Medium-term Fiscal Framework Update

This paper presents an update to the Cook Islands Government's Medium-term Fiscal Framework (MTFF) as previously described in *Medium-term Fiscal Strategy 2019/20 – 22/23* and updated in the *2021/22 Budget Estimates – Book 1*.

Due to the extended impact of the COVID-19 pandemic, the Cook Islands Government has exercised the Exit Clause from the MTFS in accordance with the MFEM Act 1995/96 Section 23(4), and this document provides guidelines for the return to those measures.

This MTFF update reconfirms the Government's commitment to sound fiscal and economic management, being implemented through the MTFS within the context of a severe global and domestic economic shock, and is fully consistent with the MTFS detailed in the *2021/22 Budget*, which was itself from the 2020 Budget Policy Statement in the *2020/21 Half-Year Economic and Fiscal Update*.

Why produce this Update?

The previous MTFF provided key guidance for fiscal settings of the Cook Islands Government, to ensure that the immediate needs of the Cook Islands could be met while still adhering to fiscal sustainability over the medium-term. However the impact of the global COVID-19 pandemic has meant the previous MTFS was in many aspects out of date much faster than anticipated.

While the Cook Islands has not seen any cases of the virus to date, the necessary precaution in closing the border to international visitors has seen a fall in GDP which approaches thirty per cent from peak to trough. Within the context of such a large contraction, extraordinary government stimulus and support has been and continues to be required in order to provide financial assistance to the people of the Cook Islands, and provide the best opportunity for recovery once the border can be safely opened again. To provide the flexibility to do this, the Exit Clause in the MTFS was enacted – providing the capability to fund the Economic Response Program (ERP) in particular.

This expenditure and the loss in revenue have resulted in large fiscal deficits during the pandemic – and as a result, greatly changed the debt situation of the Cook Islands. The changing situation means that the existing MTFF is no longer appropriate to chart the path to recovery from this emergency situation, so an updated MTFF is needed – preserving the key characteristics of the existing one, while adjusting for the new realities faced over the medium-term.

As the Cook Islands remains in an uncertain economic and fiscal position, this is not the time for a full and complete revision to the MTFF (an exercise which can be undertaken when there is more certainty in the environment, planned to be before the 2024/25 Budget is tabled). Determining the most appropriate targets and goals for key fiscal measures to apply during periods of trend growth during this uncertainty is extremely difficult and is better undertaken once the pandemic has passed.

The Cook Islands Fiscal Framework

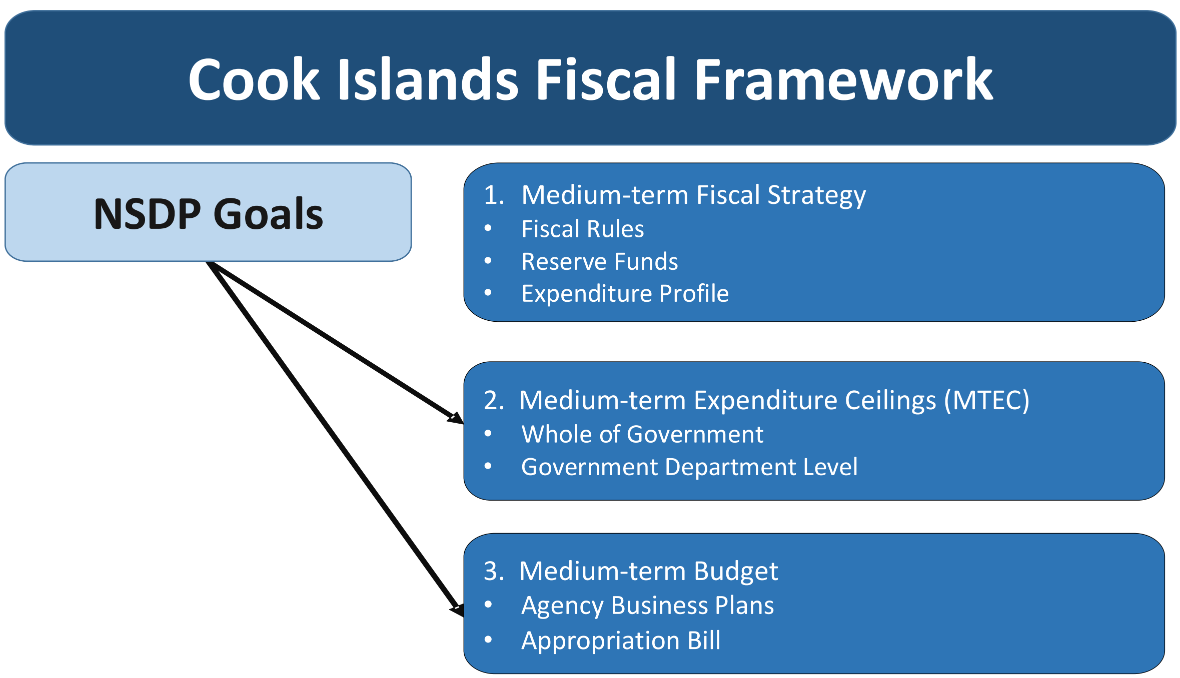
The Cook Islands Fiscal Framework (the Framework) is designed to strengthen the strategic focus of the Government's expenditure and revenue decisions by incorporating a more robust medium-term perspective that takes into account interactions with the economy. The Framework has been established to achieve the following outcomes:

