Regulatory Impact Statement

Amendment to Part 2 of the Public Finance Act 1989 (the fiscal responsibility provisions)

Agency Disclosure Statement

This Regulatory Impact Statement ("RIS") has been prepared by **the Treasury**. It draws in part on analysis contained in the Regulatory Impact Statement prepared for the Spending Cap (People's Veto) Bill (2011).

It provides an analysis of options to strengthen the fiscal responsibility provisions of the Public Finance Act. It concludes that the fiscal responsibility provisions are best augmented by additional principles and reporting requirements that aim to cover a broader set of dimensions of good fiscal policy.

The fiscal responsibility provisions of the Public Finance Act (both the existing provisions and the new provisions recommended in this RIS) aim to influence government behaviour. They do so by requiring governments to be transparent about certain aspects of fiscal policy. There is no legal sanction for breaching the provisions, and it would also be possible for a government to comply with the form of the provisions but not their substance. The success or otherwise of the fiscal responsibility provisions therefore depends on the level of acceptance and support they receive across government.

Our experience with the current provisions leads us to believe that they can and do positively influence government behaviour. Our past experience gives us some confidence that our recommended changes will have similar success, but this is by no means certain. What really matters is how the fiscal responsibility provisions are operationalised. We have assumed that in the future the fiscal responsibility provisions will be operationalised in a similar manner to the way they are operationalised now. But there is a risk that future administrations will take a different attitude to the provisions, limiting their effectiveness.

Since we consider that our recommended changes at least do no harm, we judge that the risk of our recommended changes being less effective than we expect is a risk worth taking.

The proposals in this paper will have no direct impacts on private businesses or households.

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28 March 2012

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1. Context

1.1 The fiscal responsibility provisions

1. Part 2 of the Public Finance Act 1989 contains the fiscal responsibility provisions. At a high level, the provisions have three key dimensions:

   - First, the provisions specify a set of principles for responsible fiscal management in the conduct of fiscal policy.
   - Secondly, the provisions require regular public reporting by the government on the extent to which fiscal policy is consistent with those principles.
   - Thirdly, the provisions provide for regular and independent economic and fiscal updates by the Treasury, including a pre-election update and a statement on the long-term fiscal position at least every four years.

2. The provisions require the government to set and pursue long-term fiscal objectives (≥ 10yrs) and short-term fiscal intentions (≥ 3yrs) for five variables: operating expenses; operating revenues; the balance between total operating expenses and total operating revenues; the level of total debt; and the level of total net worth.

3. The government must explain how its objectives and intentions are in accordance with the principles of responsible fiscal management, which, among other things, require public debt to be reduced to, and then maintained at, ”prudent” levels. Table 1, below, presents the principles in full alongside similar sets from other countries.

4. The provisions are not prescriptive of fiscal strategy. Rather, the provisions require governments to be transparent about their objectives and intentions, whether they have changed, and how they accord with responsible fiscal management.

5. The provisions were developed against a backdrop of high public debt, caused by ongoing structural deficits. The aim was to address this poor fiscal performance by:

   - strengthening the incentives on Ministers to set budget priorities and to follow an agreed fiscal strategy; and
   - providing more regular information to the public on the medium-term fiscal outlook and the decisions that underpinned that outlook.

6. The provisions were widely seen as a world-leading and influential institutional reform when first enacted in the Fiscal Responsibility Act 1994. They have been cited as international best practice by agencies, such the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF).[1]

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[1] See, for example, IMF (2007), *Manual on Fiscal Transparency,* http://www.imf.org/external/np/fad/trans/manual/sec02b.htm

Table 1: Principles for fiscal policy in New Zealand, Australia and the United Kingdom

New Zealand – Public Finance Act 1989	Australia – Charter of Budget Honesty Act 1998	United Kingdom – Charter for Budget responsibility 2011
Principles of responsible fiscal management The Government must pursue its policy objectives in accordance with the following principles: (a) reducing total debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total debt in the future by ensuring that, until those levels have been achieved, total operating expenses in each financial year are less than total operating revenues in the same financial year; and (b) once prudent levels of total debt have been achieved, maintaining those levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues; and (c) achieving and maintaining levels of total net worth that provide a buffer against factors that may impact adversely on total net worth in the future; and (d) managing prudently the fiscal risks facing the Government; and (e) pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.	*Principles of sound fiscal management* The principles of sound fiscal management are that the Government is to: (a) manage financial risks faced by the Commonwealth prudently, having regard to economic circumstances, including by maintaining Commonwealth general government debt at prudent levels; and (b) ensure that its fiscal policy contributes: i. to achieving adequate national saving; and ii. to moderating cyclical fluctuations in economic activity, as appropriate, taking account of the economic risks facing the nation and the impact of those risks on the Government's fiscal position; and (c) pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden; and (d) maintain the integrity of the tax system; and (e) ensure that its policy decisions have regard to their financial effects on future generations.	The Treasury's objectives for fiscal policy are to: (a) ensure sustainable public finances that support confidence in the economy, promote intergenerational fairness, and ensure the effectiveness of wider Government policy; and (b) support and improve the effectiveness of monetary policy in stabilising economic fluctuations. The Treasury's objective in relation to debt management policy is to minimise, over the long term, the costs of meeting the Government's financing needs, taking into account risk, while ensuring that debt management policy is consistent with the aims of monetary policy.

1.2 Dimensions of fiscal policy

7. Good fiscal policy is about securing high and sustainable living standards – by managing fiscal aggregates and their impact on the wider economy. Fiscal aggregates is a term that is often used to describe operating revenue and expenses and their balance, as well as the assets, liabilities (including debt) and net worth of the Crown's balance sheet. Fiscal policy can be thought of as having three dimensions:

    a. *fiscal sustainability* – the maintenance of "prudent" debt levels over time or the affordability of funding current spending given current tax settings. This has been the main focus of the fiscal responsibility provisions;

    b. *macroeconomic stability* – the role of fiscal decisions (level, mix, timing) in supporting stability by not exacerbating economic cycles. Note that while the Reserve Bank has primary responsibility for stability in the sense of reducing the variance of output around trend in order to stabilise inflation, it is recognised that broader government policy (not only fiscal policy but also structural policies that affect saving and investment) has a greater influence on the average level of real interest rates and the exchange rate; and

    c. *fiscal structure* – a term that refers to the level and composition of tax revenue, expenses, and the balance sheet. Even within a sustainable fiscal strategy, there can be variation in the size of government and the ways in which a government raises and spends money. Evidence suggests that these differences can have an important impact on economic performance and living standards.

