2024

MEDIUM-TERM FISCAL FRAMEWORK

2024 UPDATE

MINISTRY OF FINANCE & ECONOMIC MANAGEMENT, COOK ISLANDS

Medium-term Fiscal Framework Update

This paper presents an update to the Cook Islands Government's Medium-term Fiscal Framework (MTFF) Update as described in the *2024/25 Budget Estimates – Book 1*.

The Cook Islands Government exercised the Exit Clause from the Medium-Term Fiscal Strategy 2019/20 – 22/23 in accordance with the MFEM Act 1995/96 Section 23(4) to enable its fiscal response to the COVID-19 pandemic. The Exit Clause was kept in use until the end of the 2022/23 fiscal year, where this ceased to be appropriate. This document provides guidelines for Government's commitment to assessing the fiscal rules as Cook Islands nominal Gross Domestic Product returns to pre-COVID levels.

Why produce this Update?

This MTFF update reconfirms the Government's commitment to sound fiscal and economic management, being implemented through the MTFS within the context of an economy in recovery following a severe global and domestic economic shock, and is fully consistent with the MTFS detailed in the *2023/24 Half-Year Economic and Fiscal Update*, which underpins the *2024/25 Budget Policy Statement*.

The MTFF updated in 2021 provided an appropriate set of interim fiscal rules that enabled Government to utilise debt funding to respond to the economic crisis. This set of rules 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. Given the fast-changing economic environment, the 2021 update included a commitment to revisit the MTFF when nominal GDP had recovered. This update upholds that commitment, and looks to set the appropriate fiscal rules for the medium-term.

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:

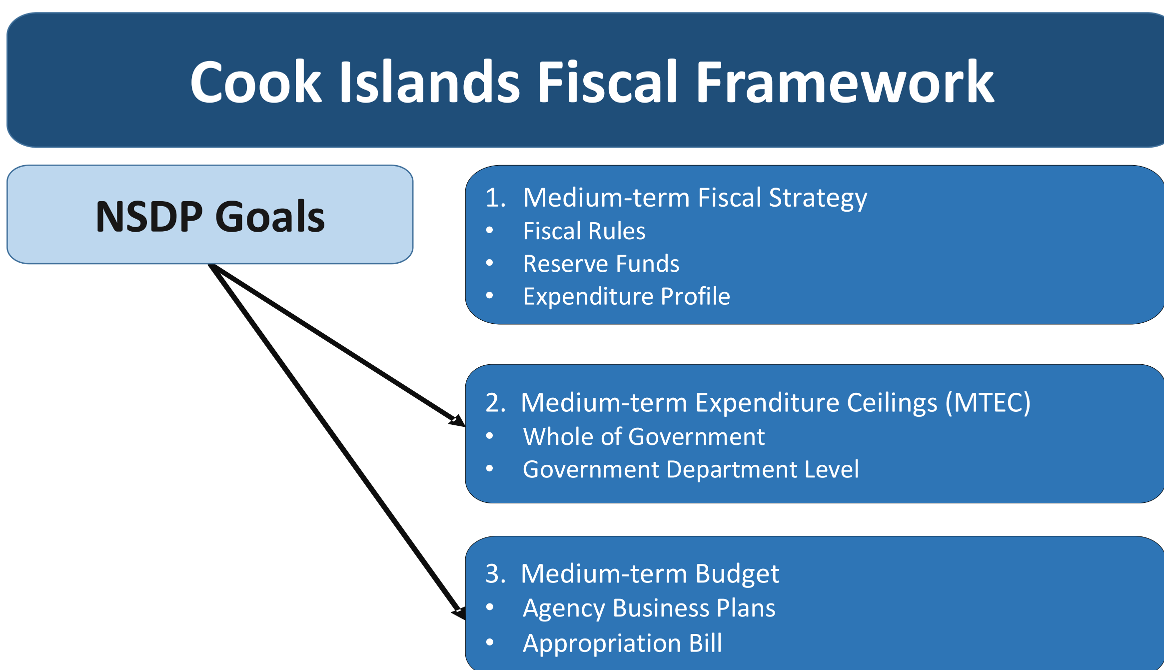
- improved long-term fiscal sustainability through responsible fiscal management and debt sustainability; and
- improved medium-term fiscal planning nationally, and within each agency.

