

Future Fund and fiscal policy

Wilson Au-Yeung, Jason McDonald and Amanda Sayegh¹

The Government established the Future Fund as part of a broader strategy to improve the government's long-term financial position. The Fund aims to increase saving now to finance future superannuation payments — the largest liability on the government's balance sheet. By doing so, the Government will free up resources in the future when other fiscal pressures will be pressing. By quarantining Fund earnings for re-investment in the Fund, the Government has tightened fiscal policy. This paper outlines why a tightening of fiscal policy has been necessary; why this requires removing Fund earnings from the underlying cash balance; and the likely magnitude of this change in fiscal policy.

¹ The authors are from Macroeconomic Group and Fiscal Group of the Australian Treasury. This article has benefited from comments and suggestions provided by David Gruen, Hugh Hartigan, Kirsty Laurie, David Martine, Neil Richardson, and David Tune. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

In April 2006, the Australian Government eliminated general government net debt, after it reached a peak of 18.5 per cent of GDP in 1995-96. The Government's strategy of eliminating net debt has increased national savings at a time of continuing economic growth and in anticipation of the fiscal pressures associated with an ageing population.

A key part of the Government's strategy to improve the long-term financial position is the 'Future Fund', a financial asset fund designed to meet the future payments associated with public sector superannuation entitlements. The superannuation liability remains the largest single liability on the government's balance sheet, estimated to be around \$100 billion (or 10 per cent of GDP). The liability has similar economic consequences to debt and represents a substantial obligation that taxpayers will have to meet.

The Government's decision to re-invest Future Fund earnings and exclude them from the underlying cash balance, has tightened fiscal policy. By increasing government saving now, the Government will free up resources in the future, when fiscal pressures associated with health costs and an ageing population will be pressing.

Fiscal policy in Australia

Over the past decade fiscal policy in Australia has become increasingly focused on medium-term fiscal sustainability, including the identification and management of fiscal risks facing current and future generations (Gruen and Sayegh, 2005). Indeed, the *Charter of Budget Honesty Act 1998* (the Charter) requires governments to focus on fiscal risks when setting fiscal policy.² The Charter also facilitates the management of these risks by requiring: a transparent medium-term fiscal framework; a comprehensive financial management system based on accrual accounting; and a regular Intergenerational Report highlighting future fiscal pressures. These reporting frameworks provide the government with more information to allocate resources in the economy and across generations efficiently.³

2 Specifically, the Charter requires that fiscal policy have regard to: government debt and the management of financial risks; the state of the economic cycle; the adequacy of national saving; the stability and integrity of the tax base; and equity between generations.

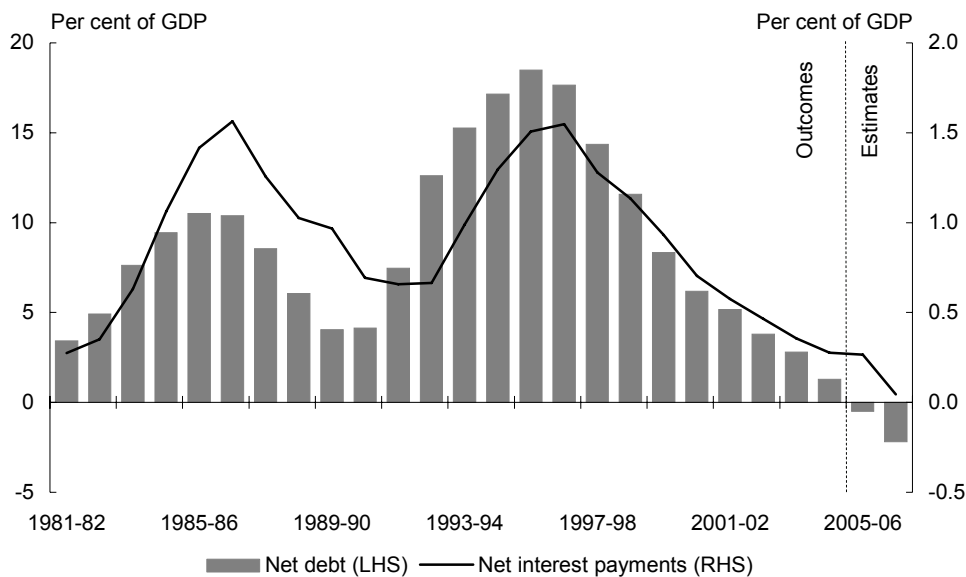
3 For a discussion on the importance of both cash and accrual budgeting and reporting and their relative roles to governments see Barton (1997) and the National Commission of Audit report (1996).