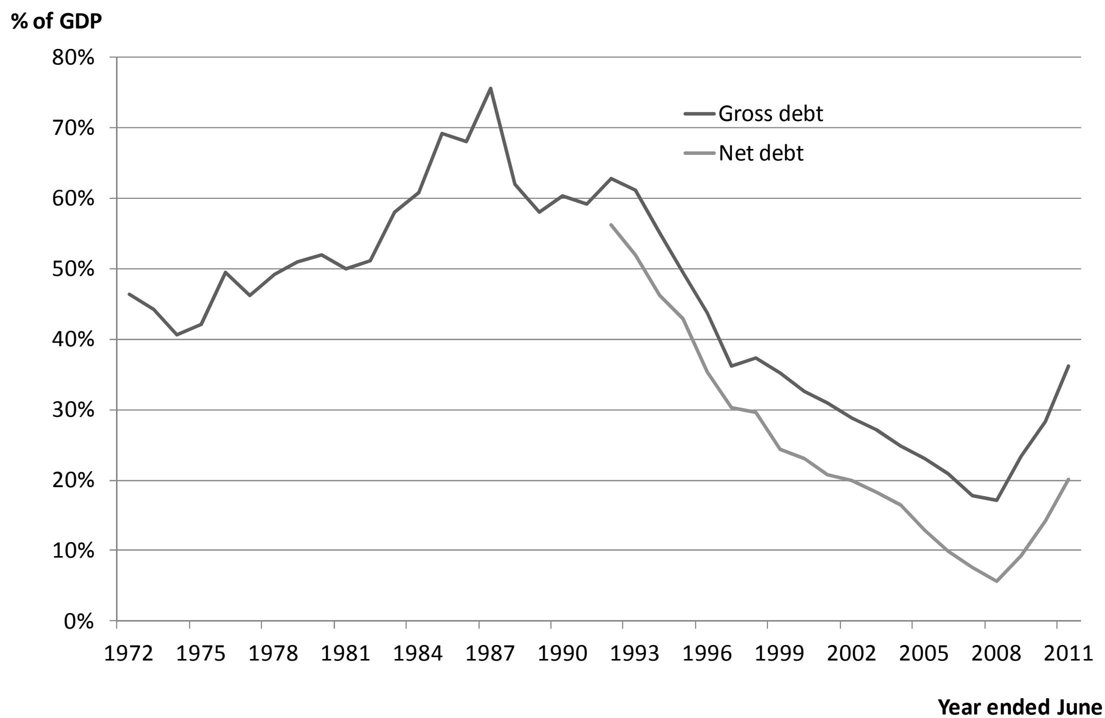
8. Each dimension matters for economic performance via effects on private decision making, such as decisions about investment and labour force participation. Fiscal policy can, among other things, affect the level and stability of tax rates, inflation, national savings, real interest rates, exchange rates and the cost of capital.

1.3 Recent fiscal performance

9. The fiscal responsibility provisions have supported an improvement in fiscal sustainability. Since 1994, successive governments have stated their objective for prudent debt, discussed the implications of current policy, and made progress towards realising that objective. As a result, New Zealand benefited from having relatively low public debt at the time of the global financial crisis and domestic recession in 2008 – 2009, as shown below in Figure 1.

10. The provisions have helped to embed public expectations of regular reporting on the government's fiscal strategy and actions being taken towards realising it. Furthermore, the provisions have provided for the Treasury to release independent economic and fiscal updates twice per year, as well as pre-election updates before every election since that held in 1996.

Figure 1: Gross debt and net debt as a share of Gross Domestic Product



11. A case can be made that the provisions were insufficient, during the last cycle, to prevent revenues that were temporarily higher due to strong economic growth being locked into inappropriately permanently higher structural spending commitments. While there is no way of clearly identifying cyclical and structural elements in the midst of a cycle, the evidence since the Global Financial Crisis does suggest that revenue windfalls during the early-mid-2000s were cyclical (temporary) in nature and not structural (permanent). Revenue forecasts increased by $5 billion per year in Budgets 2006-2008, relative to Budget 2005 forecasts (see Figure 2). These increases were, in part, used to fund larger operating initiatives – simply by revising up the previously announced plans for the operating allowance (see Figure 3).

Figure 2: Core Crown revenue – forecast and actual, Budgets 2005-2008

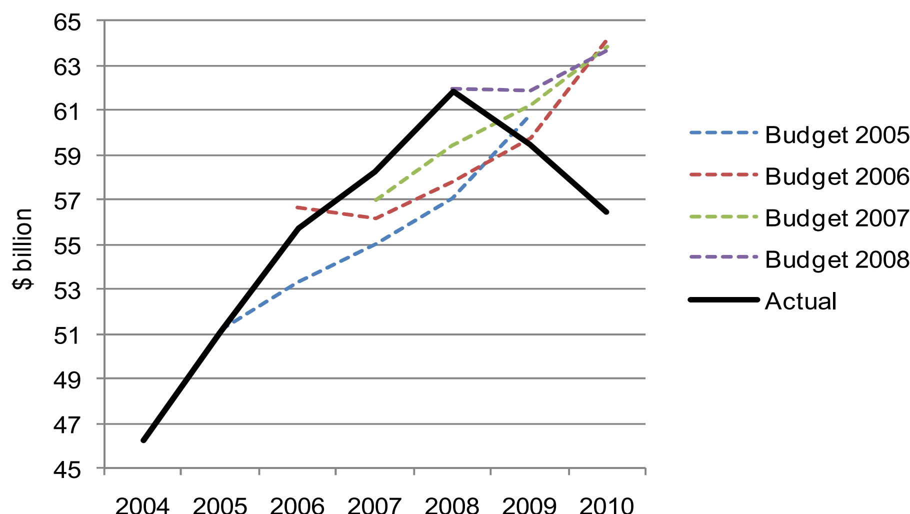
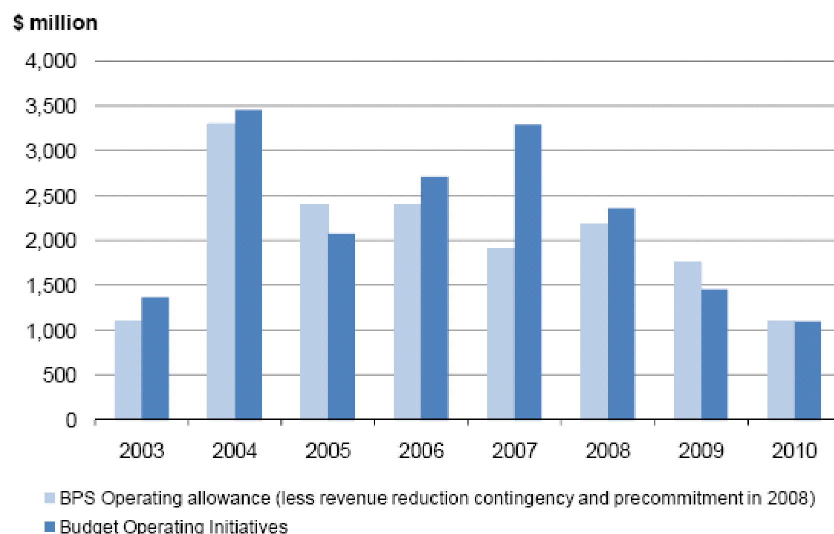