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 Agenda 2020+ (NSDA) goals 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 updated in 2021 and aims to deliver fiscally sustainable budgets. This set of rules had a particular focus around the immediate economic recovery from the COVID-19 pandemic, which meant the previous rules were no longer appropriate. The overall Framework has been a very successful strategy, resulting in a strong fiscal position for the government when the COVID-19 pandemic hit in 2020, and a robust recovery in the fiscal position with borders re-opened in early 2022. 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 economic shock experienced by the Cook Islands related to the pandemic 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. This then led to defining a new set of rules, which have been in place for the period 2022/23 to 2024/25, and as the economy has returned close to pre-COVID levels (at least in nominal terms) these rules are being revisited again.

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

- Positioning the Cook Islands economy for robust and effective continued recovery from the economic shock.
- Providing support to vulnerable sectors of the community in response to increased financial pressures.
- Repairing fiscal buffers in a gradual and responsible manner, reflecting the broader economic situation.

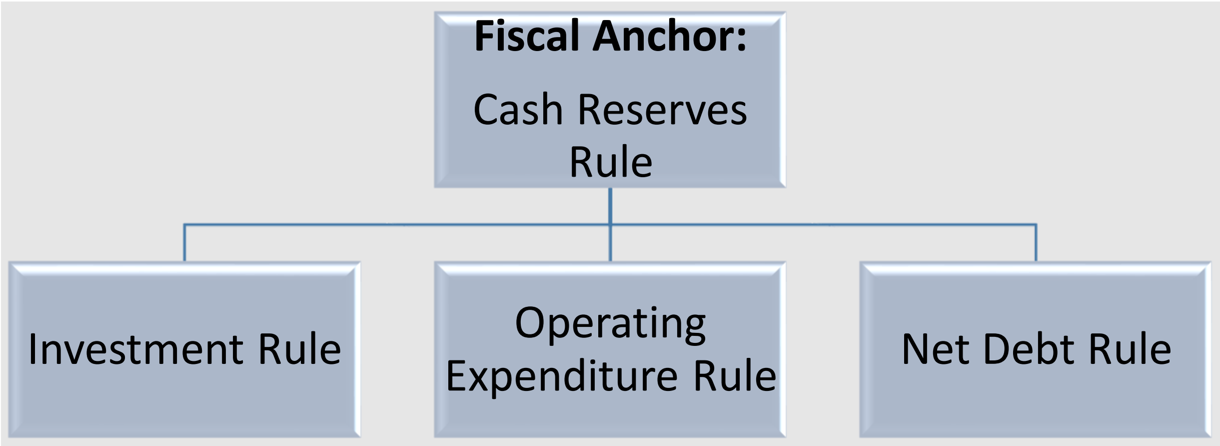
The short-term priority of the Economic Recovery Roadmap (ERR) remains a key guide in allocating funding, but Government accepts that the impacts of the pandemic will have some lasting effects on national development outcomes for many years to come. However, fiscal allocations against the goals of the NSDP/NSDA are still reported in the Budget to ensure continued monitoring.

With the overriding need for Government to support economic response and recovery having reduced over time, the importance of the National Sustainable Development Agenda 2020+ (NSDA) in prioritising expenditure will increase over the medium-term. This was reflected in the hosting of the Public Sector Leader's Conference (PSLC) in September 2023 for the first time since the pandemic.

Existing Fiscal Rules

The economic shock resulting from COVID-19 necessitated changes to the set of fiscal rules needed to reflect the changing needs of the economy. This was addressed in the Medium-Term Fiscal Framework Update in October 2021, which introduced the Fiscal Rules to guide the fiscal response to the economic recovery. These current fiscal rules have enabled government to utilise debt funding to strengthen its response to the economic crisis in order to implement the economic stimulus measures under the Economic Response Plan (ERP) and the Economic Recovery Roadmap (ERR). The rules are as follows.

Figure 2 Current MTFS rule structure



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[1] 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.

The October 2021 update also committed Government to reviewing these rules as the economy recovered, before the 2024/25 Budget, once nominal GDP had reached $520 million. With the latest GDP data showing this level has now been reached, and preparations for this Budget currently underway, the time has come to review the rules. This review starts from those existing rules, and proposes a set which are consistent with an economy which is out of the deepest parts of the recovery – but still a way from the pre-pandemic path.

