Regulatory Impact Statement

Spending Cap (People's Veto) Bill

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by **the Treasury**.

It provides an analysis of the Spending Cap (People's Veto) Bill which seeks to limit the annual growth in core Crown expenses. The analysis set out in this statement draws on research and experience in New Zealand and internationally. The agencies most directly affected have been consulted, including the Ministry of Justice, the Electoral Commission, and Inland Revenue.

There are uncertainties around the fiscal and economic impacts of the proposal – reflecting the need to rely on judgement about the behavioural responses to the introduction of a numerical fiscal rule (and the provision for binding referenda) to New Zealand's transparency-based framework for fiscal policy. Despite this, the policy proposal is a significant one that goes beyond the current "state and explain" approach to managing fiscal policy in New Zealand.

The scope of this analysis has been determined by the instructions to the Treasury to provide sufficient support for preparing the ACT Party's Taxpayer Rights Bill for introduction to Parliament as a government bill. This meant that the starting point was the Taxpayer Rights Bill, an earlier version of the Spending Cap (People's Veto) Bill prepared by the ACT Party as a member's bill. The policy development process has led to a number of refinements, most notably, with the dropping of an annual cap on revenue growth and constraints on changes to the tax mix.

Alternative non-regulatory options for securing greater spending constraint have also been considered – albeit at a high level, given the project objectives (i.e. preparation of the Bill for introduction as a government bill). Alternatives considered were: a self-imposed spending cap (as opposed to the legislated cap in this policy proposal); the quantification of a long-term objective for expenses; and a tightening of the Fiscal Management Approach – the rules that guide government decision making about expenditure and revenue.

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1 Context

The National-ACT confidence and supply agreement provides for the ACT Party's Taxpayer Rights Bill to be referred to Parliament's Finance and Expenditure Committee as a government bill. The Taxpayer Rights Bill was initially drafted as a member's bill in 2007; it has since been refined and renamed as the Spending Cap (People's Veto) Bill.

The Spending Cap (People's Veto) Bill seeks to establish a cap on the annual growth in core Crown expenses. That spending cap would reduce core Crown expenses as a share of gross domestic product (GDP). It also seeks to make the government more accountable to voters by requiring a binding referendum for any proposed increase above the spending cap.

The Bill's broader objective is to support economic growth by reducing the size of government relative to GDP – thereby creating scope to lower tax rates and reduce the overall tax burden (and potentially, to shift the tax mix towards tax bases with a lower cost to economic growth). The top-down constraint provided by the cap is expected to drive ongoing efficiency gains with government services and the reprioritisation of low-value spending.

1.1 Fiscal responsibility provisions

The Public Finance Act 1989 provides the legislative framework within which fiscal policy is conducted. The term 'fiscal policy' generally refers to the management of fiscal aggregates such as revenue, expenses, debt and net worth, and how these impact on the wider economy. Part 2 of the Act contains the fiscal responsibility provisions that require the government to pursue its policy objectives in accordance with five principles of responsible fiscal management, outlined in Box 1 below. Among other things, those principles require public debt to be reduced to, and maintained at, prudent levels by ensuring a balanced budget on average over a reasonable period of time. Definitions such as a "prudent" level of debt or a "reasonable period of time" are left to the government of the day to interpret.

Box 1: Principles of responsible fiscal management

1. Reducing total debt to prudent levels, by maintaining operating surpluses until prudent levels are reached
2. Maintaining total debt at prudent levels once they have been achieved, by ensuring budget balance on average over a reasonable period of time
3. Achieving and maintaining levels of total net worth that provide a buffer against future events
4. Prudently managing the fiscal risks facing the Government
5. Ensuring a reasonable degree of predictability about the level and stability of tax rates for future years

The fiscal responsibility provisions require the government to be transparent about its fiscal strategy by setting out long-term (at least 10 years) fiscal objectives for total operating expenses, total operating revenues, the operating balance, total debt, and total net worth. The government is also required to set short-term fiscal intentions (at least 3 years) for those variables.

A government must explain how its long-term objectives and short-term intentions are in accordance with the principles responsible fiscal management. Any departure from those principles must be temporary, with the Minister of Finance specifying the reasons for the departure, the approach to be taken to return to the principles, and the time that this will take.

