NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Public Finance (State Sector Management) Bill

April 2004

PUBLIC FINANCE (STATE SECTOR MANAGEMENT) BILL

1. Introduction

1.1 This submission on the Public Finance (State Sector Management) Bill (the Bill) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The Bill has three main elements – integrating the Fiscal Responsibility Act (FRA) into the Public Finance Act, amending the State Sector Act to extend the State Services Commissioner's mandate, and creating a new Crown Entities Act.

1.3 This submission comments only on the first element. Section 2 comments supportively on the proposed changes. Section 3 proposes some additional changes that we think could raise the quality of public debate about longer-term fiscal and economic strategies. Section 4 proposes some changes that could improve the value for money of individual government spending programmes. Section 5 sets out our conclusions and recommendations.

2. Integration of the FRA into the Public Finance Act

2.1 The NZBR believes that the FRA has in many ways served New Zealand well. We are pleased to accept the government's assurances that its fundamental features are to be retained. These include its principles of responsible fiscal management and its emphasis on disclosure and transparency.

2.2 Given this stance, the reasons for repealing the FRA as a separate piece of legislation appear to be symbolic. While this could be seen as a step towards de-emphasising the importance of fiscal responsibility, we think some features of the Bill represent improvements.

2.3 Commendable new fiscal management proposals include those that:

- require governments to set a date for achieving their specified long-term fiscal objectives, with the projections in the Fiscal Strategy Report (FSR) having to extend as far as that date;

- require the Treasury to provide very long-term projections (at least 40 years) at four-yearly intervals;

- require each economic and fiscal update to summarise new government tax decisions that materially affect the tax revenue forecasts; and

- allow governments to publish a Budget Policy Statement (BPS) earlier than 1 December.

2.4 We recommend that each economic and fiscal update also be required to list tax expenditures, with estimates of the costs to revenue where possible, along the lines of the list in the Treasury's 1984 post-election briefing paper *Economic Management*.

3. The problem of inadequate engagement and debate

3.1 In our submission on the 2004 Budget Policy Statement, we stated that a disappointment in the operation of the FRA had been the failure of the BPS process to generate meaningful debate about the value for money in government spending and the link between budget policy and economic growth. For example, business organisations have been saying since the mid-1990s that successive governments have not had credible strategies for achieving their targets for economic growth. No effective engagement on that point has occurred and, as predicted, the growth aspirations have not been achieved. Currently, the government's goal of lifting New Zealand into the top half of the OECD income rankings is not within sight of being realised.

3.2 Another disappointment has been the tendency for governments to fail to meet their long-term expenditure targets established under the FRA or to take remedial action when there is clear evidence that trends are inconsistent with the targets. The proposed change (see above) to require governments to set a timetable for achieving their long-term fiscal targets could help in this respect. However, it is unlikely to be sufficient by itself to induce an unwilling government to engage in constructive debate with submitters, parliament or the general public about the realism or consistency of its policies.

3.3 At the local government level, the equivalent to the BPS process is the draft annual plan of a council. Councils are required under section 14 of the Local Government Act 2002 to make themselves aware of, and have regard to, the views of their communities and to conduct their business in an open, transparent and democratically accountable manner. In comparing responses by central government and local government to submissions on the two sets of documents (the BPS and the draft annual plans) we have observed that a number of councils are much better at responding constructively in writing to points of substance made in submissions. We suggest that central government should hold itself to the same standard and that the select committee considering Budget submissions should respond in a similar manner. It should identify the concerns and suggestions put forward by submitters and demonstrate that due regard has been paid to them.

3.4 We also suggest that the timing of the release of the government's longer-term fiscal strategy may be part of the problem of lack of engagement. For example, under the FRA, engagement about fiscal strategy is typically intended to take place around February when a select committee hears submissions on the BPS. However, the government may have already determined its fiscal strategy for a mid-year budget by then. (The *Additional Parliamentary Briefing Material* document released in conjunction with the Bill states that governments tend to start thinking about budget strategy in September/October.) If so, from the government's point of view, submissions in February would be largely of academic interest – only relevant to the degree that they affect ongoing public debate.

3.5 One thing that may help somewhat here is the new provision that allows a BPS to be released prior to 1 December. Working in the opposite direction is the decision to make each BPS focus on short-term budget strategy. The new proposal is for fiscal strategy plans (long-term objectives and short-term intentions) to be published in the FSR which accompanies the Budget rather than in the BPS. This reduces the prospect of more engagement on longer-term fiscal strategy issues. This is despite the fact that (i) the government's long-term fiscal strategy at the time of the last Budget will be in the public domain; and (ii) the new measures require the BPS to identify any changes that the government has made to its fiscal strategy since the publication of the last FSR.

