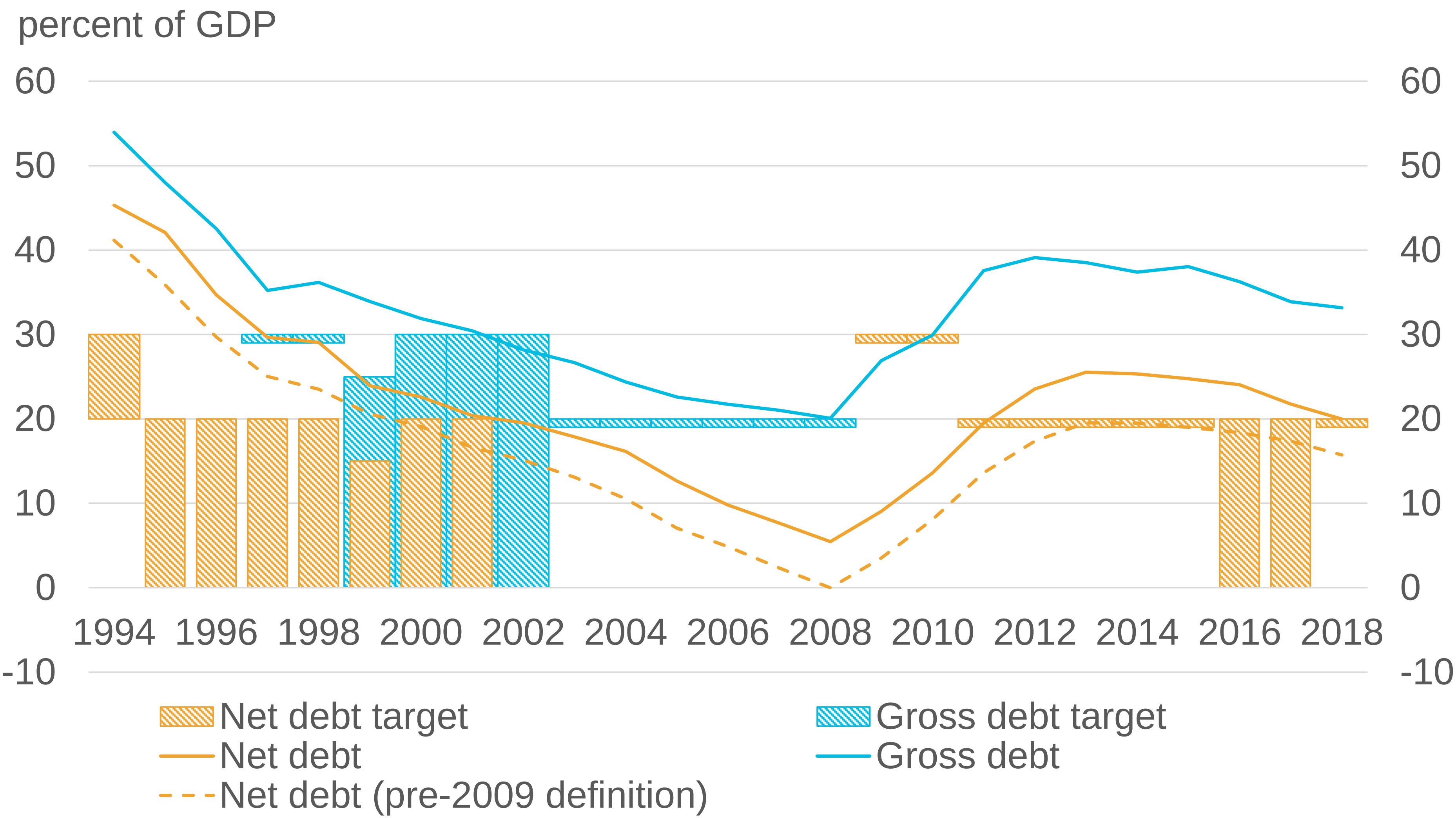
- Fiscal Strategy Report must set out long-term objectives and short-term intentions for:
  - Expenses
  - Revenue
  - Operating balance
  - Debt
  - Net worth

- These fiscal objectives must be consistent the principles of responsible fiscal management.