The economic recovery has begun to take hold, as seen during the 2022/23 fiscal year, and the first half of the 2023/24 fiscal year with visitors returning and businesses operating again. In line with Government commitments, we have taken this opportunity to review existing fiscal rules to determine whether they are still applicable to our current situation, or whether our changing economy requires the rules be amended.

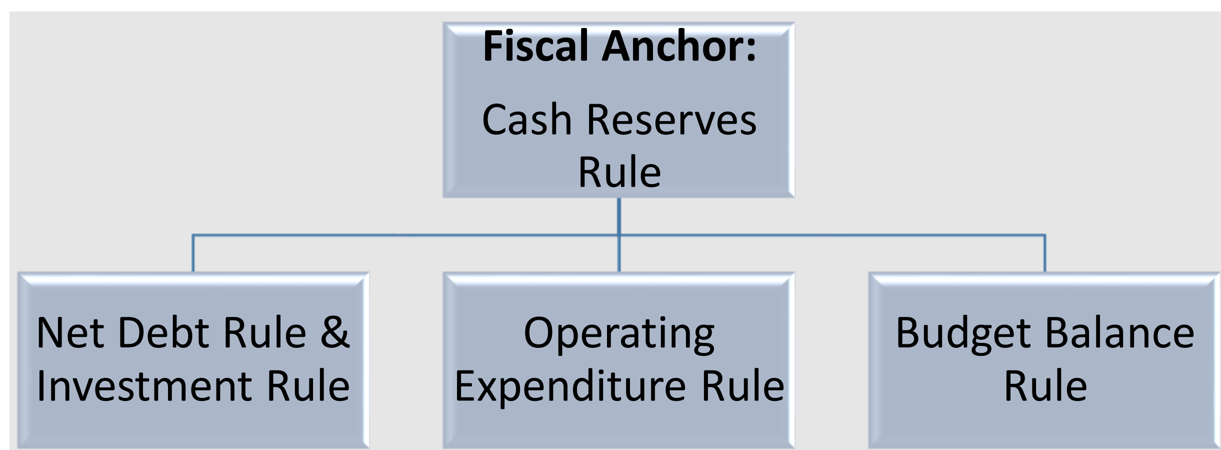
For further background on the Medium-Term Fiscal Strategy and the Medium-Term Fiscal Framework, please view the relevant papers on the MFEM website.

New Fiscal Rules

The proposed fiscal rules remain broadly similar to the existing rules, with two of the current rules being combined, and a new rule regarding the Budget Balance being introduced.

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

Figure 3 New MTFS rule structure



1. **Cash Reserves Rule** - the equivalent of 3 months of operating expenditure must be held in liquid assets at any one time.
   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.
   b. 70 per cent of excess cash balances (above three months of operating expenditure[2]) shall be placed into the Stabilisation Account in periods of strong economic growth. This transfer is to be done at the end of the fiscal year.

The government's priority is to meet immediate obligations while maintaining sufficient cash on hand due to the high fiscal vulnerabilities from the pandemic and to ensure prudency.

A key change to the existing rule is that 70 per cent of excess cash balances above three months of operating expenditure at the end of a fiscal year will be placed into the Stabilisation Account[3]. This gradual replenishment aims to prepare for the next 'rainy day' or future crisis. The remaining 30 per cent will be retained to mitigate risks and provide a year-end buffer for unforeseen circumstances. If the Stabilisation Account is replaced by another fund, such as a Sovereign Wealth Fund, the same rule will apply, in reference to the successor account.

This rule remains the Fiscal Anchor[4], prioritising sufficient cash for emergencies and shocks, while the Government seeks to reduce public debt in the short-term. As the 'dominant' fiscal rule, it takes precedence if other rules conflict.