The Minister of Finance is required to present this information to Parliament in a Fiscal Strategy Report immediately after the Budget is delivered – usually in May of each year. This information is also required in the annual Budget Policy Statement – usually in December preceding the Budget (but no later than 31 March).

These fiscal responsibility provisions were first legislated in the Fiscal Responsibility Act 1994, and consolidated into the Public Finance Act 1989 in 2004. The intention of the merger was to consolidate legislation regarding public finance.

The fiscal responsibility provisions were developed against a backdrop of high public debt, caused by a long period of structural fiscal deficits. The provisions aimed to address 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

The fiscal responsibility provisions are not prescriptive about fiscal objectives and intentions – other than requiring debt to be reduced to and maintained at prudent levels, and ensuring a budget balance on average over a reasonable period of time. A trend increase in government expenses as a share of GDP is permissible – provided that the principles relating to debt, the operating balance, and revenue are adhered to. This transparency-based approach has been successful in maintaining operating surpluses to reduce debt. As a result, by 2006, net debt had returned to below 10% of GDP and New Zealand entered the recession of 2008-2009 with historically and internationally low levels of public debt.

1.2 Fiscal management approach

The Fiscal Management Approach (FMA) is the set of rules that helps the government make expense and revenue decisions during the Budget process – to achieve its fiscal strategy. The current FMA was designed in 2003 and is based around a system of fixed, annual, nominal allowances for new capital and operating initiatives – known as the capital allowance and the operating allowance (which may contain expense and revenue initiatives).

These allowances represent the headroom for discretionary initiatives and are set by the government with regard to:

- its intentions and objectives for the operating balance, revenue, and expenses and net debt; and

- the forecasts for demand-driven expenses (e.g. New Zealand Superannuation, benefit payments) – which usually have a rising profile over time.

2 Problem definition

2.1 Causes

The underlying problem is articulated in public choice theory, which views government as comprising self-interested agents who use the state to further their private ends – resulting in outcomes that conflict with the preferences of the general public. For example, the recipients of additional spending are often visible, concentrated and immediate, whereas the cost of higher taxes (and/or future debt) is typically more widespread, diffuse and delayed (i.e. being borne by future taxpayers). The persistent fiscal deficits and rising government debt of the 1970s (known as "deficit bias") are one manifestation of these conflicts.

The bias towards deficits or pro-cyclical fiscal policy also reflects the tendency for governments to have short time horizons, given the electoral uncertainty present in the democratic process. This 'myopia' can generate a discounting of the future tax increases and/or expenditure reductions implied by current fiscal deficits. Similarly, the fiscal adjustments needed to reduce deficits tend to be delayed and revenue windfalls in good times are not banked (see Alesina and Tabellini, 1990; Rogoff, 1990[1]). Discretionary changes to fiscal policies can be "time inconsistent" when a government finds it desirable to ex-post deviate from policies that were considered optimal ex-ante. So while ex-ante there might be agreement on the benefits of low inflation or low fiscal deficits, commitment to these might not be credible if deviating from them is seen as a way to alleviate other more pressing concerns (see Kydland and Prescott, 1977; Chari, Kehoe and Prescott, 1988[2]).

The time inconsistency issue has been a motivating argument behind monetary policy reform, including central bank independence and inflation targeting. Although fiscal policy can be subject to time inconsistency, there was awareness at the time when the fiscal responsibility provisions were being formulated for the Fiscal Responsibility Act 1994 that the objectives, accountabilities and instruments in fiscal policy are different to those in monetary policy.[3]

2.2 Symptoms

The underlying problem results in a number of symptoms – with implications for fiscal sustainability and macroeconomic stability. These include higher spending and larger government, a higher taxation burden on individuals and businesses, and periods of procyclical fiscal policy that contribute to macroeconomic volatility. The net effect of these symptoms may be a negative impact on economic growth and, potentially, overall welfare.