Figure 3: Operating allowance (expense component) announced at the Budget Policy Statement relative to the subsequent actual allowance, Budgets 2003-2010



12. The consequence of the higher structural spending was a structural deficit when the cyclical revenues eased during the downturn. So even though debt was judged to be at prudent levels at the time, the structural deficit and other consequences of recent economic shocks have stretched fiscal sustainability.

13. In addition, there are concerns about the stability impacts of the increases in government spending given the stage of the economic cycle.[2] Given that the structural operating balance fell while the output gap was positive in the mid-to-late 2000s (Figure 4), fiscal policy put pressure on monetary policy which contributed to higher real interest and exchange rates than would otherwise have been the case.

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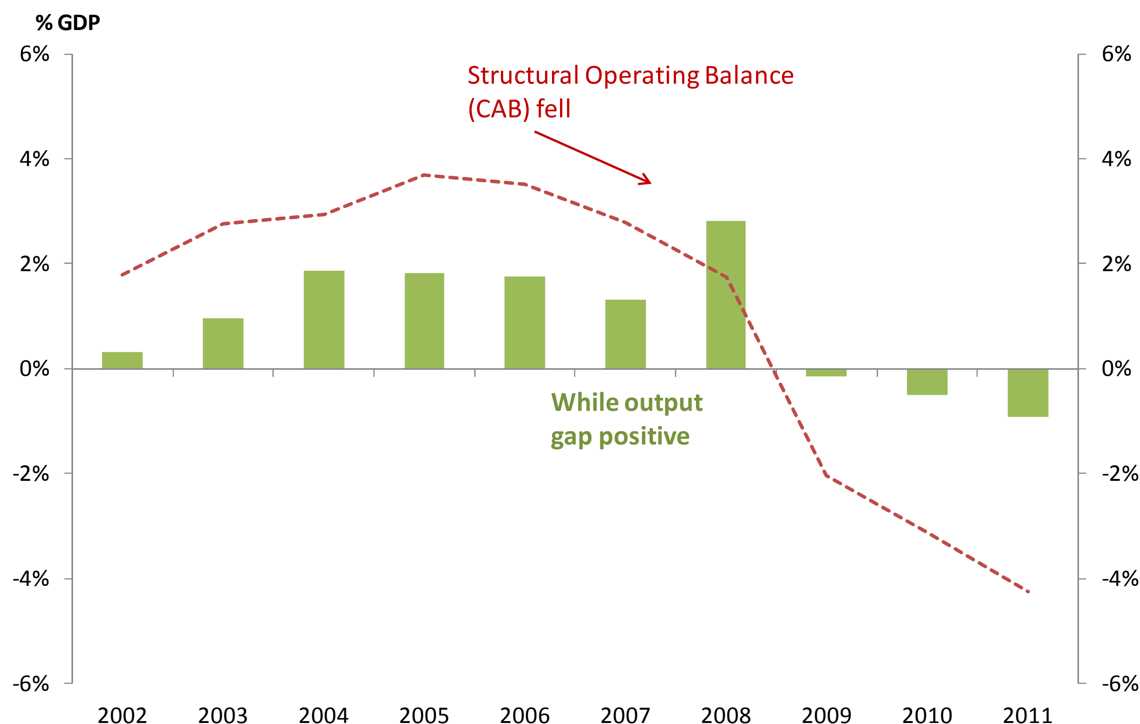
[2] Brook, A. (2011) "Making Fiscal Policy More Stabilising in the Next Upturn: Challenges and Policy Options", delivered at New Zealand's Macroeconomic Imbalances – Causes and Remedies Policy Forum, 23 and 24 June 2011 http://www.treasury.govt.nz/downloads/pdfs/mi-brook-paper.pdf3

Figure 4: Cyclically-adjusted operating balance (CAB) (excluding gains, losses and earthquake expenses)

