



Australian Government

Department of Finance and Deregulation



Australian Government

The Treasury

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## BUDGET TREATMENT OF FUTURE FUND COSTS IN THE AUSTRALIAN GOVERNMENT BUDGET AND FINANCIAL DOCUMENTS

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### Background

In the 2012-13 Budget, the Government announced that it would review the budget treatment of the Future Fund and asked the Department of Finance and Deregulation and the Department of the Treasury to consult with stakeholders on this issue. This paper has been produced to facilitate consultation by examining the current budget treatment of the Future Fund's costs and discussing potential alternatives and their effects on the Government's underlying cash balance<sup>1</sup>. The paper and the outcomes of consultations will be put to the Government for consideration in the lead up to the 2012-13 Mid-Year Economic and Fiscal Outlook.

The Future Fund's earnings have been excluded from the underlying cash balance since its establishment in 2006. This was on the basis that Future Fund earnings, while accounted for as Government receipts, are not available for recurrent spending but are instead quarantined and reinvested to meet the Government's future public sector superannuation liabilities. When the Future Fund was established in the 2005-06 Budget, the following rationale was provided:

*“Expected Future Fund earnings are excluded from the underlying cash balance. This recognises that these resources are not available for recurrent spending, instead being pre-committed to fund existing liabilities. This represents a tightening of fiscal policy”.*<sup>2</sup>

In implementing this change to the fiscal strategy, gross earnings have to date been excluded from the calculation of the underlying cash balance, while the costs of the Future Fund have been included. However, gross earnings do not reflect the amount available for reinvestment as all of the Future Fund's operating costs are paid from its earnings, as required under the *Future Fund Act 2006*.

Over the first few years of its operation, Future Fund costs had a relatively small impact on the underlying cash balance so their treatment was not a material issue. However, in recent years, Future Fund costs have grown as the Future Fund has invested in more complex financial assets with higher investment management fees (including performance fees) in line with its long-term strategy.

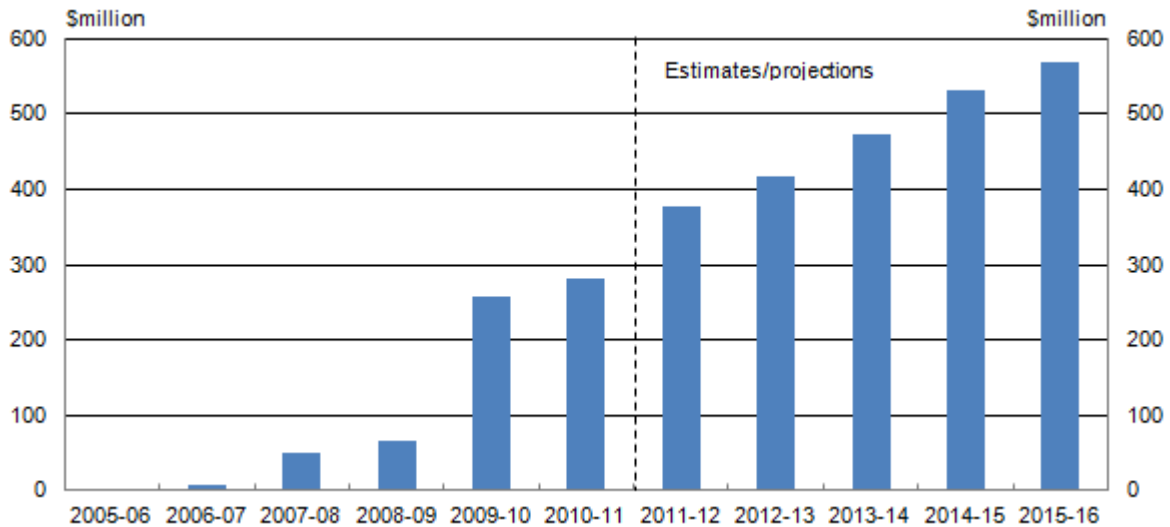
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<sup>1</sup> The underlying cash balance is the Government Finance Statistics cash aggregate with the Future Fund earnings removed. It is a measure showing whether the Government has borrowed from financial markets to finance its activities (a budget deficit) or if it is accumulating additional cash reserves (a budget surplus). The underlying cash balance is the Government's primary fiscal aggregate, reflecting the Government's spending balance in cash terms.

<sup>2</sup> 2005-06 Budget Paper No. 1, ref. 1-3

For example, in the first full year of operation (2006-07), Future Fund assets were primarily held in term deposits and Telstra shares and investment costs were therefore relatively low at \$8 million. By 2009-10, the Future Fund had built up its exposure in Australia and internationally to equities, tangible assets, such as property and infrastructure, debt securities and alternative assets, which attract higher investment management fees. Costs rose to \$257 million in 2009-10, and are projected to increase to \$417 million in 2012-13 and to \$568 million by 2015-16. At the Future Fund's current asset level of \$77 billion (as at 31 March 2012), current annual costs represent 0.5% of funds under management.

### Future Fund Costs, 2005-06 to 2015-16



Given the growing materiality of the Future Fund's costs and the effect they are having on the underlying cash balance calculation, the Government considers it is an appropriate time to review the budget treatment of these costs.

It should be noted that there are no international standards for the budget treatment of entities such as the Future Fund and comparisons between funds are difficult to make because of the different functions of the funds and the different accounting treatments applied in each country. As such, there are no accounting principles defined under the ABS Government Financial Statistics (GFS) or Australian Accounting Standards (AAS) that support a particular budget treatment of Fund earnings with respect to the underlying cash balance. Additionally, there are no particular obligations under the *Charter of Budget Honesty Act 1998* relating to the Future Fund's budget treatment.