- improved long-term fiscal sustainability through responsible fiscal management and debt sustainability; and
- improved medium-term fiscal planning nationally, and within each agency.

The Framework comprises three cascading, interlinked elements, shown in Figure 1, that together result in a fiscally responsible four-year budget that takes account of the economic cycle:

1. **Medium-term Fiscal Strategy (MTFS)** – provides the basis to meet the fiscal rules, the establishment of reserve funds for economic downturns, natural disasters, and future generations, and a Government expenditure profile guided by the economic context.
2. **Medium-term Expenditure Ceilings (MTEC's)** – guided by the MTFS, whole of Government expenditure ceilings for each of the four years are then divided into Agency ceilings, taking into account Economic Development Strategy 2030 (EDS) goals, National Sustainable Development Plan 2016–2020 (NSDP) goals[1] and Agency capacity requirements.
3. **Medium-term Budget** – Agency business plans that reflect individual ceilings, along with revenue and economic forecasts, are used to prepare the medium-term budget – the appropriation estimates for the budget year, and forecasts for three forward or outer years.

Figure 1 Framework elements



Existing Medium-term Fiscal Strategy

The Government's existing Medium-term Fiscal Framework was developed in 2018 and aims to deliver fiscally sustainable budgets. This has been a very successful strategy, resulting in a strong fiscal position

[1] This will transition to the National Sustainable Development Agenda 2020+ (NSDA) as the new strategic plan comes into effect.

for the government when the COVID-19 pandemic hit in 2020. To achieve this the Government committed to:

- Adhere to the fiscal rules on cash reserves, debt, fiscal balance and expenditure growth.
- The development of, and appropriation into, reserve funds (Stabilisation Account and Sovereign Wealth Fund) where possible to ensure that excess revenues are saved for periods of economic downturn or natural disasters, and for future generations.
- An expenditure profile that is steered by the economic context, using internal guiding principles.

The Government's fiscal strategy was underpinned by the following policy elements:

- Investing in infrastructure that will ensure the sustainability of economic growth and the resilience of the economy to climate change.
- Increasing revenue over the medium-term without increasing the tax burden on society, through economic growth and by ensuring that tax legislation is enforced in an equitable manner.
- Focusing the efforts of Government Departments on core deliverables and limiting the expansion of new programmes and costs.

The scale of the present economic shock experienced by the Cook Islands required departure from the fiscal rules and the utilisation of the Stabilisation Account in 2020/21 in order to achieve an expenditure profile which responds to the current economic context – through the use of the Exit Clause. With this shock being extraordinarily deep and long, it is not appropriate to simply 'snap' back to the same strategy once the crisis is over. So this requires building a new MTFS, using the existing elements and ensuring they reflect the changed world.