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[1] Tabellini, G. and A. Alesina (1990) "Voting on the Budget Deficit" in *The American Economic Review*, Vol. 80, No. 1, Mar. 1990 http://www.jstor.org/stable/pdfplus/2006732.pdf

Rogoff, K. (1990) "Equilibrium Political Budget Cycles" in *The American Economic Review*, Vol. 80, No. 1, Mar. 1990 http://www.jstor.org/stable/pdfplus/2006731.pdf

[2] Kydland, F.E. and E.C. Prescott (1977) "Rules Rather than Discretion: The Inconsistency of Optimal Plans" in *The Journal of Political Economy* Vol. 85, No. 3, Jun. 1977 http://www.jstor.org/stable/pdfplus/1830193.pdf

[3] Scott, G. (1995), "New Zealand's Fiscal Responsibility Act", *Agenda*, Volume 2, Number 1, 1995. http://epress.anu.edu.au/agenda/002/01/2-1-A-1.pdf

Expenses increase as share of GDP

The focus on prudent debt, and on the operating balance required to achieve it, has not prevented core Crown expenses from rising as share of GDP. During the previous period of economic expansion, self-imposed expenditure objectives were either not achieved or revised upward in response to higher-than-expected revenue increases, particularly from 2005-2008. Core Crown expenses increased from 28.9% of GDP in 2003/04 to 34.7% in 2008/09. That increase of 5.8 percentage points over five years was only partly due to the downturn in the latter part of the cycle (see Mears et al, 2010).[4]

The conclusion that New Zealand's fiscal framework is permissive with respect to spending increases, and the size of government more generally, is reflected in a number of papers – see Janssen, 2001; OECD, 2002; Wilkinson, 2004; and Buiter, 2006.[5] The Treasury has looked at ways in which governments could choose to provide more certainty about spending plans. The Treasury's 2008 Briefing to the Incoming Minister suggested there would be merit in adopting an additional fiscal anchor in the form of a medium-term expenditure or revenue constraint (e.g. as a share of GDP).[6] The benefits were seen as:

- signalling an intent to restrain spending growth and commit to particular revenue levels to better manage expectations over the next three years and beyond;
- potentially increasing the contribution of fiscal policy to macroeconomic stability by providing more certainty and better supporting monetary policy; and
- assisting the government to achieve a slowing in expenditure growth from current rates over the longer term to manage future spending pressures

Higher taxes impacting on economic growth

The increase in spending, relative to GDP reflects a tendency for governments to accept revenue increases (including unexpected 'windfalls') during periods of economic expansion rather than to focus on reprioritisation and drive efficiency within existing spending. This higher spending comes with a higher overall tax burden than would otherwise be the case. The deadweight loss associated with the higher-than-necessary tax burden reduces the potential of the private sector – usually the more dynamic part of the economy due to competitive forces – to drive economic growth.

The increase in the size of government spending, along with the associated higher tax burden and impacts on economic growth are a key motivation for the Spending Cap (People's Veto) Bill.

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[4] 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

[5] Janssen, J. (2001) "New Zealand's Fiscal Policy Framework: Experience and Evolution" *Treasury Working Paper 01/25*. http://www.treasury.govt.nz/publications/research-policy/wp/2001/01-25/

OECD (2002) Economic survey of New Zealand 2002. Paris, OECD

Wilkinson, B. (2004) *Restraining Leviathan A Review of the Fiscal Responsibility Act 1994* http://www.2025taskforce.govt.nz/pdfs/tfr-rl-1nov09.pdf

Buiter, W. (2006) "Stabilisation policy in New Zealand..." in *Testing stabilisation policy limits in a small open economy...*. Reserve Bank of New Zealand and the New Zealand Treasury http://www.rbnz.govt.nz/research/workshops/12jun06/tspl-buiter.pdf

[6] New Zealand Treasury (2008) *Briefing to the Incoming Minister of Finance 2008: Economic and Fiscal Strategy – Responding to Your Priorities*. http://www.treasury.govt.nz/publications/briefings/2008efs/

Spending temporary revenue increases

Difficulties in distinguishing between structural and cyclical revenue – a worldwide issue – have led to temporary revenue increases being locked into permanent spending plans. Revenue forecasts were increased by around $5 billion per year in total in Budgets 2006, 2007 and 2008, relative to the Budget 2005 forecasts. These revenue increases were, in part, used to fund larger operating initiatives than originally planned. At the time of Budgets 2006, 2007 and 2008, continued surpluses were forecast, and the requirement to maintain a balanced budget over a reasonable period appeared to be met. However, the subsequent recession and the benefit of hindsight have shown that these revenue increases were largely cyclical rather than structural.[7]