It is expected that the fiscal anchor may change in the long-term, with a future review planned to assess its appropriateness compared to other rules in the evolving economic context. As a matter of practice, it is useful to review these rules regularly (every four years, typically) to ensure they remain appropriate. Examples of other countries/jurisdictions using a similar rule: Solomon Islands and Tonga have similar

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[2] Note that cash committed to capital projects will not be placed in the Stabilisation Account, as this is already committed, and merely subject to timing fluctuations.
[3] Explanatory note on Stabilisation Account https://www.mfem.gov.ck/the-national-budget - 2019/20-2022/23 Budget Book 1
[4] Building Fiscal Buffers to Enhance Resilience: The Role of Fiscal Anchors https://www.elibrary.imf.org/display/book/9781513507521/ch010.xml

rules around preserving an amount of cash reserves for operating expenditure, while other nations in the Pacific have alternative backstops such as sovereign wealth funds, development partner support and a central bank which may act as a lender of last resort.

2. **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 65 per cent of GDP.
    a. **Investment Rule** – this is a subset of the Net Debt Rule whereby the government shall commit any additional borrowing above 55 per cent of GDP for capital investment and/or targeted GDP stimulus purposes.
        i. Within the Investment Rule, all capital investment using additional debt must undergo value analysis, such as Net Present Value calculations or Cost-Benefit analysis, as appropriate for the project. This requirement also applied to one-off events, costing over $100,000 (see guidelines).

The Net Debt Rule and the Investment Rule remain mostly unchanged, except for the new requirement of value analysis for capital investments requiring debt financing. This analysis must demonstrate positive value for projects involving additional government debt. While it may be tempting to reduce the ratios under this rule, it is deemed necessary due to other fiscal rules. Keeping the existing ratios allows the government to manage its debt portfolio flexibly and responsibly address investment needs over the medium-term.

This rule was the Fiscal Anchor from 2018 to 2021 and continues to be crucial for managing government's debt levels. it ensures that debt servicing remains manageable, preventing excessing strain on government resources. Maintaining creditor confidence is also vital, as a loss of confidence could lead to less favourable lending terms for the Cook Islands.

At current debt levels, there is considerable debt headroom available, with projected net debt levels of 30.0 per cent by the end of 2024/25 based on the 2024/25 Budget estimates. However, this capacity is partially constrained by other fiscal rules, particularly the Operating Expenditure Rule. If not for these constraints, staying under the 65 per cent threshold would allow for an additional $225.1 million in debt in 2024/25 (or $160.7 million under 55 per cent). In reality, the government is unlikely to approach these debt limits

Example of other countries/jurisdictions using a similar rule: Cyprus, Grenada, Ireland, Peru, Slovenia, St Kitts & Nevis, Sweden and more.

3. **Operating Expenditure Rule** - baseline budgeted operating expenditure cannot grow by more than the greater of 2 per cent or long term (5 years of non-pandemic impacted growth) nominal GDP growth[5].

During this period of economic recovery, the Operating Expenditure Rule will continue with restrictions, now based on long-term nominal GDP growth rather than year-on-year Consumer Price Index (CPI). The government's focus is promoting sustainable economic growth, aligning the rule with GDP to provide a clearer picture of the economy's growth and fiscal capacity. Linking the rule to income levels (as measured by GDP) will constrain expenditure growth to match income growth, thereby limiting operating expenditure rule expansion during periods of increasing fiscal expenditure. This reverts to a similar rule from the MTFF published in 2018.

[5] For practicality, this rate will be to the nearest half percentage point, rounded down. That is, if long-term nominal GDP growth is 4.1%, the cap on growth will be 4.0%.

Examples of other countries/jurisdictions using a similar rule: Costa Rica, Ecuador, Grenada, Iceland, Spain, Romania

Technical Note: GDP Growth calculation

For clarity, it is useful here to describe how the 'long-term nominal GDP growth' is calculated.

5 years average growth is calculated using a compound growth formula:

$$Growth\,rate = \left(\frac{Year\ 5\ nominal\ GDP}{Year\ 0\ nominal\ GDP}\right)^{\frac{1}{5}} - 1$$

Where years involved are fiscal years (July to June), and pandemic-affected years are considered to be from 2019/20 to 2023/24, inclusive – with both the large negative and large positive growth rates in these years leading to distortions.

*Baseline explicitly excludes any ERP-type business support and stimulus expenditure.

4. Budget Balance Rule – the fiscal balance may not exceed a deficit of 2.0 per cent of nominal GDP

Fiscal deficits may be required from time to time, primarily to invest in important capital projects, but the level of these deficits must be financed by either depleting cash resources or taking on additional debt. The reintroduction of the Budget Balance Rule with a deficit cap of 2.0 per cent of nominal GDP balances government's need to borrow with the goal of maintain fiscal discipline and sustainability by preventing unsustainable levels of government borrowing.