Fiscal policy and net debt

Since coming to office in 1996, the Government has maintained a fiscal strategy focused on medium-term sustainability. The primary objective of the medium-term fiscal strategy is to maintain budget balance, on average, over the course of the economic cycle. This strategy has a number of supplementary objectives, including: maintaining budget surpluses over the forward estimates period while growth prospects are sound; not increasing the overall tax burden from 1996-97 levels; and improving the Australian Government's net worth position over the medium to longer term.

Until the 1999-2000 Budget, the fiscal strategy also included a supplementary objective to halve the ratio of net debt to 10 per cent by 2000-01. This was actually achieved in 1999-2000. The Government has subsequently further improved on this performance by eliminating all net debt in 2005-06 (Chart 1).

Chart 1: General government net debt and net interest payments



Source: Data are from ABS Cat. No. 5501.0, Australian Government Final Budget Outcomes and Treasury estimates.

By eliminating net debt, and maintaining strong budget surpluses, the Government has reduced the risks associated with investing in Australia, which contributes to lower interest rates and enhances economic growth. Australia is also better placed to respond to economic shocks, should they occur, and to meet longer term fiscal pressures.

This achievement, combined with the introduction of more comprehensive fiscal reporting, has enabled the Government to increasingly focus on the management of broader risks to government finances.

Managing balance sheet risks

The 1999-2000 Budget saw the first set of budget financial statements produced on an accrual basis, including the first balance sheet for the general government sector. The balance sheet provides information on the government's assets (resources) and liabilities (obligations), which reconcile to a measure of government net worth. Net worth includes debt and other liabilities and is therefore a broader measure of the government's overall financial position than net debt.⁴

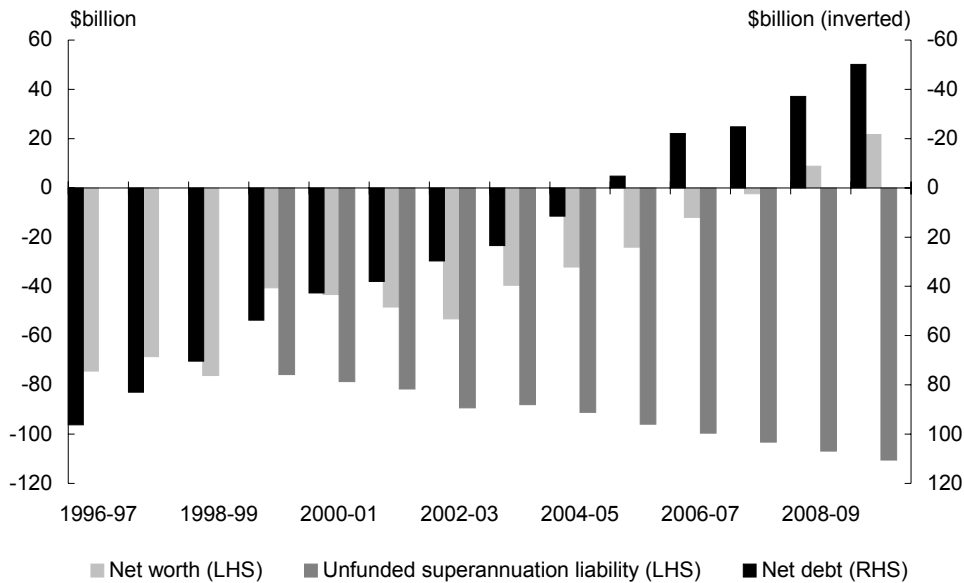
As well as reducing short-term financial risks, eliminating net debt has improved net worth from -\$74.4 billion in 1996-97 (-13.6 per cent of GDP) to an estimated -\$12.0 billion in 2006-07 (or -1.2 per cent of GDP). By 2008-09, the Australian Government is projected to have positive net worth.

The introduction of a detailed balance sheet has enabled the government to identify and manage a broader set of assets and liabilities. The largest single liability on the government's balance sheet is public sector superannuation. The 2006-07 Budget estimates that the value of the superannuation liability will be \$99.6 billion at 30 June 2007.

