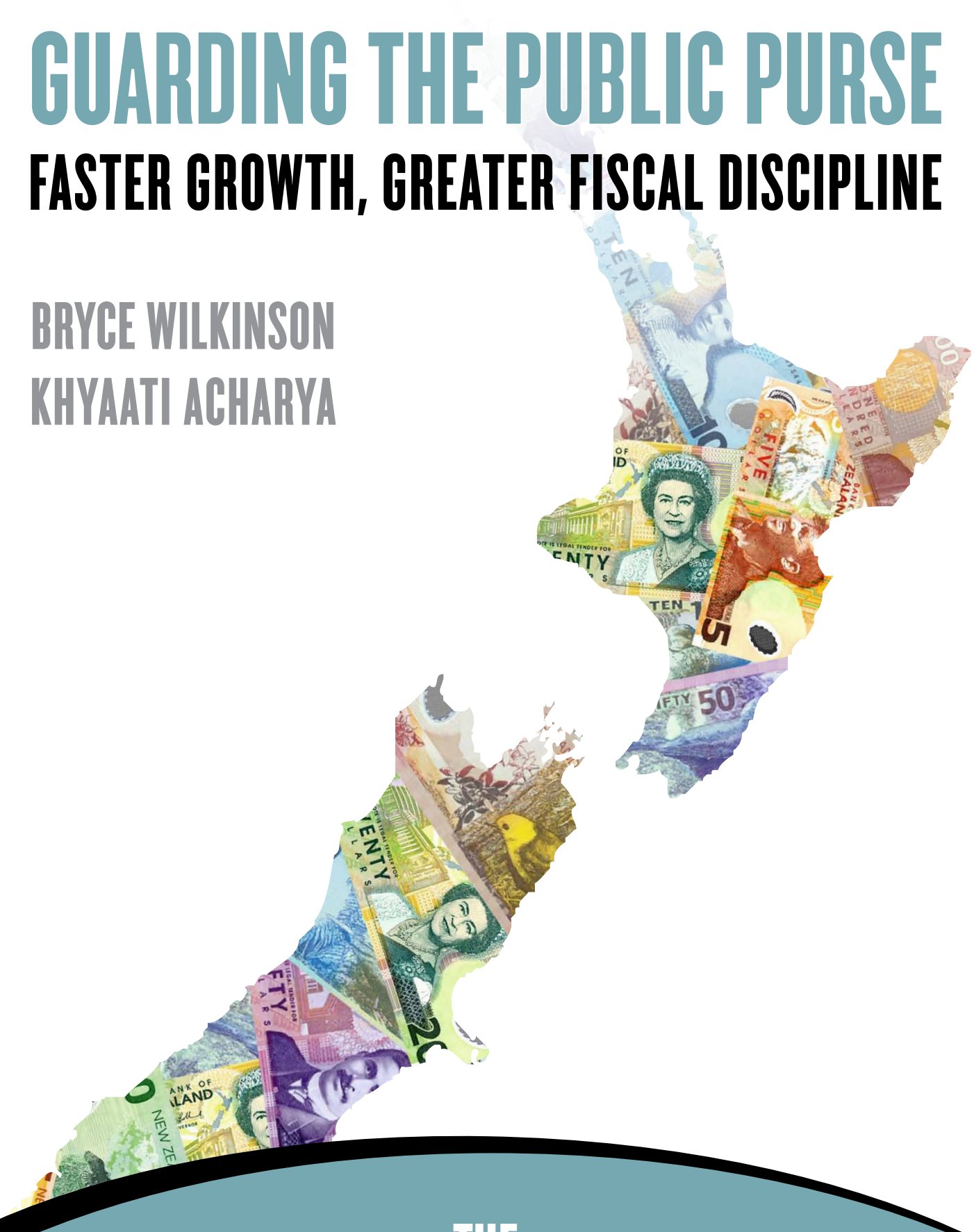
GUARDING THE PUBLIC PURSE

FASTER GROWTH, GREATER FISCAL DISCIPLINE

BRYCE WILKINSON
KHYAATI ACHARYA



THE NEW ZEALAND INITIATIVE

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2014

The New Zealand Initiative is an independent public policy think tank supported by chief executives of major New Zealand businesses. We believe in evidence-based policy and are committed to developing policies that work for all New Zealanders.

Our mission is to help build a better, stronger New Zealand. We are taking the initiative to promote a prosperous, free and fair society with a competitive, open and dynamic economy. We develop and contribute bold ideas that will have a profound, positive, long-term impact.

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ABOUT THE AUTHORS

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KEY POINTS

- Projections of an ageing population are robust on the basis of current trends. On one classification, New Zealand's population is already aged in that the proportion of people aged 65+ already exceeds 14%. It could become hyper-aged in the 2030s, when it is projected to exceed 21%.
- This has significant implications for voting proportions, government spending, and tax burdens:
  - Based on 2011 general election voting turnout records and Statistics New Zealand's (SNZ) median scenario projections, the population aged 60+ will comprise 37.6% of those eligible to vote in 2053–54, and could account for 50.2% of those actually voting.
  - Government spending on social welfare, including health and education, is projected to rise from 24.6% to 28.2% of Gross Domestic Product (GDP) between 2011 and 2061, due to ageing alone, with the peak effect occurring around 2040.
  - The number of dependent persons (under 15 or over 64) per 100 people of working age (15-64) is projected to rise by 44% from 50 in 2010 to 72 in 2060.
- Unlike in many Organisation for Economic Co-operation and Development (OECD) countries, New Zealand's projected long-term fiscal challenges arise primarily from demographic and health care cost factors rather than from the burden of existing debt.
- If government spending rises in line with historical growth rates but tax revenue is capped at 29% of GDP, New Zealand will experience an unsustainable public debt spiral well before 2060. On Treasury's projections, an average annual operating balance surplus (excluding net interest costs) of 1.7% of GDP between 2015 and 2060 could keep net public debt down to 20% of GDP. That represents a turnaround of 2.7% of GDP from its debt spiral projection.
- Options Treasury raises for dealing with the challenges include raising Goods & Services Tax (GST), lowering tax thresholds, cutting the growth in health spending, and raising the age of eligibility for New Zealand Superannuation (NZS) to 67 and linking it to the Consumer Price Index (CPI) rather than to wages.
- In this report, we illustrate how materially faster economy-wide rates of productivity growth can make the costs of an ageing population much more affordable.
- The normative criteria of liberty and efficiency favour focusing government non-transfer spending on public goods rather than on private goods. A flatter tax scale is more efficient than a more progressive one – and arguably more equitable. Such policies would lift productivity.
- Weaknesses in current fiscal arrangements make it politically difficult for governments to address projected ageing problems adequately, or to prevent future spending blowouts of the sort that occurred between 2004 and 2009.
- We propose adding a tax and/or spending limit rule to New Zealand's fiscal rules in order to make it harder for future governments to increase ill-justified government spending during periods of burgeoning tax revenues. Thirteen OECD member countries have at least one such rule.
- We also propose creating a new fiscal transparency agency that would report directly to Parliament and the public on fiscal issues, as does Australia's Parliamentary Budget Office.

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EXECUTIVE SUMMARY

Treasury's uncontentious central message in its 2013 *Affording Our Future* fiscal projections is that New Zealand is not facing a fiscal crisis; however, an ageing population does confront us with the possible need to make fiscal decisions of a belt-tightening nature.

The number of dependent persons (under 15 or over 64) per 100 people of working age (15-64) is projected to rise by 44% from 50 in 2010 to 72 in 2060. Under current policies, government spending on social welfare, including health and education, is projected to rise from 24.6% to 28.2% of GDP between 2011 and 2061, due to ageing alone.

New Zealand does not stand out from many other OECD countries in these demographic respects. Moreover, its fiscal performance has been better than most with respect to deficits and debt.

Even so, the fiscal pressures for New Zealand are potentially substantial.

Treasury's projections indicate that an average annual operating balance surplus (excluding net interest costs) of 1.7% of GDP between 2015 and 2060 could keep net public debt down to 20% of GDP. However, if government spending increases at near historical rates, the same measure of fiscal balance could average -1% of GDP. The difference between these two scenarios potentially requires belt-tightening fiscal decisions amounting to 2.7% of GDP, or fractionally more than $2,100 per capita in 2013–14 dollars.

Treasury's debt spiral projections under the historical growth rate scenario look more plausible than the more dire projections made by the OECD and other overseas experts around 2010. Subsequent revisions to those estimates have put New Zealand's 2009/10 fiscal position in a more favourable light, and the following six consecutive budgets aimed at returning the accounts to a fiscal surplus by 2014–15 have made a big difference. Even so, Treasury's long-term projections may be too optimistic in that they assume a sustained economy-wide rate of growth in labour productivity of 1.5% p.a. under current policies.

The pressing issue Treasury raises is what to do to avoid a projected public debt spiral. Major fiscal decisions are needed to reduce future tax burdens and the growth in health and NZS spending. Options Treasury is proposing include raising GST, lowering tax thresholds, cutting the growth in health spending, and raising the age for NZS eligibility to 67 and linking it to the CPI rather than to wages.

Delaying such tough decisions will potentially make adjustment more difficult politically because of the increasing voting power of the elderly population, more of whom vote compared to other age groups. According to 2011 general election voting records and SNZ's median scenario projections, the population aged 60+ will comprise 37.6% of those eligible to vote, and 50.2% of those actually voting, by 2053–54.

On the other hand, precipitous action could be premature as New Zealand's fiscal path will not necessarily track the median scenario. More and less grim outcomes are also plausible and there is an option value in moving deliberately rather than urgently.

Sustained fiscal discipline is implausible under current fiscal arrangements. Budgets have been tight for the last six years, reflecting earlier fiscal indiscipline, but even the prospect of an incipient fiscal surplus saw spending increases in the 2014 Budget and promises of more spending by nearly all political parties during the 2014 general election campaign. A future government could easily return New Zealand to serious fiscal deficits in just a few years.

The question of how to head off projected fiscal imbalances is a normative one. Normative policy criteria include considerations of liberty, efficiency of outcomes, and fairness or equity. With respect to equity, policies that reflect compassion or fair play in the sense of equal treatment are easier to justify than policies based on envy or greed.

The criteria of liberty and efficiency favour focusing government non-transfer spending on public goods rather than on private goods. A flatter tax scale is better than a more progressive one since the efficiency costs of taxes rise in rough proportion to the square of the tax rate – and is also more consistent with compassion from an equity perspective. The benefit principle of taxation also carries weight where it can be efficiently applied.

Transfer spending not related to public goods or compassion is harder to justify given the costs to liberty and efficiency of the increased tax burdens, intrusive compliance investigations and the efforts people make to reduce their tax liabilities and/or make themselves more eligible for benefits. Yet government spending is dominated by welfare spending, including spending on monetary benefits and private medical and educational services. All the fiscal concerns raised by Treasury arise from the pressure that spending on these items puts on the tax base.

Whereas New Zealand's current progressive income tax structure and social welfare benefits system is commonly thought of as helping the poor at the expense of the rich, a plausible case can be made to the contrary that it benefits those in the middle at the expense of the rich and the poor compared to the redistribution that could be achieved with a flat tax structure.

Normative policy decisions need to be informed by objective research concerning the likely efficacy of policy options. Research indicates that:

- spending cuts in the past have dealt with peacetime fiscal problems more effectively than revenue increases;
- 'unproductive' government spending (e.g. transfer spending, which taxes people with one hand to pay them a benefit with the other) tends to reduce economic growth; and
- fiscal rules and institutions can increase the chances of sustained fiscal discipline.

Transfer payments to those on middle and higher incomes essentially displace self-provision through savings and insurance – while imposing the costs to liberty and efficiency mentioned above. There is plenty of scope in principle for reducing the degree to which transfer payments are funded through the tax system, while preserving a state safety net.

As seen in Singapore and Hong Kong, and indeed in the experience of New Zealand and other industrialised countries generally prior to the 1960s, it is technically and historically feasible to run an efficient, prosperous economy with vastly less government spending than New Zealanders have become accustomed to funding (and receiving). Indeed, Singapore is achieving some of the best health and educational outcomes in the world at a relatively modest cost in relation to income. Its contrasting approach to providing and funding health care is particularly instructive.

These positive and normative considerations point to the desirability of a greater focus on policies likely to raise productivity. Faster productivity growth makes everything more affordable. Lifting trend labour productivity growth from 1.5% pa to 2.0% pa in Treasury's spending-constrained projection model would suffice to fund all the growth in aggregate primary core Crown spending to 2060 that is projected in its debt spiral scenario within the 20% net public debt target without increasing tax revenues above 29% of GDP. New Zealanders would be far better off in 2060. For a start, GDP per capita would be 22% higher.

Such a focus on productivity growth for the benefit of current and future generations seems unlikely to emerge under current institutional arrangements. The proximate problem to overcome is the lack of political will. This in turn reflects the degree to which current fiscal arrangements facilitate ill-justified churning of national income through the tax system at the expense of wealth creation.

New Zealand's fiscal rules have important virtues, but they are weak in guarding against:

- failures to reduce poor quality spending (e.g. interest-free student loans) because of the power of narrow, self-serving constituencies;
- the impulse to increase spending during revenue upturns, simply because 'the money is there to spend';
- incentives to use 'bracket creep' from inflation to increase spending and revenue; and
- the lack of transparency about the quality of general election campaign spending promises, *ex ante* and *ex post*.

Strengthening New Zealand's fiscal rules to better guard against such tendencies could help public debate by requiring more transparency concerning the benefits and costs of fiscal decisions. In particular, we recommend a tax (preferably) or spending limit rule (or both) that makes it harder to increase government spending simply because the money is there to spend or because there is an incentive in the heat of a general election campaign to promise to spend someone else's money to buy votes from a special interest group. According to an OECD review conducted in 2010, 22 member countries had a budget balance and public debt rule, as does New Zealand, but New Zealand was not amongst the 13 of these countries that had an expenditure rule. Australia was amongst the only 4 of the 22 that had all four types of rule.

Independent of such a spending or revenue limit, the efficacy of existing and proposed spending programmes need better scrutiny. Our second primary recommendation is to establish an independent fiscal council to strengthen the effectiveness of fiscal rules through public monitoring and reporting. In the paper we list 42 fiscal institutions, of which 36 are classified as independent, in 26 countries. Australia's Parliamentary Budget Office is an example of an independent fiscal institution that is a parliamentary agency, as distinct from an agency of executive government.

The proposed New Zealand body would:

- be an office of Parliament to reduce its dependence on the Executive;
- monitor the Executive's compliance with fiscal responsibility principles;
- monitor Treasury's expenditure control and expenditure assessment procedures and functions;
- assess the degree to which the Executive has a credible programme for addressing identified fiscal pressures, such as those identified in Treasury's long-term fiscal projections;
- assess the performance of government agencies administering major government spending programmes in detecting and avoiding waste through lack of clarity about objectives, failure to adequately consider alternatives, poor administration, and diffuse accountability; and
- improve the servicing of Parliament's Finance and Expenditure Committee.

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CHAPTER ONE
INTRODUCTION

This report reviews Treasury's 2013 fiscal projections to 2060 and examines policy options for dealing with the challenges posed by those projections.

Chapter 2 summarises and evaluates Treasury's projections, drawing attention to the potential for greater productivity growth to alleviate fiscal pressures.

Chapter 3 briefly compares New Zealand's fiscal challenges with those faced by other developed countries.

Chapter 4 frames the subsequent discussion on how best to respond to New Zealand's fiscal challenges. It examines positive theories aimed at explaining why countries tax and spend as they do, and discusses the value judgments needed to form opinions on inducing future governments to achieve better outcomes for all New Zealanders.

Chapter 5 reviews fiscal policy options across six main spending categories, plus taxation. A common theme is the difficulty in achieving change when opposition from vested interests is entrenched. For example, it is far easier to identify what needs to be done to prevent the projected growth in government spending on superannuation and health than it is to provide politicians with a means to achieve effective change – and surviving politically.

Chapter 6 proposes generic institutional changes that might help politicians resist pressures to spend to excess in good times and encourage adopting policies that create unsustainable, open-ended future liabilities. The first part looks at the scope for improving New Zealand's 'fiscal constitution'. This constitution is centred on the rules in the *Public Finance Act 1989* governing the authority to spend and tax, covering budget processes, and imposing accountability and transparency provisions, particularly in relation to fiscal deficits and public debt sustainability. The second part looks at the option of creating an independent fiscal council to improve transparency and accountability for compliance with those fiscal rules.

Chapter 7 presents our main recommendations.

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CHAPTER TWO
TREASURY'S *AFFORDING OUR FUTURE* PROJECTIONS TO 2060

2.1 INTRODUCTION

The *Public Finance Act* requires Treasury to publish, at no more than four-yearly intervals, fiscal projections looking forward annually for at least 40 years. Treasury's latest publication in this series was *Affording Our Future* in 2013.

Sections 2.2 and 2.3 summarise the key demographic and economic drivers of Treasury's projected fiscal aggregates, respectively.

Section 2.4 summarises projected aggregate government spending in Treasury's two base case scenarios.

Section 2.5 summarises Treasury's main modelled policy options and their indicative effects.

Section 2.6 summaries Treasury's main conclusions in *Affording Our Future*.

Section 2.7 acknowledges the contribution of the 40+ supporting papers that underlay Treasury's main document.

Section 2.8 comments on this substantial body of work.

2.2 BASE CASE DEMOGRAPHIC PROJECTIONS DRIVING THE FISCAL PROJECTIONS

Treasury's projections in *Affording Our Future* are based on the median outcomes from SNZ's stochastic demographic projections to 2060. The median migration projection is for a net inflow of 12,000 persons p.a. The population grows slowly and ages markedly under these assumptions.[1]

Table 1 summarises the key projected demographic aggregates, and some average growth rates, at decadal intervals. The top segment of the table shows compound growth rates, the middle segment shows proportions (except for the last row), and the bottom segment shows numbers in years.

1 Jenesa Jeram examines SNZ's extensive demographic projections in housing in New Zealand in *Empty Nests, Crowded Houses: Building for an Ageing Population* (Wellington: The New Zealand Initiative, 2014).

Table 1: Base case projected demographic trends from SNZ's median stochastic projections

Decadal annual compounded growth rates	2010	2020	2030	2040	2050	2060
Population – 0–14		0.3%	0.2%	0.0%	0.1%	0.2%
Population – working-age (15–64)		0.4%	0.3%	0.4%	0.5%	0.1%
Population – 65+		3.4%	3.0%	1.5%	0.6%	1.2%
Population – total		0.9%	0.8%	0.6%	0.5%	0.4%
Population proportions						
Under 15	20.3%	19.1%	18.0%	17.0%	16.4%	16.1%
Working-age (15–64)	66.4%	63.7%	60.7%	59.8%	59.9%	58.1%
65+	13.3%	17.2%	21.3%	23.3%	23.7%	25.8%
Dependents per 100 of working-age	50	56	64	67	67	72
Growing longevity (years)						
Life expectancy at birth (M/F average)	81.2	83.2	85.0	86.6	88.1	89.3
Median age	35.8	36.9	38.9	40.9	42.0	43.0
Decadal increments – life expectancy		2.0	1.8	1.6	1.5	1.2
Decadal increments – median age		1.0	2.0	2.0	1.1	1.0

Source: Treasury's Long-Term Fiscal Model 2013, using SNZ's median demographic projections.

Key points include:

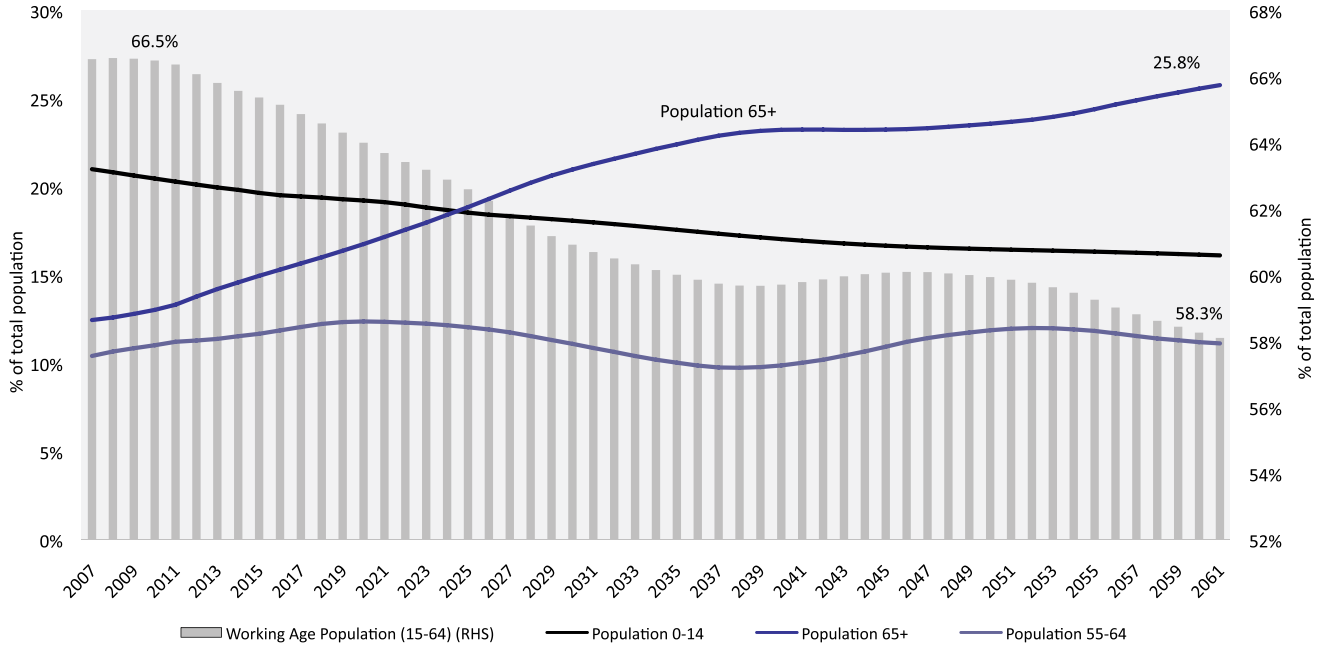
- the slowing of the average annual rate of total population growth from 0.9% p.a. in 2010–20 to 0.4% p.a. in 2050–60;
- the marked rise in projected life expectancy at birth from 81.2 years in 2010 to 89.3 years in 2060;
- the rise in the median age from 35.8 years in 2010 to 43 years in 2060;
- the sharp rise in the proportion of the 65+ population from 13.3% in 2010 to 25.8% in 2060;
- a drop of almost 25% (from 20.3% to 16.1%) between 2010 and 2060 in the proportion of the under 15 population; and
- a 44% rise in the number of dependent persons (under 15 or over 64) per 100 persons of working age (15–64) from 50 in 2010 to 72 in 2060.

The median age in Japan and Germany already exceeds the 43 years projected for New Zealand in 2060. New Zealand's 2010 median age of 35.8 years is roughly comparable to that for Australia, China and the United States, but far greater than in India (26 years).[2]

Figure 1 illustrates the 'scissor' movement changes in the proportions of young and old in the population, reducing the proportion of the 15–64 population. Note from the steep slope in the line for the 65+ population shows that its growth rate peaks before 2040.

2 See, for example, "List of countries by median age", *Wikipedia*, http://en.wikipedia.org/wiki/List_of_countries_by_median_age.

Figure 1: Proportions to total population



Source: Treasury's Long-Term Fiscal Model 2013, using SNZ's median demographic projections.

Sociologist Florian Coulmas, director of the German Institute for Japanese Studies in Tokyo and author of a book on population decline and ageing in Japan,[3] was cited in a report for the United Nations University, as classifying a society to be:

- ageing if 7–14% were 65+;
- aged if 14–21% were 65+; and
- hyper-aged if 21% or more were 65+.

These definitions imply that New Zealand is already an aged society, and will become hyper-aged in the early 2030s under the scenario projected above. In 2011, Russia (12.8%) and the United States (13.3%) were merely ageing, whereas Australia and Canada (14%); France, Spain, Switzerland and the United Kingdom (17%); and Sweden (19%) were aged. In 2011, Japan (23%) was already hyper-aged, and Germany and Italy (both 20.6%) were on the brink of being hyper-aged.[4]

2.3 BASE CASE ECONOMIC PROJECTIONS DRIVING FISCAL PROJECTIONS

Real GDP is the product of Treasury's projected hours worked and projected hourly labour productivity. Projected hours worked depends on demographic factors and additional assumptions about changes in average weekly hours, labour force participation rates, and the unemployment rate. In Treasury's base case projections, changing demographic proportions are critical drivers of fiscal pressures. Long-run projected hourly productivity growth is baldly assumed to be 1.5% p.a. in the base case. As will be seen, projected fiscal balances are markedly sensitive to this assumption.

3 See "Ageing societies", *The Wisdom Years: Ageing into the 21st Century*, World Health Organization and United Nations University, http://wisdom.unu.edu/en/ageing-societies/.

4 Jenesa Jeram, op. cit. Figure 1.

Projected inflation rates in the base case settle down at 2% p.a. Wage rates increase at a faster rate–the sum of the projected rates for inflation and productivity. Table 2 summarises the decadal average compound rates of growth in some of the major economic aggregates in the base case.

Table 2: Base case economic projections: Decadal annual compounded growth rates

Years ended June	2020	2030	2040	2050	2060
Quantity measures					
Real GDP	2.3%	2.3%	2.0%	2.0%	1.8%
Population	0.9%	0.8%	0.6%	0.5%	0.4%
Real GDP per capita	1.5%	1.5%	1.4%	1.5%	1.4%
Labour productivity (hourly)	1.0%	1.5%	1.5%	1.5%	1.5%
Employment	1.1%	0.8%	0.5%	0.5%	0.3%
Measures that incorporate inflation					
Nominal GDP	4.4%	4.4%	4.1%	4.0%	3.8%
GDP deflator	2.0%	2.0%	2.0%	2.0%	2.0%
CPI	2.1%	2.0%	2.0%	2.0%	2.0%
Hourly wage rate	2.9%	3.5%	3.5%	3.5%	3.5%

Source: Treasury's Long-Term Fiscal Model 2013, RHCG scenario. (See section 2.4.)

2.4 TWO FISCAL SCENARIOS

The fiscal projections in Treasury's *Affording Our Future* focus on two scenarios:

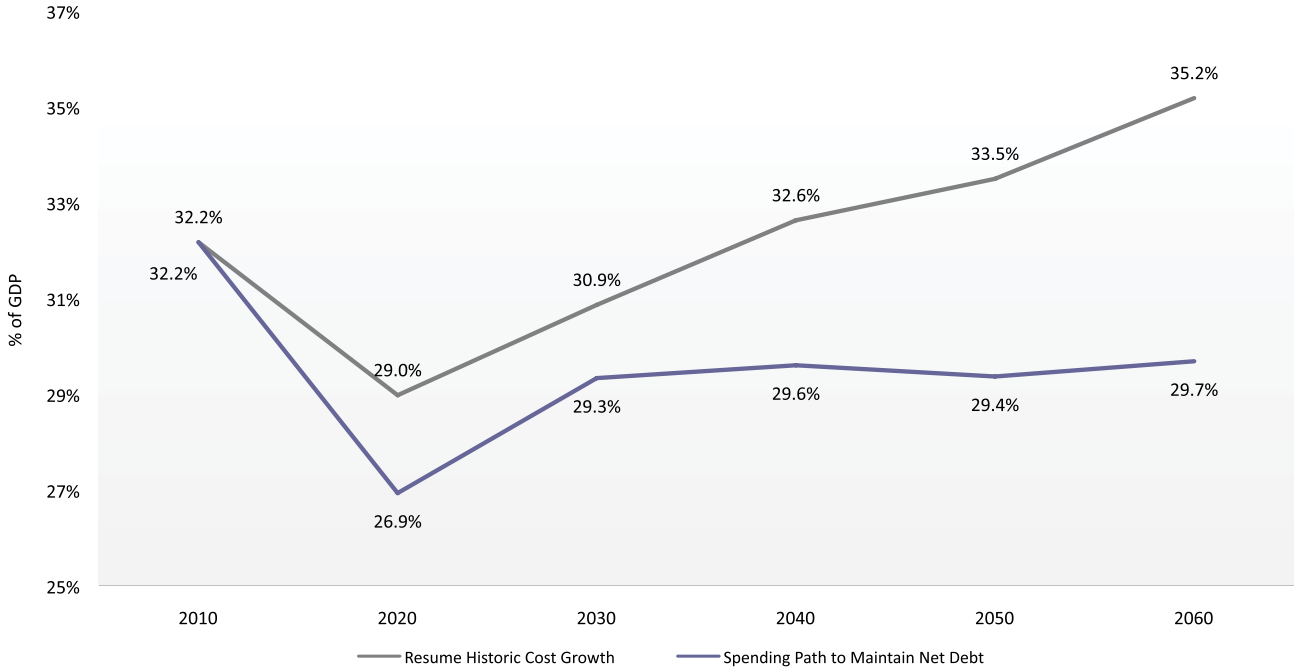
- Resume Historic Cost Growth (RHCG); and
- Spending Path to Maintain Net Debt (SPMND).

The RHCG scenario allows components of government spending to resume their historical growth rates, per recipient, after 2015–16. It takes projected values for demographic and economic variables into account but assumes no change to legislative policy settings. The base case version of this scenario fails to contain core Crown net debt within sustainable levels (e.g. it reaches 200% of GDP by 2060). This outcome will not eventuate because policy changes would occur first.

The SPMND scenario differs from the RHCG scenario by projecting a spending path that is low enough to maintain net core Crown debt exactly at 20% of GDP beyond 2020. (Projected core Crown tax revenue beyond 2020 remains at 29% of GDP in the base case version of this scenario.)

Figure 2 depicts, at decadal rests, the two spending paths in the base cases for core Crown operating spending, excluding finance costs (defined as primary spending in this report).

Figure 2: Treasury's two scenarios for primary core Crown operating spending



Source: Treasury's Long-Term Fiscal Model 2013.

Under the base case scenarios in each case, by 2060, core Crown spending, excluding finance costs, would be $29,225 per capita in 2013–14 dollars (29.7% of GDP) under the SPMND scenario compared to $34,634 per capita (35.2% of GDP) under the RHCG scenario.[5]

The difference between those two levels of spending in 2060 represents a 16% cut. From another perspective, it means reducing the average annual compound rate of growth in real per capita spending of this nature between 2010 and 2060 from 1.6% p.a. to 1.3% p.a. Either way, these are materially different spending paths.