3.6 We note that the *Additional Parliamentary Briefing Material* invites consideration of the option of seeking submissions on the FSR instead of the BPS. We think it would be better to seek submissions on the FSR given its revised content and timing. Given a mid-year Budget, we suggest submissions on the FSR (and associated Economic Strategy Report) could be considered in, say, August/September. Perhaps there could be a requirement that the government makes a statement in late July identifying any material changes to those documents that submitters may wish to take into account.

3.7 Such a change would obviously reduce the significance of the BPS. In our view that would be appropriate if the BPS is to have a short-term focus on the coming budget. The priority should be to promote constructive public debate on the longer-term issues facing the country – the appropriateness of government fiscal and other interventions, the value for money of spending programmes, the quality of tax policies and the relationship of all these to economic growth and other goals.

4. Expenditure control

4.1 A weak feature of the FRA is that it has not constrained government spending effectively. Governments in the 1990s set targets of reducing the ratios of operating expenses to gross domestic product (GDP) but never came close to achieving them. The Organisation for Economic Cooperation and Development (OECD) has commented that some 95 percent of base spending in New Zealand is not properly reviewed. There are only weak processes for investigating whether programmes provide value for money and there is regular evidence of wasteful spending. Total government spending (central plus local) in New Zealand amounts to around 40 percent of GDP. No OECD member country has achieved the kind of growth rates which the government is targeting with such a high spending and taxation burden.

4.2 There are many dimensions to these problems. One is constitutional. The official document *Putting it together: An Explanatory Guide to the New Zealand Public Sector Financial Management System* states that "[a] long-standing principle under the Westminster style of government is that no expenditure of public money can take place without the prior approval of parliament". Yet it is beyond doubt that parliament is making appropriations without anything other than a very general notion of what they may be spent on. For example, the *Dominion Post* of 30 March 2004 reported the prime minister as stating that she would never have thought in her wildest dreams that funds voted by parliament for the Community Employment Group of the Department of Labour to provide grants for "social entrepreneurs" would be spent on funding a regional television station.

4.3 The Bill appears likely to make this problem worse by giving the executive even greater discretion to determine what money will actually be spent on. This is because it allows transfers of funding between output classes within an appropriation where there is no change in the scope of the appropriation. The document *Additional Parliamentary Briefing Material* states on page 6 that this would only occur when the change to the Main Estimates approved by parliament was not "substantive". It is not clear to us who is to be the judge of what is substantive and what criteria would be used. The accountability of the executive to parliament may be further reduced when more than one minister is responsible for a vote. We are opposed to this provision.

4.4 A further problem is the absence of any principled basis for determining whether particular spending programmes represent a proper government activity. Indeed the prime minister has stated that the role of government is whatever the government defines it to be.[1] Such a conception places no limits on government expansion. It sanctions government activities that benefit sectional interests but are not in the public interest. We believe that the Public Finance Act should state the principles to be used in determining whether government spending is justified in the national interest.

4.5 In respect of the problem of poor scrutiny of expenditure, the key issue appears to be a lack of political will. For many years now, reports by the Treasury, the Auditor-General and the OECD have pointed (not necessarily in so many words) to the inability of parliaments to establish that spending plans offer value for money in the public interest. For example, there is no systematic public interest assessment of *base* spending. Parliaments approve general spending for outputs but there is no serious attempt to identify what prevents taxpayers from spending that money better on similar outputs for themselves. Nor is there any serious attempt to show that the outputs contribute effectively to the outcomes the government professes to be pursuing.

4.6 An OECD report recently commended a Canadian approach to reviewing base spending, and summarised it in the list of basic questions set out in the box below.

OECD principles for evaluating value for money

1. Does the programme still serve a clearly defined public purpose that matters?
2. Is this an appropriate role for government?
3. Would we establish the programme today if it did not already exist?
4. Is it desirable to maintain it at its current level?
5. Can it be delivered more effectively or efficiently? Have there been changes (in the service environment, infrastructure, technology, etc) since the programme's inception that would now permit an alternative means of achieving its objective with greater economy, efficiency, or effectiveness?

Sources: Canadian Office of the Auditor General and Finance Canada.

It would surely be a simple matter to include a requirement in the Public Finance Act for the systematic formal evaluation of base spending along these lines. For example, the minister of finance could be required to table evaluations in parliament every year on whether selected major categories of existing spending satisfy such tests. The reviews

[1] See Roger Kerr, *The Government's Role is Whatever the Government Defines it to Be: Discuss*, 6 May 2003, (http://www.nzbr.org.nz/documents/speeches/speeches-2003/govts_role.pdf).

would be on a rolling basis with a view to ensuring that all base spending is systematically and rigorously reviewed at least once a decade.