Although the superannuation liability has different features to debt securities (it is not traded and is not easily extinguished) it has similar economic consequences. Rather than accepting higher wages, past public servants have accepted the promise of future retirement benefits from the government. The government has effectively borrowed from public servants. Indeed, if past governments had chosen to pay for the superannuation liability as it accrued to a superannuation fund outside the general government sector, while maintaining existing taxing and spending, they would have had to issue debt to finance the liability.

4 Net debt is a sub-set of the government's broader financial portfolio. It includes financial liabilities such as government securities and other loans and borrowing and financial assets such as cash, deposits and other investments. Net worth builds on net debt by also incorporating non-financial assets, as well as certain financial assets and liabilities not included in net debt, most notably accrued employee superannuation liabilities.

Chart 2: Net worth, net debt and the superannuation liability

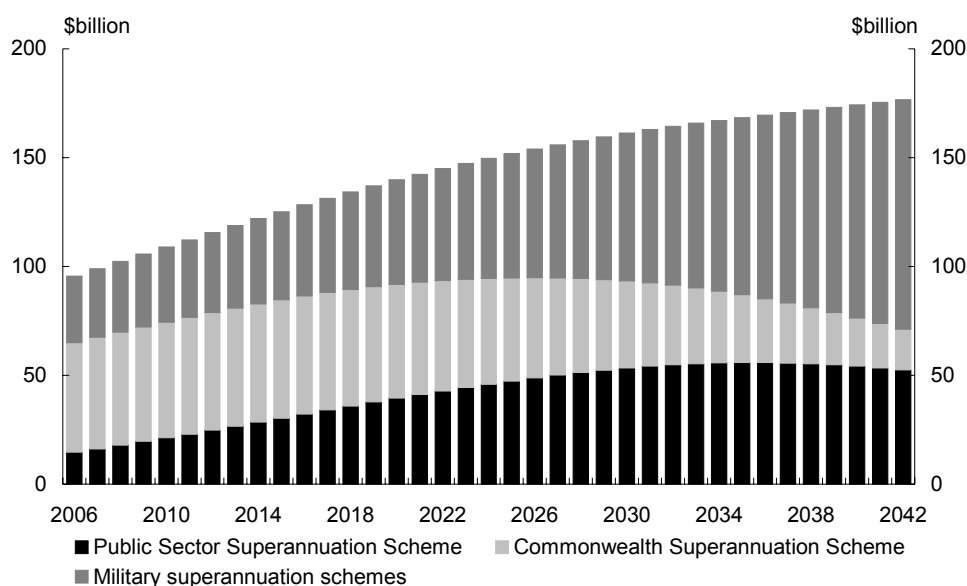


Note: Data from 1996-97 to 2004-05 are based on budget outcomes. Thereafter data are estimates and projections from the 2006-07 Budget.

The Government has taken a number of decisions to reduce the cost of the superannuation liability. These include closing the Parliamentary Contributory Superannuation Scheme to new members of Parliament from 9 October 2004; closing the defined benefit Public Sector Superannuation Scheme to new members from 1 July 2005; and making one-off payments totalling \$5 billion to extinguish fully the Government's liabilities relating to the Telstra and Australia Post Superannuation Schemes and various state rail employees.

Shifting public service employees from defined benefit to accumulation schemes reduces fiscal risks to the government and provides public sector employees with more choice in investing for their retirement. These measures are expected to see an overall fall in the growth of the superannuation liability arising from civilian public sector employees. In 2040, the largest superannuation liabilities will be generated by the Military Superannuation and Benefits Scheme, which is the only significant defined benefit scheme in the government sector remaining open to new members (Chart 3).

Chart 3: Projected public sector superannuation unfunded liability



Note: The figures do not represent all schemes operated by the Commonwealth. Only the major civilian and military schemes have been included (the military schemes above include the Military Superannuation and Benefits Scheme and the Defence Force Retirement and Death Benefits Scheme).
 Source: Australian Government Actuary.