In the context of the pandemic and economic shock, the following policy elements are also being considered at the present time:

- Positioning the Cook Islands economy for rapid and effective recovery from the economic shock.
- Providing support to vulnerable sectors of the community in response to loss of income and increased financial pressures.
- Providing support to businesses to remain viable through the economic shock, thereby generating economic stimulus and maintaining employment levels.

The short-term priority of the Economic Recovery Roadmap (ERR) is a key guide in allocating funding, but Government accepts that the immediate impacts of the pandemic may have lasting effects on national development outcomes for many years to come. Recognising the urgency of addressing the substantial impacts of COVID-19 on health, households, and private sector capacity, Government will prioritise COVID-19 response in the short term. However, fiscal allocations against the goals of the NSDP/NSDA are still reported in the Budget to ensure continued monitoring.

As the overriding need for Government to support economic response and recovery reduces over time, the importance of the National Sustainable Development Agenda 2020+ (NSDA) in prioritising expenditure will increase over the medium-term.

Existing Fiscal Rules

The MTFS[2] aims to smooth Government expenditure over the course of the economic growth cycle. That is, it aims to balance the need for Government to support the economy in economic downturns with the fiscal responsibility to save in the boom times and prevent overheating the economy. It sets out the Government's fiscal commitments over the medium-term, including the fiscal rules that the Government aims to achieve, economic forecasts and in turn, the Government's expenditure profile. This has been key in the existing MTFS, and will remain so in the updated approach.

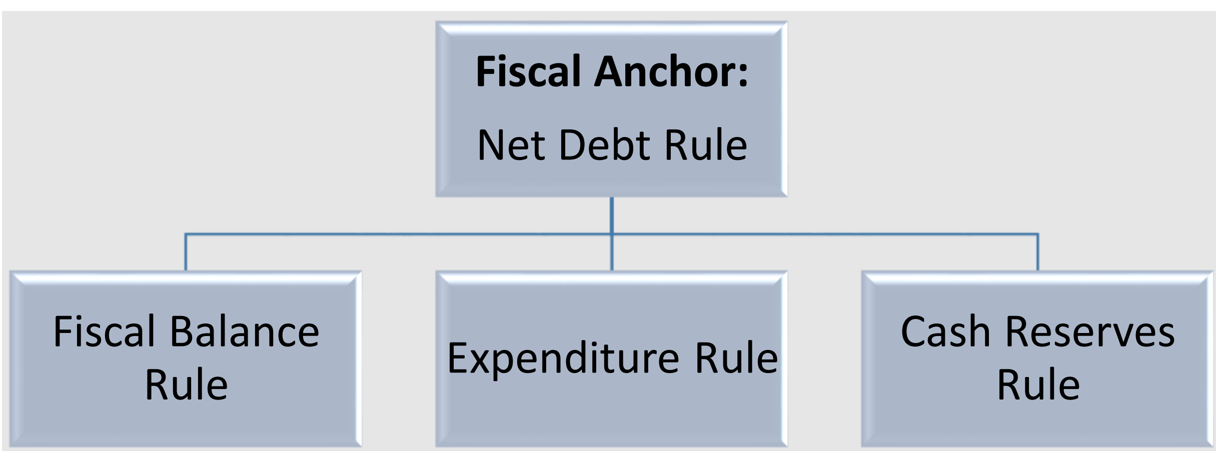
The specific objective of the MTFS is to deliver fiscally sustainable budgets.

In the existing MTFF, the Government committed to four fiscal rules; performance against each rule has been publicly reported:

1. **Net Debt Rule**: net debt should not exceed a soft cap of 30 per cent of Gross Domestic Product (GDP), and cannot exceed a hard cap of 35 per cent of GDP.
2. **Fiscal Balance Rule**: the fiscal balance cannot exceed a deficit of 1.9 per cent of nominal GDP.
3. **Expenditure Rule**: budgeted expenditure cannot grow by more than 4 per cent year-on-year.
4. **Cash Reserves Rule**: the equivalent of 3 months of operating expenditure must be held in cash at any one time.

The Fiscal Rules are structured around the fiscal anchor which is linked to the objective of the fiscal strategy - fiscal sustainability. This rule guides the development of the three operational rules. Prior to the impacts of COVID-19 on the Cook Islands economy and fiscal position, the Fiscal Rules were as outlined below.