The key features of the default version of the RHCG scenario that cause net core Crown debt to blow out unsustainably are:

- spending on health care progressively rises from 6.8% of GDP in 2010 to 10.8% in 2060;
- spending on NZS progressively rises from 4.3% of GDP in 2010 to 7.9% in 2060;
- core Crown tax revenue is held down at 29% of GDP beyond 2020;[6]
- largely as a result of the above three aspects, projected near-future surpluses in the core Crown primary operating balance (i.e. spending (excluding debt servicing) minus revenue (excluding income from financial assets)) tip into deficit in the mid-2020s when projected net core Crown debt is fractionally over 30% of GDP; and
- the projected 6% interest rate on Crown debt from 2020 p.a. exceeds the projected 4.1% p.a. growth rate in nominal GDP between 2020 and 2060.

5 Primary spending has to be cut sharply to 26.9% of GDP by 2020 in the SPMND scenario to achieve the 20% net debt target. Another option is to delay achieving that target by a few years.

6 According to Treasury's 2013 background paper, *The Role of Tax in Maintaining a Sustainable Fiscal Position*, p. 12, total Crown taxation averaged about 29–30% of GDP between 1972 and 2012, the highest ratio being around 33–34% of GDP during the mid-1990s.

From the mid-2020s, ever-increasing primary balance deficits and the interest rate/growth rate configuration inexorably cause projected public debt to spiral up both absolutely and relative to GDP. By 2060, projected interest payments on public debt would amount to 40% of total tax revenue.

2.5 MAIN FISCAL POLICY OPTIONS

The non-mutually exclusive suggestions in Treasury's *Affording Our Future* for avoiding the unsustainable debt spiral in the RHCG scenario comprise:

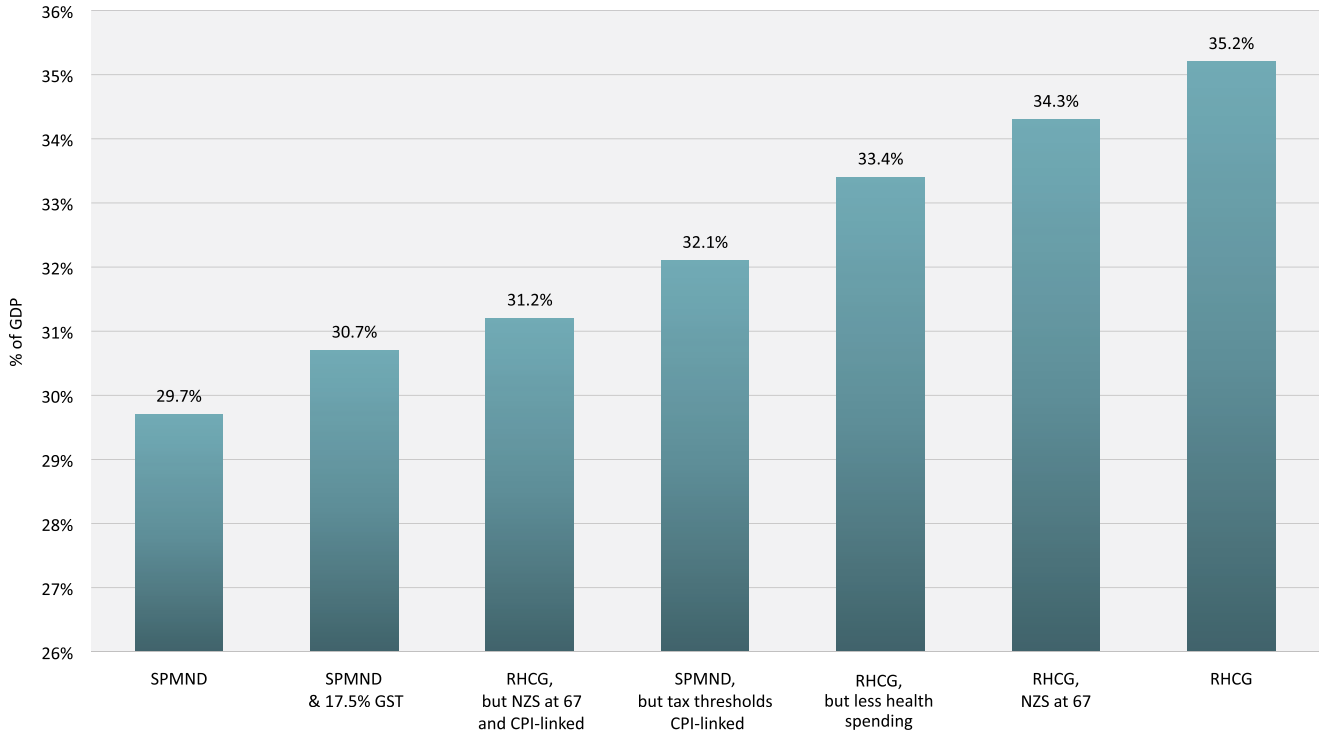
- indexing personal income tax thresholds to CPI inflation rather than to wage rate growth;
- raising the rate of GST from 15% to 17.5%;
- halving the rate of growth in health care spending to 9% of GDP in 2060 rather than 10.8%; and
- raising the age of eligibility to 67 for NZS and indexing payments to the CPI rather than to wages.[7]

Figure 3 illustrates the comparative order of magnitude of the effect of each option, as assessed by Treasury. It does so by showing projected operating spending in 2060 for the two base scenarios and selected variations on them. Moving from left to right in the chart, base case projected core Crown operating spending (excluding finance costs) in 2060 as a percent of GDP is:

- 29.7% in the SPMND scenario;
- 30.7% in the SPMND scenario if GST is 17.5% instead of 15%;
- 31.2% in the RHCG scenario, if the age of eligibility for NZS is 67, not 65, and NZS payments are linked to the CPI rather than to the average wage rate;
- 32.1% in the SMPND scenario, if tax thresholds are adjusted according to the CPI rather than to wage rates (these lower thresholds raise projected tax revenues, and therefore, the spending growth permitted by the 20% debt target);
- 33.4% in the RHCG scenario, if health spending is held down to 9% of GDP by 2060;
- 34.3% in the RHCG scenario, if the age for eligibility of NZS is lifted to 67; and
- 35.2% for the RHCG scenario.

7 NZS increases are related to increases in wages (rather than the CPI) when wage rates rise faster than the CPI, as explained in Roger Hurnard, *Setting and Adjusting the Rates of New Zealand Superannuation: A Submission to the Commission for Financial Literacy and Retirement Income on the 2013 Review of Retirement Income* Policies (2013), www.cflri.org.nz/sites/default/files/docs/RI-Review-2013-Submissions-Roger-Hurnard.pdf.

Figure 3: Effects of policy options on core Crown operating spending in 2060



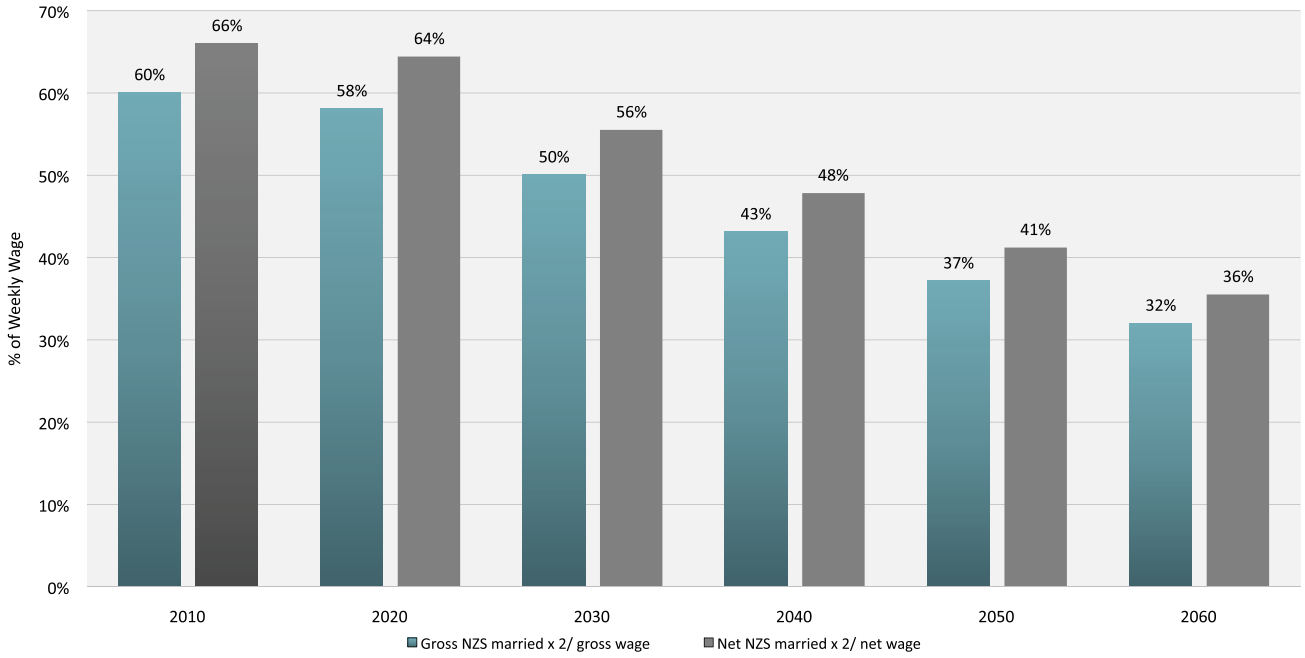
Source: Authors' calculations based on Treasury's Long-Term Fiscal Model 2013.

These projections indicate that:

- Raising GST to 17.5% would allow spending to increase only marginally (e.g. by 1% of GDP by 2060) while still keeping within the 20% of GDP net debt target;
- Linking increases in tax thresholds to the CPI rather than to wages allows spending to rise significantly faster (e.g. by 2.4% of GDP by 2060), while still keeping within the 20% of GDP net debt target;
- Raising the age of eligibility for NZS to 67 would reduce spending in 2060 by only 0.9% of GDP compared to the RHCG scenario, but doing so in conjunction with CPI-linked payments would reduce spending by 4% of projected GDP; and
- Reducing health spending so that it is 1.8% of GDP lower in 2060 than under the RHCG projection would (mechanistically) lower total primary spending to the same degree.

Adjusting NZS payments by 2020 to the CPI rather than to wage rates significantly reduces the value of those payments relative to the average wage when productivity growth is 1.5% p.a. Figure 4 indicates that it could reduce the married couple payment from 66% to 36% by 2060.

Figure 4: NZS as a percent of the weekly wage if CPI-linked – RHCG scenario



Source: Authors' calculations based on Treasury's Long-Term Fiscal Model 2013

2.6 MAIN CONCLUSIONS IN AFFORDING OUR FUTURE

Treasury's uncontentious central message is that New Zealand is not facing a fiscal crisis; however, the looming ageing population confronts us with the possible need to make fiscal decisions to avoid a future fiscal crisis. The major threats concern future tax burdens and growing health and NZS spending. While delay could unduly increase adjustment costs, unnecessarily precipitous action would also be costly.[8]

2.7 SUPPORTING DOCUMENTS

2.7.1 Introduction

Treasury's *Affording Our Future* statement was supported by more than 40 accompanying documents, many of them of considerable substance. The entire 11-article volume of the August 2014 edition of *New Zealand Economic Papers* was devoted to population ageing and long-run fiscal sustainability. Some of these articles were published versions of earlier Treasury working papers. These supporting documents delve into the complexities of the modelling uncertainties and policy choices discussed in *Affording Our Future*.

Early action could be taken on the spending side, the revenue side, or both to reduce the likelihood of the projected debt spiral in the base case of the RHCG scenario. Alternatively, given the uncertainties surrounding the likelihood of that debt spiral occurring, early action is inadvisable.

8 The option value of waiting was explored in Christopher Ball and John Creedy, "Tax Policy with Uncertain Future Costs: Some Simple Models", Working Paper 13/07 (Wellington: New Zealand Treasury, 2013).

Section 2.7.2 summarises a supporting Treasury working paper that makes much more detailed projections of transfer spending than in *Affording Our Future*. (Government spending primarily constitutes transfer spending, either in cash, as in welfare and NZS benefits payments, or in kind, as in spending on health and education.)

Section 2.7.3 rounds out the picture by summarising supporting papers on tax revenue options.

Section 2.7.4 focuses on the papers that explore the question of whether uncertainties about the future fiscal situation warrant putting weight on a 'wait and see' approach.

2.7.2 Stochastic welfare spending projections

Building on a 2002 Treasury working paper by John Creedy and Grant Scobie, a 2013 Treasury working paper by John Creedy and Kathleen Makale projected 13 categories of central government social spending to 2060–61.[9] These categories include spending on health, education, NZS and unemployment.

The projections were stochastic in that means and standard deviations were provided for values for input variables rather than just a particular value. The computer program generated random values for every input parameter in each output scenario, taking their supplied standard deviations into account. For each scenario, GDP was calculated as the product of projected labour productivity and employment (taking projected unemployment and participation rates into account). Mean and percentile outcomes were calculated across the 5,000 randomly generated scenarios thus created.

The authors' 'benchmark' projection focused on the effects of 'pure ageing' by fixing real expenditure per recipient in each spending category to grow at exactly the same rate as the projected rate of growth in labour productivity. In this case, the mean outcome was for aggregate social expenditure to grow from 24.6% to 28.2% of GDP between 2011 and 2061. By way of comparison, in the RHCG scenario, total Crown spending on health, education, social services and welfare would rise from 25.4% of GDP in 2010–11 to 29.5% of GDP in 2060–61.

Creedy and Makale also assessed the implications of raising the age of eligibility for NZS to 70 in conjunction with increased labour force participation, longer life expectancy, and reduced health care costs from 'better living'. This scenario markedly reduced the mean outcome for aggregate social expenditure in 2060 to 23% of GDP.

The authors generally found that the effect of ageing on aggregate spending would be greatest around 2040, "fall slightly beyond around 2040, following the death of the post World War II baby boom generations".[10]

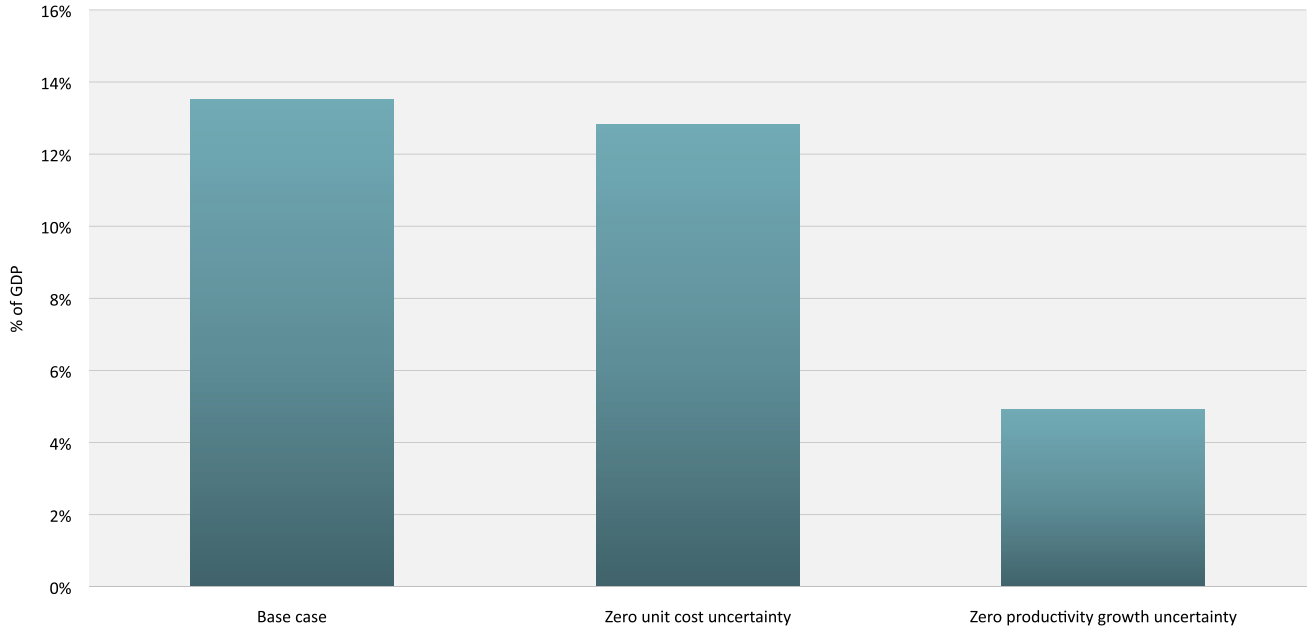
The uncertainty range for 2061 outcomes was high. The 5th and 95th percentile outcomes for 2061 were 22% and 35.5% of GDP, respectively, a spread of 13.5 percentage points (see Figure 5).

Creedy and Makale found that the dominant sources of uncertainty were future rates of unemployment and labour force participation, and the rate of productivity growth. Figure 5 shows that if there were no uncertainty about the future values for those three parameters, the uncertainty range in the base case for 2061 outcomes would be only 4.9% of GDP. In contrast, if there were no uncertainty about future real spending per recipient, the uncertainty range in the base case for 2060 would be 12.8% of GDP, little changed from the 13.5% figure.

9 John Creedy and Grant M. Scobie, "Population Ageing and Social Expenditure in New Zealand: Stochastic Projections", Working Paper 02/28 (Wellington: New Zealand Treasury, 2002) and John Creedy and Kathleen Makale, "Social Expenditure in New Zealand: Stochastic Projections", Working Paper 13/06 (Wellington: New Zealand Treasury, 2013).

10 John Creedy and Kathleen Makale, "Social Expenditure in New Zealand: Stochastic Projections", Working Paper 13/06 (Wellington: New Zealand Treasury, 2013), p. 11.

Figure 5: Factors making social welfare spending ratios by 2061 most uncertain



Source: Creedy and Makale

2.7.3 Taxation

According to Treasury's 2013 background paper, *The Role of Tax in Maintaining a Sustainable Fiscal Position*, increasing tax revenues by 3% of GDP over the next 40 years would close projected fiscal deficits. In discussing options for raising tax revenues, the paper suggested that raising GST would be more efficient than raising personal or company income tax rates.[11]

It also considered that a well-designed land tax, based on the value of unimproved land with no exemptions based on land use should be 'very efficient', but noted that including owner-occupied housing would be politically difficult while exempting it would be distortionary. New Zealand's fragmented land tax was repealed from 31 March 1992. Jonathan Barrett and John Veal are more dubious about the merits of reintroducing a land tax. To do so at central government level would tax only one form of wealth purchased from post-tax income, and could cause cash-flow problems for retired persons living in owner-occupied housing and underutilised Māori rural land.[12] A comprehensive income tax undermines the case for taxing wealth accumulated from investing post-tax income.

Table 3 summarises the potential revenue gains from raising the main tax rates, or from imposing a new land tax or widening the tax base for capital gains as outlined in the Treasury paper.

11 "The Role of Tax in Maintaining a Sustainable Fiscal Position", Background Paper for the *2013 Statement on the Long-Term Fiscal Position* (Wellington: New Zealand Treasury, 2013).

12 Jonathan Barrett and John Veal, "Land Tax: A New Zealand Perspective", *eJournal of Tax Research* 10:3 (2012), p.p. 573–588, particularly p. 583.

Table 3: Indicative scale of potential revenue gains from tax increases

Type of tax	Action to lift revenue by 1% of GDP	Action to keep net debt at 20% of GDP by 2060
Fiscal drag	Allow to operate until 2027/28	Allow to operate to 2049/50 (when the additional revenue is 4.7% of GDP and 60% of taxpayers would be on the top personal income tax rate)
Personal income tax	Lift all rates by 2 percentage points, or lift the top rate alone to 45%	Raise all rates by 5 percentage points from 2018/19 or lift more gradually by 6 percentage points in two equal steps
Payroll tax	Introduce at 2.5%	Set at 2.5% from 2018–19
GST	A 17.5% GST would lift revenue by 1.1% of GDP	Set GST at 21% from 2018–19, or set it at 19% in 2018–19 and at 23% in 2027–28
Company tax	Raise to 35% along with the top portfolio investment entities (PIE) and personal income tax rates, and the trustee rate	Raise all these rates to 45% from 2018–19
Taxing income from capital gains more comprehensively, at existing tax rates	Including owner-occupied homes and taxing nominal gains would raise 1.8% of GDP after an 18-year 'Australian-style' transitional period. Excluding owner-occupied gains would reduce this to about 0.8% of GDP	This policy would not raise enough revenue to achieve this goal
Land tax	Tax the unimproved land value annually at 0.7%	Impose at 2.2% from 2018–19

Source: "The Role of Tax in Maintaining a Sustainable Fiscal Position", Background Paper for the 2013 Statement on the Long-Term Fiscal Position (Wellington: New Zealand Treasury, 2013).

The paper also discusses excise, environmental and transaction tax options, and observes that optimal excise and environmental taxes are price-correcting measures rather than revenue-generating measures and that transaction taxes are notably inefficient. As a result, the paper does not make any quantitative assessments of these options' revenue-raising potential.

The paper does not discuss the option of a poll tax, no doubt because no political party would be interested.

Christopher Ball and John Creedy[13] project the distribution of future personal income tax and GST revenues annually from 2011 to 2061 taking into account population ageing and plausible changes in labour force participation rates.[14]
A base assumption is that the distribution of income within each age cohort is log-normal. Values for the mean and standard deviation are empirically estimated. The projection model allows savings rates and investment income to vary with age. A major finding is that the effect of projected demographic and labour force participation changes on aggregate tax revenues is "dwarfed

13 Christopher Ball and John Creedy, "Population Ageing and the Growth of Income and Consumption Tax Revenue", Working Paper 13/09 (Wellington: New Zealand Treasury, 2013).

14 Another paper on the same issue by Ross Guest suggests that effective policies to boost immigration and labour force participation by older workers could offset the effects of ageing on the ratio of workers to non-workers. See Ross Guest, "Population Ageing and Productivity: A Survey with Implications for New Zealand", *New Zealand Economic Papers* 48:2 (August 2014), p.p. 153–168.

by the much larger changes generated by wage growth".[15] Decisions concerning the indexation of personal income tax thresholds are also critical. In the absence of indexation of income tax thresholds, the average rate of income tax will rise from 18.7% in 2011 to 29.3% in 2061. Under full wage indexation of personal income tax thresholds, it barely rises, reaching only 18.9% in 2011.[16]

John Creedy and Norman Gemmell[17] use the projections in the Ball and Makale and Ball and Creedy papers to demonstrate that the fiscal pressures from projected ageing could be eliminated by adjusting personal income tax thresholds for price inflation rather than wage inflation. Whereas the arithmetic mean of social expenditures is projected to rise by 3–4 percentage points of GDP to 2061, revenues from personal income taxes and GST are projected to rise by 2.5–3.2 percentage points of GDP (to 23.4% of GDP by 2060) if personal income tax thresholds are indexed to prices.[18] Creedy and Gemmell point out that this greater reliance on the personal income tax for funding government spending is not necessarily desirable given other options.

2.7.4 Option value in waiting

Ball and Creedy[19] point out that uncertainty about increasing future tax revenues raises a policy risk that tax rates may be raised too early or too late compared to some optimal time. If taxes are raised early, and the raise turns out to have been unnecessary, the deadweight costs of those unnecessary tax increases might not be fully offset by the value of the reduced future tax burdens. Conversely, raising taxes too late would raise future deadweight costs unduly at the expense of lower initial deadweight costs.

The costs of raising taxes prematurely would, of course, be increased if the excess revenues were used to increase low quality operating spending, as seems likely under New Zealand's current fiscal arrangements.

Ball and Creedy's warning is pertinent. The stochastic simulations of spending and revenue demonstrate that it is by no means certain that the ageing population will generate a debt spiral of the sort projected in the base case of the RHCG scenario.

The authors find, in general, that the major determinants of the optimal time to increase taxes are the size of the potential tax increase and its associated probability. Full tax smoothing (i.e. treating the projected future tax increase as a certainty) is unlikely to be optimal.

2.8 EVALUATIVE COMMENTS

2.8.1 Introduction

The increase in core Crown non-finance government spending envisaged in the RHCG scenario is far from unrealistic.[20] As shown in Figure 2, it would only rise by 3% of GDP in the 50 years between 2010 and 2060 – from 32.2% to 35.2% of GDP.

Contrast that modest projected increase with the increase from 1960 to 2010. In 1959–60, central government current spending, excluding spending on interest paid in New Zealand, was only 20.3% of GDP, according to the national account estimates in SNZ's Official Yearbooks. Although this statistic is not directly comparable with the 2010 32.2% figure,

15 Ibid. p. 181.

16 Ibid. p.p. 178–179.

17 John Creedy and Norman Gemmell, "Can Fiscal Drag Pay for the Public Spending Effects of Population Ageing in New Zealand?", *New Zealand Economic Papers* 48:2 (2014), p.p. 183–195.

18 Ibid. p.p. 181–191, including Figure 5.

19 Christopher Ball and John Creedy, "Tax Policy with Uncertain Future Costs: Some Simple Models", op. cit.

20 These estimates could be conservative. See Michael Cullen, "The Political Economy of Long Term Fiscal Planning from a Social Democratic Perspective", *Affording Our Future Conference* (10–11 December 2012), www.victoria.ac.nz/sacl/about/cpf/publications/pdfs/2.3-Cullen-paper.pdf.

there is no doubt government spending has grown much faster than incomes since 1960.[21]

Indeed, a big spending coalition government could conceivably increase peacetime non-finance spending to 35% of GDP in just a couple of parliamentary terms, perhaps arguing that New Zealand's ratio was still modest from a Scandinavian perspective. To cite one precedent, core Crown operating spending, excluding finance costs, rose from 27.1% to 33.2% of GDP between the years ended June 2004 and June 2009.[22]

The only practical limits to increases in transfer spending that take the form of robbing A to pay B (and/or A) are political. Transfer spending (as distinct from collective consumption) dominates the public accounts – and general election campaign promises. From 2004 to 2008, the tax money was there to spend and the will to spend dominated.

From a narrow spending interest group perspective, the public debt spiral projected in the base case of the RHCG scenario looks like a paper tiger in that it is avoidable with appropriate tax increases or cuts to spending that benefits major interest groups.

Increasing tax revenues markedly above 29% of GDP is clearly an option, and potentially a likely one should a big spending government take office. But the costs are potentially large if the spending the extra taxes fund is of low quality.

Section 2.8.2 looks in more depth at the debt dynamics embodied in the RHCG projection. It assesses the scale of the action necessary to sustain all or much of the projected spending path, within the confines of Treasury's projection model.

Section 2.8.3 explores the option of greater spending cuts in conjunction with tax cuts using the SPMND projection model. The pressure for tax cuts could well rise from international competitiveness considerations, for example, from the growing competition from China and other growing Asian economies, and the large income gap with Australia.

Section 2.8.4 illustrates the degree to which higher rather than lower productivity growth can ease potential fiscal burdens. (All the scenarios discussed prior to this section assumed that labour productivity grows steadily at 1.5% p.a. from 2020 to 2060.)

2.8.2 Magnitude of indicated fiscal adjustment in RHCG

Close inspection of Treasury's model shows that the debt spiral generated in the RHCG scenario is due to three factors:[23]

- significant initial net indebtedness (e.g. projected net core Crown public debt of 28.4% of GDP, in 2014, 18.6% of GDP if New Zealand Super Fund assets are included);
- a tendency for net public debt to grow faster than GDP because projected nominal 'interest rates' average 6.6% p.a.[24] which substantially exceeds the projected average annual nominal growth rate for GDP of 4.2% p.a.; and
- a failure to sustain large offsetting surpluses in the core Crown primary balance (the operating balance before deducting the net interest expense).[25]

21 For a more comprehensive assessment, refer to Figure 10 in Tracy Mears, Gary Blick, Tim Hampton and John Janssen, "Fiscal Institutions in New Zealand and the Question of a Spending Cap", Working Paper 10/07 (Wellington: New Zealand Treasury, 2010).

22 Only 1 percentage point of GDP of this rise can be attributed to the weaker level of economic activity in 2009. Ibid. p. 12.

23 A fourth, more technical factor is that investments in illiquid assets that are funded by public debt issuance increased measured net core Crown indebtedness because illiquid assets are not considered to be available to offset core Crown debt.

24 This is the averaged compounded annual interest rate between 2015 and 2060, where each annual rate is calculated as net interest payments divided by year opening core Crown net debt minus NZS assets. The maximum projected yield paid on government stock is 6.0%.

25 This definition counts net gains and losses (which are typically positive) as part of the primary balance, whereas the definition used in Treasury's long-term model excludes them.

On the third point, hard-earned projected surpluses from 2015–30 subsequently become deficits, with this balance averaging a deficit of 1% of GDP between 2015 and 2060. (Note that this definition includes net gains that average 1.2% of GDP. The definition of the primary balance in Treasury's long-term model excludes net gains and so averages -2.2% of GDP between 2015 and 2060 in the base case of the RHCG scenario.)

Further analysis indicates that in the base case of the RHCG scenario, the core Crown operating balance, excluding net interest payments, averages -1% of GDP between 2015 and 2060. Under the SPMND scenario, it averages +1.7% of GDP, indicating a need for a sustained turnaround of 2.7% of GDP to keep net core Crown public debt at 20% of GDP. Expressed in per capita terms in 2013–14 dollars, it requires a switch from an average annual deficit of $963 to an annual average surplus of $1,193, representing a net taxation increase of $2,156 for every man, woman and child.

The needed entire-period turnaround would be somewhat lower if the 20% debt target for 2060 were for net core Crown debt less New Zealand Super Fund assets. (These assets are projected to increase from 10.2% of GDP in 2015 to 29.8% of GDP in 2060 under the RHCG scenario.)

If future NZS payments were indexed to the CPI instead of to wages, the core Crown operating balance between 2015 and 2060 would be in surplus on average by 0.6% of GDP, rather than in deficit by 1% of GDP. That measure alone would represent a major advance towards fiscal sustainability under the RHCG scenario.

In addition, progressively raising the age of eligibility for NZS payments from, say, 65 to 67 between 2020 and 2030 would increase the primary balance surplus further to 0.9% of GDP on average between 2015 and 2060.

The finding that these two initiatives together would move the projected primary balance from an average deficit during 2015-2060 of 1.0% of GDP to an average surplus of 0.9% of GDP demonstrates the significance of the projected ageing population for the unsustainable fiscal situation portrayed in this scenario.