There are considerable risks around the projected growth in the unfunded superannuation liability. Given the size of this liability, even small variations in growth assumptions can impact significantly on government finances. For example, between 2000-01 and 2003-04, the average annual change in the estimation of the superannuation liability was around \$3.6 billion.⁵

Off balance sheet risks

There are a number of social policy obligations, such as future health expenditure and pensions, that do not meet the accounting definition of liabilities and therefore do not impact on net worth.⁶ However, such obligations are likely to impose significant fiscal costs in the future. The 2002-03 Intergenerational Report showed that taxes may need to rise or spending be cut by up to 5 per cent of GDP by 2040 to finance these

5 The change in each financial year is the difference between the value of the superannuation liability published in the Final Budget Outcome and the first estimate of the liability for that year. The biggest contribution to this annual average is the major actuarial review to the superannuation liability for 2002-03. This major actuarial review occurs every three years.

6 Liabilities on the government's balance sheet generally cover those obligations which the government has already accrued – that is, they relate to past economic events. Future social policy obligations reflect an intention to make payments in the future and therefore do not meet the accounting definition of a liability. Brixi and Schick (2002) provide a detailed taxonomy of government fiscal risk.

obligations.⁷ Risks to the future path of fiscal sustainability may increase uncertainty and have real costs to the economy today.⁸

Steps to address the fiscal gap, such as improving participation and productivity, are aimed at increasing economic growth.⁹ These policies also need to be fiscally sustainable – you cannot spend your way out of a fiscal gap.

Future Fund

The Future Fund aims to increase government saving now to finance its superannuation payments in the future when other fiscal pressures will be pressing. By building up a pool of financial assets today to finance the growing unfunded superannuation liability, future budgets will be free of the burden of making superannuation-related payments. Aiming to eliminate the unfunded superannuation liability has exactly the same medium-term fiscal policy rationale as eliminating net debt.

Total superannuation payments were around \$4.5 billion (0.5 per cent of GDP) in 2004-05 and are projected to be around \$7.6 billion (0.4 per cent of GDP) by 2020. However, these payments, largely related to past employees, will need to be made around the time that other fiscal pressures are emerging. By beginning to provision for the liability, the Government is enhancing fiscal sustainability and reducing fiscal pressures on future generations. Leaving these payments to future generations is equivalent to arguing for a higher debt burden or higher taxes to be transferred onto future generations.

The Future Fund will finance future superannuation payments from a financial asset portfolio established from past and future budget surpluses, asset sales and reinvested earnings. Contributions to the Future Fund will be made on an 'ex-post' basis depending on actual budget outcomes, rather than making fixed contributions each period according to a pre-determined rule (as would occur for an ex-ante fund). This provides the Government with the flexibility to determine contributions to the Fund depending on cash management requirements, economic circumstances and other government priorities that may emerge.

7 The Productivity Commission's *Economic Implications of an Ageing Population* (2005) also provides an estimate of future fiscal pressures facing all levels of government.

8 See Au-Yeung, McDonald and Sayegh (2006) for a fuller discussion of this issue.

9 Gruen and Garbutt (2004) estimate the fiscal implications of raising participation or productivity growth in Australia.

Accounting for the Future Fund

Under the *Charter of Budget Honesty Act 1998*, the government is required to base its budget financial statements on both the Australian Bureau of Statistics' Government Finance Statistics (ABS GFS) and Australian Accounting Standards (AAS). Both of these frameworks closely follow their international equivalents. There are a number of fiscal aggregates reported in the financial statements consistent with these accounting frameworks. The two main fiscal aggregates used for fiscal policy purposes are the underlying cash balance, which is the Government's primary fiscal aggregate for assessing the stance of fiscal policy, and the fiscal balance.¹⁰

The underlying cash balance records government transactions at the time cash is paid or received. For some economic activities, such as superannuation, there are substantial lags between when liabilities accrue (employees accrue their benefits as they work) and when the payment is recognised (the cash payment for superannuation benefits can be up to 40 years later). This implies that if the Government achieves underlying cash balance on average over the economic cycle, it would not generate sufficient savings to meet accruing superannuation expenses – as the payment for the accruing superannuation cost is recognised long after the economic activity has taken place.

By setting up the Future Fund to finance superannuation-related payments in the future and by reinvesting and quarantining earnings, the Government is effectively pre-committing the Future Fund earnings. Since the Future Fund earnings are not available for current spending, the Government has excluded the earnings from the underlying cash balance.

If earnings were not excluded this would lead to an overstatement of the funds available for recurrent spending – the earnings of the Fund would increase the underlying cash balance today even though the payments they will finance will need to be made in the future. Even if the earnings of the Fund were ear-marked solely for such payments, the Government would still be able to issue other liabilities to offset these earnings. The underlying cash balance, net of Future Fund earnings, is a more accurate measure of fiscal sustainability.