Figure 2 Existing MTFS rule structure



The Government also committed to a number of operational MTFS guides:

Personnel ratio – expenditure on personnel less than 40 per cent of total Government revenue.

Requirement to spend cash – no new debt commitments where the Government has sufficient cash to fund the relevant expenditure.

[2] Available at: http://www.mfem.gov.ck/images/CEO/Medium_term_Fiscal_Strategy_2019_23_-_Copy.pdf.

Cyclically-adjusted balance – use of the cyclically-adjusted balance as a benchmark when developing the total expenditure ceiling to disconnect spending from cyclical revenues and allowing governments to maintain expenditure during downturns.

Stabilisation Account – cash in excess of four months of operating expenditure at the end of the financial year is transferred to the Stabilisation Account at the beginning of the next year (an additional one month to three months cash reserves are retained as a buffer).

The fiscal rules have been developed using guidance from the IMF.[3] For an explanation on the development of the Fiscal Rules, including formulae, see the MTFS Technical Paper – *Fiscal Tool 2018: Explanatory note* (Technical Paper), which is available on the MFEM website.[4]

Prudency

The Government's aim in the development of the Fiscal Rules is to ensure fiscal prudency – spending within revenues and use of sustainable debt when required. As such, in determining the rules, rounding has been applied to ensure that prudency is reinforced. For example, in the case of the expenditure ratio, this was rounded down from 4.3 to 4.0 per cent of GDP.

Exit Clause

The Government agrees to abide by the fiscal anchor and operational rules at all times, with two exceptions. The Government may breach these rules only in the event of a natural disaster (and subsequent calling of a state of emergency), or a severe economic shock (defined as real economic growth of negative 2 per cent or less).

As indicated above the existing MTFS includes an 'Exit Clause' that allows for a temporary departure from the fiscal rules, including periods of severe economic shock, to enable a Government stimulus response to boost the economy. This was enacted as a result of the pandemic, enabling Government to respond to the needs of the economy and this has remained in place since the onset of the pandemic. During this time, Government has continued to measure and publish performance against the rules in the annual Budget releases. The Exit Clause will continue to be available to provide flexibility from the new fiscal rules, should unforeseen shocks arise.

New Fiscal Rules

The economic shock resulting from COVID-19, with GDP falling by 5.2 per cent in 2019/20 in real terms, and expected to fall by a further 22.9 per cent in 2020/21, has meant an updated set of fiscal rules are needed to reflect the changing needs of the economy. While 2021/22 is expected to see growth in real GDP of almost 6.9 per cent, this still leaves GDP at a level that is 17.6 per cent lower than the 2019/20 level – itself being pandemic-affected. This severe contraction in GDP has been responsible for part of the increase in the Net Debt to GDP ratio, which will then reduce as GDP grows back toward pre-COVID levels and tax revenue improves.

[3] IMF, 2018b. Fiscal policy: How to calibrate fiscal rules – A Primer. Fiscal Affairs Department, International Monetary Fund, Washington D.C., March 2018.

[4] http://www.mfem.gov.ck/economic-planning

This new set of more appropriate fiscal rules enables Government to utilise debt funding to strengthen its response to the economic crisis, necessary for the implementation of the ERR and economic stimulus measures – including ERP-type business support- and to continue to support core government functions until revenue recovers.

These new fiscal rules are in place as an interim measure that reflects the needs of the economic and fiscal situation as the Cook Islands recovers from this shock. With this in mind, the Government commits to re-assessing the fiscal rules before the publication of the 2024/25 Budget Policy Statement (i.e. 2023/24 HYEFU), on the basis that the economy of the Cook Islands has recovered (or substantially recovered) from the impacts of the pandemic. This update will be subject to Cook Islands' GDP (nominal) reaching a level of at least NZ$520 million per year. The following fiscal rules will be regularly reported on to enable transparency and the forecasts will continue to be updated as the economic situation continues to improve.