## The Appropriate Budget Treatment of Future Fund Costs

Since, under the *Future Fund Act 2006*, the Future Fund is required to meet its operating costs from its earnings, only the Future Fund's net earnings are available for reinvestment to meet the Government's future superannuation costs. Given the aim of the original budget treatment was to exclude from the primary measure of the fiscal position those funds pre-committed to meet future superannuation costs, there is a strong conceptual basis for excluding the Future Fund's net earnings rather than gross earnings from the calculation of the underlying cash balance.

By comparison, retaining the current budget treatment by continuing to include Future Fund operating costs in the underlying cash balance means that the Government may be required to operate a very slightly tighter fiscal policy to meet a given set of fiscal policy goals (such as achieving a budget surplus over the medium term) than would otherwise be the case.

The tables below show the budget impact of this option.

**Table 1: Budget impact of the exclusion of net Future Fund earnings from the underlying cash balance**

	2012-13 (\$m)	2013-14 (\$m)	2014-15 (\$m)	2015-16 (\$m)
Underlying cash balance as at 2012-13 Budget	1,536	2,044	5,318	7,469
Future Fund Costs	417	472	531	568
Revised underlying cash balance	1,953	2,516	5,849	8,037

**Table 2: Underlying cash balance back casting from establishment of the Future Fund for exclusion of net earnings from the underlying cash balance**

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Change to underlying cash balance (\$m)	+0.4	+8.0	+50.5	+66.7	+504.3	+282.6	+377.7

A further argument to exclude Future Fund costs from the underlying cash balance is that it is likely that some of the Future Fund's costs are already excluded. For example, if the Future Fund invested in an entity that pays performance fees to managers before returning proceeds to its shareholders, then these costs would be excluded from the underlying cash balance. If, however, the Future Fund pays the performance fees directly, then this cost would be included in the underlying cash balance. Both of these costs should be classified in the same way.

### *Alternative approach*

If simply achieving consistency between Future Fund costs and earnings was a goal, then an alternative to excluding costs would be to include (for the first time) Future Fund earnings in the calculation of the underlying cash balance. However, this approach would, for a given

fiscal strategy, allow a government to spend the equivalent of the earnings of the Future Fund for other recurrent purposes, which would be contrary to the purpose of the Future Fund - which is to meet the Government's future superannuation liabilities. As a result, such a change may mislead the community about the amount of cash available to manage the Government's current spending priorities.

#### *Monitoring of Future Fund Expenses*

Should the decision be taken to remove the Future Fund's costs from the underlying cash balance, there would be continued transparency and accountability with respect to the monitoring and benchmarking of these costs. Future Fund costs would continue to be reported within the Portfolio Budget Statement and Annual Report financial statements.

### **The Treatment of Future Fund Earnings Post-2020**

The *Future Fund Act 2006* stipulates that money may not be withdrawn from the Future Fund until 1 July 2020 unless the balance exceeds the target asset level, which is broadly equivalent to the amount of the Commonwealth's superannuation liability. The year 2020 was chosen as this was the point by which, according to the Government's 2002 Intergenerational Report, the Commonwealth Government's finances were expected to be significantly affected by the costs of an ageing population. After 2020, the assets of the Future Fund can only be drawn upon to meet the unfunded superannuation liability in a particular financial year.

Once payments are made from the Future Fund, the earnings and future costs of the Future Fund will be included in the underlying cash balance, as the annual drawdown of the Future Fund will be used to meet recurrent superannuation costs each year (already included in the underlying cash balance).

## **Summary**

The Government announced in the 2012-13 Budget that it would review the impact of the Future Fund's budget treatment on the underlying cash balance. This is timely given the current size of the Future Fund costs and the impact they could potentially have on fiscal policy settings.

There is a strong conceptual basis for the exclusion of net rather than gross Future Fund earnings from the calculation of the underlying cash balance. However, it is important to note that there are no accounting principles guiding the budget treatment of the Future Fund. There are also no international standards for the budget treatment of entities such as the Future Fund.

The Department of Finance and Deregulation and the Department of the Treasury will consult with stakeholders on this issue and the options outlined in this paper. The Government will consider the future treatment of Future Fund costs prior to the 2012-13 Mid-Year Economic and Fiscal Outlook.

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## **Additional Information**

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### *Underlying Cash Balance*

At present, the underlying cash balance is defined as follows:

Net cash flows from operating activities  
*plus*  
Net cash flows from investments in non-financial assets  
*plus*  
Net acquisitions of assets acquired under finance leases and similar arrangements  
*equals*  
ABS GFS cash surplus/deficit  
*less*  
Future Fund earnings  
*equals*  
Underlying cash balance

The treatment outlined above would involve replacing 'Future Fund earnings' with 'Net Future Fund earnings', which would be defined as Future Fund earnings less costs. Government receipts and costs would continue to include, respectively, Future Fund earnings and costs.

### *Fiscal Balance*

The fiscal balance is the accrual counterpart to the underlying cash balance. It equals revenues less expenses less net capital investment. The fundamental distinction between cash and accrual approaches centres on timing – cash indicators record the transaction when cash is exchanged, whereas accrual indicators record a financial flow at the time economic value is created, transformed or exchanged. The transition to accrual budgeting was completed with the 1999-2000 Budget.

Future Fund earnings are included in the fiscal balance because superannuation expenses are recorded in the fiscal balance estimates at the time they are incurred, rather than at the time cash payments are made. The exclusion of Future Fund costs from the underlying cash balance would have no impact on the fiscal balance.