Setting the debt objective

- Wording of debt objective has changed since the first debt objective in 1994.
- Changes to:
  - **Definition** – net debt only, then both net and gross debt, then gross debt only, now net debt only (new definition)
  - **Form** – range, ceiling, point target
  - **Target level** – frequent small changes
- Reflecting changes in economic circumstances or changes in governments' fiscal strategies.
- Currently, the Government has a target to reduce the level of net debt to 20 per cent of GDP within five years of taking office [2021/22].

Evolution of long-term debt objective



Source: The Treasury

Evaluating New Zealand's experience

Experience with previous fiscal targets

- 1990s:
  - Achieved considerable debt reduction, supporting fiscal sustainability.

- 2000-2008:
  - Debt rule performed well in terms of fiscal sustainability but less well in terms of stabilisation in an upturn
    - Debt continued to decline leading to revisions in the debt target
    - Expenditure frequently revised upwards with positive revenue surprises
    - Difficulties identifying structural/cyclical movements created challenges of managing surpluses in an upturn

- 2008-2018:
  - Fiscal targets adjusted to allow debt to increase in short to medium term following recession and earthquakes, supporting stability, and capped net debt at 30% of GDP, supporting sustainability.
  - Budget balance target to return to surplus by 2015 was used as intermediate target, supplementing the debt objective to reduce net debt to 20% of GDP by 2020s.
  - Targets specifying a fixed date provided a strong fiscal anchor but risked limiting flexibility to support macroeconomic stability as the target date neared.

Evaluation of fiscal approach

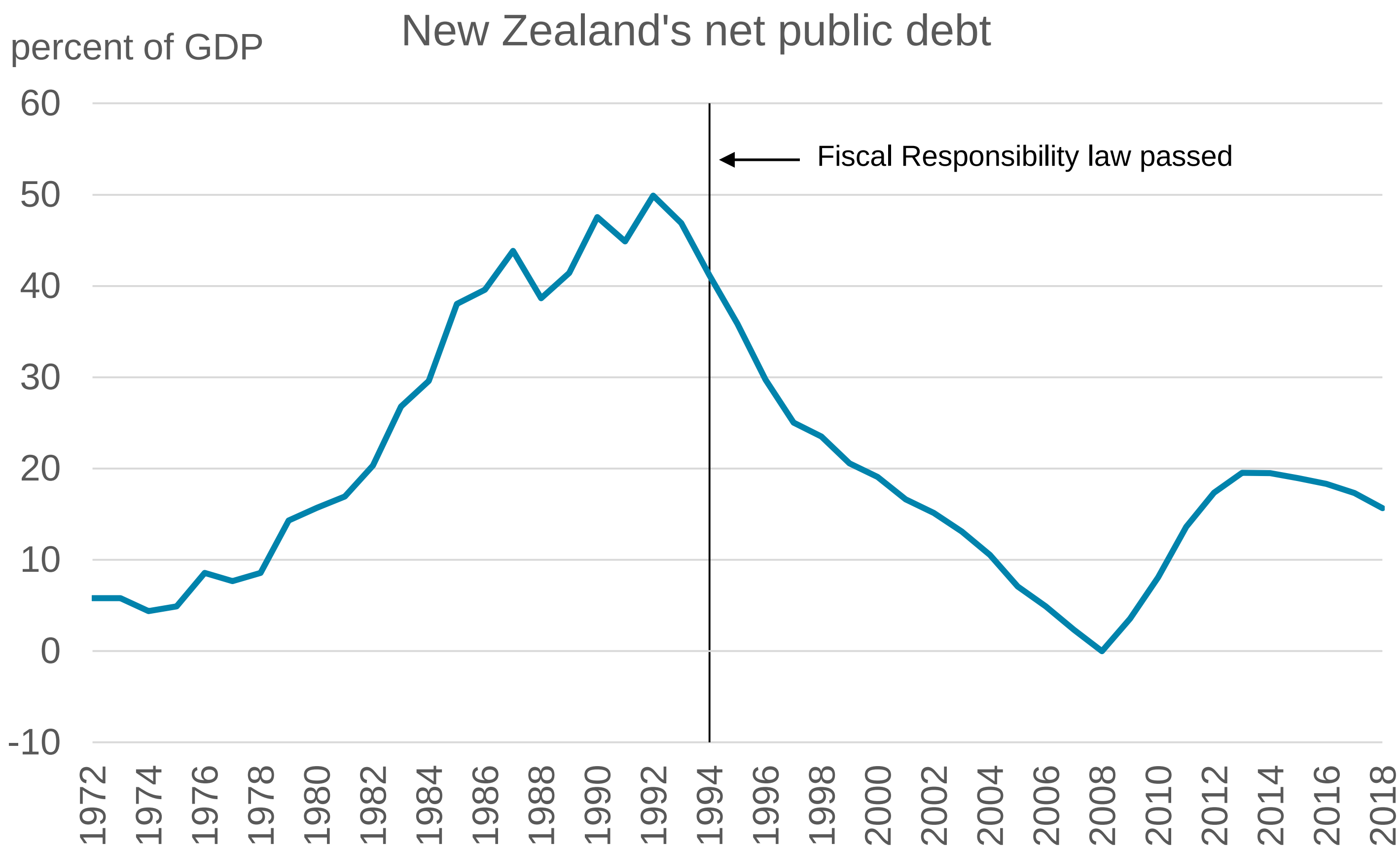
- Consider the performance of New Zealand’s approach against Kopits-Symansky criteria for a fiscal rule.
  - Sustainability
  - Stabilization
  - Simplicity
  - Operational guidance
  - Resilience
  - Ease of monitoring and enforcement