Another illustration of orders of magnitude is that allowing fiscal drag to operate between 2018 and 2054 in the RHCG model would, in isolation, suffice to get the net core Crown debt to GDP ratio below 20% by 2060. Core Crown tax revenue would peak relative to GDP in 2054 at 34.5%, but would be down to 33.3% by 2060. The proportion of taxpayers paying the highest rate would rise from 20% to 60% in just 31 years under this policy, assuming nominal wage rate growth of 3.5% p.a.[26]

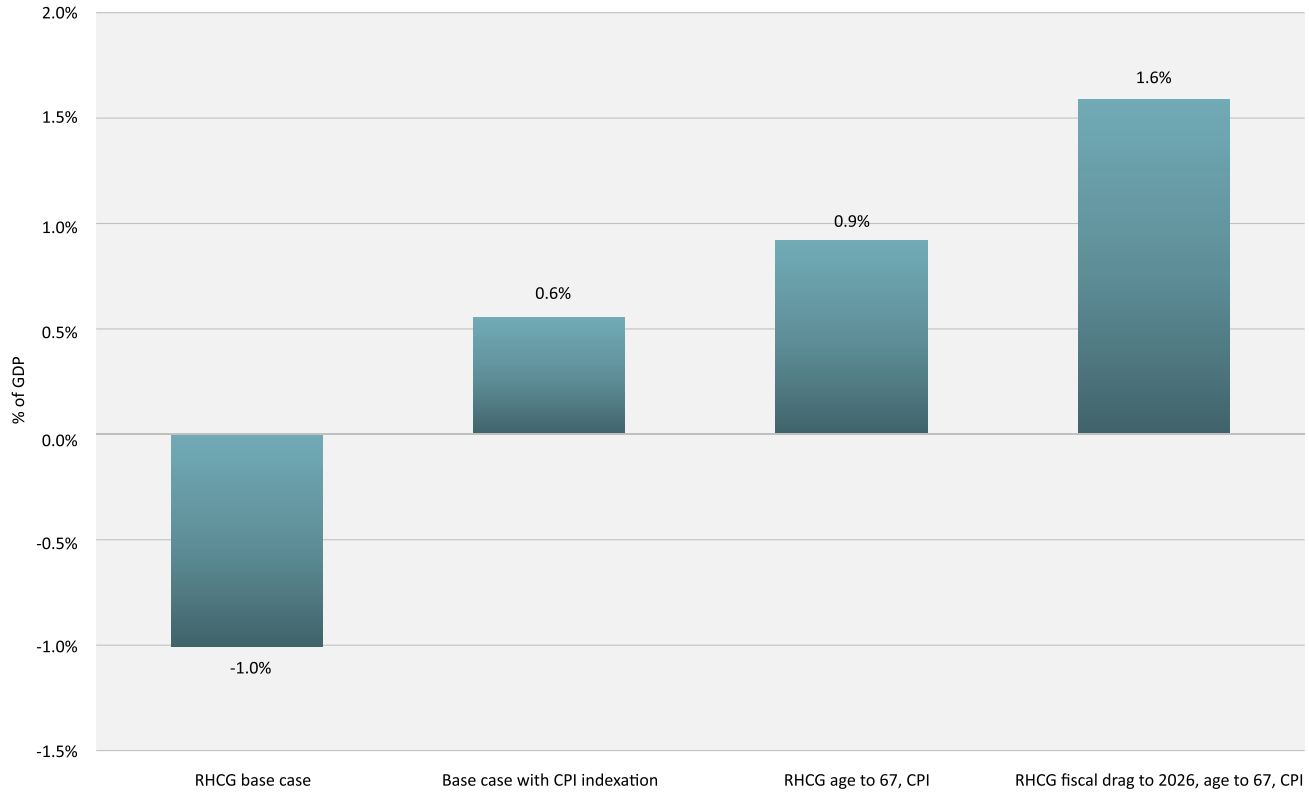
To combine these three illustrative possibilities, if future NZS payments were indexed to the CPI instead of to wages; if the age of eligibility increased from 65 to 67; and if fiscal drag were not given back between 2018 and 2037, after which tax revenue (at 0.182% of GDP p.a.) was gradually adjusted down to 29% of GDP by 2051, net core Crown debt in 2060 would be below 20% of GDP. (Under this variation of the RHCG scenario, tax revenue would peak at 31.4% of GDP in 2037 and net core Crown debt would reach a temporary low of 4.8% of GDP in 2045. The projected primary balance between 2015 and 2060 would average 1.6% of GDP.)

These illustrative outcomes for the primary balance are summarised in Figure 6.

When considering such options, it is important to note that the RHCG projections are neither predictions nor forecasts. The stochastic simulations reviewed in section 2.7.2 make it clear that the uncertainty range for relevant parameters is large enough to raise doubts about the need for precipitous action.

26 "The Role of Tax in Maintaining a Sustainable Fiscal Position", Background Paper for the *2013 Statement on the Long-Term Fiscal Position* (Wellington: New Zealand Treasury, 2013), p. 19.

Figure 6: Core Crown primary balance-reducing variations on the RHCG scenario base case



Source: Authors' calculations based on Treasury's Long-Term Fiscal Model, 2013

2.8.3 Tax cut possibilities from modified SPMND scenario

Under the base case for the SPMND scenario, spending is markedly reduced relative to the base case for the RHCG scenario on all major categories of spending by 2060, except for spending on NZS. The SPMND model forces this result to keep net debt at 20% of GDP through to 2060 when tax revenue is held down to 29% of GDP.

This comparison raises the question of how much tax rates could be reduced if spending on NZS was reduced in addition to achieving the expenditure projections posited for the other categories of spending under the SPMND scenario. A possible answer is summarised in column 3 of Table 4.

Indexing NZS to the CPI instead of to wages would reduce spending on NZS in 2060 to 4.3% of GDP rather than the projected 7.9%. That reduction of 3.6% of GDP allows tax revenues to be reduced by 3.6% of GDP, other things being equal. (The apparent 3.5% reduction in Table 4 to a tax ratio of 25.5% of GDP reflects rounding).

All the projections discussed so far assume fiscal choices have no effect on economic competitiveness and productivity growth. In the next section, we look at the significance of variations in productivity growth.

Table 4: Projected spending and revenue in 2060

% of GDP	RHCG: Base case	SPMND: Base case	SPMND + NZS CPI indexed
Health care	10.8%	7.1%	7.1%
NZS	7.9%	7.9%	4.3%
Education	5.2%	4.6%	4.6%
Law and order	1.4%	1.0%	1.0%
Welfare (not superannuation)	3.8%	3.5%	3.5%
Other	6.1%	5.7%	5.6%
Primary government spending	**35.2%**	**29.7%**	**26.2%**
Debt-servicing costs	11.8%	1.5%	1.5%
Total government expenses	**47.0%**	**31.1%**	**27.6%**
Tax revenue	29.0%	29.0%	25.5%
Other revenue	3.5%	3.5%	3.5%
Total government revenue	**32.6%**	**32.6%**	**29.0%**
Expenses, less revenue	14.4%	-1.4%	-1.4%
Net government debt	201.0%	20.0%	20.0%

Source: Treasury's Long-Term Fiscal Model, 2013.

2.8.4 Significance of productivity growth

Labour productivity is the basic determinant of GDP per capita. Higher labour productivity growth is the key to achieving higher living standards and making it easier to fund projected growth in government spending.

New Zealanders would be much better off if achieving faster productivity growth for New Zealand was given a much higher policy priority. During the last 40 years, Australia's GDP per hour has increased at 1.6% p.a. on average, compared to New Zealand's 1.1% p.a.

Treasury's projection models are static in that they do not model the effects of policy changes on productivity growth. For example, unless users build their own assumptions to the contrary into the model, real GDP growth will be the same whether taxes take 90% of income, 9%, or any other proportion. In fact, many people go to considerable lengths to reduce their tax burdens and increase their eligibility for benefits, even emigrating. Accountants, lawyers, IRD officials and prison officers no doubt benefit, but from an economy-wide perspective, all this activity is potentially a drag on productivity and thereby national income. As a result, the models leave it to users to assess the extent to which productivity might be raised by:

- increasing labour force participation by raising the age of eligibility for NZS, lowering the minimum wage, improving educational outcomes for the tail end of school leavers, and

reducing the extremely high effective marginal tax rates imposed on some welfare recipients;

- stimulating investment, encouraging work effort, and reducing costly tax-avoiding activities by lowering effective marginal tax rates more generally, funded by reducing unnecessary spending on transfer payments to those on middle and upper incomes; or
- improving the clarity of the goals of public sector spending programmes, and accountability for achieving them.

With respect to the first point, Rossana Merola and Douglas Sutherland cite a 2011 study which indicated that product and labour market reforms could lift GDP by about 4.5% in five years and 10% in 10 years for the average OECD member country.[27] The OECD's 2011 Survey of New Zealand contained a chapter drawing on an OECD working paper by Paul Conway, who observed that New Zealand's product market regulation had slipped behind the frontier and could be usefully liberalised further:

> Ongoing improvements in regulatory governance, minimising the government's influence in competitive markets and lowering barriers to trade and FDI, including ongoing policy harmonisation and mutual recognition with trading partners where appropriate, would all help in this regard.[28]

With respect to the second point, a 2012 paper by Iris Claus, John Creedy and Josh Teng found that the disincentive effects of New Zealand's top personal income tax rates are substantial. Specifically, the estimated cost to the community of the last dollar of tax revenue raised by the 39% personal tax rate is "well in excess of a dollar".[29] Expressed differently, the benefit to the community from spending that dollar needs to be "well in excess of" $2 to be worthwhile. (A 2003 Treasury working paper by John Creedy explained why the so-called deadweight costs caused to society by people's efforts to avoid tax were likely to roughly quadruple for each doubling of the tax rate.[30])

A 2011 Treasury working paper further reviewed the evidence for negative effects of unnecessarily high tax rates. One conclusion was that reducing distortionary taxes (such as income tax) and 'unproductive' spending has "moderate but not insignificant" growth effects.[31] The same paper observed that much core Crown spending would not often be considered growth enhancing. If defence and health expenditure is not regarded as growth enhancing, 'non-productive' operating spending would be around two-thirds of core Crown operating spending.[32]

Merola and Sutherland point to evidence that many countries could greatly improve public sector productivity by moving to best practice, citing education and health spending in particular. They find that such reforms would improve fiscal positions considerably in many countries, several of which would not then need fiscal tightening to keep their gross government financial liabilities under 50% of GDP.[33]

27 Rossana Merola and Douglas Sutherland, "Fiscal Consolidation: Part 3. Long-Run Projections and Fiscal Gap Calculations", OECD Economics Department Working Papers No. 934 (Paris: OECD Publishing, 2012), p. 26.

28 Paul Conway, "How to Move Product Market Regulation in New Zealand Back Towards the Frontier", OECD Economics Department Working Papers No. 880 (Paris: OECD Publishing, July 2011), p. 2.

29 Iris Claus, John Creedy and Josh Teng, "The Elasticity of Taxable Income in New Zealand", Working Paper 12/03 (Wellington: New Zealand Treasury, 2012), p. iii.

30 John Creedy, "The Excess Burden of Taxation and Why it (Approximately) Quadruples When the Tax Rate Doubles", Working Paper 03/29, (Wellington: New Zealand Treasury, 2003).

31 Diana Cook, Carsten Schousboe and David Law, "Government and Economic Growth: Does Size Matter?" Working Paper 11/01 (Wellington: New Zealand Treasury, 2011), p. 15.

32 Ibid. p. 31.

33 Rossana Merola and Douglas Sutherland (OECD, Economics Department), "Fiscal Consolidation and Implications of Social Spending for Long-Term Fiscal Sustainability", ESRI Research Bulletin 2014/1/2, 2.

It is also plausible that unduly high public debt levels can raise interest rates and reduce the rate of economic growth. The OECD Economic Outlook 2010 cites one study that found that a 10 percentage point increase in the ratio of public debt to GDP was associated with a slowdown in subsequent real GDP per capita of about 0.2 percentage points p.a.[34]

Treasury's base case assumes that long-run productivity growth (GDP per hour worked) in New Zealand will be 1.5% p.a. This is appreciably higher than the 1.1% p.a. average for the 40 years to 2013 or the 1.2% p.a. average during the last 20 years (according to Conference Board statistics). Under current policies, the risks seem to be more downside than upside.

The faster the rate of growth in productivity is relative to the real interest cost of government borrowing, the faster government spending can be increased (or taxes reduced) without running into a public debt spiral.

Three calculations illustrate the effect of higher rates of productivity growth:

1. Productivity growth of 1.94% p.a. in the SPMND model produces the same level of real per capita aggregate primary spending in 2060 as is projected in the RHCG base case while keeping within the 20% debt target and holding tax revenues at 29% of GDP.[35]
2. Productivity growth of 2.12% p.a. would also fund a 10% cut in average tax revenues (from 29% of GDP to 26.2% of GDP by 2060) within the 20% debt target.
3. Productivity growth of 4.44% p.a. in the RHCG scenario would allow much greater increases in government spending than in the base case to be funded without a debt spiral.[36]

The third scenario represents the sort of labour productivity growth rates New Zealand would have to achieve to close the 35% income per capita gap with Australia in a few decades. Singapore achieved an average rate of increase in hourly labour productivity of 4% p.a. between 1965 and 2012, according to Conference Board statistics, but New Zealand appears to have no chance of sustaining even half that growth rate under current policies.

Table 5 illustrates the power of compounding for a 50-year period. At a 4% p.a. growth rate, average GDP per capita would increase seven-fold to reach $359,000 per person in 2064 compared to $50,585 in 2014. At a growth rate of 1.5% p.a., it would merely double to $106,000 per person.

Table 6 provides more details concerning a 'Singaporean' growth scenario. Real GDP per capita and tax revenue per capita would be 3.2 times higher by 2060 under the higher productivity growth scenario. That would allow real primary government spending per capita to be 2.7 times higher than under the base case RHCG scenario. The gap between those increases allows debt to be reduced to 20% of GDP, reducing projected real per capita debt servicing costs in 2060 from $11,588 to $3,918.

34 Organisation for Economic Co-operation and Development, *Economic Outlook*, Volume 3 (Paris: OECD, 2010), p. 231.

35 However, the composition of spending would be materially different. Specifically, the average compounded rate of growth in real spending per capita on NZS between 2010 and 2060 would be only 1.4% p.a. under the SPMND scenario compared to 2.7% p.a. under the RHCG scenario. That implies the necessity for a policy change to delink the level of payments from real wage growth in New Zealand.

36 Real NZS payments per capita rise at 5% pa between 2010 and 2060 in this case, but other welfare payments only increase at 3.3% p.a.

Table 5: The power of compounding higher rates of productivity growth for long periods

	GDP per capita growth rate (% pa) between 2014 and 2064							
	0.5%	**1.0%**	**1.5%**	**2.0%**	**2.5%**	**3.0%**	**4.0%**	**5.0%**
GDP per capita in 2064 in 2014 dollars (rounded)	$65,000	$83,000	$106,000	$136,000	$174,000	$222,000	$359,000	$580,000
Multiple of 2014 value of $50,585	1.3	1.6	2.1	2.7	3.4	4.4	7.1	11.5

Source: Authors' calculations.

Table 6: Effect of very fast productivity growth on outcomes under the RHCG scenario

2060 projections, constant 2013–14$ per capita (CPI)	Base case	Productivity growth 4.445% p.a.	Multiple
Health care	$10,601	$27,235	2.57
NZS	$7,712	$24,331	3.16
Education	$5,145	$12,732	2.47
Law and order	$1,334	$3,427	2.57
Welfare (not superannuation)	$3,751	$8,536	2.28
Other	$5,958	$16,000	2.69
Primary government spending	**$34,501**	**$92,261**	**2.67**
Debt-servicing costs	$11,588	$3,918	0.34
Total government expenses	**$46,089**	**$96,179**	**2.09**
Tax revenue	$28,467	$91,966	3.23
Other revenue	$3,461	$3,461	1.00
Total government revenue	**$31,928**	**$95,426**	**2.99**
Expenses less revenue	$14,161	$753	0.05
Net government debt	$197,135	$63,368	0.32
Real GDP per capita	$99,722	$322,161	3.23

Source: Authors' calculations.

2.8.5 Conclusions

The fiscal consequences of New Zealand's ageing population will undoubtedly put pressure on future governments to raise taxes and/or cut spending. While the extent of that pressure depends on many uncertain factors, delay will always increase the scale of any required adjustment. However, voters might prefer to delay until a crisis is at hand, particularly when the case for precipitous action is not robust.

A political complication is that delay increases the voting power of the elderly. More of the elderly population vote than other age groups. Based on 2011 general election voting records and SNZ's median scenario projections, the population aged 60+ will comprise 37.6% of those eligible to vote in 2053–54 – and 50.2% of those actually voting.

The scale of the required fiscal adjustment (increase in the balance between operating revenue and spending, excluding finance revenue and costs) is 0.9% of GDP, compared to projected balances for the next three years, but the implied primary balance surpluses need to be maintained in real per capita terms for the following 40 years in order to offset the debt spiral effects of (reasonably) projecting interest rate on debt that exceeds the growth rate for income.

Faster productivity growth makes everything more affordable as long as government spending growth is not cranked up stepwise. Faster productivity growth sustained over a 40-year period can allow for much faster government spending growth than otherwise, along with tax cuts, while not generating a debt spiral. Policies capable of seriously raising productivity growth, perhaps motivated by the need to be more competitive with Australia, would also make the fiscal implications of an ageing population markedly more affordable.

Lower, flatter tax rates on productive effort and risk-taking are better for economic growth than higher tax rates. Less churning of private income through the tax-benefits system and less corporate welfare would allow these goals to be achieved. More people could find work and more jobs could be created if labour market laws were less restrictive. The *Resource Management Act* is a standout obstacle to investment and productivity, but it is hardly atypical. Less restrictive product and labour market regulation would be pro-growth. Greater competition in state-dominated industries could empower users and force productivity gains. Continued efforts to ensure that the welfare system encourages working-age people to work rather than choose to live on a benefit are important, while not reneging on a safety net for those not exercising choice. Action on these fronts is arguably justifiable independent of demographic ageing, but that issue increases the case for such action.

THE NEW ZEALAND INITIATIVE

CHAPTER THREE
NEW ZEALAND'S RELATIVE FISCAL POSITION

3.1 INTRODUCTION

This section compares New Zealand's fiscal position with those of other OECD countries. Readers need to bear in mind that the OECD Secretariat describes the fiscal positions of its members as generally "dire".[37]

In a 2011 working paper for the Bank for International Settlements (BIS), Alan Auerbach observed that it is useful to distinguish between three sources of fiscal balance:

- cyclical imbalances during recessions;
- structural imbalances that would persist in the short run even at full employment; and
- long-term imbalances due to unfunded long-term entitlement programmes, particularly in pensions and health expenditures that can become unsustainable under current policy settings for demographic or other reasons.

Cyclical imbalances can be large in any one year because cyclical movements in revenues and spending can be large. But since they are temporary (by definition), they do not represent a serious fiscal problem.[38] Large structural imbalances pose a greater fiscal challenge, but it is unchecked long-term imbalances that dominate future fiscal trends.

Section 3.2 examines New Zealand's cyclical and structural fiscal outlook from an OECD perspective.

As is well known, New Zealand's current fiscal position is better than that of some other countries, but short of being exemplary.

Section 3.3 examines New Zealand's longer-term fiscal outlook from an international perspective using analyses undertaken for the OECD and the BIS.

3.2 COMPARATIVE SHORT-TERM FISCAL OUTLOOKS

The OECD has projected detailed assessments of the short-term fiscal positions of 24 or 25 member countries up to 2015. Table 7 compares New Zealand with Australia on nine fiscal measures and ranks each country compared to the other 22 or 23 countries. The OECD's explanations for these measures are summarised in the Appendix.

New Zealand's general government total outlays for 2015 are projected to be 39.5% of GDP compared to 35.6% for Australia. New Zealand's tax and non-tax receipts are also higher than those in Australia by over 5 percentage points of their respective GDPs.

Korea is projected to have the lowest projected total outlay ratio, at 32.8% of GDP, with Australia in the third slot and New Zealand in the eighth. The United States has the lowest projected revenue ratio, at 32.1% of GDP, Australia is in the fourth slot, and New Zealand in the thirteenth.

New Zealand's four projected fiscal balances all show small surpluses relative to GDP, whereas three of the four are negative for Australia. Reflecting the assessment that Australia and New Zealand will be at near-opposite points in their economic cycle in 2015, New Zealand's cyclically

37 Organisation for Economic Co-operation and Development, *Restoring Public Finances 2012 Update* (Paris: OECD Publishing, 2012), p. 18.

38 What were thought to be cyclical deficits can turn out to be structural deficits (and *vice versa*). Measurement is a problem.

Table 7: OECD's short-term fiscal indicators for 2015

Fiscal indicators for general government	New Zealand 2015		Australia 2015		1st-ranked country	% GDP
	% GDP	Rank	% GDP	Rank		
Total outlays	39.5	8	35.6	3	Korea	32.8
Total tax and non-tax receipts	40.2	13	34.1	4	USA	32.1
Financial balances	0.7	2	-1.4	13	Norway	10.2
Cyclically adjusted balances	0.2	10	-0.6	17	Greece	3.7
Underlying balances	0.3	10	-0.6	16	Greece	3.6
Underlying primary balances	1.4	11	0.1	21	Greece	7.8
Net debt interest payments	1.1	11	0.7	10	Norway	-2.4
Gross financial liabilities	38.1	4	35.9	3	Estonia	12.7
Net financial liabilities	5.3	7	14.6	10	Norway	-207.0

Source: OECD Economic Outlook Annex tables 25–33, downloaded 4 July 2014, for 24 or 25 member countries.

adjusted financial balance in 2015, at 0.2% of potential GDP, is appreciably below its revenue-swollen expected balance (0.7% of GDP), whereas Australia's is materially less negative than its revenue-deficient expected deficit.[39] As a result, the gap between Australia and New Zealand on these two measures is substantially smaller on the cyclically adjusted measure.

The underlying balance measure simply removes assessed 'one-off' expenditure or revenue items from the cyclically adjusted financial balance estimate. For Australia and New Zealand, this does not make a material difference.

The underlying primary balance measure shows the cyclically adjusted financial balance after eliminating assessed one-off items, but before paying interest on general government debt net of interest received on assets.

Some 10 or 11 of the 24 or 25 member countries of the OECD for which these measures are published are projected to have larger cyclically adjusted surpluses on these three measures than New Zealand in 2015. New Zealand's position is not exemplary, even by the OECD's low standards, despite six consecutive years of budgets aimed at stopping spending growth.

Remarkably, Greece stands out for having the largest surpluses of all on the last three of the cyclically adjusted measures.[40] The projected underlying financial balance surplus for Greece of 3.6% of potential GDP represents an extraordinary 19% of potential GDP turnaround from its underlying primary financial balance deficit of 15.3% of potential GDP in 2009.

39 All the cyclically adjusted measures are percentages of potential GDP to purge both numerator and denominator of assessed cyclical influences.

40 Norway's net petroleum revenues are excluded as a special case.

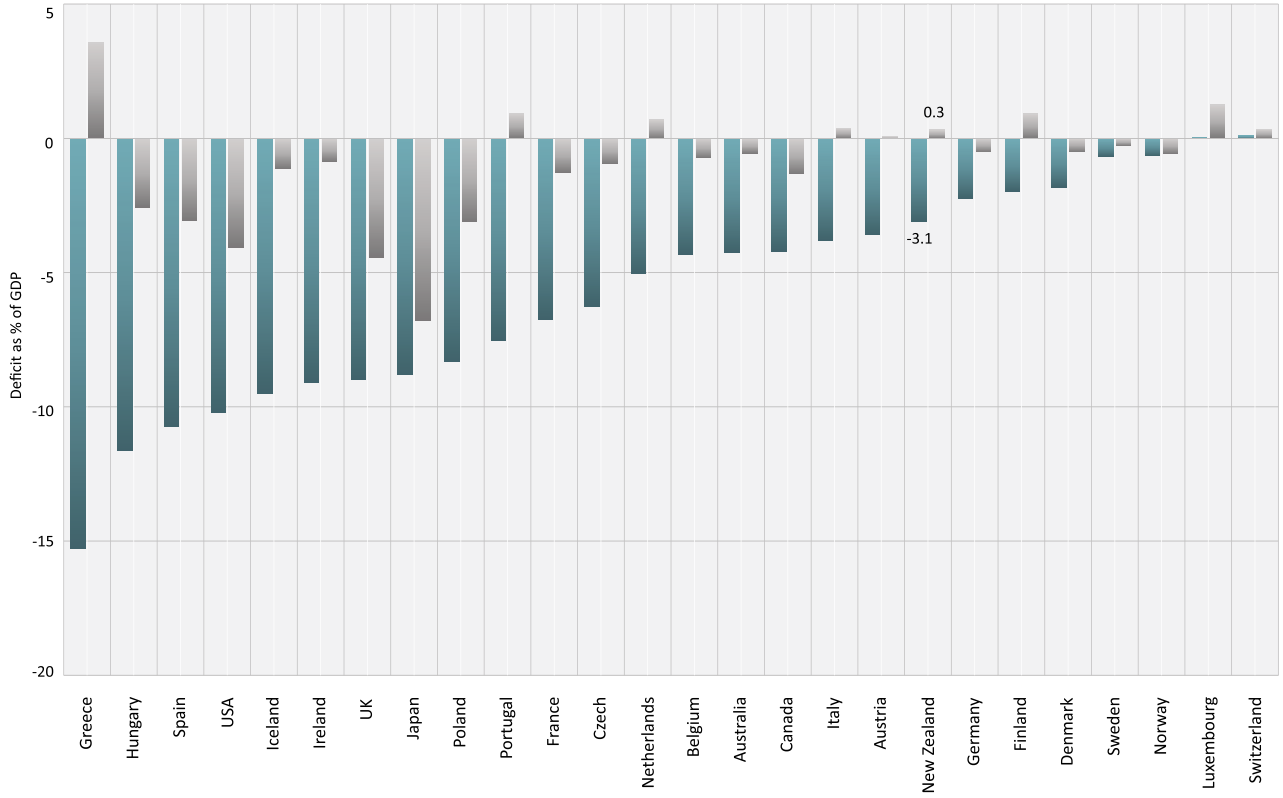
Figure 7 shows the degree to which by 2015, 26 member countries of the OECD are projected to have reduced the worst of the deficits they have experienced in their general government financial balances in the last decade. Greece, Hungary, Ireland, Iceland and Spain are expected to have to make the biggest adjustments on this measure. Japan is set to have the highest cyclical deficit as a percent of potential GDP in 2015, with the United Kingdom beating the United States for the second worst position.

New Zealand's largest deficit on this basis in the last decade was 3.1% of GDP (in 2010). This reflected in part a worrying lack of fiscal discipline between 2004 and 2008.

New Zealand's gross debt and net financial liabilities in 2015 are projected to be relatively modest by OECD standards, ranking fourth and seventh lowest, respectively (Table 7). Somewhat curiously, Australia has a higher projected net debt ratio than New Zealand but a lower projected ratio for net interest payments. This may reflect timing differences and a lower cost of public debt in Australia.

Two points come out of these comparisons. First, OECD countries can make significant adjustments to their underlying fiscal imbalances in 5–10 years. Second, New Zealand's fiscal position is quite strong, both absolutely and relatively, from a short-term perspective.

Figure 7: Cyclically adjusted general government financial balances, excluding one-offs



Source: OECD Economic Outlook June 2014, Annex table 29.

3.3 COMPARATIVE LONG-TERM OUTLOOKS

3.3.1 OECD projections to 2025, 2030 and 2050

PROJECTIONS TO 2025

The OECD's Economic Outlook for December 2010 estimated New Zealand's general government underlying primary balance in 2010 to be -4% of GDP. It predicted that government could stabilise the general government public debt by 2025 if the forecast reduction in the underlying primary balance deficit to 2.8% of GDP in 2012 were achieved, and if in addition, the government progressively reduced it by a further 0.5% of GDP every year for six consecutive years. (New Zealand's projected general government net financial liabilities in 2025 were 7% of GDP, compared to -4% of GDP in 2010.)[41]

This adjustment was around the unweighted average requirement for OECD member countries.

This illustrative 2010 'baseline' fiscal consolidation took account of estimated and forecast levels of debt and deficits between 2010 and 2012, and also projected GDP growth rates and interest rates on debt through to 2025.

However, this projection did not take into account the additional spending pressures from ageing populations and cost increases in health care. New Zealand's ageing population may necessitate increasing spending on health care, long-term health care for the aged, and pensions between 2010 and 2025 by 1.4, 0.5 and 2.4 percentage points of GDP, respectively, making 4.2% of GDP in total.[42]

Out of 18 other OECD member countries, only Luxembourg (5.5%), Greece (5.4%), and Finland (4.6%) faced larger projected pressures from ageing and health care costs.

To keep New Zealand's debt ratios stable, that 4.2% of GDP fiscal consolidation to 2025 would be additional to the 3% of GDP requirement in the baseline projections, making about 7% of GDP in total.

The OECD report does not mention at what rate New Zealand would need to make fiscal savings annually to achieve the same goal of debt stabilisation by 2025, but in a stylised calculation we assess that it could be necessary to progressively reduce other spending relative to revenue by approaching 0.78% of GDP every year between 2013 and 2020. That is a daunting scenario.