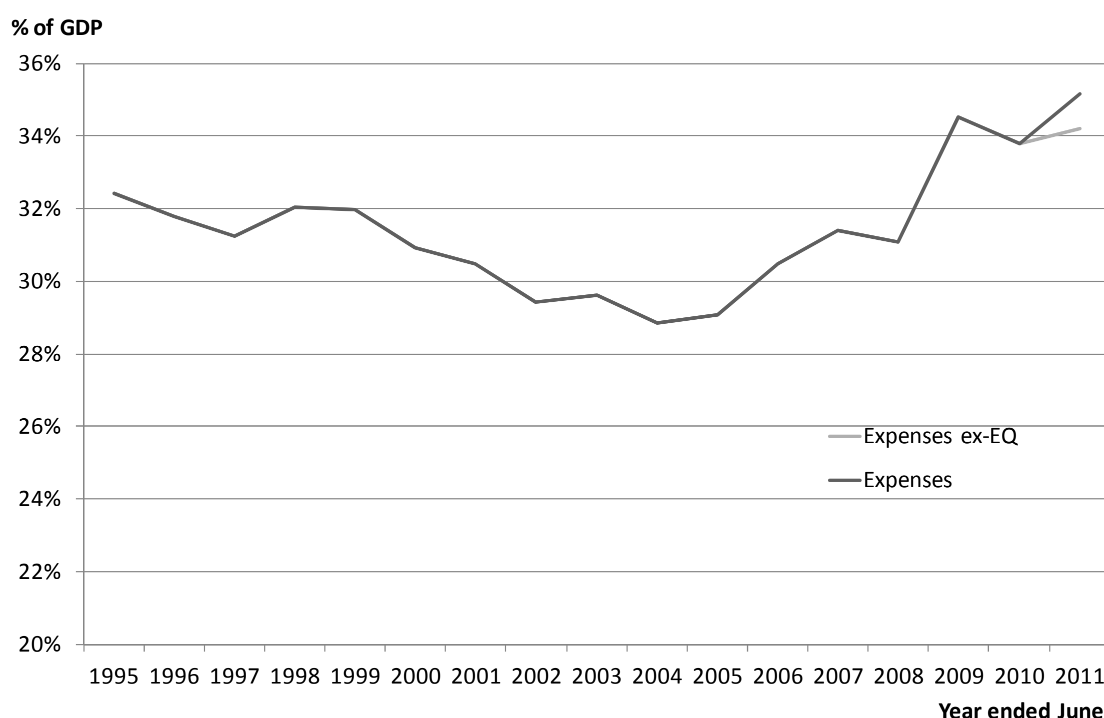


14. The ease with which spending plans can be revised upwards contributed to a focus on adding resources at the margin rather than looking for opportunities to reprioritise or improve efficiency within operating baselines or balance sheets. There were weak incentives to focus on the effectiveness of spending and a lack of a culture of continuous improvement in the absence of fiscal pressures.

15. As a result, core Crown expenses increased from around 29% of GDP in 2003/04 and 2004/05 to just over 34% of GDP in 2010/11 (excluding the earthquake impact in 2011), as shown in Figure 5. That increase of 4.8 percentage points over five years was largely structural in nature and only partly due to the economic downturn in the latter part of the cycle.[3]

[3] Mears T., G. Blick, T. Hampton, and J. Janssen (2010) "Fiscal Institutions in New Zealand and the Question of a Spending Cap," *New Zealand Treasury working paper 2010-07* http://www.treasury.govt.nz/publications/research-policy/wp/2010/10-07/twp10-07.pdf

Figure 5: Core Crown expenses as a share of GDP, 1995-2011



2. Problem definition

16. New Zealand's fiscal performance over the previous economic cycle has shown that although the fiscal responsibility provisions are supportive of debt reduction, they have not been sufficient to take into account the impact of fiscal policy on other aspects of the economy. In particular,

    - there is an insufficient requirement or mandate to consider the stage of the economic cycle in formulating fiscal policy;
    - there is no requirement to focus on the efficient and effective management of resources during good times as well as during times of relative constraint; and
    - there is no requirement to consider future generations when formulating fiscal policy.

17. In addition, since governments are not required to consider these aspects formally in developing fiscal policy, they tend not to report on them. The lack of transparency about the potential impacts of fiscal policy may have contributed to limited public debate about fiscal strategy and its interaction with the economy. In particular,

    - there is no requirement for governments to look back and assess past fiscal policy, meaning that lessons from the past can be lost and also that it is relatively easy for governments to depart from previously announced fiscal policy; and

- there is a risk that current practices that are voluntary, such as the preparation of the revenue strategy and the Investment Statement, are dropped by future governments if they are not codified.

3. Objectives

18. The main objectives of a robust fiscal responsibility regime are to ensure that governments **take into account** and **publicly discuss** all of the relevant dimensions of fiscal policy. Most of the current principles of responsible fiscal management contained in section 26G of the Public Finance Act are focussed on the sustainability dimension of fiscal policy. While that is a critical dimension, it is not the only consideration. The analysis above highlights how, during the last cycle, governments reduced debt to a “prudent” level, apparently satisfying the sustainability dimension of fiscal policy. The principles, however, provided insufficient additional guidance about other factors governments should take into account in formulating fiscal policy.

19. Thus any changes need to ensure that governments consider not only whether fiscal strategy is sustainable, but also whether it is consistent with macro-economic stability, promotes the effective and efficient management of resources, and is consistent with inter-generational equity.

20. Such changes should therefore be:

    - flexible - to enable governments to take into account the prevailing economic circumstances when setting fiscal policy, and;

    - transparent – to enable the public to hold governments to account for their performance.

4. Regulatory impact analysis

4.1 Options

21. The most obvious option for achieving the objective is to change the Public Finance Act to make it a requirement for governments to consider and report on the impact of their fiscal policy on macro-economic stability, on the effective and efficient use of public resources, and on inter-generational equity. This could be achieved in two ways:

    - in a way that is consistent with the current transparency-based approach; or

    - using fixed numerical targets or other more concrete objectives.

22. A third option might be to facilitate an improvement in the quality of public debate, with the intention of putting public pressure on governments to take into account all of the dimensions of responsible fiscal management without amendment to existing law.

23. These three options are discussed below.

4.2 Increased public debate

24. The Treasury considered whether increasing the quality of public debate around fiscal policy could put sufficient pressure on governments to consider a broader range of factors in developing and reporting on fiscal policy. In particular, the Treasury considered whether it would be beneficial to have an **independent fiscal council** providing ex-post commentary on fiscal strategy and the macroeconomic stability dimension.

25. There was no consensus that such a council is the best way to address the problem definition. Concerns about capability and durability were raised. But there was agreement that, if government were to decide to establish a fiscal council, there would likely be a net benefit, given that the small fiscal cost would likely come from the Treasury's baseline and that the potential for harm appears small.

26. Alternative options considered for facilitating public debate were: a larger role for the Treasury in contributing to informed fiscal debate; requiring the Reserve Bank to comment on fiscal policy; and a periodic independent review of performance against fiscal strategy, potentially using expertise from an existing council offshore.

27. While public debate is an important part of New Zealand's transparency based fiscal institutions, the Treasury concluded that options to increase the public debate on fiscal policy matters were insufficient on their own to achieve the objective of encouraging governments to better take into account and report on the broader impacts of fiscal policy. Increased public debate is always helpful, however, and will likely be an additional benefit of Treasury's recommended fiscal responsibility additions (discussed below).

Treasury conclusion: independent fiscal council not recommended as insufficient to achieve objectives.