¹⁰ Prior to 1996-97 the headline cash balance provided the key fiscal aggregate for government. However, the headline cash balance provides a poor indicator of fiscal sustainability and the budget's impact on the economy because it includes investments in financial assets for public policy purposes. This means that when governments sell financial assets, the balance is improved. Clearly financing government through the sale of financial assets is not sustainable. In 1996-97, the Government therefore chose to report its fiscal strategy against the underlying cash balance.

Excluding Future Fund earnings from the underlying cash balance does not affect any of the fiscal aggregates required to be reported under the *Charter of Budget Honesty Act 1998*. The underlying cash balance is not an accounting concept required under GFS or AAS. Rather, it is a concept defined by government to manage fiscal policy. Future Fund earnings, such as dividends and interest, are included fully in the GFS and AAS cash flow and operating statements. The financial statements also disclose how the underlying cash balance is derived from the GFS cash surplus.

In contrast to the underlying cash balance, the fiscal balance is an accrual measure that records financial flows at the time of the economic activity and is not conditional on the exchange of cash. In budgeting for superannuation, an expense is recorded as the benefit is accruing, so the accrual measure does not suffer from the timing issues associated with cash accounting. Conceptually, fiscal balance on average over the cycle would ensure that any growth in the superannuation liability is fully financed.¹¹ The remaining portion of the superannuation liability that would need to be financed is the existing superannuation liability. This will be funded through the Government's capital injections to the Future Fund and the compounding growth in the invested assets from capital gains over time.¹²

Another significant benefit of excluding Future Fund earnings is that the underlying cash balance will not be affected by how the Future Fund Board of Guardians chooses to invest.

Magnitude of fiscal tightening

By removing Future Fund earnings from the underlying cash balance, the Government has tightened fiscal policy. From a budgeting perspective, this tightening is represented as the foregone receipts from the Future Fund that would have otherwise been available for current spending. The magnitude of this fiscal tightening is currently estimated to be \$1.8 billion in 2006-07 (0.2 per cent of GDP). This estimate is based on the Government providing the Fund with \$18 billion in April 2006 and the technical assumption that the proceeds from the sale of Telstra will also be provided.¹³

11 A fiscal balance over the cycle means all costs are covered over the period; strictly speaking, this requires that net capital investments and other economic flows are on average zero over the course of the economic cycle.

12 Capital gains (or losses) are recorded in the statement of other economic flows, rather than the fiscal or underlying cash balances.

13 The initial capital injection to the Future Fund was financed from accumulated budget surpluses held on term deposit with the Reserve Bank of Australia. Interest receipts on these term deposits contributed to the underlying cash balance.

Future Fund and fiscal policy

Over the forward estimates, the improvement in government saving is greater than shown by the Future Fund earnings in the government GFS cash flow statement. The Future Fund is eventually expected to invest in a diversified portfolio of financial assets, including fixed income securities as well as equities. However, only cash flows, such as dividends and interest income, are recorded in the cash flow statement. Capital gains on equities are recorded in the statement of other economic flows. The 2006-07 Budget assumes that the Future Fund will invest in assets consistent with the Government's required benchmark real return of at least 4.5 to 5.5 per cent.¹⁴

Depending on the size of future contributions to the Future Fund (which are not yet determined given the ex-post nature of the fund) the future tightening in fiscal policy could be in the order of $\frac{1}{4}$ to $\frac{1}{2}$ per cent of GDP per year. For example, if future surpluses projected in the 2006-07 Budget are realised and transferred to the Future Fund, the tightening in fiscal policy could rise to around $\frac{1}{2}$ per cent of GDP by 2009-10.

Concluding remarks

Sound government finances are important for maintaining economic prosperity. Pressures to government finances are projected to emerge over the medium term primarily due to an ageing population and rising public health costs. The Government's unfunded superannuation liability is the largest liability on its balance sheet. The Future Fund will ensure that adequate funds are available to finance this liability. By excluding Future Fund earnings from the underlying cash balance the Government has tightened fiscal policy, making government finances more sustainable over the medium term.

¹⁴ The Government's required benchmark is set out in its investment mandate as given to the Future Fund Board (for more information see www.futurefund.gov.au).

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