Sustainability

- *Sustainability*: Compliance with the rule should ensure long-term debt sustainability.

- Successful in achieving debt reduction and strong public finances.
- Debt objective provides an anchor to decision making that closely aligns with fiscal sustainability objective.

Public debt 1972-2018



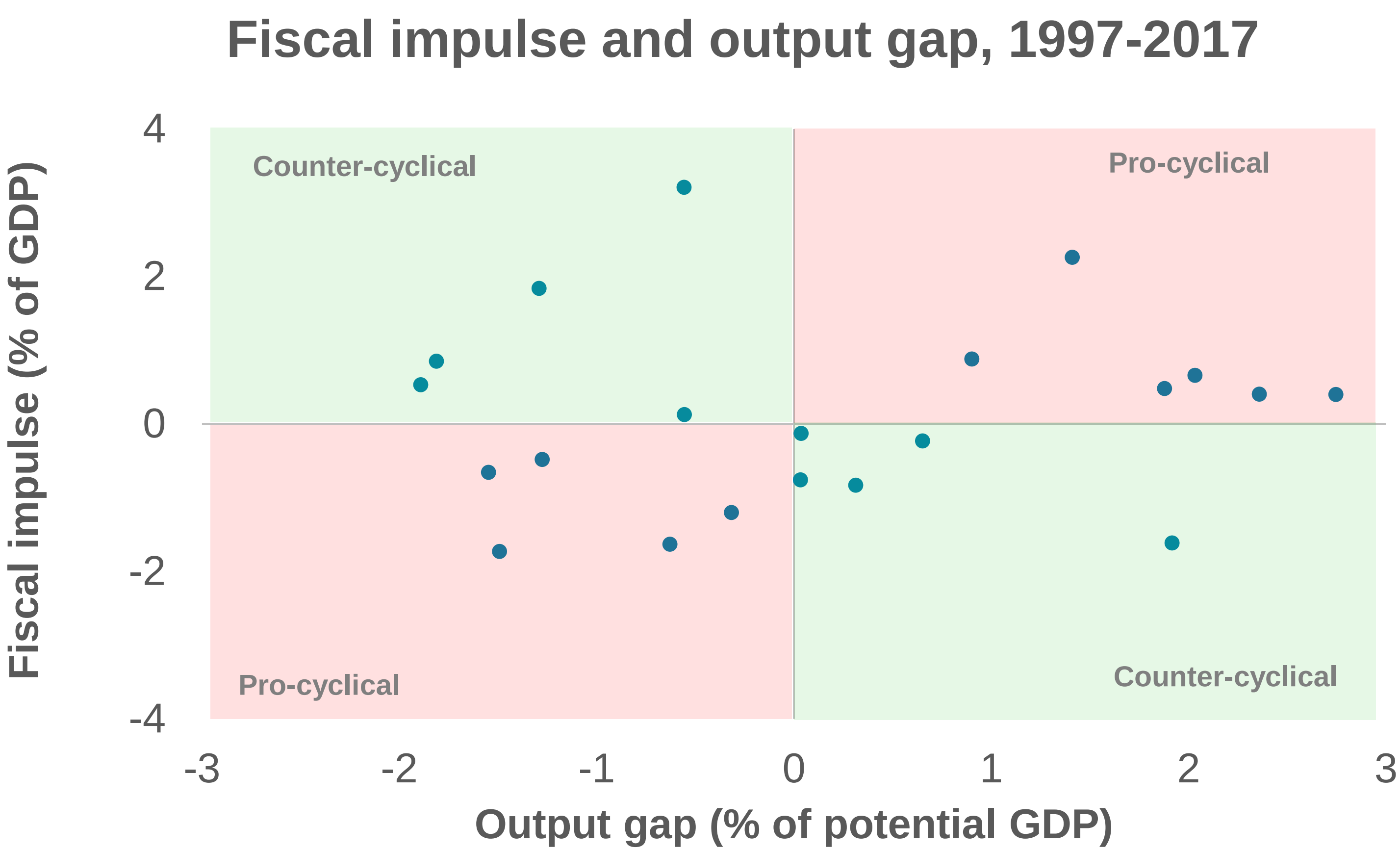
Source: The Treasury.
Note: Measure is “former net core Crown debt” owing to data availability.

Stabilization

- *Stabilization*: Following the rule should not increase (and might even decrease) economic volatility.

- In New Zealand, debt objective is set for the long term and sufficiently flexible to accommodate shocks.
- However, a debt rule may create pro-cyclical fiscal responses as debt outlook is sensitive short-term forecast revisions.
- Once debt has been reduced to prudent levels, rule may not be very binding.
  - Positive, cyclical revenue surprises in 2000s boom was associated with increased spending (Brook, 2013).
- Other targets or institutions may be necessary
  - E.g. strategy for revenue surprises.

Fiscal stance



Source: The Treasury, Half Year Economic and Fiscal Update 2018.
Note: Each dot represents a fiscal year, 1996/97-2016/17. Fiscal impulse is defined as the core Crown fiscal impulse and a positive (negative) value represents a decrease (increase) in the structural primary balance. Estimates are indicative, subject to uncertainty and future revisions.

Simplicity

- *Simplicity*: The rule should be easily understood by decision makers and the public.

- Wide public and cross-party commitment to keep public debt at prudent levels.
- Targeting long-term outcomes avoids need for setting fiscal targets in cyclically adjusted terms.
  - Challenges in trend/cycle decomposition – particularly in presence of terms of trade shocks.
  - Communication difficulties with cyclically-adjusted balances.

Operational guidance

- *Operational guidance*: It should be possible to translate the rule into clear guidance in the annual budget process. Budget aggregates targeted by the rule should be largely under the control of the policymaker.

- Debt objective provides an anchor to decision making.
- Requires medium-to-long term forecasts and projections.
- Fiscal outcomes supported by ‘fiscal management approach’ – operating guidelines that ensure budget decisions are consistent with overall fiscal strategy.
  - Fixed nominal baselines.
  - Expenditure allowances for new policy measures.
  - Expenditure allowances are adjusted, if necessary, to ensure alignment with the fiscal strategy.