28. The Treasury also considered legislative change to require **increased reporting of tax expenditures** as a means of increasing public debate. The fiscal responsibility provisions require the Treasury's *Budget Economic and Fiscal Update* to include a statement of tax policy changes that have resulted in a material change in the tax revenue forecasts. Through this mechanism, tax expenditures, or spending through the tax system, are reported at the Budget when the policy decision is taken. However, the provisions do not require subsequent reporting on the existing stock of tax expenditures and how they have changed over time.

29. Two limiting factors have been: uncertainty over the "baseline" against which tax expenditure is measured; and the costs of collecting or estimating information are likely to be high. The Treasury resolved to continue to look at ways to improve current practice while balancing the resource costs of doing so against the expected benefits.

Treasury conclusion: requirement for increased reporting of tax expenditures not recommended, but Treasury will continue to consider ways to improve current practice.

4.3 Adding new principles and reporting requirements to the PFA consistent with the transparency approach

30. The Treasury's preferred approach involves a series of additions and amendments to the fiscal responsibility provisions, consistent with the existing transparency-based framework. The Treasury's recommended changes would expand the set of factors that governments need to consider when setting its fiscal strategy. The changes relate directly to the issues outlined in the problem definition above and are summarised under those headings below.

4.3.1 To ensure that governments consider the interactions between fiscal policy and economic cycles

31. Treasury recommends that the following provisions be added to Part 2 of the Public Finance Act:

- A principle of responsible fiscal management that governments must take the impact of fiscal policy on economic cycles into account, with a view to minimising interest rate and exchange rate pressures;
- A reporting requirement that the Fiscal Strategy Report include an explanation of how the government has considered the interaction between fiscal policy and economic cycles when formulating its fiscal strategy, including any implicit trade-offs and the expected impacts on the economy, with particular reference to interest rates and exchange rates.

32. The new principle of responsible fiscal management would require governments to have regard to economic stability when formulating fiscal strategy.

33. The reporting provision would require governments to communicate how they have considered economic stability when formulating their fiscal strategy, including the stage of the economic cycle, any trade-offs with other fiscal objectives, and the impacts they expect their strategy to have on the economy. This reporting would take place in the Fiscal Strategy Report.

34. Given the methodological challenges inherent in measuring the stage of economic cycles, and the judgements involved, reporting on this as a dimension of fiscal policy lends itself to a narrative involving a range of variables, rather than a single measure.

35. One of the key benefits of ensuring that governments take into account macro-stability in setting fiscal strategy is that fiscal policy should be less pro-cyclical. This will put less pressure on monetary policy, resulting in lower interest/exchange rates than otherwise.

36. A stronger focus on economic stability will result in future governments using future revenue windfalls to pay down debt or build up assets – rather than for discretionary initiatives that may over-stimulate the economy during an upturn.

37. One of the consequences of avoiding pro-cyclical fiscal policy during a period of buoyant economic activity is that a government may consider it necessary to run large operating surpluses. The requirement to take macro-economic stability into account may help governments to manage cyclical pressure to use cyclical revenues for structural changes such as increased structural spending or tax cuts.

38. This change is not without international precedent. The Australian Charter of Budget Honesty Act includes the principle of "moderating cyclical fluctuations in economy activity, as appropriate, taking account of the economic risks facing the nation and the impact of those risks on the Government's fiscal position."

4.3.2 To ensure that governments are transparent about the areas they are prioritising, leading to greater efficiency in managing resources

39. Treasury recommends that the following provisions be added to Part 2 of the Public Finance Act:

- A principle of responsible fiscal management relating to the need for governments to manage resources efficiently and effectively;
- A reporting requirement that the Fiscal Strategy Report include an explanation of the Government's medium-term priorities for new and existing spending and the management of the expenditure base and balance sheet; and
- An extension of the current principle dealing with predictability of the level and stability of tax rates so that it also refers to the need for the tax system to raise revenue efficiently and fairly.

40. This dimension has three core elements relating to public expenditure, taxation revenue and the Crown balance sheet, and has parts that relate to the principles and the reporting provisions.

Spending and the balance sheet

41. The concept of "managing public resources efficiently and effectively" could be added to the principles of responsible fiscal management. This principle would cover existing and future expenditure (operating and capital) and the management of the Crown's balance sheet. This change would provide Ministers (and officials) with a clearer mandate to emphasise the efficient stewardship of resources during good times as well as times of constraint.

42. To support this principle, a reporting provision could be added to require the government to state clearly and consistently the medium-term priorities that will guide its resource decisions with respect to:

- the allocation of new capital and operating spending;
- the reprioritisation or re-allocation of existing expenditure and assets over time; and
- the management of the expenditure base and balance sheet.

43. These priorities would bring more transparency around what the government is trying to achieve through its management of public resources. These priorities would complement what already occurs with the tax revenue strategy and build on the current Government's approach to setting investment intentions in the *Investment Statement of the Government of New Zealand*. This change would help shift the focus of budget decision-making from additional spending initiatives at the margin to managing the baseline and balance sheet as a whole.

Taxation revenue

44. The existing principle contained in s26G(e), which relates to tax revenue, states: "Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years." This principle could be broadened to include the concept of raising tax revenue efficiently. Although the stability and predictability of tax rates is important, this is not all that matters. Other elements matter, including: raising sufficient revenue to meet government priorities; minimising behavioural distortions; keeping administrative costs low; and fairness. Most of these elements can be captured succinctly by referencing the raising of revenue efficiently.

45. The tax principle is a useful signalling tool, and something officials and Ministers can use to push back against particular proposals for tax system change. We would expect the proposed change to have a modest, but nevertheless positive, impact. It would provide a stronger legislative mandate for officials and Ministers to use in promoting fiscal policy that is consistent with a good tax system.

4.3.3 To ensure that governments consider future generations when formulating fiscal policy

46. The Treasury recommends that a principle of responsible fiscal management that governments must have regard to the impact of fiscal policy on current and future generations be added to Part 2 of the Public Finance Act.

47. A reference to inter-generational impacts of fiscal policy could be added to the principles of fiscal responsibility. It would require the government to consider the impact of current policies on future generations.

48. The fiscal responsibility provisions currently have a medium-term focus of a maximum of 15 years. Yet fiscal policy decisions invariably have longer-term effects. The *Statement on the Long-term Fiscal Position*, which the Treasury is required to produce at least every four years, takes a long-term view and models the expected impacts of current policies decades into the future. There is scope for closer integration of the fiscal responsibility provisions with the *Long-term Fiscal Statement*. An explicit inter-generational approach is particularly useful

now, when New Zealand's changing demographic structure means that our current decisions are likely to have different impacts on different generations.