PROJECTIONS TO 2030

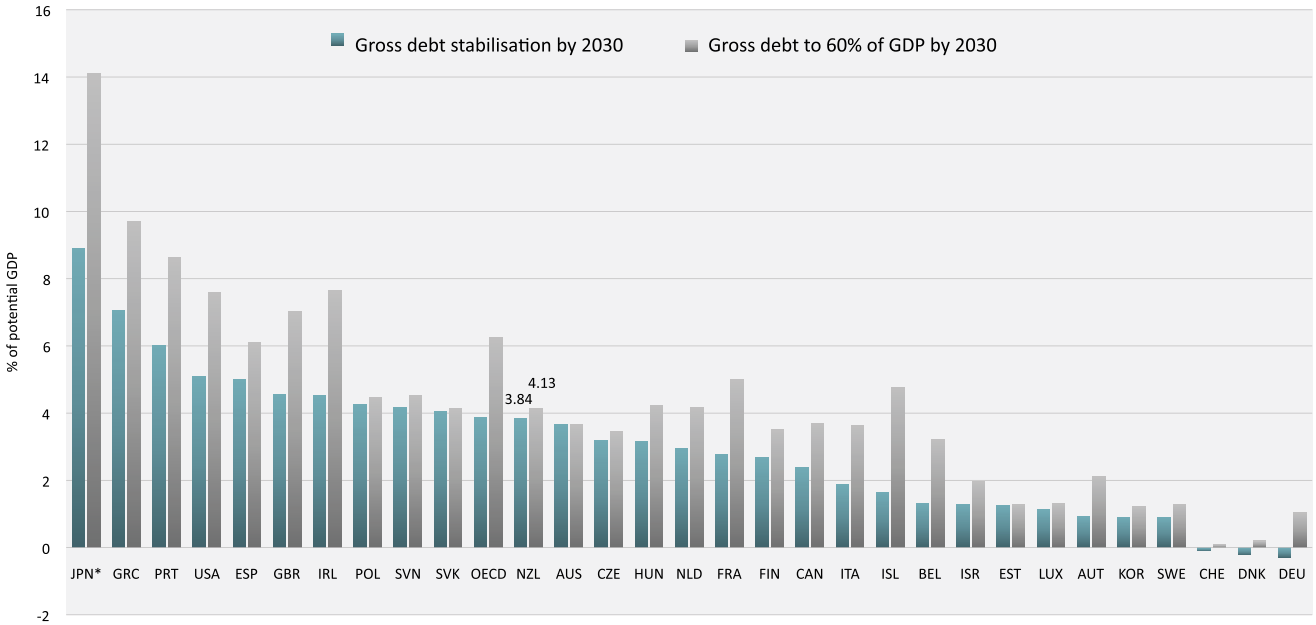
The OECD's Economic Outlook for June 2012 estimated New Zealand's general government underlying primary balance in 2011 to be -4.6% of GDP and provided updated projections to 2030.[43] The projections suggested that New Zealand would have to progressively increase the general government primary balance, from its 2011 ratio to GDP, by 3.8% or 4.1% of potential GDP to 2030 to stabilise debt ratios. Figure 8 puts these orders of adjustment into an OECD-wide perspective. Starting from 2011, New Zealand had fractionally more adjusting to do than Australia. The extent of the assessed adjustment for New Zealand is more significant than for many OECD countries.

41 Organisation for Economic Co-operation and Development, *Economic Outlook* No 88, 2010/2 (Paris: OECD Publishing, 2010), tables 4.3 and 4.4. See also OECD, "Fiscal Consolidation: Targets, Plans and Measures", *OECD Journal on Budgeting* 11/2 (2011).

42 Organisation for Economic Co-operation and Development, *Economic Outlook* No 88, 2010/2, Ibid. Table 4.5, p. 233.

43 Organisation for Economic Co-operation and Development, *Economic Outlook* No 91, 2012/1 (Paris: OECD Publishing, 2012), Chapter 4, Table 4.3. See also OECD, "Fiscal Consolidation: Target, Plans, and Measures in OECD Countries", in *Restoring Public Finances 2012 Update* (Paris: OECD Publishing, 2012).

Figure 8: OECD estimates of the required fiscal consolidation by 2030



Source: OECD (2012), "Fiscal consolidation targets, plans and measures in OECD Countries", in Restoring Public Finances, 2012 Update, OECD Publishing, figure 1.3, p 23.

PROJECTIONS TO 2050

A further OECD paper in the same year published fiscal gap projections up to 2050.[44] This time its baseline projection assessed the degree to which general government primary balances would need to be increased immediately and permanently from the 2012 levels to stabilise debt ratios by 2050, taking into account projected values for future interest rates relative to GDP growth, but ignoring additional spending pressures due to ageing populations and rising health care costs.

For New Zealand, the baseline fiscal consolidation adjustment was substantial as the 2012 primary balance ratio was -4% of GDP and the assumed interest rate of 4.9% materially exceeded the projected growth rate for nominal GDP of 3.2% p.a.[45] Specifically, the general government primary balance would need to be increased immediately and permanently by around 5.5% of GDP from 2012 (to put it permanently into surplus by the order of 1.5% of GDP) to stabilise the debt ratio. Of 26 OECD member countries, only the United Kingdom, the United States and Japan had bigger fiscal gaps than New Zealand on this measure.[46]

The same paper also assessed likely increases in pension and health care spending for each country between 2010 and 2050. New Zealand's pension spending was projected to rise by 8% of GDP between 2010 and 2050, a rise matched only by Korea and exceeded only by Luxembourg (13.5%) across 26 OECD member countries. The projected rise for Australia was only 1.6% of GDP. New Zealand was also projected to be at risk that cost pressures in health spending could lift health spending by 1.8% of GDP between 2005 and 2025 and a further 2.4% of GDP between 2026 and 2050. Both these projections were close to the top of the range for the same 26 countries. Finally, New Zealand was more in the middle of the pack for projected increases in spending on long-term

44 Merola and Sutherland (2012), op. cit.

45 Ibid. Table 1, p. 11.

46 Ibid. Figure 2 and Table 3.

Table 8: OECD's fiscal gap projections for New Zealand and Australia

	Baseline (% of GDP)	**Add pension spending growth** (% of GDP)	**Also add high cost growth scenario for health care spending** (% of GDP)	**Further add allowance for increased spending on long-term health care** (% of GDP)
New Zealand	5.5	7.5	9.0	9.6
Australia	0.5	1.2	2.7	3.2
Implied immediate and permanent underlying primary balance surpluses				
New Zealand	1.5	3.5	5.0	5.6
Australia	1.1	1.8	3.3	3.8

Source: Merola and Sutherland (2012), op cit, table 3, p. 18 and table 4, p. 23

health care with projected increases of 0.6% of GDP between 2005 and 2025 and 1.4% of GDP between 2026 and 2050.[47]

The upshot of these projections was that of 25 OECD member countries, only Japan faced a bigger fiscal adjustment requirement than New Zealand, although Luxembourg and the United States are in the same category as New Zealand.

Specifically, where the target for each country for gross debt is 50% of GDP in 2050, and projected health care cost pressures are not contained, the general government primary balance in 2012 would need to be increased immediately and permanently by 12.2% of GDP in Japan, by 9.6% in New Zealand, 9.8% in Luxembourg, and 9.5% in the United States.[48] Now, there's a challenge. For Australia, the figure was only 3.2% of GDP.

Table 8 provides further details on fiscal gaps (% of GDP) if gross public debt is to be held down to 50% of GDP by 2050. In New Zealand, the projected growth in spending on pensions due to demographic factors adds 2% of GDP to the fiscal gap, cost pressures in health spending threaten to add a further 1.5% of GDP, and increased government spending on long-term health care for the ageing population could add a further 0.6% of GDP to the fiscal gap.

Such figures need to be interpreted very cautiously because they are very sensitive to imprecision in the estimation of the underlying fiscal balance in the base year for the projections, and this imprecision is serious. As already mentioned, the historical estimated base year primary balances for New Zealand were in deficit by 4%, 4.6% and 4% of GDP in 2025, 2030 and 2050, respectively. Yet the estimated deficits for the same years in the Annex tables in the latest OECD Economic Outlook (May 2014) have been reduced to 2.4%, 1.5% and 0.2% of GDP, respectively. Other things being equal, that revision would reduce the fiscal gaps for New Zealand by 3.8 in each case (Table 6). Conversely, the latest estimate of Australia's general government primary balance for 2012 is a deficit of 2.2% of GDP, whereas the 2012 projections to 2050 estimated a surplus of 0.6% of GDP. Other things being equal, that would increase all the figures for Australia by 2.8 (Table 6). For example, the baseline gap would reduce from 5.5 to 1.7 for New Zealand, and increase from 0.5 to 3.3 for Australia.

To guard against this problem, the bottom of Table 8 presents the projected primary balance surpluses that need to be achieved promptly and permanently by 2050 to have a stable gross debt outlook of 50% of GDP up to 2050. The required surpluses are appreciably larger in New Zealand.

One point of interest is that higher pension burdens due to ageing add more to New Zealand's fiscal

47 Ibid. Table 2, p. 13.

48 Ibid. Table 4.

challenge that to Australia's, but rising health care costs pose much the same challenge (relative to respective GDPs) in both countries.

3.3.2 BIS projections to 2060

Auerbach assessed the long-term fiscal sustainability of 20 'major' economies in a BIS working paper.[49] New Zealand was included. Auerbach started with 2010 levels for GDP and net publicly held debt for general government, and the International Monetary Fund (IMF) projected primary surpluses out to 2016 for each country. Beyond 2016, he used IMF projections for the growth in health and public pension spending, but assumed that revenue and all other non-interest components of spending would be constant as a percentage of GDP at their 2002–07 average levels. For his base case projection, Auerbach assumed a 3% real interest rate and 2% p.a. real growth rate for GDP up to 2060.

New Zealand's fiscal gap in the base case (which includes increases in pension and health spending relative to GDP) is 3% of GDP. Since Auerbach's paper does not disclose whether the base year for calculating that gap is 2010 or 2016, or what the assumed deficit or surplus was for New Zealand in the base year, it is not clear what permanent primary surplus this would require New Zealand to sustain from 2016.[50]

However, one clue is that Figure 4 in the paper indicates that if health care and spending did not increase as a percentage of GDP up to 2060, New Zealand would not have a positive fiscal gap at all; instead, it would actually have a negative gap of around 0.3% of GDP.[51] This finding stands in sharp contrast to the OECD projections reviewed in the previous section, but if Auerbach used 2016 for his base year that could explain much of the difference.

Other points arising from Auerbach's paper include:

- initial debt levels can easily make a smaller contribution to fiscal gaps than the magnitude of future primary balances when projecting up to 2060;
- higher interest rates relative to assumed GDP growth rates can markedly raise calculated fiscal gaps for countries with large primary imbalances and large initial net debt. (Note that the OECD projections assumed a 2% gap between interest rates and the GDP growth rate.); and
- empirical evidence that countries with larger budget deficits tend to face higher borrowing costs (specifically, an increase in a budget surplus of 1% of GDP might reduce the government's borrowing costs by 17 basis points).

3.4 CONCLUDING OBSERVATIONS

New Zealand's fiscal performance has been better than most other OECD countries with respect to deficits (see Figure 8) and debt. New Zealand's relative net debt situation would have been more favourable if the assets in New Zealand Fund were counted as part of net debt.

The OECD's projections for New Zealand present an unduly dire picture of New Zealand's fiscal situation, given its much stronger budget balance situation since 2012. But they are a reminder of both the materiality of the budget balance adjustments under the current government and their fragility.

49 Alan J. Auerbach, "Long-term Fiscal Sustainability in Major Economies", BIS Working Papers No 361 (Bank for International Settlements, 2011). Discussion Comments by Pier Carlo Padoan, Paul van den Noord and Ray Barrell.

50 The 2014 IMF World Economic Outlook estimated New Zealand's general government primary net borrowing requirement at 5.4% of GDP in 2010 versus a primary net lending (surplus) of 1.7% of GDP in 2016.

51 This indicates that the rise in health care and pension costs in Alan Auerbach's projections is materially smaller than that shown in Table 8 of this report.

Any government can easily return New Zealand to serious fiscal deficits in just a few years.

Both the OECD and BIS (Auerbach) projections point to projected increases in government spending on pensions and health as being a particularly significant problem for New Zealand in an OECD-wide context. Many other countries have much more serious structural fiscal problems than New Zealand independently of this consideration, but the fiscal cost of demographic ageing seems to be particularly severe for New Zealand relative to GDP.

It is not clear why in 2012 the OECD projected a rise in pension spending of 8% of GDP between 2010 and 2050 when Treasury's RHCG scenario projects a rise of just under 3% of GDP. In the same scenario, Treasury projects that health spending will be 9.9% of GDP in 2050, up from 5.7% in 2005. This increase of 4.2% of GDP is the same as the sum of the increases of 1.8% and 2.4% that the OECD projects for 2005–25 and 2026–50, respectively.

Nonetheless, the message is that New Zealand's future fiscal balance challenges come from projected rises in health care and pension costs (in addition, of course, to ongoing risks of budget blowouts from lack of fiscal discipline by some future government).

THE NEW ZEALAND INITIATIVE

CHAPTER FOUR
PUBLIC FINANCE FRAMEWORK

4.1 INTRODUCTION

Statisticians and public sector accountants can and do tell us what government is spending our money on. But they cannot tell us why. Nor can they tell us what governments *should* be spending our money on.[52]

Section 4.2 summarises what governments have been spending our money on, using the international system of national income accounts classification, as applied by SNZ.

The analysis of why governments are spending as they are requires a theory of political decision-making that can be tested against observed spending patterns. Economists refer to such a theory as a positive theory because it is concerned with understanding what *is* happening whether the analyst likes it or not. The positive theory that economists have developed to examine why politicians and government agencies behave as they do is called public choice theory.

Section 4.3 summarises some findings from positive analyses of government actions.

In contrast, section 4.4 looks at the government spending problem from a normative perspective. A normative analysis seeks to examine what *ought* to be happening from a value-laden perspective. In an optimising framework, a normative analysis might propose that politicians should be seeking to maximise some objective (such as greater prosperity for the people, more law and order, a cleaner environment, or greater observance of a religious or moral code) and show why different decisions need to occur to achieve that goal.

More particularly, in the current context, the projected debt blowout in the RHCG scenario implies that decisions may need to be taken sooner or later to reduce aggregate spending net of revenues. So when will those decisions be made and what will be their nature? Moreover, are they likely to be the best possible decisions, from some normative perspective, if nothing is done to change the budgetary processes, or is some change to existing budgetary processes desirable so as to increase the changes of better future decision-making?

4.2 WHAT GOVERNMENT IS SPENDING OUR MONEY ON

The United Nation's system of national accounts distinguishes between four main categories of *current* government spending:

- collective consumption;
- social assistance in kind (e.g. provision of tax-funded state schools and hospitals);
- social assistance in cash (e.g. NZS payments and welfare benefits);[53] and
- other current spending (e.g. capital consumption, interest on public debt, subsidies, financial support for domestic charitable organisations, and overseas aid).

52 For an extensive discussion of the positive and normative analytical frameworks for assessing public policy issues, see New Zealand Business Roundtable, *Public Policy: An Introduction* (Wellington: New Zealand Business Roundtable, 2007).

53 The classification does distinguish between social security *benefits* in cash and social security *assistance* in cash, but the latter is much larger fiscally for New Zealand; for the purposes of this report, the term 'social assistance in cash' includes social security benefits in cash.

Collective consumption is defined as current spending on goods and services that 'benefit society as a whole'. This is the category that comes closest to the economists' definition of public good spending – spending that is non-rivalrous and non-exclusive. The classic example is spending on defence, security and police where all law-abiding persons should, in principle, benefit from greater security for their persons and possessions, with no one person's benefit detracting from another's and without it being practical to exclude from the benefits any person who avoids paying a share of the costs.

Most 'core' or 'traditional' government spending falls into this category. Spending to protect the public against the transmission of communicable diseases is widely regarded as public good spending. In contrast, spending on your or my knee operation is rivalrous (no one else's knee gets the benefit) and exclusive (if payment was required, I could be excluded if I didn't pay). Most government spending on health benefits only the recipient. Economists define it as spending on private goods and consider the money to be transferred from taxpayers at large to individual recipients. Statisticians categorise it as social assistance in kind as distinct from in cash.

Social assistance in kind or in cash benefits the particular individuals receiving that benefit; the dollar received in cash or in kind by the recipient can't in itself give a dollar of benefit to anyone else, except at the expense of the recipient.

Table 9 summarises SNZ's breakdown of central government spending and income for the year ended March 2013 using these categories.

During that year, government tax revenues amounted to 28% of GDP, or $35,664 per household. Total current revenue, including fees, charges, levies and investment income, amounted to 33% of GDP, or $41,953 per household. Spending, including finance costs and provision for capital consumption (depreciation), exceeded this at 33.9% of GDP, or $43,071 per household.

Government spending on collective consumption was the smallest of the four current spending categories in that year – at $6,952 per household, or 5.5% of GDP. It was dwarfed 4.2:1 by spending on social assistance in kind or in cash of 28,918 per household, or 22.7% of GDP. (Average annual spending on such social assistance has exceeded spending on collective consumption by 3.7:1 on average during the 27 years between 1987 and 2013.)

In short, SNZ's statistics establish, whether one likes it or not, that taxes in New Zealand are primarily levied for redistributive, social assistance purposes.

Table 9: Central government current spending and income, year ended March 2013

	% of GDP	Per household ($)	% of total
Total taxes	28.0	35,664	85%
Other revenue	4.9	6,289	15%
Total government income	**33.0**	**41,953**	**100%**
Collective consumption	5.5	6,952	16%
Social assistance in kind	11.8	14,995	35%
Social assistance in cash	10.9	13,923	32%
Other current spending*	5.7	7,200	17%
Total current spending	**33.9**	**43,071**	**100%**
***Memorandum item: Breakdown of 'other current spending'**			
Finance costs	2.0	2,542	35%
Capital consumption	1.0	1,333	19%
Subsidies	0.2	271	4%
Other payments	2.4	3,054	42%

Source: Statistics New Zealand, "Institutional Accounts" (SNZ, November 2013).

Governments can and do also provide for public and private goods through capital spending. Table 10 summarises central government capital

spending during the year ended March 2013. Gross fixed capital formation was only $1,538 per household, well under a third of current spending on collective consumption and barely enough to cover capital consumption of $1,333. Net lending was negative overall.

Table 10: Capital outlays by central government, year ended March 2013

Financing of capital outlays	% of GDP	$ per household
Government savings	-0.9%	-$1,118
Capital consumption	1.0%	$1,333
Net capital taxes and transfers	-0.6%	-$788
Total financing	**-0.5%**	**-$573**
Capital outlays		
Increase in inventories, land and intangible assets	0.2%	$249
Gross fixed capital formation	1.2%	$1,538
Net lending	-1.9%	-$2,361
Total outlays	**-0.5%**	**-$574**

Source: Statistics New Zealand, "Institutional Accounts" (SNZ, November 2013).

Central government gross fixed capital formation has averaged 28% of spending on collective consumption during the last 21 years. Net of capital consumption it has averaged 0.7% of GDP, whereas collective consumption has averaged 6% of GDP.[54]

In short, the provision of public goods through either current or capital spending is not a major financial activity of government. The fiscal choices the country faces are largely those relating the degree to which national income should be churned through the public accounts via taxes and social assistance spending.

The level and composition of government spending have implications for the standard of living:

> Theory and evidence suggest that it is possible for large governments to undermine economic growth due to the economic costs of raising taxation to finance expenditure. There is strong evidence that taxes reduce economic growth through their negative impact on incentives to work, save and invest. However, much expenditure contributes to economic growth and some taxes are more damaging for economic growth than others. Therefore, the impact on economic growth of the level of expenditure will depend on the type and quality of expenditure and the mix of taxes used to finance it.[55]

Well-justified capital spending by government and current spending protecting individual autonomy and enhancing the ability of individuals to contract and exchange goods and services with one another obviously raise community well-being, in principle. Transfer spending that taxes middle- and higher-income earnings with one hand to give it back to the same taxpayers with the other is particularly hard to justify from a growth/productivity perspective.

4.3 POSITIVE ANALYSIS OF THE LEVEL AND COMPOSITION OF GOVERNMENT SPENDING

The positive analysis of government spending (and regulation) seeks to explain why governments do what they do, rightly or wrongly.

The base proposition is that politicians seek political power. To achieve that power in a democracy, they have to attract more votes than their opponents. A successful politician must

54 The composition of New Zealand Government spending in an economic classification is similar to the OECD average. See Diana Cook, Carsten Schousboe and David Law, "Government and Economic Growth: Does Size Matter?" op. cit.

55 Ibid. Abstract.

be able to 'count heads' – to assess relatively accurately what policies and positions will attract enough votes.

Which policy and positioning combinations will attract the most votes depends on the nature of the electoral options (particularly the constraints they put on self-serving actions) and what appeals to active supporters (who fund and staff political campaigns) and, ultimately, to voters at large.

The most naïve proposition is that voters vote only for the common good, caring not one whit for the effect of those policies on themselves personally. It means that a pensioner is just as likely to vote for a cut to NZS as a 20-year-old voter, or someone on the top tax rate is just as likely to vote for that rate to be increased as someone on the bottom tax rate, or *vice versa*.

In reality, voter groups lobby politicians incessantly for benefits at the expense of someone else. Beneficiary groups lobby for enhanced benefits, teachers and their unions lobby for more pay and less accountability, higher-income earners lobby for lower tax rates, ethnic groups lobby for greater resources for their group, and leading business organisations lobby for greater corporate welfare. Some of the smaller political parties unashamedly focus on getting votes from small, unrepresentative constituencies, such as 'our' people.

Every self-interested constituency naturally provides 'good' public interest reasons to support its claims, and politicians who decide to appeal to their votes will find themselves echoing those reasons. But voters know much of it is a charade and hold politicians in low esteem for counting heads.

The reported favourable reactions in the mainstream media from those benefiting from the increases in social assistance spending announced in the 2013 Budget made it clear that there is little public shame in advocating and applauding self-serving spending increases. More is better, as long as it is at someone else's expense. Since there are always people who are better off than oneself, there is no difficulty in arguing for such redistribution on equity grounds.

As Frédéric Bastiat pointed out around 150 years ago, if a political system is dominated by self-serving redistributive impulses, no voter (or politician) can safely be neutral.

> As long as it is admitted that the law may be diverted from its true purpose – that it may violate property instead of protecting it – then everyone will want to participate in making the law, either to protect himself against plunder or to use it for plunder.[56]

Richard Epstein summed up the situation today as follows:

> Today's unending cycle of regulation, taxation, and transfer payments induces non-stop political competition, which lets strong voting coalitions take from their adversaries in order to enrich their friends. This dynamic leads to crony capitalism that reduces the return to both capital and labour.[57]

Of course, self-interested voters also care about adequate provision of public goods – security in their own person and property; protection against unwanted pests and diseases from overseas; control of communicable diseases; and the provision of efficient and effective network industries, such as water supply, waste treatment, public administration more generally, and uncongested, well-maintained public roads. 'Law and order' is commonly a general election campaign issue, along with road congestion and immigration. But as we have seen in section 4.2, nowadays these public good or collective consumption issues are of relatively minor fiscal importance.

Moreover, there are countervailing tendencies as public attitudes towards welfare are nuanced and commonly ill-disposed towards welfare fraud.

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56 Frédéric Bastiat, *The Law*: *The Classic Blueprint for a Just Society* (Irvington, New York: Foundation for Economic Education, 1998).

57 Richard Epstein, "The Piketty fallacy", *Real Clear Politics* (6 May 2014), www.realclearpolitics.com/articles/2014/05/06/the_piketty_fallacy_122547.html.

A positive analysis would propose that the outcome of the choices that must be made depends on the relative strengths of the voting constituencies at the time decisions are taken. But these relative strengths will also determine the time at which decisions are taken. As Treasury has pointed out, delay in such matters as raising the age of eligibility for NZS will shift the costs of doing so into the future through a higher public debt burden. This is more likely to concern younger voters than elderly voters, so little or nothing may be done until some crisis forces interest groups to acquiesce to some adjustment.[58]

Given the complexities of the factors that could alter the relative strength of voting constituencies, it is perhaps unsurprising that there are no clear conclusions from the positive analysis of the reasons why government spending has risen so much relative to incomes since the 1960s. Gordon Tulloch's review of the theories concluded that they all fail to provide a fully satisfying explanation.[59] It can't be explained by a Peacock-Wiseman wartime 'ratchet' effect, and the Wagner (growing demand) and Baumol (low public sector productivity) explanations fail to explain the long earlier periods of stable government spending. Rent-seeking interest groups lobbying for transfer payments were definitely influential before the 1960s, but why they were not as effective remains unexplained.[60]

The rise of the redistributive role of government ('the welfare state') has been well documented, both in New Zealand[61] and in the industrialised world.[62] It is significant that fiscal choices identified by Treasury and summarised in section 2.5 have nothing to do with the provision of public goods. Instead, those fiscal choices are all about the redistributive welfare state – options for raising taxes or reducing spending on social assistance in cash or in kind.

The positive empirical analysis reviewed in section 2.8.4 indicates that the welfare state in the industrialised world has expanded, for better or for worse, at the expense of national income per capita.

Positive analysis also shows that much existing welfare spending does not redistribute from the rich to the poor as much as benefitting those further up the income distribution.[63] This observable tendency led Aaron Director to propose that many public programs are designed primarily to benefit the middle classes but are financed by taxes paid primarily by the upper and lower classes. In a nutshell, this middle group has the numbers, the education and the nous to strong-arm politicians in its favour. In 1970, George Stigler described this empirical proposition as Director's Law.

58 The paper by Colin James to Treasury's conference on these issues in December 2013 did make the point that the fact that earlier adjustment is desirable does not mean that it will be politically achievable.

59 Gordon Tullock, "Government spending", *The Concise Enyclopedia of Economics*, www.econlib.org/library/Enc1/GovernmentSpending.html. For a long-term series on government spending in New Zealand relative to GDP, see See Diana Cook, Carsten Schousboe and David Law, "Government and Economic Growth: Does Size Matter?" op. cit. Figure 10, p. 27.

60 Suggestive observations are that the growth in government spending from the 1960s was associated with high inflation and a progressive income tax scale. In contrast, local authorities lacked the ability to print money and did not have a progressive tax structure – and their spending did not surge relative to GDP.

61 See, for example, Margaret Tennant, *The Fabric of Welfare: Voluntary Organisations, Government and Welfare in New Zealand 1840–2005* (Wellington: Bridget Williams Books, 2007) and David Thomson, *A World Without Welfare: New Zealand's Colonial Experiment* (Auckland: Auckland University Press, 1998). A special article in the *Official Yearbook 1972* sympathetically documents the rise in government welfare spending in New Zealand.

62 See, for example, Vito Tanzi, *Government Versus Markets: The Changing Economic Role of the State* (New York: Cambridge University Press, 2011).

63 See, for example, Omar Aziz, Matthew Gibbons, Christopher Ball and Emma Gorman, "The Effect on Household Income of Government Taxation and Expenditure in 1988, 1998, 2007 and 2010", *Policy Quarterly* 8:1 (Victoria University of Wellington: Institute of Policy Studies, 2012).

In recent times, interest-free student loans for tertiary students exemplify Director's Law. Tertiary education is largely the preserve of those from well-off households. State spending on tertiary education tends to benefit those who have achieved adult levels of literacy at school. The progressive income tax rate aims to ensure that those on higher incomes pay disproportionately. Children from low-income households tend to attend the lowest decile schools. Higher minimum wages benefit those who retain their jobs at the expense of those with less skill and experience who can't retain or obtain jobs.[64] Universal pensions benefit most those with the greatest life expectancy. Furthermore, in the customary static analysis, a progressive tax structure favours middle-income earners at the expense of highest- and lowest-income earners, compared to a single rate of tax with a substantial tax-free income threshold, or a benefit system equivalent.[65]

An obvious objection to Director's Law is that the bottom 50% of households in New Zealand do not pay taxes in excess of NZS and the social assistance benefits they receive in cash and kind. How could those on middle incomes benefit at their expense? The answer is they could be better off again if middle-income earners were not gaining disproportionately. For example, German economists found that across 23 OECD countries from 1971 to 2005, increasing income inequality raised redistribution from the rich and from the bottom 20% of the income distribution towards those on middling incomes.[66]

The fundamental problem is that if a political system fails to provide adequate protection for minorities, it will allow political majorities to vote for options that benefit them at the expense of minorities. The political majority may or may not represent a majority of voters. For example, minority government is an entrenched feature of Mixed-member proportional (MMP) representation, commonly gives disproportionate power to minor parties representing minority interests. That power is exercised at the time a coalition government is being formed and on a case-by-case basis when the largest party in a minority government seeks a parliamentary majority for any particular measure.[67]

Politicians and political parties that seek to obtain or retain power obviously have to bring home the bacon for their constituencies, even if the full play of the process reduces national income per capita markedly compared to what it might have been.

Of course, to identify the collective self-destructive tendencies of a system that rewards self-serving behaviour is not to assume that these tendencies must inexorably dominate. The future is not pre-determined. Figure 9 shows that central government spending, excluding finance costs, has both risen and fallen for periods between 1993 and 2013, both as a percentage of GDP and as real spending (CPI deflated) per household.

Real central government outlays per household, excluding finance costs, rose by 26% between years ended March 1996 and 2013, although the rise was less marked relative to GDP. Spending on social assistance in kind rose by an extraordinary 56%, with spending on collective consumption rising only by 16%. Despite the ageing population, social assistance paid in cash rose by only 5%.

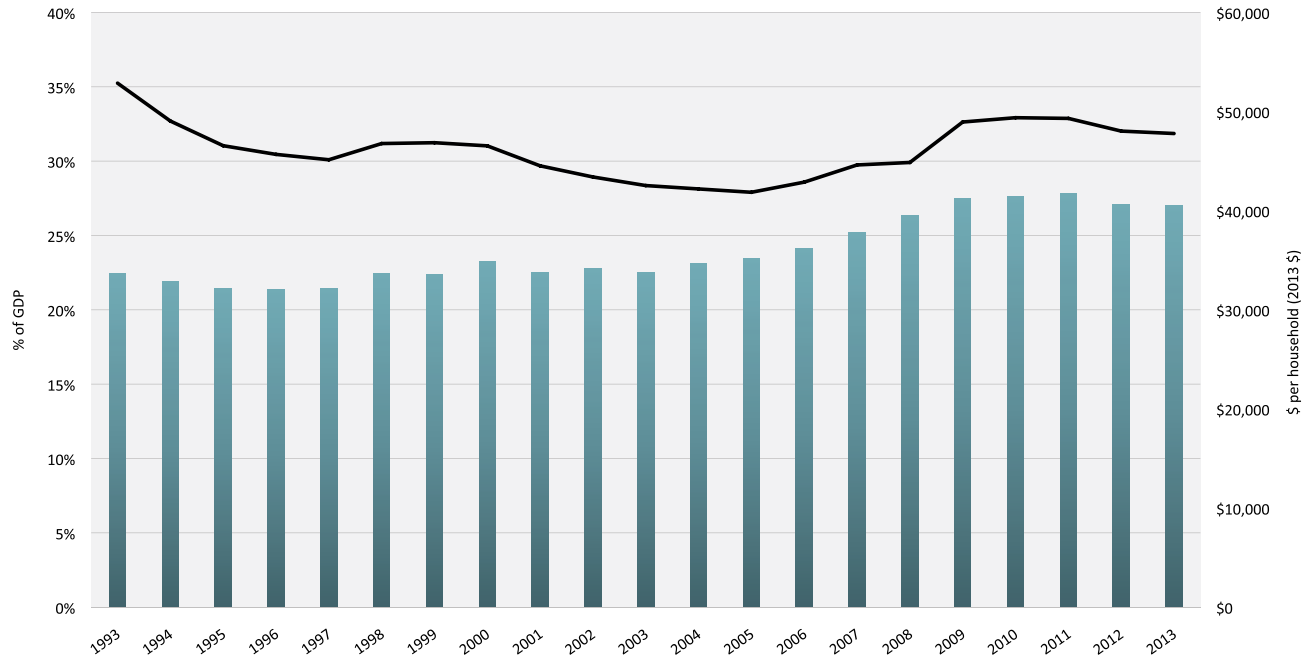
64 For an extensive discussion, see James Cox, *Middle Class Welfare* (Wellington: New Zealand Business Roundtable, 2001).