Resilience

- *Resilience*: A rule should be in place for a sustained period to build credibility, and it should not be easily abandoned after a shock.

- Fiscal responsibility framework has endured since 1994, across political and economic cycles.
- All governments since mid 1990s have committed to ‘prudent’ long-term debt targets, expressed as a percentage of GDP.
- However, frequent changes to the specification of debt objective and other fiscal targets over time.
  - Although this reduced consistency of the targets, the changes have reflected successive governments’ setting their own fiscal strategy and strong political buy-in.

Ease of monitoring and enforcement

- New Zealand's fiscal policy framework is based on transparency, rather than enforcing legislated numerical rules.
- Behind this transparency-based framework is a judgment that a framework of this kind is likely to provide effective **incentives** for New Zealand governments to conduct responsible fiscal policy.
- This approach has created strong incentives for governments to meet their fiscal targets because there is high reputational cost of not achieving them.
- The framework has a high reliance on disclosure and transparency.
  - Importance of independent reporting, standards and audit.
  - An independent fiscal institution could further enhance monitoring and ex post accountability.

Forecasts

- With numerical rules, fiscal policy makers may have incentive to produce optimistic forecasts.
- E.g. Frankel (2011) studies forecasts of budget balances made by official government agencies among 33 countries. In general, the forecasts are found to have a positive average bias.
- No optimism bias found in New Zealand fiscal forecasts.

Designing a debt objective

Issues with setting a debt target

- Definition
- Level and form of target
- Stock-flow inconsistency in objectives
- Fit with wider balance sheet
- Allowing for trend movements and cyclical fluctuations

Definition

- Net debt or gross debt (or both)?
- Treatment of financial assets?
- Current definition is **net debt** excluding advances (illiquid financial assets) and New Zealand Superannuation Fund assets (time varying asset level for pre-funding future expenses).
- In addition, floor on gross debt to support bond market liquidity.
  - The Government has also committed to maintain levels of NZ Government Bonds on issue at not less than 20 percent of GDP over time.

Level of target

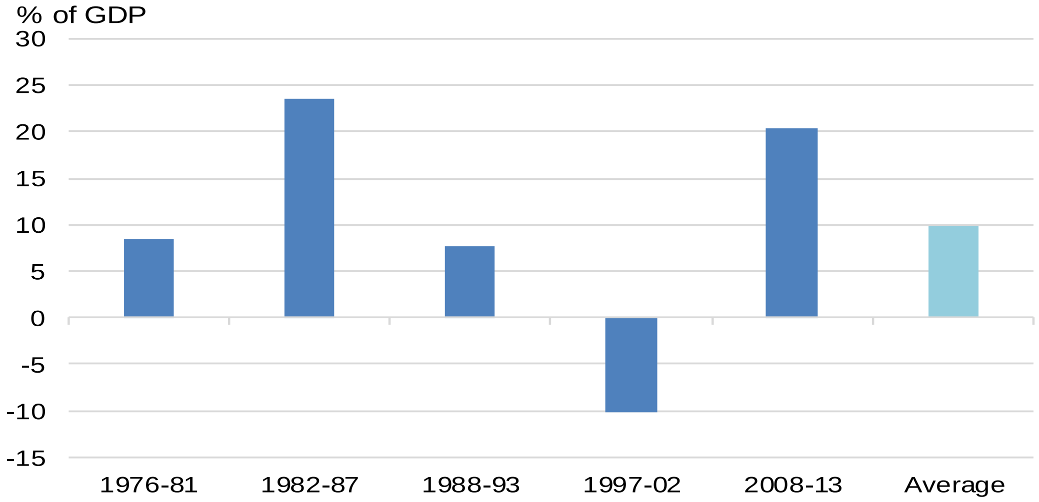
- What is "prudent debt"?
- An on-balance judgement, taking into account:
  - The size of the **buffer** needed to manage response to shocks and allow for uncertainty.
  - The wider set of **vulnerabilities** facing the economy – economic and natural disasters.
  - Longer term fiscal **sustainability** in light of population ageing.
  - The role of debt in funding **capital expenditure**, especially for long-lived assets.
  - **Interest rates** and debt dynamics.
- Currently widespread political consensus around a target similar to the current level.