49. There is international precedent for this. The Australian Charter of Budget Honesty Act 1998 includes the principle of "ensure that its policy decisions have regard to their financial effects on future generation."

50. This addition would provide the government with a clearer mandate to highlight the impact of current decisions on future generations, including issues of inter-generational equity. It will also bolster the role of the *Long-term Fiscal Statement*, and provide the Treasury with a clearer mandate to highlight issues of inter-generational fairness.

4.3.4 To ensure that governments look back and assess past fiscal policy

51. The Treasury recommends that the following provisions be added to Part 2 of the Public Finance Act:

    - A reporting requirement that the *Fiscal Strategy Report* contain the Government's assessment of its past performance against its fiscal strategy; and

    - An independent review of fiscal strategy.

A reporting requirement for governments to assess their past performance

52. The fiscal responsibility provisions are currently forward-looking on the strategy that the government is about to set or has already set. There is no requirement for a government to look back and assess its progress. A requirement could be added for governments to look back and assess their past performance against their fiscal strategy, including how and why that strategy has been changed over time.

53. The reporting requirement would require governments to report on past performance of their fiscal strategy in the *Fiscal Strategy Report*. The idea is to increase the onus on governments to discuss and justify any changes in their fiscal objectives and intentions. It will also encourage governments to tell a clear story about progress being made towards their fiscal strategy.

An independent review of fiscal strategy

54. To complement the government's own assessment of its past fiscal performance, an independent review of performance against the government's stated fiscal strategy, and of the Treasury's performance as an advisor on fiscal policy, could be required. Such a review would be held every four years or once during each parliamentary term.

55. The aim would be to secure an independent assessment of fiscal policy that would generate public debate as well as debate within Parliament. The reviews could have included a panel of reviewers, with candidates drawn from New

Zealand and/or an offshore, fiscal authority. Alternatively, this role could be delegated to an Independent Fiscal Council, if one were to be established.

4.3.5 To ensure that current good practices remain part of our reporting framework

56. Treasury recommends that the following provisions be added to Part 2 of the Public Finance Act:

- a reporting requirement that the *Fiscal Strategy Report* must include a revenue strategy that outlines the Government's priorities for the tax system; and

- a reporting requirement that the Treasury produce an Investment Statement at least every four years, describing any significant assets and liabilities on the Crown's balance sheet, how they have changed over time, and how what the Crown owns and owes is forecast to change over the coming five years.

Tax strategy

57. By convention, the *Fiscal Strategy Report* has, in recent years, had a revenue strategy appended to it. It is a succinct and useful reference document to communicate what the government is trying to achieve. It is sometimes used as a reference point to help officials and Ministers respond to tax policy proposals. There is no legislative requirement for the inclusion of this document and the risk is that future governments will decide not to produce this useful communication tool.

58. A requirement that a revenue strategy be attached to the *Fiscal Strategy Report* could be introduced. The requirement to produce this strategy would be high-level rather than prescriptive. It would require the government to outline its priorities for the tax system.

Investment statement

59. The emerging practice of a government Investment Statement could be added to the fiscal responsibility provisions. As with the Long-Term Fiscal Statement, the Investment Statement would be:

- produced by the Treasury, with the emphasis on the quantifiable elements of the Crown balance sheet (e.g. composition, forecast movements, and funding sources); and

- produced at least every four years, given the relatively slow-changing nature of much of the factual information about the balance sheet.

60. A standalone Investment Statement would ensure that the balance sheet continues to receive in-depth focus and that the direction pursued by governments and the associated trade-offs, receive sufficient attention. The release of the Investment Statement could be timed to avoid overlapping with Budget day and ensure sufficient public attention for the Statement.

4.3.6 Package of recommendations

61. As a package, these recommended changes would help to achieve the objective of requiring the government to take into account and publicly discussing a greater range of the dimensions of fiscal policy. There will need to be a broader emphasis on the stage of the economic cycle and on how resources are being managed. The additional reporting requirements will make the process by which the government arrived at its fiscal policy more transparent and also highlight the major trade-offs and choices involved.

62. We expect that the proposed changes would provide increased discipline on the part of the Treasury to consider actively, and to advise consistently on, the stability and structural dimensions of fiscal policy. The changes would also better assist the Minister of Finance to raise issues of fiscal constraint and caution with colleagues.

63. The overall impact is expected to be modest in the short term. Looking to the future, we feel the changes could be of most use after a return to fiscal surplus has been secured and particularly in response to any revenue surprises during the next economic upturn.

64. At best, a macroeconomic stability dimension could mean that any such windfalls would in the first instance be used to pay down debt further rather than boost discretionary stimulus at a time when the domestic-oriented sectors of the economy are already operating above capacity. In an economic upturn, all things equal, this would reduce the risk of pro-cyclical fiscal policy, and consequently put less pressure on interest/exchange rates and tradable sector than would otherwise be the case.

Treasury conclusion: recommended changes will require governments to take into account and publicly discuss all aspects of fiscal policy.

4.4 Adding new principles that set a numerical limit or target for specified fiscal variables

65. Another option for ensuring that governments take certain factors into account is to set a numerical limit or target for specified fiscal variables. A spending limit was agreed as part of the National-ACT Confidence and Supply Agreement. The core element of the limit would be that the government will limit the annual growth in operating expenses to no more than inflation plus population growth. This limit will be reflected in the principles of fiscal responsibility.[4]

66. The design of the limit would be largely the same as that contained in the Spending Cap (People's Veto) Bill 2011, and would include:

[4] There are a number of possible design options for a spending limit. The option considered in this RIS is that recommended in the Cabinet paper that this RIS accompanies, *Strengthening the Fiscal Responsibility Provisions of the Public Finance Act*. A different design option is contained in the Spending Cap (People's Veto) Bill, currently before the House. The Treasury's analysis of the spending limit design in that Bill is set out in its RIS of August 2011, available at www.treasury.govt.nz.