1. **Cash Reserves Rule**: the equivalent of 3 months of operating expenditure must be held in liquid assets at any one time (currently estimated to be approximately $60 million).
    a. Within the Cash Reserves Rule, an emergency-level of cash reserves (that is, the level below which the ability of Government to meet its obligations is at risk) has been determined to be equal to one month of expenditure, which is rounded to $20 million.
2. **Investment Rule**: the Government shall commit that any additional borrowing once debt has reached 55 per cent of GDP is for capital investment and/or targeted GDP stimulus purposes.
3. **Operating Expenditure Rule**: baseline budgeted operating[5] expenditure cannot grow by more than the greater of 2 per cent or the average of the past two years growth in the Consumer Price Index (CPI) year-on-year. Baseline explicitly excludes any ERP-type business support and stimulus expenditure.
4. **Net Debt Rule**: net debt should not exceed a soft cap of 55 per cent of Gross Domestic Product (GDP), and cannot exceed a hard cap of 65 per cent of GDP.

Given the severe depth of the recession, the net debt rule has been modified most from the existing MTFS in order to allow Government to access the funds needed to support and stimulate the economy. As debt is a stock variable, this will take time to come back within the rules – as both GDP is lower and debt is higher. Much of this space has already been taken up with the large increase in debt over the 18 months of the pandemic. The remaining space in this rule, provides the ability for the Government to respond with more support and stimulus to guide the recovery.

Due to the nature of debt being a collection of previous decisions, while the economy still requires support the primary fiscal rule is considered to be the Cash Reserves Rule. This ensures that government can always pay its bills such as the wages of staff, and has some buffer in place for unforeseen circumstances (see Figure 3). Without access to emergency cash reserves from a central bank or the International Monetary Fund, a cash liquidity crisis in the Cook Islands would be devastating There is a further look at the cash balances from the 2021/22 Budget in the Appendix and how it interacts with planned capital expenditure in particular.

Over the Medium-term it is anticipated that the primacy of debt as the Fiscal Anchor will return once circumstances allow (and will be reviewed in detail as part of the scheduled update before the 2024/25 Budget). Current expectations are for the Operating Expenditure Rule to be achieved across all forward

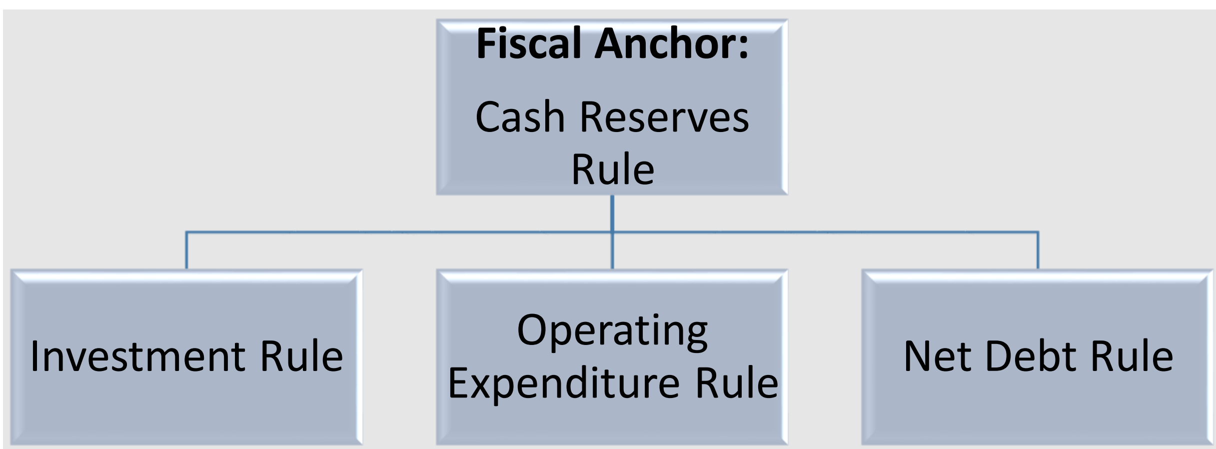
[5] Operating expenditure is defined as total government expenditure, excluding that on capital investment and loan repayment principle amounts.

years and the adjustment to this rule provides some balance between the need to exercise fiscal restraint, but provide fiscal support for the economy as needed.