Form of target

- Point, range and ceiling targets have all been used.
- Fixed date targets or rolling horizon?
  - Fixed date targets help with accountability but reduce flexibility as the target date nears.

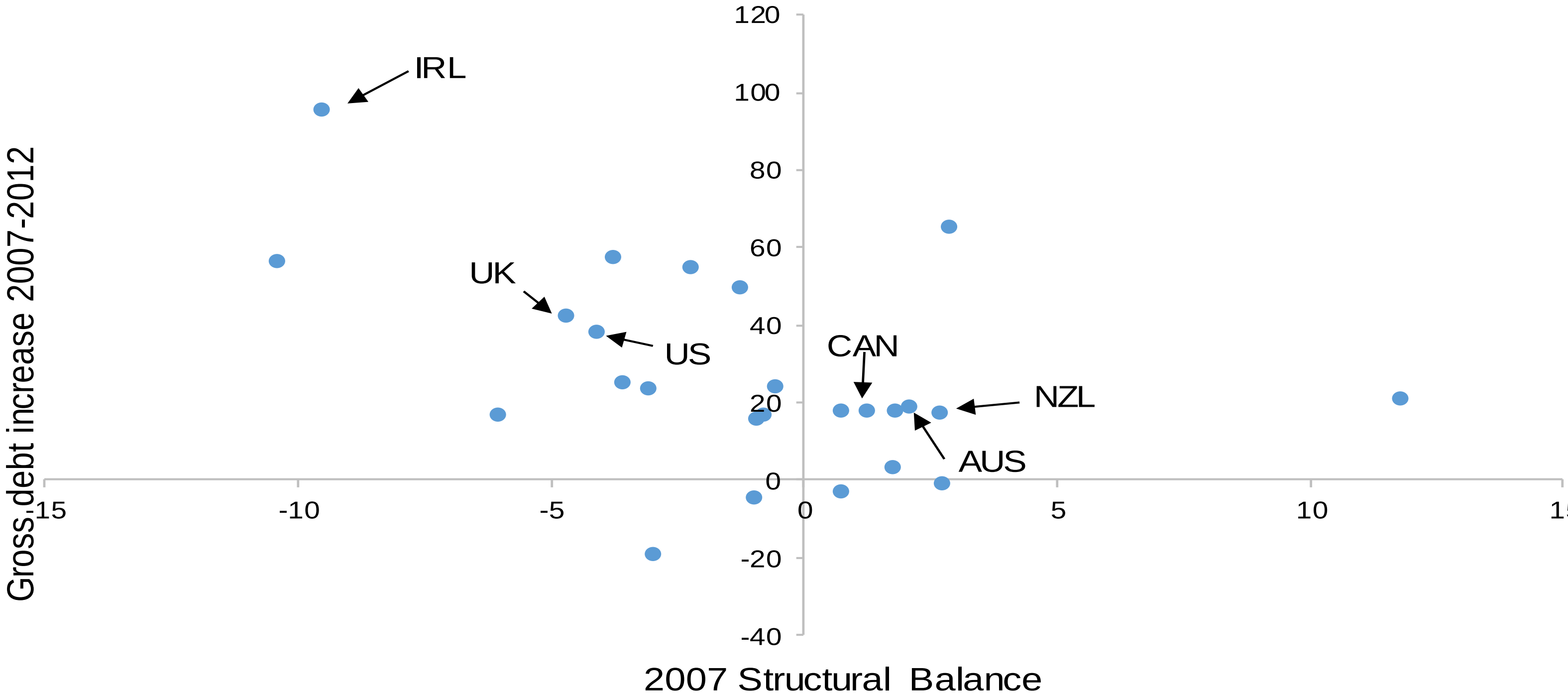
NZ’s experience with shocks

Five-year change in net debt following recessions



Source: The Treasury

GFC experience



Source: IMF, The Treasury

Stress tests

- Stress testing is the systematic assessment of the impact of selected shocks on the government balance sheet.
- The New Zealand Treasury published fiscal stress tests in its 2018 Investment Statement.
- Three scenarios:
  - a severe earthquake
  - an outbreak of disease that affects a large export industry
  - A major global economic slowdown
- There is a risk that net debt could rise by a greater amount if there were multiple shocks, a more extreme event or policy did not sufficiently adjust.
- Useful to test buffering capacity of current levels of debt. Expect to develop further (see also IMF’s October Fiscal Monitor).