65 Cathy Buchanan and Peter Hartley, *Equity as a Social Goal* (Wellington: New Zealand Business Roundtable, 2000), Chapter 6.

66 Philipp Mohl and Oliver Pamp, "Income Inequality, Redistributional Spending & Director's Law – An Empirical Investigation", Paper presented at the *Annual IPES Meeting Philadelphia* (14–15 November 2008).

67 Government spending tends to be higher under more proportionate voting systems. See Torsten Persson, Gerard Roland and Guido Tabellini, "Electoral Rules and Government Spending in Parliamentary Democracies", *Quarterly Journal of Political Science* 2:2 (2007), p.p. 155–188. See also section 3.6 in Penelope Brook Cowen, Tyler Cowen and Alexander Tabarrok, *An Analysis of Proposals for Constitutional Change in New Zealand* (Wellington: New Zealand Business Roundtable, 1992).

Figure 9: Central government current outlays (excluding finance costs), 1993–2013



Source: Authors' calculations.

This rise per household in real spending on social assistance in kind between 1996 and 2013 accounted for 84% of the rise in total real per household government outlays, excluding finance costs, during the same period. This higher spending on largely private goods reflects the political clout of the provider and recipient beneficiaries of that spending during that period.

4.4 NORMATIVE FRAMEWORK

What government should be spending more or less on is a normative issue. Positive economic research can inform normative choices, but it can't determine them.

In their 2000 book, *Equity as a Social Goal*, Cathy Buchanan and Peter Hartley discussed the question of which normative considerations should be used to guide public policy recommendations.

Buchanan and Hartley start with the reasonable proposition that public policy decisions should be ethically justifiable in terms of both likely outcomes (which requires a consequentialist ethical theory) and consistency with widely accepted moral absolute deontological ethical principles.

Utilitarianism, or the goal of achieving the greatest good for the greatest number, is a popular consequentialist ethical theory. But its pursuit may involve the unprincipled exploitation of a minority. A mainstream utilitarian proposition is that it is wasteful (inefficient) to allocate resources other than in a way in which no one person's utility (well-being) can be improved without reducing that of someone else. The normative proposition is that inefficiency, as defined, is bad. [68]

Deolontological principles are of a moral absolute nature. Kantian principles are particularly influential in the English-speaking world. They affirm the importance of individual liberty, horizontal equity, and the rule of law. Voluntary cooperation is better than coercion. The coercive power of the state is used as a last resort but never

68 An outcome that satisfies this condition is called a Pareto optimum. Many outcomes can commonly satisfy this condition, making the choice between them moot.

to deprive people of their freedom of expression or religion. John Stuart Mill's famous normative proposition – that people should be free to make their own choices, for better or for worse, subject to safeguarding the like freedoms of others – is Kantian.

Buchanan and Hartley propose that liberty and efficiency, as outlined, are justifiable normative public policy goals. In many situations, policy decisions may be consistent with both criteria. For example, freedom of trade and contract is a personal liberty that is also consistent, at least in principle, with efficiency in the competitive supply of private goods.

A central proposition in public finance literature is that people will organise their affairs in costly ways to reduce their tax burdens and increase their eligibility for (corporate or individual) welfare programmes. The hidden costs (for example, in reduced work effort) are difficult to measure but are likely to be much larger than the amounts the relatively well-off spend on tax lawyers and accountants. These costs represent a 'deadweight cost' to the community in that no one benefits from the foregone productive work because of all this diverted activity.

It follows that it is generally more costly to fund private goods (such as education and much health care) through general taxation rather than through user-pays arrangements. Private provision of private goods will include pooling arrangements such as those provided by health insurance and private philanthropy, as in privately endowed universities and schools.

As someone once put it, "that which is free costs more". Price is one thing, cost is another. Wasteful use is costly. (The saying that there is 'no free lunch' embodies the same point, although in the broader context that one can have more of a scarce good only by having less of something else.)

In the case of public goods, such as national defence and public health, economists widely agree that taxpayer-based funding and state provision is justifiable on efficiency grounds, despite the infringement on liberty of a majoritarian-based tax system. However, taxpayer-funded provision of private goods likely reduces both efficiency and liberty.

Hence, we have the normative proposition that taxpayer-funded provision of goods and services should focus on the provision of public goods. As shown in Table 9, this category may account for 16% of government spending.

In terms of who should pay for the provision of public goods, the benefit principle of taxation proposes that the necessary taxes should be levied on those who benefit from the provision.[69] Government user-charge policies commonly embody the same normative principle. This has implications for charging for the public provision of health and education services.

However, it is often not easy to determine the distribution of benefits from the provision of public goods such as national defence. In such cases, other normative criteria such as liberty and efficiency, along with issues of consent and/or fairness, need to be considered.

Buchanan and Hartley do address the question of how to best incorporate equity considerations into normative policy deliberations. The authors endorse as valid normative public policy goals horizontal equity (equal treatment of equally situated people), equality before law, and compassion.

However, they reject envy as a valid justification for public policy recommendations. They argue that a concern about income or wealth equality all the way up the income scale indicates an envy motivation, since it implies that those who are not wealthy would be better off if no one else was wealthy, even if their own positions were entirely unchanged.

Buchanan and Hartley suggest that a single rate of tax meets the normative goals of efficiency and equity better than a multiple rate progressive tax

69 See, for example, the "Economic Definition of benefit principle. Defined", *Economic Glossary*, http://glossary.econguru.com/economic-term/benefit+principle.

structure.[70] (A single rate of income tax would reflect a greater weight on compassion and less on envy.)

Claims that 'intergenerational equity' requires that resource use should not jeopardise the prospects of future generations fail to balance this concern with the welfare of the present generation.[71] The authors also point out that political processes provide a 'less than ideal' mechanism for looking after future generations.

They summarise their conclusions on the normative role for equity considerations as follows:

> In summary, equity, or fairness, can best be achieved by safeguarding each individual's right to personal safety and personal property, by ensuring that each individual is equal before the law, by promulgating a belief in the power and duty of families and private charities to help the indigent, and by creating a limited government welfare programme to aid those in need who fail to receive familial or charitable assistance.[72]

In *The Spirit Level*, Richard Wilkinson and Kate Pickett make an empirical case that countries with high income inequality have poorer well-being outcomes all the way up the income scale than countries with less income inequality. Even the rich are worse off. At its starkest, the proposition seems to be that if Bill Gates decided to live in New Zealand, the life expectancy of New Zealanders would somehow fall, purely because the income distribution in New Zealand would have become less equal. This thesis, if correct, would make an *a priori* consequentialist (efficiency) case for policies to reduce income inequality. Indeed, Pickett told an Auckland University audience in May 2014 that she would impose a 100% inheritance tax if she could.[73]

Apparently, people should not be allowed to pass a family farm or business on to their children. However, the robustness of their empirical work and assertions concerning causation have been seriously questioned.[74]

Another recent book that has attracted substantial international fame is *Capital in the Twenty-First Century* by Thomas Picketty. Its central proposition is that if future economic growth is low relative to the return on capital, the rich may become richer to a degree that destabilises societies, with dire consequences for all. Picketty thereby makes a consequentialist case for government action, including very high marginal income tax rates for those on very high incomes, and a global wealth tax for those with extreme wealth. His thesis and remedies have been strongly contested,[75] but it is worth noting that these proposals are not his most preferred policies.

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70 Also see Richard Epstein, *The Case for the Flat Tax* (Wellington: New Zealand Business Roundtable, 2004).

71 Cathy Buchanan and Peter Hartley, *Equity as a Social Goal*, op. cit., p. 205.

72 Ibid. p. 234.

73 As reported in the *Sunday Star Times* (3 August 2014), p. D6 in respect of Kate Pickett.

74 Roger Kerr provides links to several critical assessments at "The Spirit Level 2", *Roger Kerr* (1 February 2011), http://rogerkerr.wordpress.com/2011/02/01/the-spirit-level-2/. See also Christopher Snowden, *The Spirit Level Delusion: Fact-checking the Left's New Theory of Everything* (Monday Books, 29 August 2011), and his exchanges with Richard G. Wilkinson and Kate Pickett on his blog site: http://spiritleveldelusion.blogspot.co.nz/. The blog *Offsetting Behaviour* reported on 3 May 2012 that Australian Labor Party MP and economist Andrew Leigh had commented that he used to believe in the proposition that greater inequality causes worse social outcomes, and still wants to believe it, but his own research persuades him otherwise. Any negative effects must be extremely small, and there are also small positive effects. Wikipedia's entry on *The Spirit Level* also lists many critics and their criticisms. See Wikipedia, "The Spirit Level: Why more equal societies almost always do better", http://en.wikipedia.org/wiki/The_Spirit_Level:_Why_More_Equal_Societies_Almost_Always_Do_Better.

75 See, for example, the review by Tyler Cowen of Thomas Piketty, *Capital in the Twenty-first Century*. Translated by Arthur Goldhammer (Belknap Press, 2014), in "Capital punishment: Why a global tax on capital won't work foreign affairs", *Foreign Affairs* (May/June 2014), www.foreignaffairs.com/articles/141218/tyler-cowen/capital-punishment; Richard Epstein, "The Piketty fallacy", op. cit.

PIKETTY: Well, first of all, you know, the best policy, of course, is to raise the growth rate. So the first thing that you want to do is to raise the growth rate. The other thing that you want to do is to raise education, which is the major way to reduce inequality in earnings.[76]

Buchanan and Hartley's general conclusion is that public decision-making involves a continual rebalancing of various goals rather than the exclusive pursuit of any one of them. Constraints on political majorities are necessary to protect minority groups.

4.5 CONCLUSIONS

Government spending is dominated by transfer spending, including spending on monetary benefits and private medical and educational services. All fiscal concerns arise from the pressure that spending on these items puts on the tax base.

The question of what should be done to head off projected fiscal imbalances is a normative one. Normative policy criteria include considerations of liberty, efficiency of outcomes, and fairness or equity. Policies that reflect compassion or fair play in the sense of equal treatment are easier to justify than policies based on envy or greed.

The criteria of liberty and efficiency favour focusing government non-transfer spending on public goods rather than on private goods. A flatter tax scale is better than a more progressive one since the efficiency costs of taxes rise in rough proportion to the square of the tax rate, and it is also more consistent with compassion from an equity perspective. The benefit principle of taxation also carries weight wherever it can be efficiently applied.

Transfer spending not related to public goods or compassion is harder to justify, given the costs to liberty and efficiency of increased tax burdens and competition between recipients of such spending.

Whether transfer spending motivated by compassion and genuinely aimed at alleviating poverty should be provided in kind (as with health and education) or cash is a matter for debate. Payment in cash gives the recipient more options to maximise the benefit received, but payment in cash to people who cannot budget because of drug dependency will obviously have unfortunate results.

Achieving fiscal consolidation when necessary, and improving policies and institutions so that it is less likely to become necessary, requires effective political leadership. It likely also requires independent voices in the media, whether from journalists, academics, businesses, think tanks or the lay public more widely, to make the case for more socially cohesive policies and institutions.

Where fiscal consolidation is necessary, the OECD's summary assessment is that:

- past experience indicates that spending cuts are more effective than revenue increases;
- pension reform, greater efficiency in health and education, reducing subsidies and tax expenditures, and removing barriers to employment should be priorities;
- tax structures should focus on minimising the distortionary effects of raising tax revenues; and
- fiscal rules and institutions can increase the chances of success.[77]

Chapter 6 develops this last point.

THE NEW ZEALAND INITIATIVE

76 Thomas Picketty, interview by Justin Vogt, "Focus on books: Thomas Piketty on economic inequality", *Foreign Affairs* (23 April 2014), www.foreignaffairs.com/discussions/audio-video/foreign-affairs-focus-on-books-thomas-piketty-on-economic-inequality.

77 Organisation for Economic Co-operation and Development, *OECD Economic Outlook*, *Volume 2012/2, Preliminary Version* (Paris: OECD Publishing, 2012), p. 221.

CHAPTER FIVE
FISCAL POLICY OPTIONS

5.1 INTRODUCTION

This chapter looks at expenditure growth reducing options and revenue options in greater detail.

As discussed in section 4.3, these options focus on enhancing growth in national income by reducing effective marginal tax rates and encouraging government to alleviate poverty and provide public goods in a more efficient manner. This means increasing the degree to which private goods are supplied by competing private providers and reducing the prevalence of middle- and upper-income welfare.[78]

The biggest ticket items of core Crown operating spending in 2010 were health, social welfare spending (other than on NZS), education and NZS. In the year ended June 2010, spending on these items was 6.8%, 6.7%, 6.1% and 4.3% of GDP, respectively (23.9% of GDP in total).[79]

From a poverty-alleviating perspective, a high proportion of this public spending is poorly targeted.[80] From an efficiency perspective, the deadweight costs of raising taxes to fund the large private good component of such spending are likely to be high. While Treasury's cost-benefit primer suggests that $1 of tax-funded government expenditure should be assessed as costing the community $1.20, the research cited in section 2.7.3 indicates that the cost is much higher for at least some tax dollars.

Figure 10 shows the projected rises in six categories of primary spending between 2010 and 2060 under the RHCG scenario. The projected rise in health spending of 4% of GDP (to 10.8% of GDP) is the largest, followed by 3.5% on NZS. However, projected spending grows more slowly than GDP for the remaining categories of primary government operating spending. The scale of spending on health and NZS is so considerable that it raises projected primary spending by 3% of GDP.

The costs of unnecessary public provision of private goods are greater the less efficient the public sector is in providing those goods. Lack of competition, inadequate price discovery, conflicting objectives, and poor measurement and evaluation systems are always a threat to public sector efficiency. Diana Cook, Carsten Schousboe and David Law cite a number of studies and surveys that indicate broad deficiencies in public sector efficiency in New Zealand. One study of education spending efficiency found New Zealand to be "in the middle of the OECD pack".[81] A study of health spending also put New Zealand around the OECD average but with particularly low scores for acute care and very high administrative costs.[82]

78 The 2025 Taskforce's two reports on how the income gap with Australia could be closed by 2025 had a similar focus. 2025 Taskforce, *Answering the $64,000 Question: Closing the Income Gap with Australia by 2025* (Wellington: New Zealand Treasury, 2009) and *Focusing on Growth* (Wellington: New Zealand Treasury, 2010).

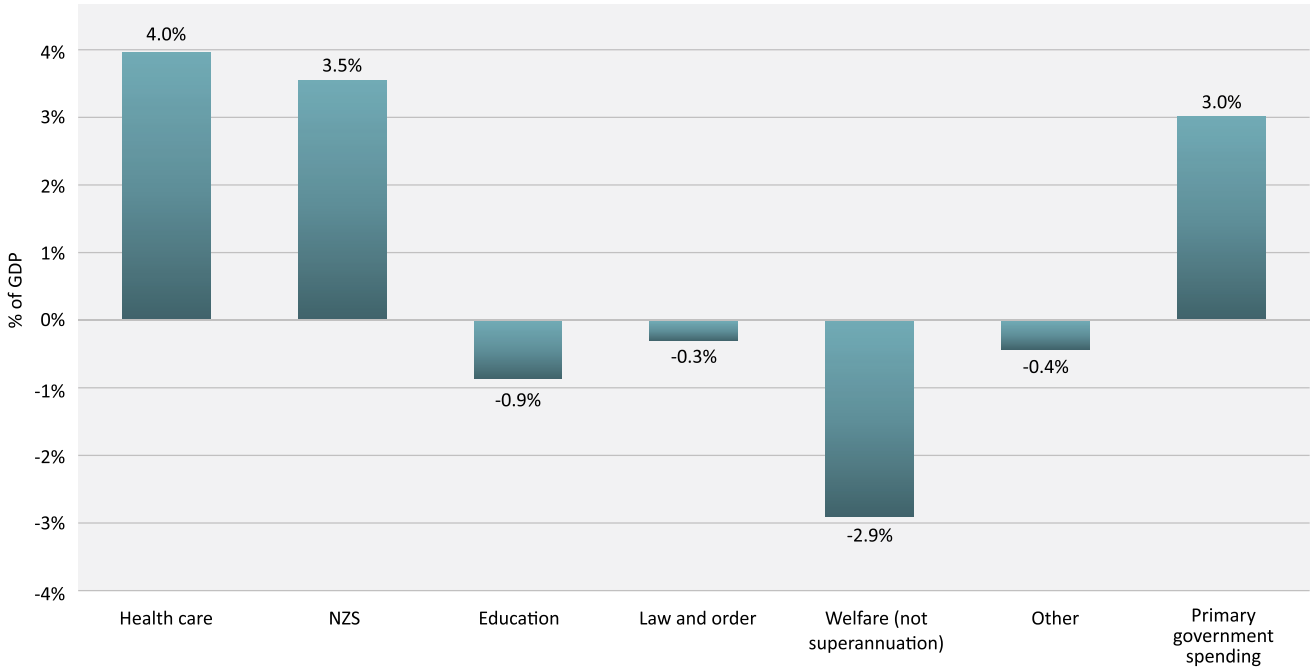
79 Treasury's pre-election economic and fiscal update in August 2014 projects that NZS payments and other social welfare spending will both be 4.9% of GDP by the year ended June 2016.

80 An OECD analysis suggests that less than 20% of New Zealand's social spending is means tested. We transfer about 1% more of GDP than the OECD average to people of working age, but still have a "relatively high poverty rate" for this group. See Diana Cook, Carsten Schousboe and David Law, "Government and Economic Growth: Does Size Matter?" op. cit., p. 33.

81 Ibid. 33.

82 Ibid. 33.

Figure 10: Increases in projected spending between 2010 and 2060–RHCG scenario



Source: Treasury's Long-Term Fiscal Model, 2013.

Given the significance of health spending in total spending, we look at options for containing it first –in section 5.2.

Sections 5.3, 5.4, 5.5 and 5.6 consider options for reducing government spending on NZS, other welfare, education, public goods, and 'other' spending, respectively.

Section 5.8 provides some concluding comments.

5.2 HEALTH

Central government public spending on health care was running at 3.6% of GDP in the mid-1960s. The big spending third Labour government lifted it to 5.3% of GDP by 1975/76. For the next two decades, it ranged between 4.6% and 5.7% of GDP. It took the fifth Labour government to break the 6% of GDP barrier, and the current National government has been holding it at a record high of 6.8% of GDP. The RHCG scenario projects health spending to be around 10.8% of GDP in another 50 years.

An international perspective can be found in David Gadiel and Jeremy Sammut's comparative statistics on health spending and outcomes in Singapore, Australia, New Zealand, the United Kingdom, and the United States.[83]

83 David Gadiel and Jeremy Sammut, *Lessons from Singapore: Opt-Out Health Savings Accounts for Australia* (Sydney: The Centre for Independent Studies, 2014).

Table 11: Total (public and private) health expenditures and indicative outcomes, 2011–12

Health expenditure	Singapore	Australia	New Zealand	United Kingdom	United States
% of GDP	3.6	9.5	10.3	9.1	17.0
Per person, AUD	1,766	6,230	4,751	4,898	12,206
Indicative health outcomes					
Life expectancy at birth, M/F	79.9 / 84.5	79.9 / 84.3	79.4 / 83.0	79.1 / 83.1	76.3 / 81.1
Life expectancy at 65, M/F	18.5 / 21.9	19.1 / 22.0	19.0 / 21.2	18.0 / 21.2	17.8 / 20.4
Infant mortality per 1,000 live births	1.8	3.8	5.5	4.3	6.1
Under 5 mortality per 1,000 live births	2.8	4.9	5.7	4.8	7.1

Source: David Gadiel and Jeremy Sammut, *Lessons from Singapore: Opt-Out Health Savings Accounts for Australia* (Sydney: The Centre for Independent Studies, 2014), table 2, p. 8 and table 4, p. 15.

One striking finding is that Singapore is spending much less per person than the other four countries, and is getting much better outcomes in terms of infant and pre-school mortality. (The United States is spending more than everyone else, for no apparent gain, at least on these measures.)

As Gadiel and Sammut point out, Singapore seems to provide a greater value-for-money discipline for providers and consumers by having a greater element of user-pays (see Table 12). Public health expenditure in Singapore in 2012 was 37.6% of total health expenditure, compared to 82.7% in New Zealand. Expressed differently, private spending on health was $1.66 per dollar spent by government in Singapore, but 21 cents per dollar in New Zealand. Moreover, a particularly high proportion of private health spending in Singapore (58.6% in 2012) was out-of-pocket spending. The contrast between Singapore and the United States is particularly dramatic in this respect. Private spending in the United States is not too far short of that in Singapore as a proportion of total health spending, but in the United States a much smaller proportion is funded on an out-of-pocket basis.

Table 12: Public vs private expenditure balances, 2012

	Singapore	Australia	New Zealand	United Kingdom	United States
Public expenditure % total health expenditure	37.6	66.9	82.7	82.5	46.4
Out-of-pocket expenditure % of private expenditure	58.6	18.5	10.9	9.9	11.1

Source: The World Bank, "2.15: World Development Indicators: Health systems", http://wdi.worldbank.org/table/2.15.

Singapore's configuration reflects several factors in its historical development:

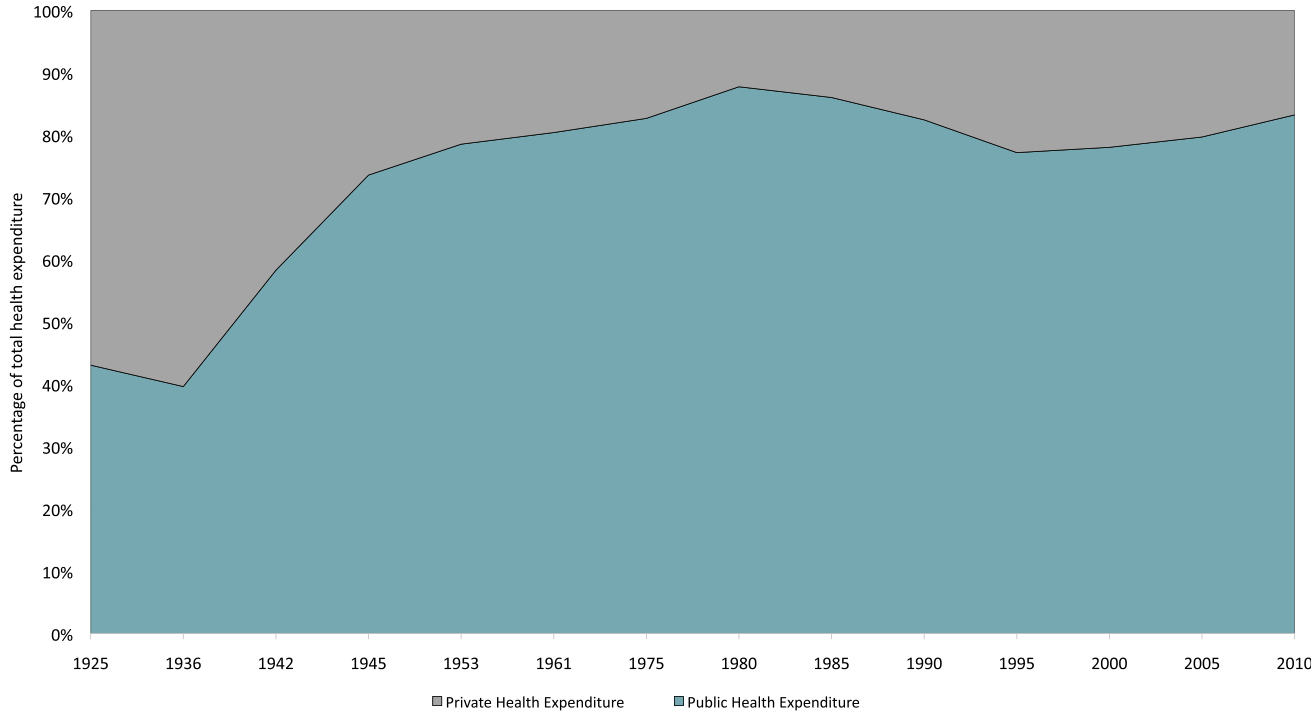
- a recognition that an out-of-pocket element is essential to induce providers to be concerned about customer affordability and 'value for money', and for customers to think hard about whether additional components of spending really were necessary;
- a marked aversion to a large (US-scale) role for private insurance, for fear that it would undermine spending control disciplines;
- a mandatory health savings account to ensure citizens set aside money for out-of-pocket health expenses; and
- an administrative commitment to excellence in provider performance.

Singapore's approach was part of a broader determination to avoid the 'cradle to grave' welfare system being adopted in the Western world, seeing it as inimical to Singapore's chances of survival as an independent entity.

There are fundamental philosophical differences between the approaches in Singapore, the United States, and the other three countries. When state-funded providers dominate the system, it is hard to create competitive pressure and price discovery – critical requirements for achieving 'value for money' efficiency in private goods and services.

During the late 1930s, New Zealand moved decisively towards a 'cradle to grave' welfare state. That move has largely endured. Figure 11 shows its effects on the proportion of state health spending. There was some reduction following New Zealand's debt crisis in the mid-1980s, but the degree to which health spending is financed through the tax system trended back upwards during the 2000s. Labour's 2014 general election campaign spending promise to provide free GP visits for the elderly, regardless of their wealth, illustrates the ongoing impulse to expand public spending on private good health services. Yet the effect is to reduce the ability of users and providers to assess 'value for money' and increase recourse to non-price rationing (e.g. of GPs' scarce time), while the deadweight costs of the increased taxes and paperwork make everything less affordable.

Figure 11: Public-private health care spending in New Zealand, 1925–2010



Source: Ministry of Health – *Health Expenditure Trends in New Zealand 2000–2010*

The OECD has assessed the savings in health spending that could be achieved by moving each member country towards the efficiency levels of the best-performing countries, while raising life expectancy outcomes.[84] Switzerland, Australia and South Korea (in that order) have the smallest scope for achieving productivity gains (0.5% of GDP), while it is over 2.5% of GDP in New Zealand, and almost 4% for the United Kingdom and Greece.

New Zealand's health sector was restructured on a government-owned funder/purchaser/provider model during the 1990s, aiming to improve public sector accountability and introduce a degree of funding competition between public hospital groupings. However, the absence of a comprehensive price discovery system, Singapore-style or otherwise, between providers and users continued to disempower users and ensure individual 'value for money' allocation decisions remained politicised.

Richard Mulgan summed up the subsequent political dynamics as follows:

> For instance, when kidney dialysis was denied to a dying patient by a crown entity hospital, the Minister of Health was forced to answer for the decision. Indeed, the attempt to quarantine the health service from political control and accountability proved so unpopular that the Labour/Alliance government from 1999 returned to a form of the pre-reform structure whereby political accountability through the Ministry and the Minister is combined with accountability through locally elected board members. The government has thus opted for a plethora of overlapping accountability channels over [sic] any attempt at clarification and simplification.[85]

The spiralling public health spending during the 2000s came with declining productivity in public hospitals. In 2008, Mani Maniparathy found that the volume of public hospital outputs per head of personnel fell by 8% between 2000/01 and 2005/06.[86] SNZ reported in 2013 that "Labour productivity estimates produced by the Ministry of Health show a decline in the labour productivity of public hospitals of 1.2 percent between 2004 and 2010".[87] Regulations and multi-employment collective agreements could be a factor by coercing providers into government-imposed structures, such as primary health organisations (PHOs), and imposing costs on choice and responsiveness.[88]

Politically, the dominant drive under current incentive structures is to further increase public spending on health services, regardless of productivity, cost-effectiveness, need, income or wealth.

> National outmanoeuvred Labour in May with a Budget promise to extend free GP visits and prescriptions to children under 13 from next July, at a cost of $30 million a year. Until then, this had been the territory of the Greens – and the Child Poverty Action Group, which wants the extension of the current free under-6s care to all school-aged children.
>
> But now Labour has trumped National by adopting its under-13s policy and extending it to the elderly, at an additional cost of $120 million a year, including prescriptions.
>
> More free care, including dental treatment, for pregnant women is among a cluster of promised Labour additions to free or low-cost primary care. The party says this would fund

84 Alan J. Auerbach, "Long-term Fiscal Sustainability in Major Economies", op. cit. Figure 5.

85 Richard Mulgan, "Public Sector Reform in New Zealand: Issues of Public Accountability", Asia Pacific School of Economics and Government (Canberra: Australian National University, 2004), p. 18.

86 Mani Maniparathy, *Productivity Performance of New Zealand Public Hospitals: 1998/99 to 2005/06* (Wellington: New Zealand Business Roundtable, 2009), p. 4.

87 Statistics New Zealand, *Education and Health Industry Productivity 1996–2011* (Wellington: SNZ, 2013), p. 15.

88 Refer for example to James Hogan, "Health sector labour market dynamics and multi-employer collective agreements", Masters thesis, University of Canterbury, 2014).

free GP visits for nearly 40 per cent of the population – up from 12 per cent now – and nearly 30 per cent would get low-cost visits.

The Greens want free primary healthcare for all children.[89]

Such spending increases cannot be easily justified on the grounds of equity since they are not targeted at hardship cases.

Unfortunately, that which is free costs more. Taxpayers pay for 'just in case' or unnecessary visits that waste GPs' time; unused, expensive prescription medicines stockpiled in household medicine cabinets; and much else of a wasteful nature. Costly services have to be rationed under a 'free' system by non-price measures in which service users need neither know nor care about the real cost or efficacy of the service. Yet, if they knew the real cost to society and could benefit from avoiding imposing that cost, some might prefer 'the money to the bag'. Of course, the 'deadweight' costs of raising taxes to fund any additional spending represent a further cost to the community.