The Investment Rule takes an approach which is modified from the so-called "Golden Rule" approach, where new borrowing is only available for capital investment. The rule used for the Cook Islands has this only come into place once the debt to GDP ratio exceeds 55 per cent of GDP – which enables the government to undertake stimulus expenditure to support the economy along the road to recovery. A similar fiscal rule is in place in Montenegro, where once a threshold of debt to GDP is breached, any additional borrowing must be for capital investment and reported on in more detail[6]

The Net Debt Rule and the Operating Expenditure Rule together provide the ability for Government to support investment in capital and infrastructure to both stimulate the economy on the path to recovery, and to expand the productive capacity of the Cook Islands. This ensures that 'business as usual' spending is limited in growth, but the Government retains the ability to support the economy when it is appropriate to do so. The change in parameters for the Net Debt Rule has been informed by a range of internationally-utilised fiscal rules, which set net debt to GDP limits around 60 per cent of GDP (such as the Maastricht criteria in the European Union). Recognising the additional uncertainty and economic headwinds currently facing the Cook Islands, an additional buffer of five per cent is appropriate – to guard against unforeseen events (such as further outbreaks, or a natural disaster).

Figure 3 New MTFS rule structure



The Fiscal Balance Rule while no longer considered a rule will still be used as a guide (as are the personnel ratio, requirement to spend cash, cyclically-adjusted balance and stabilisation account). This decision has been made with the understanding that the fiscal balance and net debt rules are closely linked (with new debt being used to fund fiscal deficits).

Along with this movement of the Fiscal Balance Rule, a new guideline is created around Debt Servicing, to reflect the risks associated with the increased level of debt which has been taken on to support the economy. This guideline limits the amount of expenditure on debt servicing as a proportion of total expenditure. In the current low interest rate environment, the largest component of debt servicing is the

[6] IMF, 2017, *Fiscal Rules at a Glance*

principal on the loans, which is not considered operating expenditure – and as such is not captured by the Operating Expenditure Rule. Adding this guideline ensures that debt servicing is explicitly considered.

Debt Servicing ratio – expenditure on debt servicing no more than a soft cap of 10 per cent of total government revenue, and a hard cap of 15 per cent of total revenue. The 10 per cent rule has been modelled on the benchmark used by the Christchurch City Council, and as a guideline is not binding, but provides a very useful signpost when the debt service burden is becoming high.

Debt "Headroom"

One of the eight ERR work streams is the need for infrastructure investment to stimulate the economy and in the current environment, much (if not all) of this investment needs to be financed through borrowing. This means there is significant interest in the amount of potential new borrowing to fund this between the current (2021/22 Budget) level of debt and the 65 per cent limit.

Table 1 shows that, based on the forecasts from the 2021-22 Budget, if Government were to borrow to the extent of the 65 per cent of GDP limit, this would provide room for approximately $160 million (in aggregate) in borrowing by 2024-25[7]. However, this should not be seen as endorsing borrowing this much without considerable further investigation – as this depends on the ability to service the debt, as well as how that debt is used.

Table 1: Potential debt headroom under 65% of GDP rule ($ million)

	2021-22	2022-23	2023-24	2024-25
Nominal GDP forecast	431.34	491.97	528.04	555.48
Debt at 65% of GDP	280.37	319.78	343.23	361.06
Debt net of LRF as at 2021-22 Budget	243.59	235.14	220.09	199.07
Debt headroom ($m)	**36.78**	**84.64**	**123.13**	**161.99**

Table 1 shows the amount of new debt the Cook Islands could theoretically take on over the forward estimates, under the 65 per cent Net Debt Rule (using 2021/22 Budget GDP forecasts). The 2021-22 Budget has a number of key capital projects as yet unfunded, which results in projections of cash balances going negative in the outer forward years. The need to fund these projects means that a portion of the debt headroom shown in Table 1 is already committed to projects – the details of the debt is just not yet known. This needs to be accounted for as shown in Table 2. Once taken into account, there is still approximately $75 million available to Government over the forward estimates period.