This rule is a key mechanism to allow government to invest in important infrastructure through running small deficits, but requiring overall fiscal restraint. Variations on this rule are some of the most commonly used Fiscal Rules around the world, as they are simple and effective in maintaining responsibility. A limit of 2.0 per cent of GDP currently reflects a fiscal deficit of just over $10 million, which (under circumstances with responsible debt management and operation of the other fiscal rules) does not threaten fiscal sustainability.

Examples of other countries/jurisdictions using a similar rule: Germany, Bahamas, Armenia, Latvia, Romania, Vietnam and more.

Guidelines

To help support the Fiscal Rules described above, three guidelines are used as well. These do not carry the weight of the Rules, and do not necessarily constrain Government, however are used to inform fiscal policy and decisions made.

1. **Capital Expenditure** - Overall capital expenditure (including donor-funded) should not fall below 5 per cent of GDP, nor should it rise above 7 per cent of GDP. Within this CIG-funded capital expenditure should not exceed 4 per cent of GDP per year on average over the forward estimates.

The purpose of this guideline is to balance the need to ensure sufficient levels of capital investment are undertaken, with some guidance on how to allocate any fiscal space which arises under the Fiscal Rules.

2. **Debt Servicing –** Debt servicing (interest and principal) should be kept below 10 per cent of total revenue.

This guideline is used in conjunction with the Net Debt rule to consider not just the level of debt, but the burden imposed by servicing that debt. In striving to keep debt servicing below 10 per cent of revenue, this limits the share of total resources which are taken up by servicing debt.

3. **Personnel to Total Revenue –** Total personnel expenditure across Government should not exceed 40 per cent of total revenues.

This guideline prevents unstainable growth in government size, drawing from previous fiscal rules (the 'Manila ratios').

4. **One-off events –** Any event costing over $100,000, requires a cost-benefit analysis before government participation. Events may include hosting events, or sending teams and delegations to those events abroad.

This guideline ensures informed decisions on hosting events, optimising the use of resources involved in hosting events, while managing competing fiscal priorities. These analyses should be conducted alongside (or in addition to) the requirements of the Tarai Vaka Process (TVP) for a full proposal to be developed.

Together these guidelines aid fiscal management and help prioritise spending within the framework governed by the Fiscal Rules.

Box: One-off Event Analysis

What are we trying to achieve with this guideline?

Given limited resources, we cannot afford to host every event which may be of interest – considering both financial limitations and human resources. Therefore, conducting thorough analysis is crucial to prioritise events effectively, making informed decisions on which events to host and their scale. This analysis should consider a wide range of benefits and costs involved to provide the best possible information for a decision.

Why is the threshold for analysis $100,000 in estimated costs?

It is reasonable to consider applying an additional scoping requirement to all events, regardless of size, given finite government resources. Setting a threshold based on event size helps manage these resources effectively amidst numerous upcoming events.

By choosing a threshold of $100,000, this ensures that significant national events like Te Maeva Nui and the Cook Islands Games undergo analysis to help determine their appropriate scale. For such events, the focus shifts from deciding whether to hold them to determining their optimal size. The threshold also applies to larger potential events such as hosting the Pacific Islands Forum Leader's Meeting.

Events below this threshold, like the biannual Island Government Mayors' forum, are exempt from analysis as it would not be the best use of resources. The forum serves an administrative purpose, not requiring extensive evaluation.

The Economic Planning Division can assist in the preparation of these analyses, to ensure consistency and provide guidance to agencies involved.

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 meant that the binding nature of the MTECs was 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). This temporary departure was an example of the operation of the Exit Clause, and ceased to be in operation after the 2022/23 fiscal year.

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.

While the economy is recovering fairly rapidly in nominal terms, the fiscal environment remains very constrained. In this environment, 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 2024/25 Budget Policy Statement (and its previous year versions). 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 make key investments which provide support to households and businesses. Government remains committed to providing a social safety net for the most vulnerable in our society, which includes recent increases to Carer and Destitute Payments. This has resulted in new expenditure limited to only to the highest priority projects.

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 one-off revenue sources including potential 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.

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.