The example of Singapore and the OECD's 2.5% of GDP figure of potential savings for New Zealand illustrate the magnitude of gains in health outcomes and financial savings New Zealand can hope to achieve.

Singapore's health policy points to the importance of extending rather than reducing the degree of private user-funding, at least for those on higher incomes and/or with considerable wealth.

Greater efforts to define, and thereby limit, the range of tax-funded health services makes it easier for private providers and insurers to organise themselves to supply and fund non-tax-funded health services. Singapore shows how to use a hierarchy of self-selecting user charges in public hospitals.

Singapore uses mandatory savings accounts to facilitate user pays, a feature that explains the extraordinarily heavy reliance on out-of-pocket funding of health expenditure. New Zealand is unlikely to go that far. However, if KiwiSaver is made mandatory, pressure would mount for such savings to be accessible for many things, including health care costs.

Another option is to make (private) income-related sickness health insurance mandatory, at least for higher-incomes earners.[90] Mandatory policies requiring a significant degree of co-payment would force costs to be assessed and balanced to some degree against benefits, as perceived by the user.

Patricia Danzon and Susan Begg in 1991 explored at length such options under an institutional economics framework.[91] However, the reform experience of the 1990s indicates that the political obstacles to introducing even modest charges for public hospital services were too great. That was under a first-past-the post government with a majority in the House. It is hard to see any grounds for greater optimism in the endemic minority governments under New Zealand's MMP system.

Nevertheless, the problem of a burgeoning health budget for relatively poor outcomes will not go away. Maintaining pressures to measure productivity in the public hospital system will help improve performance incentives, especially when compared to the superior performance of Singapore. In addition, the fiscal pressures to consider alternative approaches will build under the RHCG scenario.

Failing such measures, the projected outcomes under the RHCG scenario may eventuate.

89 Martin Johnston, "Election 2014: Free visits to doctor big gun on health battlefield", *The New Zealand Herald* (20 August 2014), www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=11311349.

90 Explicit public-sector provided accident insurance is mandatory in New Zealand, but the political costs of making sickness insurance similarly explicit and mandatory have exceeded the benefits to date.

91 See discussion on mandatory health insurance in Patricia Danzon and Susan Begg, *Options for Health Care in New Zealand* (Wellington: New Zealand Business Roundtable, 1991). New Zealand already has mandatory income-related accident insurance and a sickness benefit.

5.3 SUPERANNUATION

NZS expenditures under the RHCG scenario are projected to rise from 4.3% of GDP in 2010 to 7.9% in 2060. Raising the age of eligibility to 67 and indexing payments to the CPI would reduce the 2060 projection to 3.9% of GDP, other things being equal.[92]

However, responding to the fiscal pressures created by the existing scheme is not merely a matter of making technical adjustments. There must also be a conversation about the forward-looking objective for NZS to assess how well a modified scheme is achieving that objective.

Figure 4 showed that raising the age of eligibility to 67 and CPI indexation would reduce the post-tax payment to a married couple from 66% of the average net wage currently to 36% in 2060. (A slower/faster rate of productivity growth would reduce the payment by less/more relative to the average net wage.)

Open-ended, defined benefit schemes also have the potential for major intergenerational transfers. Most obviously, if the working-age population falls relative to the retired population, other things being equal, the per capita burden rises for those of working age relative to an unchanged per capita retirement benefit for those workers. Raising the future rate of retirement benefits (e.g. through faster economy-wide productivity growth) could reduce intergenerational transfers.

One implication is that private retirement savings would rise as NZS fell relative to the average wage, at least for those prepared to cut consumption before retirement accordingly. Whether this shift to greater direct reliance was achieved spontaneously, through tax incentives, or through mandatory savings schemes, or some combination of the same, is a public policy choice.

The great mass of retirees would oppose CPI indexation on the (not unreasonable) grounds that they had organised their retirement savings on the basis of wage indexation. They might be supported by many concerned about 'relative poverty', or just the gap between those on the highest and lowest incomes. Implementing CPI indexation could take many years, if it is politically achievable at all.

Another consideration is the relationship between NZS payments for those too old to work and disability payments for those unable to work. In April 2013, the basic weekly disability benefit, net of tax, was $429.58, 52% of the post-tax average weekly wage in 2013.[93]

Why the disability rate should be lower than the NZS rate is a matter for debate and discussion. If the objective of the disability benefit and NZS is to alleviate poverty for those with no independent means, perhaps the two benefits should be set at the same level. But what should be the common level?

Also, if the objective is to alleviate poverty, should NZS be explicitly means tested and/or asset tested? After all, one does not alleviate poverty by paying NZS to millionaires, as at present. Historically, the age benefit in New Zealand was means tested. Currently, the equivalent in Australia is means and asset tested.[94] The deadweight costs of taxing middle- and higher-income people during their working lives to pay them a similar sum in retirement are likely to be substantial, but have to be balanced against the costs of a more targeted regime.

However, NZS payments are already means tested to a material extent because they are subject to income tax. The higher the beneficiary's marginal

92 These projections do not allow for greater labour force participation.

93 The NZS rate has risen relative to the disability benefit rate since 2000. See Roger Hurnard, *Setting and Adjusting the Rates of New Zealand Superannuation*, op. cit., p. 3.

94 Australian spending on cash benefits for old age and survivors was 3.4% of GDP in 2007 compared to 4.3% of GDP for New Zealand. The OECD member average was 7% of GDP in 2007. See Organisation for Economic Co-operation and Development, *Public Pensions at a Glance: Retirement-income Systems in OECD and G20 Countries* (Paris: OECD Publishing, 2011).

tax rate, the greater is the claw-back.[95] The additional administrative costs of this claw-back are very low. Moreover, high-income earners pay a lot more in tax than low-income earners, but both receive the same benefit payments in dollars. In contrast, many state-supported schemes internationally pay more to those who had higher pre-retirement incomes.

In addition, the fiscal cost of NZS is modest relative to the fiscal costs of comparable overseas schemes. In part, this is because New Zealand mainly adopts a TTE (tax, tax, exempt) income tax structure that taxes full income with no exemption for income set aside for private saving or for income from earnings on private savings (use of accumulated savings is exempt from tax). Many countries have income tax structures that provide greater incentives for private savings, helping those on higher incomes much more than is the case in New Zealand.

Moreover, means and asset tests create troublesome distortions.[96] They can distort savings and retirement age decisions directly and induce people to shift income and assets using family trusts, company structures, or adult children. Probably, the major asset of most households, the residential home, would be exempted for political reasons. Endless political tinkering with threshold levels and the provisions designed to curb gaming of the definition and valuation of assets is likely.

On this basis, the case for moving to means or assets testing is less compelling than the case for lifting the age of eligibility or resetting the relativity between NZS and the disability benefit.

Entrenched interests have prevented dispassionate public debate about such issues in recent decades, and age demographics suggest that this problem is more likely to get worse. However, there is a countervailing consideration: NZS can be a poor deal for a working population, which is small relative to the retired population and when economic growth is low. Ultimately, young workers can emigrate to escape intergenerational transfers. Tax competitiveness matters.

Meanwhile, the proposal to raise the age of eligibility for NZS to 67 has been gaining political traction recently. It would be more effective as a solution to the fiscal pressure problem if accompanied by mechanistic increases in the age of eligibility in response to increases in life expectancy at retirement age. Such a rule might reduce the political impediments to progressive increases in the age of eligbility.[97]

5.4 OTHER WELFARE

Other welfare payments are projected to *fall* from 6.7% of GDP in 2010 to 3.8% in 2060 under the RHCG scenario. The fall is largely driven by the assumption that benefits will remain CPI-indexed rather than wage-indexed, but of course the projected demographic changes also play a role.

Such a fall in welfare payments is plausible – as long as unemployment rates remain low, there is considerable emphasis on dealing with situations likely lead to prolonged periods on welfare and/or in prison for 'at risk' individuals, and the forces to create benefit creep are held at bay. While none of those things is guaranteed, we should aim to achieve them all.

5.5 EDUCATION

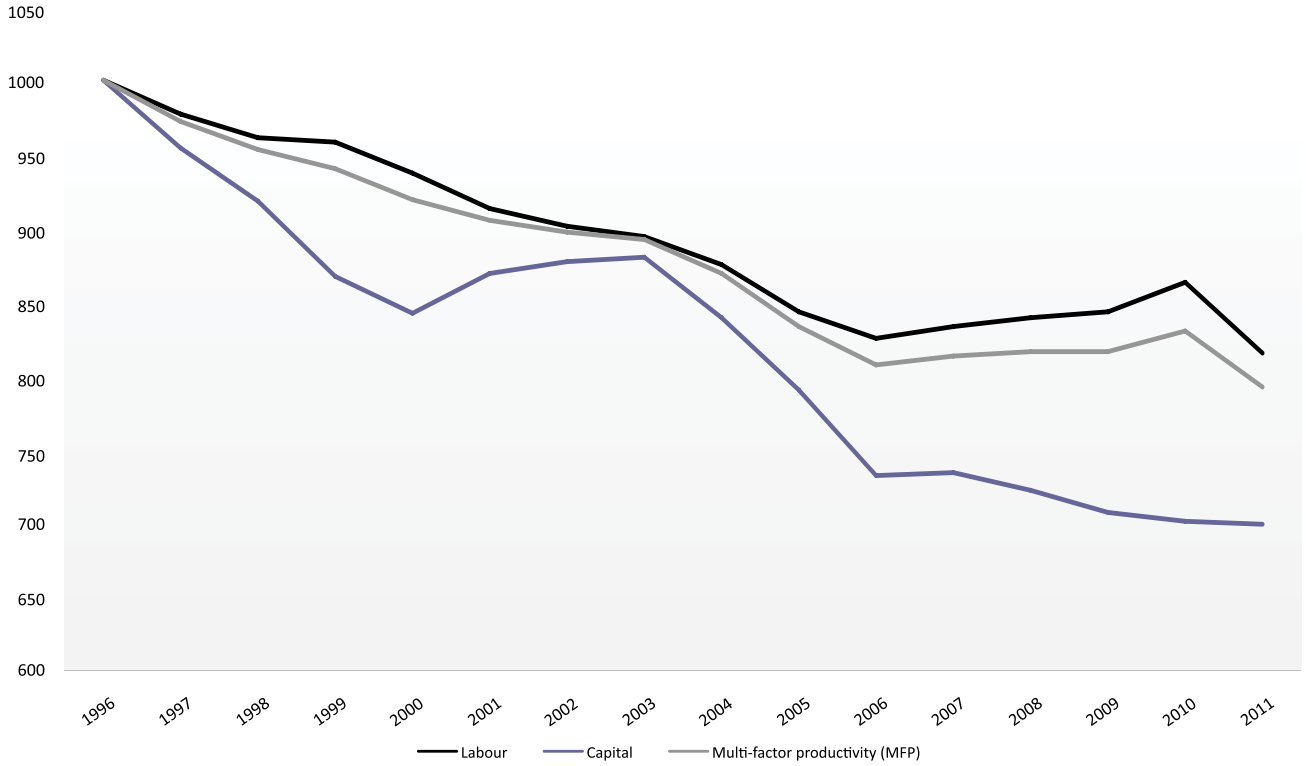
Education spending is projected to fall from 6.7% of GDP in 2010 to 5.2% in 2060. Education spending is linked to wage rates rather than the CPI so this projected fall largely reflects demographic changes. (The proportion of the population aged 0–14 is projected to fall from 19.5% in 2010 to 15.8% in 2060.)

95 In 2013–14, the claw-back represents 15% of the $10.9 billion fiscal cost of NZS.

96 For the analytics of the relative efficiency of pay-as-you-go versus funded schemes, see Martin Feldstein and Jeffrey B. Liebman, "Social security", in Alan J. Auerbach and Martin Feldstein (eds.), Handbook of Public Economics (Elsevier, 2002), p.p. 2245–2324.

97 A referee for this report observed that the average age at which young people start full-time work is older now than it used to be.

Figure 12: Productivity growth in education and training, 1996–2011



Source: SNZ

Productivity growth in education and training was negative between 1996 and 2005 and its level was no higher in 2011 than in 2006 (Figure 12). New Zealand does not seem to be achieving economies of scale or exploiting advances in remote learning.

Again, Auerbach has drawn attention to an OECD comparative analysis suggesting that:

> … substantial fiscal resources could be saved in underperforming countries through the gradual adoption of best practices in primary and secondary education, which currently cost on average about 3% of GDP. The estimated potential cost savings, with no prejudice to education outcomes, amount to 0.2% to 0.4% of GDP per annum for most countries, while reaching 0.6% to 1.3% of GDP for several European countries and the United States (Figure 4). Reforms in this area might include *inter alia* the possibility for pupils and/or their families to choose between schools (therefore making schools more responsive to needs), a definition of performance objectives for public educational institutions along with incentives to reach them, and devolution of responsibilities to sub-central governments.[98]

New Zealand was not included in this analysis, but the indicated savings for Australia were between 0.5% and 0.6% of GDP annually.

Singapore appears to be achieving superior educational results to New Zealand very economically.

In the 2012 Programme for International Student Assessment (PISA) results, secondary school students in Singapore outperformed New Zealand students in mathematics, reading and science. New Zealand's mean score was 14% below Singapore's for mathematics, and 6% or 7% below for the other two subjects. Contrary to stereotypical thinking that Asian education focuses on rote learning,

98 Alan J. Auerbach, "Long-term Fiscal Sustainability in Major Economies", op. cit., p.p. 29-30.

Singapore and South Korea both topped the first PISA rankings for creative thinking in 2014.[99]

Government spending on all forms of education in Singapore was 3.6% of GDP in 2010, approximately 20% of total government expenditure and second only to defence. In New Zealand, government spending on education was 7% of GDP in 2010.[100]

The New Zealand Initiative's second education report, *Around the World: The Evolution of Teaching as a Profession*, looked at Singapore and other educational models in considerable detail. Particular attention was paid to Singapore's attractive career structure for excellent teachers. The New Zealand Government's 2014 *Investing in Educational Success* initiative to provide a better career ladder for teachers and encourage collaboration between schools was influenced by this report.

The NZI has released a fourth report on teacher quality, *No School is an Island: Fostering Collaboration in a Competitive System*. It looks at how policy settings can be adjusted to make it easier for teachers to share their expertise and work more effectively with parents and children.

5.6 PUBLIC GOODS AND OTHER

The remaining categories of core Crown spending, excluding finance, are projected to fall from 8.2% of GDP in 2010 to 7.2% in 2060 in the base case for the RHCG scenario.

These remaining categories are larger than the category SNZ defines as spending on collective consumption (defined in section 4.2). Estimated spending on collective consumption in the year ended March 2013 was 5.5% of GDP (see Table 9).

Collective consumption includes spending on public goods. Public goods cannot be provided adequately on a 'for profit' basis because of the technical impossibility of excluding from the benefit of the provided good or service those who refuse to pay. Voluntary, not-for-profit organisations and philanthropy commonly fund public goods, but so does taxation. Tax funding is necessary for defence, law and order, diplomatic arrangements, parliament, judiciary, police, border protection, communicable diseases, core administrative functions of government, and related matters.

New technologies may create new public goods or convert previous public goods into private goods. Opportunities to replace the petrol tax and road user charges by direct electronic billing technologies illustrate the potential for efficiency improvements from technological change.

The 'other' category includes foreign aid, corporate welfare, sports subsidies, and transfers to charitable organisations and local authorities. The efficiency of much of such spending is debatable.

There is undoubted scope for considerable efficiency gains in providing core public services through a tighter focus on objectives and harder questioning of the desirability of government involvement.

While the opportunity for such gains should not be overlooked, the reality is that the greatest scope for reducing fiscal burdens is in reducing the burden of transfer payments on taxpayers through greater reliance on self-provision, including insurance arrangements, and private savings.

5.7 TAXATION

Taxes are a necessary evil. They are necessary to fund government spending, but 'evil' in that they induce people to undesirably distort their affairs to reduce their tax burdens. Tax lawyers, tax accountants, and Inland Revenue officials may benefit through higher incomes, but the community as a whole incurs a cost. An efficient

99 Organisation for Economic Co-operation and Development, "Singapore and Korea top first OECD PISA problem solving test", (April 2014), www.oecd.org/pisa/singapore-and-korea-top-first-oecd-pisa-problem-solving-test.htm.

100 See Bryce Wilkinson, *Savings Policy in Singapore* (Capital Economics Limited, 2014), Section 6.

tax system is one that raises the required revenue while minimising undesirable (and potentially avoidable) costs.

New Zealand's tax system was expertly reviewed by the Department of Inland Revenue for its incoming Minister after the 2011 general election. The review made a convincing efficiency case for preserving a system of broad-based taxes at a low rate. By international standards, New Zealand's scheme is at the efficient end of the spectrum, with its broad-based GST being particularly 'clean'.

There are debates over the (reducing) efficacy of capital income taxation given capital mobility and globalisation. While economists debate the pros and cons of options for reducing the tax rates on income from foreign-sourced capital to reduce the cost of capital for New Zealand firms and stimulate investment, others propose to make it harder to attract foreign capital to New Zealand and to extend the scope of capital gains taxes. Some of the latter options promise to markedly complicate taxpayers' affairs and even introduce many distortions.

There are also debates about the efficacy of a central government land tax (New Zealand's local body rating system is already a form of land tax) and the wisdom of taxing the returns to risk (e.g. in the form of capital gains or losses). The 1991 McLeod report suggested taxing capital annually, as if its return was the risk-free rate, to solve the problem while preserving New Zealand's TTE tax structure.

As with public goods, efficiency gains should be sought, but the big prior question is what to do about the level of transfer spending in the light of the potential increases due to demographic pressures needs to be addressed.

5.8 CONCLUDING COMMENTS

There is no shortage of options for responding to the fiscal pressures emanating from demographic changes.

Not adjusting income tax thresholds for inflation would significantly increase tax receipts in the fullness of time, and could be part of a move to an arguably fairer and more efficient flat tax structure. Raising the age of eligibility for superannuation, at least as life expectancy rises, is a 'no brainer'. Indexing superannuation payments to the CPI would markedly reduce projected fiscal stresses, but there should be a debate about the future relativity between this benefit and the disability benefit.

Measured productivity gains in health (section 5.2) have been disappointing and measured productivity losses in education (section 5.5) lamentable. New Zealand can do much better.

As the examples of Australia, Hong Kong, Korea, Singapore and Switzerland show, it is possible to run an efficient and prosperous economy with appreciably less government spending than New Zealanders have become accustomed to funding (and receiving). In addition, faster productivity growth in New Zealand would go long a way in solving many fiscal and other problems.

A key fiscal policy difference between New Zealand and Singapore and Hong Kong is the degree to which New Zealand needlessly churns national income through the tax system.

New Zealand's transfer payments to the relative well-off displace self-provision through savings and insurance. There is plenty of scope in principle for reducing the degree to which transfer payments are funded through the tax system at considerable cost, while preserving a state safety net.

There are technical issues to be solved along the way and choices to be made between options, but the prior barrier is the strength of the interest groups opposed to change.

THE NEW ZEALAND INITIATIVE

CHAPTER SIX
OPTIONS FOR IMPROVING FISCAL ARRANGEMENTS

6.1 INTRODUCTION

This chapter describes the many options that have been tried internationally to make it easier for politicians to resist pressures to tax and spend wastefully and unsustainably – and considered for New Zealand.

Identifying options is easy. One only has to look at the diverse fiscal arrangements across the world, and the literature assessing their strengths and weaknesses and possible improvements.

This chapter divides these options into two categories. Section 6.2 considers fiscal rules; section 6.3 fiscal councils. Fiscal rules are the rules that govern fiscal decisions. The fiscal rules embodied in the *Fiscal Responsibility Act 1993* – and survive in the *Public Finance Act* – illustrate this approach. Fiscal councils are bodies that comment publicly on government fiscal proposals, usually with a degree of independence. These two broad options are potentially complementary.

The hard part is to assess which options can make a worthwhile difference, be implemented, and endure changes in government. After all, if it were easy to improve on current fiscal arrangements for the common good, some current or earlier government would already have done so.

The difficulty of the task is illustrated by the major fiscal challenges facing many OECD member nations, and the intensity of ongoing international efforts to find better arrangements. Section 4.3 provided evidence of the ability of entrenched domestic interest groups to defend their privileges.

It may be easier politically to get such interest groups to acquiesce to options that appear to address the problem on paper, but will be ineffectual in practice, than to get political support for options capable of really making a difference.

Strong political leadership is necessary if greater fiscal disciplines are to be put in place in New Zealand. But political wisdom is also required in assessing which meaningful options are potentially capable of being sustained. Section 6.4 presents some concluding comments.

6.2 FISCAL RULES

6.2.1 Types of fiscal rules

Fiscal rules are part of the institutional arrangements that regulate parliamentary processes and decision-making. They encompass the legislative framework for parliamentary appropriations and budgetary processes; delegations of powers to spend, charge or tax; cabinet guidelines; written and unwritten conventions; and rules governing the activities of public agencies and any more-or-less independent entities that give fiscal advice or monitor performance.

Many of the rules that govern fiscal decisions are set out in the *Public Finance Act*, Standing Orders, and the Cabinet Manual and related documents. Examples of such rules include:

- those that make the decisions of the Executive government subservient to those of Parliament in a unicameral system, and/or of a second chamber in the case of a bicameral government;
- the principle that Parliament will not delegate the power to tax;
- the rule that government money cannot be spent except in accordance with parliamentary appropriations;

- rules relating to voting arrangements on fiscal matters;[101]
- rules relating to direct democracy, for example, binding initiative or strike-down referendums;
- rules that affect the transparency of who gains and who loses from fiscal decisions;[102] and
- rules aimed at constraining fiscal outcomes, such as the extent of fiscal deficits, debt issuance, or tax rates.

Fiscal rules are commonly defined more narrowly. For example, the IMF defines them to be rules that set numerical limits on specific budget aggregates. The IMF distinguishes between budget balance (BR), debt (DR), spending (ER), and revenue (RR) rules.[103] The usual purpose of such rules is to enhance fiscal discipline and credibility, reducing pressures to overspend and risks of debt unsustainability, thereby lowering the risk premium in interest rates and encouraging investment.

The remainder of this chapter will use the term 'fiscal rules' in this narrow sense, unless explicitly stated otherwise.

6.2.2 Fiscal rules internationally

The IMF's fiscal rules dataset in September 2013 contained systematic information on the national and supranational fiscal rules in 87 countries from 1985 to August 2013.[104] This is up from 80 countries in 2009 and seven in 1990. The rise is in good part a response to the public debt problems of the 1970s and 1980s, with the 2008 global financial crisis heightening the concerns.[105]

An IMF working paper in 2012 observed that "strengthening fiscal frameworks, in particular fiscal rules, has emerged as a key response to the fiscal legacy of the crisis".[106]

It considered that the development of fiscal rules has followed three 'waves':

- the first occurred in the 1990s in response to bank and debt crises and the need for fiscal consolidation in the Eurozone;
- the second occurred in the early 2000s, largely among emerging economies in response to fiscal excesses; and
- the third is the response to the global financial crisis in 2008–09. A number of countries, especially in the Eurozone, are complementing their supranational rules with national rules while other economies are 'upgrading' their fiscal frameworks and rules.

Expenditure rules have become more prevalent during this third phase. The IMF listed 25 countries with spending rules in 2009, up from 10 in 1999.[107] Most countries now have several rules that combine sustainability goals with flexibility provisions.

101 MMP commonly gives disproportionate power to minor parties in Parliament that do not need to appeal to the median voter, and majoritarian voting rules give different outcomes in some cases to supra-majority voting rules.

102 Obligations with respect to parliamentary debate, public consultation through select committees, etc. affect transparency.

103 See International Monetary Fund, "Fiscal Rules Dataset 1985–2013: Fiscal rules (countries and groups)", IMF Fiscal Affairs Department (September 2013), www.imf.org/external/datamapper/FiscalRules/matrix/matrix.htm.

104 See International Monetary Fund, "Number and type of fiscal rules – national and supranational (1985–2013)", IMF Fiscal Affairs Department (September 2013), www.imf.org/external/datamapper/FiscalRules/map/map.htm.

105 Tracy Mears, Gary Blick, Tim Hampton and John Janssen, "Fiscal Institutions in New Zealand and the Question of a Spending Cap", op. cit.

106 Andrea Schaechter, Tidiane Kinda, Nina Budina and Anke Weber, *Fiscal Rules in Response to the Crisis – Toward the "Next-Generation" Rules. A New Dataset*, Working Paper 12/187 (IMF, 2012), Abstract.

107 Tracy Mears, Gary Blick, Tim Hampton and John Janssen (2010), "Fiscal Institutions in New Zealand and the Question of a Spending Cap", Working Paper 10/7, (Wellington, New Zealand Treasury) November, 3.

A chapter in the OECD's *Economic Outlook* in December 2002 assessed the contribution of fiscal rules to fiscal consolidation and sustainability during the 1990s.[108] It found that fiscal rules were an important factor in the substantial progress towards fiscal consolidation in many member countries during that period, but were not proof against the widespread, unforeseen deterioration in the fiscal positions that occurred in the 2000s.

All rules have strengths and weaknesses. The review observed that the specific contribution of rules to good fiscal performance is not easy to establish.[109] It suggested that rules should be credible, simple to understand, perceived to be binding, and backed by sanctions. According to the review, the rules in the US *Budget Enforcement Act* and the European Stability and Growth Pact satisfied these criteria.[110] It also commended improving transparency to alleviate the trade-off between credibility and flexibility, citing New Zealand, Australia and the United Kingdom as examples.

Twelve years later, the European Stability and Growth Pact and the UK Code for Fiscal Stability have clearly failed and the US budgetary experience has been summed up by Auerbach as 'mixed'.[111]

Perhaps the OECD's key message was that rules can't solve the looming fiscal unsustainability problems due to population ageing and spiralling health care costs on their own.[112]

Reforms to reshape this spending and boost economic growth are needed to support good rules. Finding rules that can be sustained is fundamentally a political economy question.

The OECD's *Economic Outlook* 2010/2 reviewed the incidence of fiscal rules amongst member countries, and the IMF also identify the number and type of fiscal rules in selected countries.[113] Table 13 lists the rules and their type in 22 selected member countries. Fifteen of those countries had signed the EU's Growth and Stability Pact, which includes fiscal rules. All 22 countries had a budget balance rule and 16 also had a debt rule. Of those 16, 10 also had an expenditure rule. The three countries that had an expenditure rule but no debt rule in 2010 were Germany, Japan and the USA. Only four countries, Australia, Denmark, France and the Netherlands had a revenue rule. The same four countries were the only ones to have all four rules. New Zealand has legislated rules about budget balance and prudent debt, but is not deemed to have an expenditure or revenue rule.

The OECD summarised its findings as follows:

> Historical evidence suggests that fiscal rules and institutions can play an important role in consolidation. In current circumstances, specifying a debt objective including the path to stabilising and subsequently reducing the debt-to-GDP ratio would be useful. It could be supplemented by a spending and/or deficit rule, with a combination of such rules seemingly giving the best results. An independent fiscal watchdog can play an important role in assessing fiscal conditions in general and compliance with rules, with the implied greater discipline on policy helping to boost credibility.[114]

108 Organisation for Economic Co-operation and Development, "IV Fiscal Sustainability: The Contribution of Fiscal Rules, 2", *Economic Outlook 72* (Paris: OECD Publishing, 2002), p. 117.

109 As Alan Auerbach has pointed out, it can be difficult to distinguish between a rule that accords with what the authorities would have done anyway and a rule that changes fiscal decisions.

110 Organisation for Economic Co-operation and Development, "IV Fiscal Sustainability: The Contribution of Fiscal Rules, 2", op. cit., p. 126.

111 See, Ray Barrell, "Fiscal Policy in the Longer Term: Comment on Alan Auerbach", Discussion Comment in Alan J. Auerbach, "Long-term Fiscal Sustainability in Major Economies", op. cit., p. 35.

112 Organisation for Economic Co-operation and Development, "IV Fiscal Sustainability: The Contribution of Fiscal Rules, 2", op. cit., p. 125.

113 Organisation for Economic Co-operation and Development, "IV: Fiscal Consolidation: Requirements, Instruments and Institutional Arrangements", in *Economic Outlook, 2010/2* (Paris: OECD Publishing, 2010). The pages cited are from a preliminary version downloaded on 13 August 2014 from www.oecd.org/eco/outlook/46435606.pdf; International Monetary Fund, "Number and type of fiscal rules - national and supranational (1985-2013)", op. cit.

114 Ibid. p.p. 221–222.

Table 13: Specific fiscal rules in selected OECD countries

Selected OECD Countries	Legislation	Date	Budget Balance Rule	Debt Rule	Expenditure Rule	Revenue Rule
Australia	Charter of Budget Honesty	1998	yes	yes	yes	yes
Austria*	Domestic Stability Pact*	1997	yes	yes	no	no
Belgium*	National Budget Rule*	1997	yes	yes	no	no
Czech Republic*	Law on Budgetary Rules*	2004	yes	yes	no	no
Denmark*	Medium-term Fiscal Strategy*	1997	yes	yes	yes	yes
Finland*	Multiyear spending limits	1997	yes	yes	yes	no
France*	Central Government Expenditure Ceiling*	1997	yes	yes	yes	yes
Germany*	Constitutional Rule*	1997	yes	yes	yes	no
Hungary*	Fiscal Responsibility Law*	2004	yes	no	yes	no
Italy*	Domestic Stability Pact*	1997	yes	yes	no	no
Japan	Public Finance Law	1947	yes	no	yes	no
Luxembourg*	Coalition agreement on expenditure ceiling*	1997	yes	yes	yes	no
Mexico	Budget and fiscal responsibility law	2006	yes	no	no	no
Netherlands*	Coalition agreement on multiyear expenditure targets*	1997	yes	yes	yes	yes
New Zealand	Fiscal Responsibility Act	1994	yes	yes	no	no
Norway	Fiscal Stability Guidelines	2001	yes	no	no	no
Poland*	Act on Public Finance*	2004	yes	yes	yes	no
Spain*	Fiscal Stability Law*	1997	yes	yes	yes	no
Sweden*	Fiscal Budget Act*	1997	yes	yes	yes	no
Switzerland	Debt Containment Rule	2001	yes	no	no	no
United Kingdom*	Code for fiscal stability*	1998	yes	yes	no	no
United States	PAYGO Rules	2010	yes	no	yes	no
Total Countries			*Total (yes)*	*Total (yes)*	*Total (yes)*	*Total (yes)*
22			**22**	**16**	**13**	**4**

Note * = Also members of the European Union and signatories of the Stability and Growth Pact (SGP).