Table 2: Uncommitted debt headroom ($ million)

	2021-22	2022-23	2023-24	2024-25
General Cash as at 2021-22 Budget	19.82	-16.93	-44.77	-66.66
Emergency cash level	20.00	20.00	20.00	20.00
Debt headroom 'pre-committed'	0.18	36.93	64.77	86.66
Uncommitted debt headroom	**36.59**	**47.71**	**58.36**	**75.33**

[7] Assuming no impact on GDP of the additional borrowing, which is unlikely

Medium-term Expenditure Ceilings

The Government determines an aggregate medium-term expenditure profile, effectively a budget ceiling, consistent with the fiscal rules and the economic context as at the time of publication of the Budget Policy Statement, which is released in the MTFS in the Half-Year Economic and Fiscal Update in December each year.

In determining the recommended expenditure profile for the MTFS, two fiscal space measures are considered in addition to the fiscal rules:

- the structural deficit ceiling approach, which estimates the difference between the structural fiscal balance and nominal fiscal balance, and
- the cyclically adjusted balance method, which accounts for the effects of business cycle fluctuations on revenue and expenditure.

The Government adopts a budget ceiling that provides a fiscally responsible level of fiscal space, while acknowledging the investment needs of the country and the need to utilise fiscal policy to stimulate GDP.

The impact of the COVID-19 recession has meant that the binding nature of the MTECs has been temporarily suspended to enable the support of the Economic Response Plan (ERP) and the necessary stimulus in the form of capital investment to support recovery through the Economic Recovery Roadmap (ERR). However, this does not mean that the Government is departing from the commitment to fiscal responsibility. Any departures from the MTECs are focused solely on recovery.

This departure is in line with one of the stated aims of the MTFS: to provide counter-cyclical support to the Cook Islands economy. Discussions are currently taking place with funding partners on the source of funds for projected capital projects, which may affect the expenditure forecasts in the outer years.

Government has focused on the prioritisation of core services and outputs within the limits of the fiscal space as set in the MTFS published in the 2020/21 Budget Policy Statement. This has required Government to transfer funding between agencies and programmes to support necessary expenditure. Funding for new programs has been prioritised against the need for agencies to focus on the delivery of core services to the community, and the need for Government to provide economic support to households and businesses. Government remains committed to providing a social safety net for the most vulnerable in our society, which includes maintaining the current public payments for pensioners and children. This has resulted in new expenditure limited to only those projects with a clear demonstration of short-term benefits exceeding the costs while both the economy and fiscal position is in recovery.

The government-wide salary increases will remain on hold until the economic conditions improve and the resulting fiscal balances have stabilised. The relationship between GDP per capita as a measure of income levels and average wages and salaries is key. Once GDP per capita returns to levels seen before the pandemic, then broad salary increases can be reconsidered across the public sector. This decision defers an approximate $6.0 million (as at 19/20 budget) cumulative increase in Government expenditure in each forward year.

Reserve Funds

With a view to improving the fiscal resilience of the Cook Islands against economic shocks and natural disasters, and collecting revenues from seabed minerals harvesting for future generations, the

Government has established the Stabilisation Account, and intends to establish a second reserve fund under the MTFS as and when conditions allow.

Stabilisation Account

The Stabilisation Account was created in the 2019/20 Budget using $56.7 million of the $106.7 million unencumbered cash as at 1 July 2019.

The Stabilisation Account is designed to hold excess cash. It can be used to make additional debt repayments in periods of strong economic growth, or to cover operational and capital expenditure during periods of economic contraction, defined as growth less than 1 per cent per year.

The account was drawn down to support Government's fiscal capacity during 2020/21 as the triggers for drawdown from the account were met. Fiscal forecasts indicate that Government will operate with fiscal deficits or small fiscal surpluses in the forward years, and as a result, the Stabilisation Account is unlikely to be replenished in the near-term.

Sovereign Wealth Fund

The Sovereign Wealth Fund will capture the revenues expected in the future from seabed minerals harvesting with the intention for these funds to be set aside for use by future generations. The fund is being scoped and will be established in concert with the development of the seabed minerals sector.