- a formula that limits the annual increase in core Crown operating expenses to the rate of population growth plus the rate of inflation, with the "base" year to which the formula is applied being 2011/12;
- a requirement that the spending limit for a coming fiscal year be announced in the annual *Budget Policy Statement* (due before Parliament by 31 March each year) and be based on the latest actual data for annual population growth and inflation; and
- a requirement that the Minister of Finance explain in the *Budget Policy Statement* whether expenses for the past year remained within the spending limit.

67. A difference between the Spending Cap (People's Veto) Bill and the option analysed in this RIS is that instead of providing for a referendum to re-set the expense base to which the annual limit applies, this option would provide for the government to reset the limit every six years (from the "base" year of 2011/12) – following a review of the government's performance against the limit and of spending pressures. The review would need to take into account the other principles of fiscal responsibility. The review would reset the base level of spending to which the formula is applied, but the formula for determining increases over subsequent years would remain limited to the rate of inflation and population growth.

68. The Spending Cap (People's Veto) Bill proposed to introduce a spending limit as standalone legislation. The option analysed in this RIS would integrate a spending limit with our broader fiscal responsibility framework by making it a principle of responsible fiscal management. Specifying the spending limit as a principle of responsible fiscal management provides additional flexibility because, as with other principles of responsible fiscal management, a government may depart from the spending limit temporarily. If a government decided to depart temporarily from the spending limit, the Minister of Finance would be required to state the reason for departure, the approach the government intends to take to return to the limit, and the period of time the government expects to take to return to the limit.

69. The six-yearly interval for the review of the spending limit represents a balance between providing a challenging but manageable ceiling for government spending versus the flexibility needed to take changing circumstances into account. A six-yearly review would coincide with the start of the parliamentary term of every second government, provided each term of government went for the full three years.

70. Having a review mechanism is likely to make the spending limit more durable, but there remains a risk that a government that would otherwise be bound by the spending limit set by a prior government would change the Public Finance Act to amend or repeal the limit or simply choose to ignore it. While it is positive that the new provisions mean a government that consciously does not adhere to the spending limit would be required to be transparent about that fact, such action could undermine the credibility of the fiscal responsibility provisions.

71. There would be some pragmatic exclusions from the spending limit, namely:

- Finance costs – to prevent unmanageable swings in spending as a result of changes in financing costs. The provisions of the Public Finance Act have been shown to provide an effective limit to growth in finance costs;

- Unemployment benefit expenses – to allow their expansion and contraction to continue to play a stabilisation role through the economic cycle;

- Asset impairments – are recorded as an expense, tend to be volatile and difficult to forecast, and are largely outside the government's immediate control. The student loan portfolio is an example of where an impairment can arise; and

- Emergency expenses – such as those incurred in response to a natural disaster.

72. Capital expenditure would be outside the spending limit, but any associated operating expenses would need to be met from within the limit.

73. The limit could have some advantages for fiscal policy. Fixing a formula-based limit on operating expenses for the year ahead at the *Budget Policy Statement* would discourage upward revisions of spending plans in response to revenue windfalls, such as those that occurred between 2006-2008 (see Figure 3). This spending restraint may help to drive productivity gains within the state sector and the ongoing reprioritisation of ineffective spending. It could also help to avoid pro-cyclical fiscal stance in an economic upturn, although this depends on the economic effects of any tax policy changes and capital expenditure plans.

74. One possible unintended negative consequence of a spending limit, however, is that it may increase the incentives on governments to circumvent the limit by using less transparent ways of spending, such as through tax expenditures or higher capital expenditure.

75. Furthermore, a spending limit operates at all stages of the cycle and may prevent some forms of counter-cyclical measures that might otherwise be advisable. Ideally, any discretionary counter-cyclical measures would meet the criteria of timely, targeted and temporary. It would normally be revenue or capital initiatives that would meet this criteria and the spending cap would not prevent a government using those options. But in rare circumstances, a government may wish to use counter-cyclical spending measures such as one-off discretionary payments to households. Such measures could lead to a breach of the cap, bringing two principles of responsible fiscal management into conflict.

76. Despite the possible benefits outlined in paragraph 73, the Treasury does not recommend a prescriptive formula-based spending limit. The primary reason is the risk of gaming behaviour to circumvent the rule (eg, increased use of tax expenditures), and the risk of further changes to the legislation if the limit lacks widespread support (although we note that the addition of the review of the limit's expense base every six years may help the durability of the spending limit).

Treasury conclusion: spending limit not recommended due to risks of gaming behaviour and possibility of frequent changes to Part 2 of the Public Finance Act.

4.5 Overall assessment of proposals

4.5.1 Compliance costs

77. None of the options discussed in this RIS would place any compliance costs on the public or on private businesses. This is because the options relate to the machinery of government and to the budget cycle. The options directly affect the government, and in particular the Minister of Finance in the setting and communication of budget priorities and the overarching fiscal strategy.

78. The options would also affect the Treasury as the lead advisor to the government on fiscal policy. The changes do not necessarily mean an increase in the volume of advice, but they will raise government and public expectations about the quality, scope and clarity of the Treasury's fiscal and economic advice.

4.5.2 Fiscal impact

Treasury's recommended changes

79. The changes recommended by the Treasury should assist with fiscal sustainability in terms of helping to keep debt under control. The economic stability dimension, the long-term inter-generational focus, and the immediate or short-term spending limit can all help to restrain discretionary spending that is inconsistent with sustainability and/or stability.

80. One potential consequence of these provisions is that governments may want to run larger surpluses during periods of strong economic activity to avoid destabilising pro-cyclical fiscal policy.

Spending limit

81. If a spending limit is implemented, the sustainability of government services may receive increased focus. A numeric rule will result in government's expenditure as a share of the economy reducing over time as on average, economic growth tends to outstrip the sum of inflation and population growth. Real per capita expenses remain constant, but it is unlikely that an equivalent basket of goods and services could be sustained – given that long-run wage pressures tend to exceed inflation and an ageing population is likely to increase demand for some services (e.g. health care, superannuation).

82. As the spending cap allows for population growth but not changes in the composition of population, it will require hard policy choices to be made over the next 10 years about how to deal with the cost pressures associated with an ageing population. This may create the impression that recurring ex-post breaches of the spending limit are inevitable over the long run without a substantial curtailment of government activity. Ongoing breaches could undermine the status and credibility of the fiscal responsibility provisions in

general, and may simply create an expectation that the Public Finance Act will be amended again. The six-yearly review mechanism was designed in part to allow flexibility for a government to respond to these pressures, but it is difficult to predict whether it will be successful in doing so.