Stock-flow inconsistency

- A debt rule can be supplemented with a intermediate target e.g. for budget balance.
- In New Zealand, an operating surplus target did not easily reconcile to the change in net debt, because of institutional coverage, differences between accrual and cash movements, and treatment of capital expenditure.
- Stock-flow inconsistency can create challenges for fiscal management and communication.

Fit with wider balance sheet

- Net debt only one indicator of the strength of the balance sheet; others include net worth, net financial liabilities.
- Potential objectives of financial assets/liabilities on the balance sheet:
  - **Buffering** general economic and other shocks by reducing debt and accumulating assets
  - **Matching** particular liabilities with ring-fenced assets (eg, defined-benefit pension funds)
  - **Prefunding** future obligations by increasing assets.
- Net debt mainly reflects buffering and liquidity roles.
- Requires strategy to manage broader class of assets and liabilities.

Trend movements and cyclical fluctuations

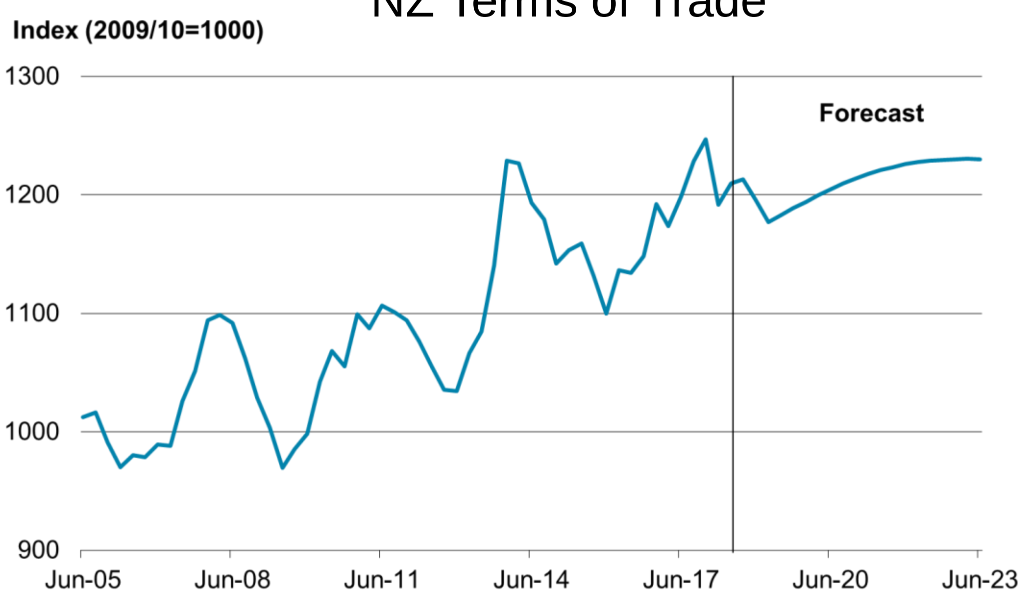
- **Trend:** Should the long-term debt objective contain time-varying dimensions to allow for changing circumstances over time (demographic changes and prefunding)?
- **Cycle:** Surpluses/deficits fluctuate over the economic cycle, should this be recognised in the debt objective?

Managing commodity price volatility

Challenges as a commodity exporter

- New Zealand is an exporter of agricultural goods.
- New Zealand has experienced an increase in the level and volatility of the terms of trade in the last two decades (commodity price boom, falling import prices, structural shifts in domestic and global economy).
- Monetary policy and a floating exchange rate support macroeconomic stability.
- Export prices matter for the budget balance to the extent that private sector income and consumption are affected, impacting general tax revenues.