Source: OECD, "Fiscal Consolidation: Requirements, Timing, instruments and Institutional Arrangements," OECD Economic Outlook: Volume 2010/2, http://dx.doi.org/10.1787/8889323483O1, p. 257; International Monetary Fund, "Number and type of fiscal rules – national and supranational (1985–2013)", IMF Fiscal Affairs Department (September 2013), www.imf.org/external/datamapper/FiscalRules/map/map.htm.

The IMF's 2012 review also gave some support to the creation of fiscal councils to support fiscal rules through better communication.

> While the use of budget balance rules that adjust for the economic cycle explicitly considers the stabilization objective of fiscal policy, they also bring greater challenges in terms of design – in particular estimating the output gap – and communication. Communication policies seem so far slow to respond, but a number of countries has [sic] started to put greater emphasis on the use of independent fiscal councils as monitoring and assessment devices to fill this gap.[115]

6.2.3 Effectiveness of fiscal rules internationally

The effectiveness of fiscal rules internationally is difficult to assess because fiscal outcomes are the result of fiscal rules and many other factors. Good fiscal outcomes may reflect variously fortuitous circumstances or good government fiscal management, despite poor rules. In turn, good rules may be a product of good government rather than its cause. Treasury summed up the state of opinion on the efficacy of fiscal rules as follows:

> Research into the effectiveness of fiscal rules is ongoing, but in reviewing available empirical studies the IMF has concluded that fiscal rules have generally been associated with improved fiscal performance (IMF, 2009).[116]

Meaningful fiscal rules may or may not be a necessary condition for sustainable paths for public debt, but they are certainly not a sufficient condition.

Despite the existence of the fiscal rules discussed in section 6.2.2, the 2008 global financial crisis quickly saw an alarming number of countries, especially Eurozone countries, facing seriously challenging, unsustainable deficit/debt paths.[117] Many countries are grappling with debt sustainability problems and how best to continue servicing growing public debt as public expenditures on medical services and pensions rise sharply.

Of course, the need in some countries to bail out domestic banks (and finance companies in New Zealand's case) does not represent a failure of the fiscal rules. However, the prevalence of fiscal deficits before the crisis, and associated levels of public debt, clearly left some countries with "inadequate fiscal cushions".[118] It is possible to solve problems of over-optimistic forecasts for economic growth and inadequate sanctions for deficit spending by introducing changes to the rules or the transparency of compliance with the rules.

6.2.4 New Zealand's fiscal rules post-1993

The *Fiscal Responsibility Act 1993* introduced new rules relating to transparency and fiscal outcomes. Treasury was made accountable for the accuracy (lack of bias) in fiscal projections, including the economic projections underlying them, but the Minister of Finance was made responsible for ensuring that Treasury was fully informed about the government's fiscal decisions. This initiative appears to have eliminated the problem of unduly optimistic scenarios for economic growth producing unduly rosy fiscal scenarios.[119]

Another major new transparency rule was to make Treasury, not the Minister of Finance, responsible for determining how all fiscal transactions would be classified for accounting reporting purposes, while complying with internationally

115 Andrea Schaechter, et al. *Fiscal Rules in Response to the Crisis – Toward the "Next-Generation" Rules. A New Dataset*, op. cit., p. 38.

116 Mears et al, op. cit., p. 3.

117 Robert Hagemann, "How Can Fiscal Councils Strengthen Fiscal Performance", *OECD Journal: Economic Studies* 1:83 (2011), p. 76.

118 Ibid. p. 77.

119 The test here of 'unduly optimistic' is how Treasury's projections at the time compare with the forecasts of private sector forecasters and with surveys of private sector expert opinion at the time.

specified Generally Accepted Accounting Principles (GAAP) principles and determinations. That innovation further limits the ability of an incumbent government to reduce transparency by 'fiddling the books'. The same Act also provided for 'no surprises' transparency in the form of regular advance statements of fiscal intentions, explicit subsequent comparisons between both fiscal outcomes and earlier fiscal intentions, and updated statements of intentions. It also incorporated sanctions of a transparency nature for governments that moved the public account into fiscal deficits and had no credible plan for restoring surpluses and for governments that failed to keep within self-selected earlier 'prudent debt' targets.

The preceding 1993 Bill was supported by Treasury at the time, the governing party, and enough public opinion because of the painful period of fiscal consolidation that followed the fiscal deficits and public debt blowouts from 1975 to 1984, compounded by the nasty deficit surprise that the incoming government was confronted with after the 1990 general election. The leading opposition parliamentary party at the time voted against the Bill, with the then Hon. Dr Michael Cullen declaring in the Hansard record: "It will not actually work in practice; it is constitutionally wrong; it is economically wrong".[120] However, as Minister of Finance, Cullen later faithfully preserved intact all the Bill's provisions when transferring them to the *Public Finance Act*, where they remain to this day.

A 2004 review of efficacy of these measures after the first decade of their existence by one of this report's authors considered that these measures had usefully focused attention on the need for fiscal prudence, transparency and longer-term fiscal targets. [121] The imposed disciplines of regular monitoring and reporting of fiscal outcomes relative to targets helps a disciplined government to build confidence in the credibility of its targets. However, the absence of a time limit for achieving longer-term fiscal targets reduced their effectiveness and fiscal surpluses in good years were a necessary but not sufficient condition for sound fiscal stewardship.

The review stressed the importance of the quality of government spending. On the one hand, wasteful spending unduly raises tax rates, with all the disincentive effects that entails. On the other hand, failures to spend beneficially, taking costs into account, also makes the the community worse off. This 2004 analysis noted that the practice during that decade of expressing government spending targets as a percentage of GDP made economic growth a 'windfall' for additional spending, with scant disciplines on its quality. Explicit policy decisions between 1993 and 2002 had raised government spending by around 3 percent of GDP according to an OECD working paper in 2002.[122] Of course that would not be a concern if the additional spending was well-justified. Unfortunately but unsurprsingly, political processes can focus on the short-term political benefits of new spending for the incumbent government rather than on the case that it benefits the community as a whole.

Of even greater concern was the absence of meaningful value-for-money scrutiny of base spending. The same OECD working paper observed that budget allocations have a strong historical basis and there is "no centrally driven systematic or regular review" of the 95 percent of government spending that is not new spending, and no "systematic framework for assessing value for money". It also noted little evidence of any willingness by spending ministries to change priorities.

A bottom line conclusion from the lack of a focus on systematic rigorous analysis of spending quality was that:

120 Michael Cullen, Hansard Parliamentary Debate, *Fiscal Responsibility Bill*, Third Reading (22 June 1994), www.vdig.net/hansard/content.jsp?id=42073.

121 Bryce Wilkinson (2004), *Restraining Leviathan* (Wellington: New Zealand Business Roundtable), see section 2.4, p.p. 13–15 in particular.

122 David Rae (2002), 'Next Steps for Public Spending in New Zealand: The Pursuit of Effectiveness', Organisation for Economic Cooperation and Development, Economics Department, Working Paper No 337 (ECO/WKP(2002)23), Paris, 2 August.

By and large, governments have refused to take seriously the notion that they should not be spending taxpayers' money unless they are doing so for sound national interest reasons.[123]

Given that the level of taxes and spending is fundamentally a political (democratic) matter that report proposed adding an additional rule to the 1993 measures – that parliamentary proposals to certain increases in spending or tax burdens proposed by Parliament be subject to binding strike-down public referendums.

This proposal for a New Zealand Taxpayer Bill of Rights was, and remains, a contribution to public debate.

The decade of additional experience with the 1993 measures arguably supports the 2004 reviews conclusions that the experience is concerning from a spending control perspective but encouraging with respect to debt prudence.

The Labour-led government managed to increase core Crown government operating spending from 28.6% of GDP in the year ended June 2004 to 34.5% of GDP in the year ended June 2009. [124] The increase was greater than 6% of GDP, from 27.1% of GDP to 33.2% of GDP, if finance costs are excluded. (Fiscal surpluses were reducing finance costs relative to GDP.) Six consecutive years of fiscal deficits followed. These provided the first major test of the deficit and debt provisions in the *Fiscal Responsibility Act 1993* and dominated the fiscal decisions of the first six years of the current National-led government.[125]

The post-2008 National-led governments have demonstrably treated the fiscal balance and debt prudence rules with respect. Both the prime minster and the minister of finance put their credibility as economic and fiscal managers on the line to achieving a fiscal surplus in the public accounts in the year ended June 2015, with the target of sustaining surpluses in order to reduce net public debt to 20% of GDP. (Of course, this does not mean the provisions were a critical factor, but the structured framework set by the measures and the incumbent government's need to establish its credentials as a good fiscal manager surely helped.)

The big increase in government spending between 2004 and 2009 has given Treasury and finance ministers food for thought about the disruptive nature of big increases in spending when tax revenue growth is buoyant and about what might be done to reduce the risks of the same thing occurring again.

In 2011, National permitted its smaller coalition party, ACT, to introduce a Spending Cap (People's Veto) Bill to the House for a first reading. Treasury's Regulatory Impact Statement evaluating the spending cap proposal agreed it might make it less likely that a cyclical lift in tax revenues would be used to increase structural spending. However, it did not recommend a legislated spending rule, fearing in part that it would not survive a change in government and preferring to seek instead options based on achieving yet greater transparency.[126]

After the 2011 general election, National and ACT agreed on a new supply and confidence agreement that provided a transparency check on increases in a real per capita spending aggregate, but omitted the referendum discipline and the constraints on tax and debt increases. In the event, even that lesser option has not progressed because ACT and National's combined votes prior to the 2014 general election were one short of a parliamentary majority, and no other parliamentarian would support such a measure.

A futher conclusion from New Zealand's post-1993 experience is that the autonomy the 1993 fiscal rules gives to Treasury to produce economic growth forecasts appears to have been successful

123 Wilkinson, op. cit., p. 15.

124 These statistics are from Treasury's "fiscaltimeseries1972–2013" spreadsheet. Also refer to section 2.8.1 of this report.

125 The fiscal costs of the Christchurch earthquakes and the economic downturn associated with the global financial crisis at the time were other causative factors.

126 New Zealand Treasury (2011) Regulatory Impact Statement –Spending Cap (People's Veto Bill), 27 April, p. 20.

in avoiding the tendency of governments to bring down budgets whose revenue forecasts are unduly optimistic due to 'rosy scenario' bias in the underlying economic growth forecasts.

Treasury's 2013 assessment of its forecasting record found that its projection errors between 1990 and 2012 for real and nominal GDP growth and for tax revenues were statistically unbiased.[127]

A cross-country analysis in 2011 by Jeffrey Frankel found that between 1995 and 2008, the New Zealand Treasury's forecasts of fiscal balance three years ahead had been *pessimistic* by 0.8% of GDP on average. Of the 30 countries in his sample, only South Africa had a more pessimistic forecasting record.[128]

Treasury's pre-global financial crisis forcasts for economic growth proved to be too optimistic after the event. But Treasury does not stand out from other forecasters in this respect.[129] Economists are not good at forecasting turning points in the business cycle. Shocks are surprises, by definition.

New Zealand's existing fiscal rules also appear to adequately insulate the accounting rules for classifying expenditure and revenue items from opportunistic ministerial interventions.

6.2.5 Updated assessment of weaknesses in New Zealand's fiscal rules

Our conclusion from the discussion in 6.2.4 is that New Zealand's existing fiscal rules continue to be weak in guarding against the following sources of fiscal profligacy:

1. failures to reduce poor quality spending because of the power of self-serving, entrenched vested interests (subsidised student loans, age eligibility for national superannuation, etc.);
2. the difficulty of stopping increased spending during revenue upturns simply because 'the money is there to spend';
3. incentives to use 'bracket creep' from inflation to increase spending and revenue;[130] and
4. lack of transparency about the quality of general election spending promises, *ex ante* and *ex post*.[131]

Some citeable evidence in support of the first conclusion is provided in John Roughan's recent book on National Party Prime Minister John Key. It cites former National Party President Michelle Boag as opining that National's pledge not to tamper adversely with superannuation entitlements and Labour's electioneering promises of interest-free student loans and Working for Families income supplements were 'precisely calculated' to get National 'over the line'.[132]

Key was quoted as saying in 2012 that:

> That is about the only thing that will get [young people] out of bed before 7 o'clock at night to vote, but it's not politically sustainable to put interest back on student loans. It may not be great economics, but its great politics. It is a bit of a tragedy because it sends the wrong message to young people, it tells them to go out and borrow debt.[133]

127 New Zealand Treasury, *Analysis of the Treasury's Macroeconomic and Tax Forecast Accuracy* (Wellington: New Zealand Treasury, 2013), www.treasury.govt.nz/publications/informationreleases/forecastingperformance/reviews.

128 Jeffrey Frankel, "Over-optimism in Forecasts by Official Budget Agencies and its Implications", *Oxford Review of Economic Policy* 27:4 (Oxford University Press, 2011), p.p. 536–562.

129 See figure 3 on page 6 of Treasury (2011), "Treasury's Forecasting Performance".

130 New Zealand's inflation rate in the last two decades has been higher than is consistent with "maintaining stability in the general level of prices", despite the fact that section 8 of the *Reserve Bank Act* decreeing that achieving this was the Reserve Bank of New Zealand's primary function.

131 The incoming government can ensure that the public service does not evaluate the value-for-money from spending promises during general election campaigns.

132 John Roughan, *John Key: Portrait of a Prime Minister*, op. cit., p. 147.

133 "Student loans to remain interest free", *Stuff.co.nz* (13 March 2012).

The second conclusion reflects the big increase in government spending between 2004 and 2009 that was mentioned in section 6.2.4. Most of this increase took place in the 2009 fiscal year, but Tracy Mears, et al. found that only a small portion of it could be attributed to the 2009 recession. One of the authors' broader conclusions was:

> Self-imposed expenditure objectives [during a period of sustained economic expansion] were either not achieved or revised upward, and there was insufficient attention paid to the base of spending – both its level and composition.[134]

The 2014 general election campaign illustrates the continuing strength of the pressures on politicians to spend projected fiscal surpluses before they have been achieved. The Wellington-based Taxpayers' Union hired an ex-Inland Revenue Department expert to track and cost spending/tax promises by political parties during this campaign. After 9 years of fiscal deficits, the incumbent National party's campaign promises were costed at $1.4 billion as against $5.8 billion and $6.5 billion respectively for the Labour and Green parties.

In support of the third conclusion, note the marked 'bracket creep' occurred in New Zealand between 1999 and 2008. When announcing the increase of the top marginal income tax rate from 33% to 39% in 1999, Labour stated that only 5% of earners would pay the higher rate. Yet by Labour's 2008 Budget, 15% of earners were projected to be subject to this rate for the year ended March 2009. This expanded impost was largely an automatic process.[135]

With respect to the fourth conclusion, general election campaign spending promises are only costed at the time by Treasury at the explicit request of the incumbent Minister of Finance. After the election, the incoming government has little incentive to request a rigorous assessment by Treasury of the public benefits and costs of its spending 'mandates'. For example, the 2005 interest-free student loan election promise was implemented without any formal cost-benefit assessment by Treasury. (Treasury, of course, quantifies the extent of the fiscal subsidies in Crown financial statements, but is not required to assess the benefits.)

We suggest that taxpayers funding official agencies are entitled to expect impartial assessments to be made of the quality of the spending of taxpayers' money, including monitoring and reporting of whether the anticipated benefits from that spending are actually being achieved. Transparency is reduced when institutional arrangements allow the government of the day to avoid such disciplines.

Parliament is the key fiscal decision-maker. It is the guardian of the public purse and the government of the day cannot spend taxpayers' money on activites not approved by parliament.

6.2.6 Options for enhancing New Zealand's fiscal rules

The in principle, 'first-best' option for enhancing New Zealand's fiscal outcomes is to try and find arrangements that eliminate poor quality spending. Spending proposals and programmes can (and should) be assessed using cost-benefit analysis and for their compliance to accepted constitutional and public policy principles. The rigour brought to these analyses should be improved, particularly for major spending programmes. But nowhere does anyone appear to have found a way of doing such 'bottom-up' assessments with rigour sufficient to avoid the need for 'top-down' constraints in the form of approved budget limits and (in New Zealand's case) budgeted provisions for unitemised new spending.

It is reasonable therefore to propose that the search for better fiscal discipline in New Zealand should encompass better top-down and bottom-up spending constraints and disciplines. An effective

134 Tracy Mears, et al. "Fiscal Institutions in New Zealand and the Question of a Spending Cap", op. cit., p. 507.

135 "Treasury's key facts for taxpayers, 2008 Budget", *Scoop* (23 September 2007), Cullen Over-Taxing 352,000 Kiwis and section 1 in Treasury's 2009 paper on Medium Term Tax Policy Challenges and Opportunities.

tax and expenditure limit (TEL) would go some way to leaning against the growth in government spending arising from such factors.

Treasury's 2008 briefing to the incoming minister saw merit in a rule 'anchoring' medium-term expenditure or revenue restraint. In 2009, the OECD recommended that the New Zealand government consider a spending cap rule. Also in 2009, the government's 2025 Taskforce proposed amending the *Public Finance Act* to require the Minister of Finance to specify a 5- to 10-year target for future operating spending, either per capita or as a percent of GDP.[136]

The 2010 Treasury working paper by Mears, et al. evaluating a spending cap option considered that its biggest change on current arrangements would have been to force large changes in forecast fiscal costs (e.g. from benefit indexation) to be potentially traded off against other spending "which does not occur under the current system".[137]

The rules proposed by ACT in recent years are based on population growth and inflation, and worthy of further consideration and development. Exceptions are permitted for cyclical and non-discretionary spending. A 'force majeure' clause allows for natural disasters and comparable disturbances. More mundane deviations are permitted, if the electorate approves by popular referendum. This referendum option is somewhat novel in New Zealand, although the Conservative Party made acceptance of binding public referendums a non-negotiable coalition-formation issue in the 2014 general election. However, the dominant political party, National, is unlikely to accept it. A more politically acceptable option would be one in which the sole discipline for violating such a limit would be adverse public opinion. Arguably, a rule setting a ceiling for average tax revenues per person or per household would resonate more with voters than a spending ceiling, and thereby produce more political sanction if violated. A related point is that the real demand for government spending on collective consumption may be more closely related to the growth in real incomes than to population growth. However, the quantity of such spending is small relative to transfer spending (see section 4.2). If it were deemed to be material or to become material, a per capita spending limit could be modified to accommodate this tendency.

In short, it should be possible to design a TEL rule that improves top-down spending and revenue disciplines in a politically acceptable and sustainable manner, as long as it is sufficiently supported by public opinion in the fullness of time. An overly rigid rule would not pass this test. On the other hand a rule that allows too much discretion may be ineffectual. A TEL rule is not a panacea.

Regardless of whether an effective TEL rule can be put in place, there is also a need to guard against the risk of foregoing high quality spending to preserve poor quality special interest group spending.

Treasury is currently the guardian of expenditure evaluation techniques in the public sector, but its ability to enhance and enforce greater rigour in spending analysis seems to be limited. The most likely reason for this is lack of demand for more rigour by Cabinet ministers generally. This is readily understandable. Through the *Official Information Act*, advice on poor quality spending can become publicly available. Unless the government is willing to take on the interest groups that benefit from spending, the publication of that advice will simply embarrass the incumbent government. Such embarrassment will rebound on what Ministers perceive to be the cause of the embarrasment– the government agency that provided the politically inconvenient assessment. The natural response from a risk averse public service is to cover the difficulty with poor quality spending assessment, or none at all.

Parliament arguably has a greater interest in publicly exposing government spending of dubious quality than the Executive government: Opposition

136 Diana Cook, Carsten Schousboe and David Law, "Government and Economic Growth: Does Size Matter?" op. cit., p.p. 19–21.

137 Tracy Mears, et al. "Fiscal Institutions in New Zealand and the Question of a Spending Cap", op. cit., p. 512.

parties in Parliament can make political capital out of the Executive's reluctance to take on interest groups, particularly those that may have helped it to secure office.

Currently, the Controller and Auditor-General is Parliament's key watchdog for the spending of government money. Section 16 of the *Public Audit Act 2001* gives the Auditor-General the power at any time to undertake a 'performance audit' of any government entity, *inter alia*, whether any waste has resulted, or may result, as a result of any act or omission by that public entity. Clearly, waste is likely to occur when there is little or no clarity about why a spending programme is necessary or what it is meant to achieve. What, for example, is the optimal number of private schools or hospitals relative to public schools and hospitals, how might this change over time, and to what degree is the government entity diligent in assessing the efficacy of its spending programmes?

The Controller and Auditor-General is in a good position to ask the questions that allow it to identify major programmes that appear to be inadequately justified, without necessarily being the right entity to go beyond the watchdog role and fully determine whether the proffered justifications are adequate. In section 6.3, we consider the question of the right entity further.

6.3 INDEPENDENT FISCAL INSTITUTIONS OR COUNCILS

6.3.1 Introduction

As mentioned in section 6.2.2, both the OECD and the IMF have suggested that fiscal rules might be more effective if they were supported by a fiscal watchdog or council. Rules have three points of vulnerability: weak political commitment, weak enforceability, and design flaws. Well-designed fiscal councils could supplement rules by improving transparency and accountability. (Fiscal councils are distinguished from fiscal authorities in that only the latter have the power to make fiscal decisions.)

The IMF defines fiscal councils as independent public institutions that aim to strengthen commitments to sustainable public finances through various functions, including public assessments of fiscal plans and performance, and assessments or provisions of macroeconomic and fiscal forecasts. By January 2013, it was keeping a dataset on 29 institutions it considered to be fiscal councils.[138] A 2014 IMF working paper explains the dataset.[139]

The European Union similarly defines independent fiscal institutions (IFIs) as non-partisan public bodies that prepare macroeconomic forecasting, monitor fiscal performance in relation to existing fiscal rules and budgetary requirements, and often also advise the government on fiscal policy matters.[140] Financed by public funds, but functionally independent, IFIs exist to provide public advice on fiscal issues and help maintain discipline and transparency in national finances during policymaking processes, bolstering credibility and discipline. They vary immensely in legal form.

Long-standing 'fiscal watchdogs' and 'independent fiscal institutions', or 'fiscal councils', are few in number. Most of the existing ones around the world are novel and unproven. But dissatisfaction with the outcomes from reliance on fiscal rules alone has seen the concept gain traction.[141]

Governments should maintain fiscal positions that foster macroeconomic stability and sustainable

138 See International Monetary Fund, "Fiscal Council Dataset" (IMF, 2013), www.imf.org/external/np/fad/council/.

139 Xavier Debrun and Tidiane Kinda, "Strengthening Post-Crisis Fiscal Credibility – Fiscal Councils on the Rise. A New Dataset", Working Paper 14/58 (International Monetary Fund, April 2014).

140 European Commission, "Independent fiscal institutions in the EU member states", *Economic and Financial Affairs*, http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/independent_institutions/index_en.htm.

141 George Kopits, "Independent Fiscal Institutions: Developing Good Practices", *OECD Journal on Budgeting* 11/3 (2011), p. 2.

growth. Budgetary discipline is a necessary precursor for this.[142] Robert Hagemann ambitiously proposes that countries adopt counter-cyclical fiscal stances to help "smooth output fluctuations", while acknowledging the need for "vigilance to ensure symmetric budgetary impacts over the cycle".[143] Ensuring fiscal prudency by allowing the accrual of fiscal cushions gives governments room to respond to unexpected shocks in the short and medium terms, as well as projected pressures in the long term such as the pressure of an ageing population.[144] However, such prudent practices have not been manifest among OECD members in recent decades, with many countries experiencing large, sustained deficits and a tendency to "adopt and implement pro-cyclical fiscal positions during cyclical upswings, resulting in high levels of public debt".[145] The adverse effects of sustained high deficits on long-term economic growth are widely recognised, and this can often wreak havoc with the implementation of good fiscal strategies such as tax smoothing.[146]

IFIs are one option among a number of different instruments and approaches that might be used to improve fiscal performance and improve policymaking incentives.[147] There are several ways in which implementing an IFI with constrained responsibilities can contribute to better fiscal performance. These include limiting unnecessary political influence over technical aspects of fiscal policy formulation, intervening when needed during any point in the policymaking process, conducting independent macroeconomic forecasts, providing assumptions of key variables or parameters on which fiscal projections can be based, and preventing overly optimistic macroeconomic projections.[148]

142 Robert Hagemann, "How Can Fiscal Councils Strengthen Fiscal Performance", op. cit., p. 76.

143 Ibid. p.p. 76–77.

144 Ibid.

145 Ibid. p. 77.

146 Ibid.

147 Ibid.

148 Ibid. p. 81.

Section 6.3.2 discusses the number and types of fiscal councils that currently exist around the world.

Section 6.3.3 reviews the reasons that have been given for creating these councils.

Section 6.3.4 assesses their likely effectiveness in New Zealand.

6.3.2 Independent fiscal institutions worldwide

Table 14 summarises two characteristics of 42 IFIs in 26 countries as gleaned from Hagemann and the United Kingdom's Office for Budget Responsibility (OBR).[149] Of these 42 IFIs, 36 were considered to be independent and 27 to provide forecasts and projections. Estonia is the only country included in the selection to have an IFI without either feature.

Xavier Debrun and Tidiane Kinda have observed that in addition to the US Congressional Budget Office (CBO), parliamentary budget office IFIs have emerged in Australia, Canada, Italy, Georgia, Kenya, Korea, Mexico and South Africa. However, many, such as the United Kingdom's OBR are attached to the Executive. Many again are stand-alone agencies. Only France and Finland have fiscal councils attached to their country's supreme audit institution.[150]

AUSTRALIA

Australia's Parliamentary Budget Office was established in July 2012 as an independent parliamentary office under Parliament's Joint Committee of Public Accounts and Audit, with a budget of AU$24.9 million over four years. Its purpose is to better inform Parliament by providing independent and non-partisan analysis of the budget cycle, fiscal policy, and the financial

149 The IFI attached to the EU–The European Court of Auditors–is additional.

150 Xavier Debrun and Tidiane Kinda, "Strengthening Post-Crisis Fiscal Credibility – Fiscal Councils on the Rise. A New Dataset", op. cit., p. 13.

implications of proposals. While it can initiate its own policy and work programmes, it is required to prepare policy costings on request for widely authorised Members of Parliament and to make submissions to parliamentary committees at the request of those committees. It is too early to assess its enduring effectiveness.

UNITED KINGDOM

The United Kingdom's OBR is another well-regarded IFI. It was created in 2010 to provide independent and authoritative analyses of the United Kingdom's public finances.[151]

It has four main tasks: producing five-year forecasts for the economy and public finances twice a year, using these forecasts to evaluate the government's performance against fiscal targets, dissecting Treasury's costing of tax and welfare spending measures, and assessing the long-term sustainability of public finances, including setting out long-term projections.[152] The OBR is responsible for "monitoring fulfilment of the mandate, preparing macro-fiscal forecasts … and analysing debt sustainability".[153] As an initial step toward the mandate, the UK Government has implemented a number of tangible policy measures, including trimming welfare entitlements and raising the value-added tax rate.[154]

The OBR does not make policy and the Government is not compelled to do what the OBR proposes.[155] Compared to many other IFCs, the OBR has a narrower remit and focuses more on fiscal policy.

In contrast to the short-lived cases of Australia and the United Kingdom, several long-standing IFIs exist, generally with the purpose of improving the quality and transparency of principal economic forecasts.[156] In 2013, the IMF published case studies of seven fiscal councils based on longevity, functions performed, and diversity of region.[157]

151 UK Office for Budget Responsibility, "Fiscal councils overseas", op. cit.

152 Ibid.

153 George Kopits, "Independent Fiscal Institutions: Developing Good Practices", op. cit., p. 13.

154 Ibid. p. 13.

155 Ibid.

156 Patrizia Magarò, "Independent Fiscal Institutions: A Comparative Analysis", *Transylvanian Review of Administrative Sciences* 39 (2013), p. 74.

157 Curristine, Teresa, Jason Harris, and Johann Seiwald, "Case Studies of Fiscal Councils – Functions and Impact" (International Monetary Fund, July 2013), p.p. 1–53.

Table 14: Independent fiscal councils in selected countries

Country	Institution	Forecasts and Projections		Independent Analysis	
Australia	Australian Parliamentary Budget Office	yes		yes	
Austria	Institute for Advanced Studies	yes			none
	Institute for economic research	yes			none
	Government Debt Committee	yes		yes	
Belgium	National audit institute	yes		yes	
	Belgian Federal Planning Bureau	yes		yes	
	High Council of Finance		none		none
Canada	Parliamentary Budget Officer	yes		yes	
Denmark	Danish Economic Council	yes		yes	
Estonia	State Audit Office		none		none
France	Commission Economique de la Nation and Conference Economique Annuelle	yes		yes	
	French Fiscal Council (Haut Counseil des Finances Publiques)	yes		yes	
	Court of Audits (Cours des Comptes)		none	yes	
Germany	Working Party on tax revenue forecasting	yes			none
	Joint Economic Forecast by 6 leading research institutions (JEF)	yes		yes	
	Council of Economic Experts on Overall Economic Trends	yes		yes	
	Advisory Board to the Federal Minister of Finance		none	yes	
Greece	Center of Planning and Economic Research (KEPE)	yes		yes	
Hungary	State Audit Office (ASZ)		none	yes	
	Fiscal Council of Hungary	yes		yes	
Ireland	Irish Fiscal Advisory Council		none	yes	

Country	Institution	Forecasts and Projections		Independent Analysis	
Italy	Institute for Economic Studies and Analyses (ISAE)	yes		yes	
	Italian Parliamentary Budget Office	yes		yes	
Japan	Japan Fiscal System Council	yes		yes	
Korea	Korean National Assembly Budget Office	yes		yes	
Luxembourg	Court of Auditors		none	yes	
Mexico	Mexican Center for Public Finance Studies	yes		yes	
Netherlands	The Netherlands Bureau for Economic Policy Analysis (CPB)	yes		yes	
Portugal	Portuguese Council on Public Finances	yes		yes	
	Court of Auditors		none	yes	
Romania	Romanian Fiscal Council		none	yes	
Serbia	Serbian Fiscal Council	yes		yes	
Spain	Court of Auditors		none	yes	
	National Committee of Local Administration		none		none
Slovakia	Slovak Republic Council for Budget Responsibility		none	yes	
Slovenia	Republic of Slovenia Fiscal Council		none	yes	
	Institute of Macroeconomic Analysis and Development	yes		yes	
Sweden	Fiscal Policy Council		none	yes	
	National Institute of Economic Research	yes		yes	
United Kingdom	National Audit Office		none	yes	
	Office of Budget Responsibility	yes		yes	
United States	United States congressional Budget Office (CBO)	yes		yes	
Total Countries	**Total Institutions**	*Total Yes*	*Total None*	*Total Yes*	*Total None*
26	**42**	**27**	**15**	**36**	**6**

Source: Robert Hagemann, "How Can Fiscal Councils Strengthen Fiscal Performance?" op. cit. p.p. 83–84; UK Office for Budget Responsibility, "Fiscal councils overseas", http://budgetresponsibility.org.uk/links/.