4.7 The OECD report suggested that an outcome-based review of social assistance would probably offer the greatest scope for eliminating unjustifiable spending. It advocated a focus on welfare administration, benefit levels, the use of market mechanisms and recourse to user charges to limit demand, and noted the benefits of competition, choice and diversity. We concur with this priority. A considerable body of economic research indicates that tax-funded transfer payments substantially reduce national income, and that increases in such spending in industrialised nations since 1960 do not appear to have materially improved other measures of well-being. In New Zealand in 2002-03 social assistance paid in cash and in kind amounted to 19.5 percent of GDP (SNA basis). Such assistance can be an expensive way of churning money through the hands of the relatively well off.[2] It also creates poverty and dependency traps. The OECD reported in 2003 that many beneficiaries are better off on welfare (in dollar terms) unless they can move into a full-time job paying at least the average wage. We believe there would be major social and fiscal gains from reforms to social assistance programmes.

4.8 In our view, changes also need to be made to improve the disciplines on governments to provide value for money for *new* spending. Disciplines have become weaker in the MMP parliament where deals have been made between coalition parties to benefit their constituencies at the expense of taxpayers in general. We believe that proposals for new spending should have to meet similar tests to those suggested by the OECD for base spending, and that these should be written into the Public Finance Act.

4.9 NZBR submissions on BPSs have also argued that governments should not be treating revenue generated by economic growth as a free cash flow available for discretionary spending. This revenue belongs to taxpayers, and the presumption should be that it should be returned to them. The burden of proof should be on the government, not taxpayers, to establish – to parliament in the first instance and to taxpayers in general – that any spending projects will produce greater benefits for taxpayers than tax reductions.

4.10 The argument is analogous to the company situation where it is well understood that firms' revenues belong to shareholders and that boards and managers must be fully accountable for returning that money to them or spending it solely in their interests. There is a weaker principal-agent relationship between governments and taxpayers.

2 See James Cox, *Middle Class Welfare*, New Zealand Business Roundtable. August 2001.

We believe it needs to be shored up through specific provisions in the Public Finance Act.

Other desirable provisions in the Public Finance Act.

4.11 In our last two BPS submissions we drew attention to a large number of initiatives among state governments in the United States to impose the burden of proof for spending taxpayers' money on politicians. Around 26 states have adopted some form of tax and expenditure limitations. Constraints that limit government spending to the inflation rate and population growth and that mandate immediate rebates of government surpluses appear to have been most effective.[3] States are generally required to put any proposals for spending in excess of these limits to the public in the form of a referendum. We recommend the incorporation of such provisions in the Bill.

4.12 Further provisions could include a prohibition on subsidies to businesses, along the lines of the constitution of the US state of Georgia, and rules that would direct the government to its prime role of ensuring the provision of public goods and a social safety net.

5. Conclusions and recommendations

5.1 We are pleased that the Bill retains all the important features of the Fiscal Responsibility Act. In the part of the Bill that relates to the FRA, we oppose only the proposal to delegate more discretionary power over spending to the executive.

5.2 The thrust of this submission is to suggest additions to the Bill that might improve public debate and the quality of government spending. We believe the provisions relating to responsible fiscal management should be strengthened to increase the focus on value for money considerations. In particular, we recommend introducing some form of tax and expenditure limitations, with strict criteria for authorising and correcting any departures from them.

5.3 Our specific recommendations for improvements to the FRA-related section of the Bill are as follows:

- each economic and fiscal update should be required to include a table listing tax expenditures, with estimates of the costs to revenue where possible;

- the relevant select committee (currently the Finance and Expenditure Committee) should be required to respond constructively in writing to points of substance made

3 See Michael New, 'Limiting Government through Direct Democracy: The Case of Tax and Expenditure Limitations', *Policy Analysis*, Cato Institute, 13 December 2001.

in submissions. The responses should acknowledge the major concerns of submitters and demonstrate that due regard has been paid to them;

- further consideration should be given to the issue of scheduling public contributions on long-term fiscal and economic strategies to coincide with the time when governments are most actively considering them. In particular, we suggest the main focus of submissions should be on the FSR rather than the BPS, and submissions should normally be considered in August or September rather than in February as at present;

- parliament should not delegate greater discretionary power over the allocation of spending to the executive, as is proposed. We suggest that the government should also be required to report on what it is doing to ensure that the principle that public money should not be spent without the prior approval of parliament is observed;

- changes should be introduced to the Bill to oblige governments to furnish parliament with competent assessments of the value for money of *base* spending. These might be tabled annually, on a rolling basis, so that all base spending is evaluated at least once every 10 years;

- there should also be stronger disciplines on *new* spending. Provisions should be included in the Bill to require the government to state the principles that it will use to determine whether spending is justifiable;

- the Bill should include provisions that create a presumption that revenue increases in excess of inflation plus population growth will be returned to taxpayers. The burden of proof should be on the executive to establish that any of these revenues should be used to increase government spending. The provisions should require governments to seek taxpayer approval by way of a referendum of spending in excess of these limits;

- there should be a general provision in the Bill which focuses governments on their prime role of ensuring the provision of public (not private) goods and a social safety net; and

- governments should be prohibited from subsidising individual businesses or industries unless such spending is justified on market failure grounds.