83. In the short term, there is a risk of the spending limit being seen as a safe or appropriate level of spending, with pressures to increase expenses up to that limit.

4.5.3 Economic impact

Treasury's recommended changes

84. The Treasury's recommended changes are largely about encouraging governments to think through and publicly communicate their fiscal strategy in a more systematic and comprehensive manner than is currently required. At a minimum, this would increase the transparency, and therefore bring more certainty, about the government's intended course of action over the short and medium term, and what those choices mean for the longer term. Any associated increase in public certainty and confidence about the direction of fiscal policy is likely to be beneficial for economic growth.

85. The changes will also be beneficial for economic growth to the extent that they support fiscal sustainability and macroeconomic stability. In particular, the addition of an economic stability dimension should help to reduce the risk of fiscal policy exacerbating the economic cycle. At best, a macroeconomic stability dimension could mean that any such windfalls would be used to pay down debt further rather than boost discretionary stimulus at a time when the economy is already operating above capacity. In an economic upturn, all things equal, this would reduce the risk of pro-cyclical fiscal policy, and consequently put less pressure on interest/exchange rates and the tradable sector than would otherwise be the case.

86. The size and composition of government matters a great deal for growth. The requirements for the government to state its medium-term priorities for public resources will enhance transparency but the economic impact would be dependent on the underlying policy direction being pursued by a government.

Spending limit

87. This spending limit may help to drive productivity gains within the state sector and the ongoing reprioritisation of ineffective spending. However, there is a chance that a spending limit may conflict with the macroeconomic stability dimension in a downturn. In certain circumstances, it may be desirable for macroeconomic stability to increase government spending temporarily, an action that could lead to a breach of the spending cap.

4.5.4 Administrative complexity

88. The Treasury has considered whether the range of options analysed in this RIS would increase the complexity and make it harder – for officials, Ministers and the

public – to interpret what is required, which provisions take precedence (if at all) and if the provisions are being fulfilled.

Treasury's recommended changes

89. The Treasury's recommended changes would increase the length of the fiscal responsibility provisions, requiring reporting on more aspects of fiscal policy than the status quo. More complex fiscal responsibility provisions could potentially increase the administrative complexity of producing budget documentation, but whether this is true in every case will vary.

Spending limit

90. If a spending limit is introduced as a principle of responsible fiscal management, there may be some circumstances in which some of the principles will be in conflict. For example, in a downturn a spending cap may conflict with a government's desire to increase spending as a counter-cyclical measure or in an upturn a government may need to delay a tax cut that would reduce a high operating surplus if the economy is above potential. Such an outcome would require the government to explain the tradeoffs it is making in choosing a particular fiscal strategy.

91. A spending limit will be a prescriptive element and would give the government less flexibility, depending on the fiscal and economic context. Nevertheless, as is currently the case, a government would continue to be able to depart temporarily from the principles of responsible fiscal management if it can explain why and give a timeframe for returning to the principles.

5. Consultation

92. Agencies most directly affected have been consulted on the proposals outlined in this RIS, namely the Ministry of Justice, Inland Revenue, Crown Law, and the Reserve Bank. The Ministry of Economic Development and the Department of Prime Minister and Cabinet were informed.

93. No formal public consultation on the specific package of proposals outlined in this RIS has taken place. However, there has been considerable public and expert engagement on most of the more significant options outlined here, in particular:

    - There was considerable public debate around the Spending Cap (People's Veto) Bill, which Treasury took into account in developing this analysis.
    - In June 2011 the Treasury held a Macro-economic Conference in which a paper discussing the impact of fiscal policy on macro-economic stabilisation was discussed.[5] That paper was the starting point of many of the recommendations in this RIS. Comments on that paper have informed the

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5 Brook, A. (2011) "Making Fiscal Policy More Stabilising in the Next Upturn: Challenges and Policy Options," delivered at New Zealand's Macroeconomic Imbalances – Causes and Remedies Policy Forum, 23 and 24 June 2011 http://www.treasury.govt.nz/downloads/pdfs/mi-brook-paper.pdf3

proposal to include a new principle around macro stability as well as provided more rigorous analysis of the problems identified.

- Various consultations have been conducted with the IMF and the OECD on different elements of the proposals and they have provided useful information about the best practice internationally.

6. Conclusions

94. The Treasury's recommended option is a series of additions to the fiscal responsibility provisions of the Public Finance Act, namely:

    - A new principle and reporting requirement relating to the interaction between fiscal policy and economic cycles;
    - A new principle and reporting requirement around managing public resources efficiently and effectively;
    - An extension of the current principle relating to tax;
    - A new principle relating to the inter-generational impacts of fiscal policy;
    - New requirements for periodic review of past fiscal policy; and
    - Codification of the existing practices of producing a revenue strategy and an Investment Statement of the Government of New Zealand.

95. The options this RIS considers that the Treasury does not recommend are:

    - A spending limit as a new principle of responsible fiscal management;
    - The establishment of an independent fiscal council; and
    - Requirements for increased reporting of tax expenditures.

7. Implementation

96. The Cabinet paper that this RIS accompanies, *Strengthening the Fiscal Responsibility Provisions of the Public Finance Act*, proposes that Cabinet agree to the introduction of a number of the options considered in this RIS. It is proposed that the changes be included in a Bill amending the Public Finance Act. However, many of the proposals can be implemented prior to the Bill being passed. Many of the proposals are about elements that any government should take into account in developing its fiscal policy and how it makes those decisions transparent. The Government is able to take these elements into account without the formality of changes to the Act.

8. Monitoring, evaluation and review

97. The spending cap proposal includes a specific monitoring mechanism whereby the government has to report on how actual costs compare to those specified by the cap. This review will happen after the release of the *Annual Financial Statements* and will appear in the *Budget Policy Statement*. The proposal also explicitly requires the government to review the spending cap every six years to ensure it is appropriate for the economic and demographic circumstances applying at the time taking into account the principles of fiscal responsibility. The results of this review would be announced in the *Fiscal Strategy Report* following the review.

98. The proposals also contain a requirement for the government to undertake an ex post review of its performance against its fiscal strategy. The outcome of this review will be published each year in the *Fiscal Strategy Report*.

99. The Treasury will continue to monitor the performance of New Zealand's fiscal frameworks as part of its normal course of business.