NZ Terms of Trade



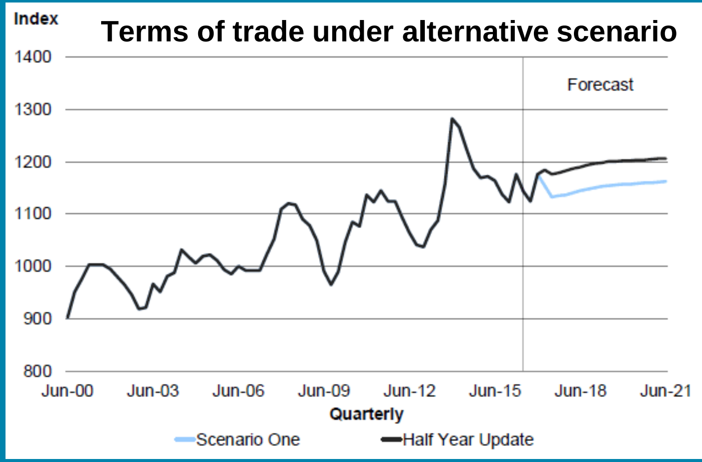
Terms of Trade - Quarterly

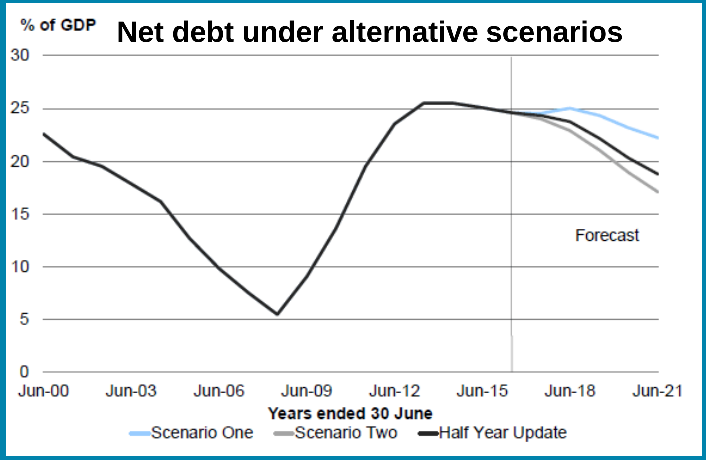
Source: Stats NZ, The Treasury (HYEFU 2018)

Managing commodity price volatility

- Challenges for fiscal policy in determining whether movements are persistent or transitory.
  - Focus on medium to long term in setting fiscal policy, supported by five-year forecast horizon and ten-year fiscal projections.
  - Supplementary analysis of scenarios and structural budget balance with terms of trade adjustment.
- Over last decade, fiscal policy has focussed on rebuilding fiscal buffers while recognising that a permanent deterioration in export prices would require structural fiscal adjustment.
- A stabilisation fund could be a future option to help manage volatility, but has not been considered necessary to date.

Example: Scenario One illustrates the impact of an international shock that lowers trading partners' growth and export commodity prices.





Source: The Treasury, HYEFU 2016

Concluding remarks

- New Zealand’s fiscal framework has endured over nearly three decades.
- Main features are:
  - Principles based
  - Emphasis on transparency
  - Independent reporting, standards, audit
  - Focus on “prudent” debt with specific objective determined by government.
- Framework reflects New Zealand’s particular history, institutions and political culture.
- Debt objective associated with reducing public debt and providing an anchor that supports fiscal sustainability.
- No clear “optimal debt” target – judgement required.
- Debt objective has proved effective because it has adapted to remain relevant to different governments and circumstances.
- Fiscal objectives that are determined by governments create effective incentives for achievement.
- Debt objective is likely to continue to evolve as circumstances change.
- Debt objective not sufficient to achieve all fiscal objectives.

Questions

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