BELGIUM

Unlike many other countries, Belgium has more than one independent fiscal body involved in the budget process.[158] Belgium's Conseil Superieur des Finances (High Council of Finance (HCF)) is the longest-standing fiscal council in the world, having been established in the 1930s.[159] Since its inception, the council has undergone multiple reformations, and its influence on national fiscal policy has varied. In 1989, the HCF was mandated to focus on promoting and coordinating fiscal discipline at the federal level and recommending public sector borrowing requirements. At a broad level, the council produces normative recommendations, monitors fiscal policy of the regional governments, produces medium-term financial objectives, and also assesses the national government's compliance with the Maastricht Treaty criteria.[160] However, the HCF's influence, like that of many other IFIs, is largely indirect, so it depends on fostering a strong media presence to convey its messages to the public and put pressure on Parliament to act accordingly.

Formally, the HCF is an advisory body to the Ministry of Finance and is chaired by the Minister of Finance, but is not legally independent.[161] The council itself is made up of the Minister of Finance, who appoints two deputy chairs, and 24 members who are appointed for five-year renewable terms.[162] The IMF reports that the HCF has around 12 full-time staff and a good reputation for independent, high-quality analysis, but its influence started waning after fiscal problems developed in 2004 after adopting the euro and running into political difficulties. Cottarelli considered that this difficulty reflected constrained operational independency and limited autonomy of resources. However, the HCF has since reinvigorated itself and its good reputation.[163]

Following the transformation of Belgium into a federal state, there was widespread agreement that another agency was needed to improve the economic forecasting and help prepare the budget. In 1994, the Bureau Federal du Plan (Federal Planning Bureau (FPB)) was established and charged with analysing problems of "an economic nature on its own initiative or at the request from the Ministry of the Treasury or the Ministry of Finance".[164] A split of responsibilities between the FPB and the HCF allows not only for greater technical specialisation but also minimises the political pressure put on each of these institutions.

While both public interest and parliamentary receptiveness to Belgium's IFIs have fluctuated throughout pre- and post-Eurozone periods, the council's long history and well-established reputation ensures that the HCF maintains a key role in the budgetary process.[165]

CANADA

Canada's Parliamentary Budget Officer (PBO) is modelled on the US CBO and is part of the Library of Parliament. It was created by legislation in 2006 to provide parliamentarians with technical expertise and independent information, and to provide an objective assessment of the Department of Finance's fiscal and economic forecasts. The wider goal was to strengthen accountability, transparency and ethics.[166] All parliamentary parties supported its formation. The IMF reports that the PBO had around 15 full-time equivalent staff divided into two divisions, one analysing economic and fiscal trends, and the other costing proposals and budgetary estimates. The selection process for the council is conducted by the Parliamentary Librarian, and the official appointment is made by the Governor in Council based on the advice of the Prime Minister.[167]

158 Ibid. p. 5.
159 Ibid.
160 Ibid. p. 6.
161 Ibid.
162 Ibid.
163 Ibid. p. 10.

164 Magarò, "Independent Fiscal Institutions: A Comparative Analysis", op. cit.
165 Curristine et al, op. cit., p. 10.
166 Ibid. p. 11.
167 Ibid.

There have been some tensions regarding the broad legal and operational design of the PBO. Many of these tensions have arisen out of the decision to locate the PBO within the Library of Parliament, which means it has less independence than officers of Parliament, like the Auditor-General.[168] Further tensions have arisen over the PBO's publications; while the Library of Parliament provides confidential services to MPs, the PBO publishes all reports and actively promotes its research and analysis through the media.[169] Substantial controversy erupted when the PBO published a report during the 2010 election campaign showing that Canada's involvement in the Afghanistan war was significantly more costly than reported by the government.[170] These tensions surrounding the independence of the PBO lasted throughout the first five years of the council's inception.

However, despite this controversy, the PBO has successfully fostered a good reputation, domestically and internationally, and improved its credibility. The PBO ensures its reports are peer reviewed by independent external experts, and also emphasises regular collaboration with international organisations, universities, think tanks and other fiscal councils.[171]

Like other IFIs around the world, the PBO has worked hard to ensure it has a strong media presence, and ensure that its research and analysis are relevant and accessible to the media. It even commits resources towards training the media on understanding and using its reports.[172]

HUNGARY

Hungary's Office of the Fiscal Council (OFC) started in 2009, had a broad mandate, modelled on the US CBO model, and was well resourced with more than 30 economists. It reports directly to Parliament and members are elected for nine years on a non-renewable basis.

Its misfortune was that support for it was not bipartisan and the government that set it up was replaced in May 2010 by a government whose first budget was criticised by the new OFC.

The new government gutted the OFC, reducing staff levels from around 30 to just 3, changed its composition, and radically reduced its responsibilities.[173]

The OFC is now a part-time body, with insufficient resources, severely eroded independence, and no "specific responsibility for applying criteria of fiscal transparency and sustainability, or for macro-fiscal forecasting or costing of legislative proposals".[174]

Even so, on the OECD's latest published figures, Hungary's government net financial liabilities were 56% of GDP, which was lower than in the United Kingdom (75%), Belgium (83%), and the United States (90%). The Netherlands and New Zealand were doing better at 45% and 18% of GDP, respectively.

SOUTH KOREA

The South Korean National Assembly Budget Office (NABO), modelled on the US CBO, was established in 2003 to provide independent fiscal policy advice to Parliament.[175] The Director of NABO is appointed by the Speaker of the National Assembly and is not appointed for a fixed term, but serves at the discretion of the Speaker. (This is a potential point of weakness in the arrangement.) The Director is advised by a panel of outside advisors consisting of a chairperson and 14 members. The council is very well resourced, with 125 members of staff in 2011 and a separate line of funding within the National Assembly budget.

168 Ibid. p. 12.

169 Ibid.

170 Ibid.

171 Ibid. p. 14.

172 Ibid. p. 18.

173 Ibid.

174 George Kopits, "Independent Fiscal Institutions: Developing Good Practices", op. cit., p. 13.

175 Carlo Cottarelli, "Case Studies of Fiscal Councils – Functions and Impact", op. cit., p. 24.

The council is charged with supporting "legislative activities through analysis and evaluation of national finances and policies" and is committed to four broad principles: independence, non-partisanship, expertise and credibility. The NABO provides objective and nonpartisan analyses of annual budget drafts. A unique feature is its evaluation of a diverse range of projects, programmes and policy initiatives.[176]

NABO had very little media presence during its initial years, but has since been building a rapport with various media outlets. The media have at various times questioned the credibility of NABO's reports and analysis, criticising its forecasts as being too optimistic. Nevertheless, NABO has grown into maturity over the past decade and is recognised for its valuable reports and analyses, improving the transparency of government's budgetary data and facilitating greater public engagement with fiscal policy and budgetary concerns.[177]

NETHERLANDS

One of the world's oldest known IFIs is The Netherlands' Bureau for Economic Policy Analysis. It is more commonly known by the acronym CPB, which refers to its original name of Centraal Planbureau.[178]

Established in 1945, and made official by law in 1947, the CPB's function was to conduct research on public policies. Its immediate focus was on policies to enhance economic recovery from World War II. It aimed to contribute to the economic decision-making process of politicians and policymakers. The first Director of the Council was Jan Tinbergen, a renowned economist who won the Nobel Prize in 1969 and who had a major influence on the council's evolution and helped cement its reputation for high-quality, independent analysis.[179] It had a broad mandate and was entrusted with developing forecasts.[180] This involved preparing short-, medium- and long-term forecasts often used by the government when preparing the annual budget, as well as analysing the state's finances and performing research and evaluations on public policies.[181]

Formally, the CPB operates as a branch of the civil service within the Ministry of Economic Affairs (MEA) and is allocated funding from the MEA's budget.[182] It does have a small degree of financial independence in that it can receive up to 20% of its annual funding from external assignments.[183] The CPB has established itself as fully independent in its operations as well as analysis and research. It has an extensive costing role and often receives requests from government ministries to estimate the cost and economic impact of new policy proposals as well as cost-benefit analyses of significant infrastructure projects. Through this role, the CPB has contributed to improving the quality of public information and influenced much of the debate during elections.[184]

The degree of influence attributable to the CPB alone is difficult to isolate, but the Netherlands' fiscal performance over the past 15 years has been relatively stable.[185] The CPB has also fostered a strong media strategy, timing its media intervention in systematic ways to ensure it effectively engages with the public following the release of its reports to best influence public debate.[186]

All in all, the CPB has successfully proved its credibility and its impartiality, with the IMF

176 Ibid. p. 25.

177 Ibid. p. 29.

178 Patrizia Magarò, "Independent Fiscal Institutions: A Comparative Analysis", op. cit., p. 73.

179 Carlo Cottarelli, "Case Studies of Fiscal Councils – Functions and Impact", op. cit., p. 31.

180 Patrizia Magarò, "Independent Fiscal Institutions: A Comparative Analysis", op. cit., p. 73.

181 Ibid. p. 73.

182 Carlo Cottarelli, "Case Studies of Fiscal Councils – Functions and Impact", op. cit., p. 31.

183 Ibid.

184 Ibid. p. 32.

185 Ibid. p. 33.

186 Ibid. p. 36.

reporting that "its strong position is underlined by the fact that all parties now request its assessment of their respective electoral policy program".[187] The CPB is a good example of how an IFI can be well-integrated with government processes and maintain a strong media presence without suffering perverse effects on its institutional independence.[188]

SWEDEN

The Swedish Fiscal Policy Council (FPC) was established in 2007 by the newly elected liberal-conservative government, but without the support of Sweden's three main opposition parties. Its objective was to "promote long-term fiscal sustainability and fiscal space for counter-cyclical measures during economic downturns".[189]

The FPC comprises five part-time members assisted by a Secretariat with five full-time employees. Its comparatively small budget is included in the Ministry of Finance's annual budget.[190]

The Chair, Vice-Chair and other members are appointed by the government and on proposals from the council itself. Appointments are for fixed terms; six years for chairmanship and three years for membership. The council is directly accountable to the Ministry of Finance but has a close relationship with the Finance Committee of the Parliament.[191]

The FPC does not produce forecasts or costings of government or legislative policies, but instead mainly reviews and monitors the extent to which the government abides by its fiscal policy objectives.

Like most other IFIs, Sweden's FPC depends largely on media contacts to publicise its work. It communicates through formal reports and contributions to parliamentary hearings rather than advising the government on normative policy directions.

Nevertheless, in Cotarelli's view the FPC has been very influential during its short life thus far, and has "contributed to promoting a more cyclically adjusted budgetary policy".[192]

UNITED STATES

The US CBO, established in 1974, is regarded as one of the world's most successful 'first generation' IFIs. It was one of the first to be entrusted with real-time surveillance of public finances.

The CBO arose from the passing of the *Congressional Budget and Impoundment Control Act* in response to a conflict over the budget between the executive and legislative branches of the federal government. Members of the House objected to President Nixon's threats to withhold congressional appropriations for programs that were inconsistent with his policies.[193]

The CBO is strictly nonpartisan and conducts "objective, impartial analysis" in the reports and cost estimates produced by its economists and policy analysts each year.[194] It does not make policy recommendations. All its work is published on its website, apart from the informal cost estimates for legislation being developed privately by Members of Congress.[195]

In addition to analysing fiscal policy, the CBO looks at labour markets, employment policy, and climate change. It also examines public service spending streams and projects in areas such as defence and health care.[196]

The CBO earned a reputation for integrity and impartiality well into the Carter administration

187 Ibid. p. 37.

188 Ibid.

189 Ibid. p. 38.

190 Ibid.

191 Ibid.

192 Ibid. p. 42.

193 US Congressional Budget Office, "Overview", *Congressional Budget Office* (2012), www.cbo.gov/about/overview, p. 1.

194 Ibid.

195 Ibid.

196 Robert Chote, *Britain's Fiscal Watchdog: A View from the Kennel*, op. cit., p. 7.

after it demonstrated its ability to display the same "critical demeanour to both administrations".[197] Its official website states that employees are appointed on the "basis of professional competence, without regard to political affiliation".[198]

6.3.3 'In principle' role of independent fiscal institutions

IFIs exist to ensure the transparency of macroeconomic forecasts and the validity of assessments of financial aspects of public policies.[199] Of course, as many academics acknowledge, better fiscal behaviour may be conditioned by the mere existence of a fiscal watchdog.

According to the OECD, IFIs should perform five basic functions:

- monitor how well a government complies with its budget;
- conduct macroeconomic fiscal evaluations and forecasting;
- assess the sustainability of long-term debt;
- analyse and lay bare the costs of legislative proposals; and
- present policy advice on fiscal issues.[200]

IFIs' principal function is to analyse and assess, before enactment, a budget or other legislative fiscal proposals. The assessment would encompass the proposals' consistency with fiscal rules. This role requires the capacity to undertake 'real time' forecasting and analysis over a short and medium term to the long term.

A decision to set up an IFI must be capable of attracting bipartisan support as it must be a long-term commitment to be applied by successive governments.[201] Proving technical competence and non-partisanship while surviving changes of government is one of the most difficult challenges fiscal institutions face in the early stages of their establishment.[202]

There have been suggestions that IFIs could be given the power to make or proscribe fiscal policy decisions, given the autonomy some central banks have over interest rate decisions. Few, if any, IFIs have such a role, and it is very difficult to see it being taken seriously in New Zealand. Around the world, the role of IFIs is fundamentally advisory. Published analytical reports improve public information about the choices of the government's economic policy.[203]

Robert Chote, author of *Fiscal Watchdog: A View from the Kennel* and Chairman of the United Kingdom's OBR, asserts that the 'core analytical argument' for establishing fiscal councils is the belief that if democratic governments are left to their own devices, they may fall victim to 'deficit bias' and 'pro-cyclicality' in managing the public purse. [204] Deficit bias is the tendency of governments to allow deficit and public debt levels to increase. Pro-cyclicality is the tendency for government spending to rise during a boom, exacerbating spending, and forcing contractions during fiscal recessions. Chote quotes Lars Calmfors and Simon Wren-Lewis who list six possible sources of deficit bias that commend the creation of a fiscal council:[205]

- over-optimism and differential access to information;
- impatience regarding long-term effects of monetary and fiscal policies because politicians

197 George Kopits, "Independent Fiscal Institutions: Developing Good Practices", op. cit., p. 5.

198 US Congressional Budget Office, "Overview", op. cit.

199 Patrizia Magarò, "Independent Fiscal Institutions: A Comparative Analysis", op. cit., p. 71.

200 George Kopits, "Independent Fiscal Institutions: Developing Good Practices", op. cit., p. 4.

201 George Kopits and Steven Symansky, "Fiscal Policy Rules" (International Monetary Fund, 1998), p. 2.

202 George Kopits, "Independent Fiscal Institutions: Developing Good Practices", op. cit., p. 5.

203 Patrizia Magarò, "Independent Fiscal Institutions: A Comparative Analysis", op. cit., p. 71

204 Robert Chote, *Britain's Fiscal Watchdog: A View from the Kennel*, op. cit., p. 3.

205 Ibid.

predominantly focus on winning the next election;

- electoral competition, knowing that costs of borrowing will be borne by a future government and thus reduce that government's manoeuvrability;
- 'common pool' problems caused by high borrowing as a result of powerful lobby groups;
- expansionary fiscal policy for macroeconomic management; and
- the exploitation of future generations by financing consumption through borrowing rather than taxes.

As described in section 6.2.5, New Zealand's arrangements since passing the *Fiscal Responsibility Act* in 1993 appear to have been effective in guarding against persistent optimism in official projections of economic growth and, thereby, tax revenues and fiscal balances.

Nevertheless, New Zealand has experienced a prolonged period of unplanned fiscal deficits since 2008. The fundamental problem was that government responded to large fiscal surpluses by raising discretionary spending simply because the money was there to spend and it needed more votes to win the 2005 and 2008 general elections. New Zealand's economic downturn shortly preceded the global financial crisis, but that crisis made the downturn worse and precipitated the deficits.

Economic forecasting is not good at picking turning points in the economic cycle, and Treasury's economic forecasts did not underperform those of other major domestic forecasters in the years preceding the 2008 economic downturn. There is reason to doubt whether an IFI could have outperformed the forecasting consensus during this period, or credibly altered the political impulse to spend even if it had.

It is clear from section 6.3.2's review of long-standing international IFIs that an IFI may have a broad or a narrow mandate, and the choice greatly affects the scale of its operations. The US CBO is at the broad end of the spectrum and Sweden's FPC is at the modest end.

6.3.4 Guidance for designing an effective IFI

Hagemann states the efficacy of IFIs hinges on a number of critical factors, including having full autonomy, active and unconstrained dissemination of their analyses, and proving their credibility.[206]

George Kopits, in *Independent Fiscal Institutions: Developing Good Practices*, considers that it would be far-fetched to "promulgate best practices or absolute standards" in this area of fiscal institutions, but that international experience accumulated thus far provides a useful basis for formulating a broad set of lessons.[207] He provides six broad recommendations or lessons for ensuring the success and longevity of independent fiscal watchdogs.

- Independent fiscal councils should absolutely be home-grown and home-owned for the best assurance that they will address local needs and conform to domestic legal frameworks and political culture.[208]
- IFIs must be independent, non-partisan, technically competent and accountable to the Legislature.[209]
- For an IFI to perform its tasks and conduct meaningful surveillance and analysis of fiscal policymaking, it must have the support of skilled technical staff and unlimited access to timely information from the government. Furthermore, all staff in an IFI or in charge of any fiscal rules council should be employed through an open competition system and have no links to other public or private institutions,

206 Robert Hagemann, "How Can Fiscal Councils Strengthen Fiscal Performance", op. cit., p. 3.

207 George Kopits, "Independent Fiscal Institutions: Developing Good Practices", op. cit., p. 15.

208 Ibid.

209 Ibid.

thus removing any possible conflicts of interest.[210]

- The key responsibility of an IFI is to assess fiscal positions and debt sustainability, including monitoring how well a government is complying with any fiscal rules or targets through real-time evaluations of the budgetary effects of all legislative proposals.[211]
- Newly established fiscal councils must immediately begin operating according to their terms of reference, as this is imperative for creating a positive reputation and gaining public support. Fast, professional implementation is vital for an IFI's survival as it must prove its non-partisanship within the first two electoral cycles.[212]
- IFIs must work quickly to develop effective communication channels to promote transparency and responsibility because "ultimately, in a free society, the media are the closest allies and promoters" of any independent fiscal body.[213]

Debrun and Kinda use cross-country regression analysis to assess whether the presence or absence of fiscal rules and fiscal councils tend to guard against fiscal deficits. They find empirical support for this proposition only with respect to "better designed fiscal rules" and with fiscal councils that have the characteristics of independence, numerical fiscal rules to monitor, responsibility for assessing or producing fiscal forecasts, and media impact.[214]

There is no single formula for IFIs or fiscal rules, only the consensus that IFIs should exist primarily to maintain discipline and transparency in public finances during policymaking processes.

6.3.5 Evidence on the efficacy of fiscal councils in a New Zealand context

The development of IFIs is too recent to form strong conclusions about their efficacy. Some academics postulate that the mere presence of a fiscal watchdog may condition and influence fiscal behaviour for the better.[215] However, everything depends on how well an IFI performs its tasks and comes to be well-regarded in the public eye for its professionalism and effectiveness.

Neither Australia nor New Zealand has established a fiscal council. Stephen Kirchner has recently made the case for establishing one in Australia.[216]

New Zealand does not have an encouraging track record of setting up independent and enduring economic forecasting institutions. An independent Monetary and Econoimc Council was set up in 1961 to study major economic problems. It did some useful work but was wound up in 1978, when its activities were taken over to some degree by the Economic Monitoring Group that was part of the New Zealand Planning Council that had its first meeting in 1977. However, the entire Planning Council was wound up in 1991. A less mainstream and not economically oriented Commission for the Future was set up by a National Government in 1977 and wound up by a Labour Government in 1992. The Economic Development Commission was set up in 1987 and headed by a former Secretary to the Treasury. But it was disbanded without much controversy in 1989.

One problem is that lead government agencies see such organisations as less capable of doing the job than they are themselves. This may be true given their greater resources and better recruiting capabilities. During periods of fiscal stringency, the budgets of these small agencies may be the easiest to sacrifice.

210 Ibid.

211 Ibid.

212 Ibid.

213 Ibid. p. 16.

214 Xavier Debrun and Tidiane Kinda, "Strengthening Post-Crisis Fiscal Credibility – Fiscal Councils on the Rise. A New Dataset", op. cit., p.p. 20–21.

215 Robert Hagemann, "How Can Fiscal Councils Strengthen Fiscal Performance", op. cit., p. 3.

216 Stephen Kirchner, *Strengthening Australia's Fiscal Institutions* (Sydney: The Centre for Independent Studies, 2013), p. 7.

The sustainability of the recently formed New Zealand Productivity Commission is yet to be established. Its association with its well-established Australian counterpart gives it a strength that the other agencies did not have, but its initial funding through the budgets of lead government agencies rather than directly by Parliament was a potential source of weakness.

6.3.6 A fiscal institution option for New Zealand

In 2011, a Treasury paper by Ann-Marie Brook recommended establishing an IFI to increase the transparency and accountability of "key fiscal policy judgments".[217]

Section 6.2.5 considered that New Zealand's existing fiscal responsibility rules based on accountability, monitoring and transparency appear to be serving the country well. However, the existing provisions do not adequately guard against four remaining areas of potential weakness. Section 6.2.6 canvassed some options for strengthening fiscal rules accordingly, and raised the issue of using an independent agency, such as the Office of the Controller and Auditor-General, to improve the monitoring and transparency of fiscal choices and decisions.

Section 6.3.5's rather discouraging review of the survival chances for independent, government-funded agencies in New Zealand leads us to suggest that, as in the case of Australia's Parliamentary Budget Office, any such monitoring and transparency functions be located in an office of Parliament rather than in an Executive government agency. After all, fiscal policy is primarily a parliamentary matter. Parliament votes on the Appropriation Bill each year; the Finance and Expenditure Committee, which considers matters relating to the audit of the financial statements of the government and government departments, government finance, revenue, and taxation, is a parliamentary select committee, and the Office of the Controller and Auditor-General is an office of Parliament.[218] As an office of Parliament, a fiscal council could usefully improve the servicing of the Finance and Expenditure Committee.

We suggest that the prime functions of such a monitoring and transparency agency would be to report to Parliament publicly on:

- The degree to which:
  - Parliament and the public are being adequately advised as to the full range of options for addressing identified long-term fiscal threats;
  - relevant government agencies competently assess the relative merits of those options; and
  - Executive has developed an effective programme for responding to these threats;
- The systemic quality of the Executive government processes and systems for assessing whether government spending programmes are providing value-for-money for the public at large, as distinct from serving the self-serving interests of particular entrenched groups; and
- Specific spending programmes that appear to lack adequate justification, perhaps because of lack of clarity about trade-offs between conflicting objectives; the lack of a competent, up-to-date assessment of the problems with private arrangements that warrant the programme in its current form; or the problems of inadequate information and incentives in the administration of the programme.

A failure by the Executive government to develop credible responses to the fiscal challenges posed by an ageing population in conjunction with open-ended spending programmes for retirement

217 Anne-Marie Brook, "Making Fiscal Policy More Stabilising in the Next Upturn: Challenges and Policy Options" (Wellington: New Zealand Treasury, June 2011), p. 42.

218 Two other offices of Parliament are the offices of the Ombudsman and of the Parliamentary Commissioner for the Environment.

incomes and health would be made transparent under the first of these functions. There is also a pressing need to independently audit New Zealand's approach to providing health services, given the evidence that countries like Singapore are achieving better outcomes much more economically.

Any systemic deficiencies in Treasury's, and thereby the Minister of Finance's, processes for evaluating the value-for-money from government spending, including the quality of its Cost-Benefit Primer and the failure of public service training programmes to ensure dispersed competence in assessment techniques across spending agencies, should be exposed and made transparent under the second function. We suggest that this activity require agencies to assess who is likely to benefit from a programme and at whose expense, and the degree to which the consent of the latter has been sought or indicated. This function should capture the issue of spending programmes that entirely escape competent assessment processes for the convenience of the Executive government. Parliament and the public should be informed about the quality of government spending programmes even if those programmes were a general election mandate.

The proposed institution could report on specific programmes through some combination of its own initiative, referral by the Controller and Auditor-General, or at the instruction of the Chair of the Finance and Expenditure Committee. Justifications for government provision need to be kept up-to-date as new technologies can change the balance between the efficiency of voluntary and coercive process for providing goods and services.

Careful attention is needed in designing the institution to secure its independence and ensure that appointment processes develop and protect a reputation for impartiality, independence and high-quality analysis. Such an institution should have the ability to initiate work programmes with security for tenure and budgets, and a well-defined access to departmental information relating to fiscal programmes and proposals. (The Australian Memorandum of Understanding approach is a possible model.)

6.4 CONCLUDING COMMENTS

The proposal in section 6.2.6 to put in place a rule imposing a top-down tax and/or spending limit of a sufficiently elastic nature to permit its survival, while still proving effective in normal circumstances, left open the problem that poor quality spending can displace higher-quality spending.

The evident lack of enduring ministerial demand for more rigorous assessments of the quality and efficacy of major government spending programmes (and regulatory programmes, for that matter) led to the proposal in section 6.3.6 of an independent fiscal agency to increase public transparency of such matters through monitoring and reporting. Such an agency would not have any power to make fiscal decisions.

The detailed design of such a rule and such an institution lies outside the scope of this report, but there is no shortage of design options. We merely make the case that these proposals are worthy of public consideration and discussion.

The bottom line is that spending rules and fiscal councils are neither necessary nor sufficient conditions for good fiscal outcomes, but there is good reason and evidence to think that well-designed rules and councils can help.

THE NEW ZEALAND INITIATIVE

CHAPTER SEVEN
RECOMMENDATIONS

New Zealand's fiscal outlook is not dire, but the issues of too much poor quality spending and looming demographic pressures need to be addressed. Our key recommendations are that:

- Corrective policy actions should focus on reducing barriers to achieving higher economy-wide productivity growth, in part by reducing the degree to which national income is needlessly churned through the tax-benefit system and increasing the role for competition and price discovery in the provision of goods and services.
- The political difficulties with implementing even such obviously necessary and desirable policies such as raising the age of eligibility for NZS could be reduced by:
  - strengthening New Zealand's fiscal rules to make it harder for aggregate spending to be increased without good reason; and
  - establishing an office of Parliament responsible for improving the transparency of fiscal policies, including the adequacy of the Executive government's programme for responding to identified fiscal issues and risks.

THE NEW ZEALAND INITIATIVE

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APPENDIX
NATIONAL ACCOUNT DEFINITIONS

ABBREVIATED 2011 OECD EXPLANATIONS OF NATIONAL ACCOUNTING TERMS

Annex Table 25 – Government total outlays

Definition: The figures for total outlays consist of current outlays plus capital outlays. Current outlays are the sum of current consumption, transfer payments, subsidies and property income paid (including interest payments).

Annex Table 26 – Government current tax and non-tax receipts

Definition: Tax receipts of the government sector are defined as the sum of direct taxes on household and business sectors, indirect taxes and social security contributions. Non-tax receipts include operating surpluses, property income, user charges and fees, other current and capital transfers received by the general government.

Annex Table 27 – Government financial balances

Definition: Government net lending is government current tax and non-tax receipts less government total outlays.

Annex Table 28 – Government cyclically-adjusted balances

Notes and definitions: The decomposition of budget balance into a cyclical and a non-cyclical component is aimed at separating cyclical influences associated with divergences between actual and potential output (the output gap), from those which are non-cyclical. Changes in the latter can be seen as a cause rather than an effect of output fluctuations and may be interpreted as indicative of discretionary policy adjustments. It should be noted, however, that changes in resource related revenues – as a result of oil price changes, for example – and in interest payments – as a result of past debt accumulation or changes in interest rates – are neither cyclical nor purely discretionary. Yet these changes are reflected in the evolution of the cyclical component of the budget balance.

Annex Table 29 – Government underlying balances

Definition: This indicator eliminates the impact of so called one-off transactions from the cyclically-adjusted financial balances. One-offs are derived as the deviations from trend in net capital transfers, special one-offs not related to capital transfers and one-off revenues from the sale of the third generation mobile telephone licenses.

Annex Table 30 – Cyclically-adjusted government primary balances

Definition: These figures are derived by adding back net interest payments (Annex Table 31) to government underlying balances (Annex Table 29). See notes to Tables 27, 28, 29 and 31.

Annex Table 31 – Government net debt interest payments

Definition: Interest paid for government debt net of interest received for government assets.

Annex Table 32 – Government gross financial liabilities

Definition: Gross financial liabilities are defined as the debt and other liabilities (short and long-term) of all the institutions in the government sector, defined by ESA95/SNA93, subject to data availability.

Annex Table 33 – Government net financial liabilities

Definition: Net financial liabilities are defined as the gross financial liabilities of the government sector less the financial assets of the government sector. Such assets may be cash, bank deposits, loans to the private sector, participation in private sector companies, holdings in public corporations or foreign exchange reserves, depending on the institutional structure of the country concerned and data availability.

The status and treatment of government liabilities in respect of their employee pension plans in the national accounts have been diverse across countries, making international comparability of government debts difficult. The current interpretation of the 1993 SNA is that: i) "autonomous" funded pension plans should be classified outside the general government sector, which entails that their assets and liabilities are not reflected in the government debt data; ii) non-autonomous pension plans should be classified inside the government sector and only the funded component should be reflected in the government liabilities. Furthermore, the 1993 SNA recommends that the liability inherent in unfunded schemes be recorded as a memorandum item for the government sector. However, while some countries have produced some estimates of these implicit liabilities, few follow the 1993 SNA recommendation.

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