Fiscal policy placing pressure on monetary policy

Pro-cyclical fiscal policy refers to policy that is expansionary during an economic boom (or contractionary during a recession) – potentially increasing macroeconomic volatility and harming economic growth. The Reserve Bank has cited fiscal policy in New Zealand as being among the factors that stimulated aggregate demand during the period of economic expansion over the mid-to-late 2000s, contributing to higher real interest rates and a higher exchange rate than would otherwise have been the case.[8] These conditions are likely to have constrained activity in tradable sectors (which include exporting and import-competing industries) – thereby harming economic growth.

Weak incentives for efficiency and reprioritisation

When the economy was growing strongly, large operating allowances made it relatively straightforward to meet cost pressures. There was little incentive to seek reprioritisation from within existing baselines, as it was relatively easy to allocate additional resources. The Public Finance Act does not require the mix of existing spending to be reviewed for cost-effectiveness or quality, or for efficiency gains to be secured on an ongoing basis.

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[7] 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

[8] Finance and Expenditure Committee, New Zealand Parliament (2008) *Inquiry Into the Future Monetary Policy Framework* http://www.parliament.nz/NR/rdonlyres/51084E05-C9EC-4C7F-889B-

3 Design of the proposal

3.1 Intervention logic

The Spending Cap (People's Veto) Bill would set a legislated and quantified limit on the growth in core Crown expenses – based on a simple formula. The intervention logic is that this spending cap would lead to lower levels of expenses over time than would otherwise be the case – absent any referenda passing proposals to reset the spending cap at a higher level. This explicit constraint on the growth in government spending, beyond those provided by the limits to revenue and debt, would require ongoing efficiency gains and reprioritisation of poor quality spending.

Greater spending restraint would allow for revenue to grow more slowly and to be at a lower level in aggregate than would otherwise be the case.

The Public Finance Act 1989 would still require governments to run balanced budget on average over time, to achieve and maintain public debt to prudent levels.

As a result, the spending cap would require the government to pursue its goals via a smaller and more efficient state sector. This would mean a lower tax burden on the economy over time, and less crowding out of private sector activity than would otherwise be the case.

3.2 Key design elements

The main features of the Spending Cap (People's Veto) Bill are:

a. a spending cap that limits the annual increase in core Crown expenses to the rate of population growth multiplied by the rate of inflation;

b. a requirement that the spending cap for a coming fiscal year be announced in the annual Budget Policy Statement and be based on the latest actual data for annual population growth and inflation;

c. a provision that excludes the items of finance costs, unemployment benefit expenses, and asset impairments from the core Crown expenses covered by the spending cap;

d. a requirement that any proposed increase in core Crown expenses above the spending cap be subject to a government-initiated binding referendum on whether the cap is be raised to allow for that increase;

e. a requirement that referenda on an increase in the spending cap be held under the provisions of the Referenda (Postal Voting) Act 2000;

f. a provision for a temporary waiver of the spending cap with respect to unplanned expenses incurred in response to a national emergency; and

g. a requirement that the Minister of Finance explain any unplanned breach of the spending cap to Parliament and outline what actions will be taken to ensure expenses remain within the cap in future.

The spending cap would apply to core Crown expenses because they represent the operating expenses most directly within the government's control.

Capital expenditure would be outside the spending cap. Capital expenditure is effectively constrained – by the available revenue, by the prudent debt requirements of the Public Finance Act 1989 and by the fact that any operating costs associated with capital expenditure would need to be met from within the cap.

Three categories of expenses are excluded from the cap on core Crown expenses:

- finance costs – to retain flexibility for the debt management programme to pre-fund future debt needs. The provisions of the Public Finance Act 1989 have been shown to provide an effective limit to growth in finance costs;
- unemployment benefit expenses – to allow the counter-cycle expansion and contraction of these expenses to continue to play a macroeconomic stabilisation role through the economic cycle (without displacing other expenses); and
- asset impairments – relate to cash flows being less or later than previously estimated. These are recorded as an expense, tend to be volatile and difficult to forecast, and are largely outside the immediate control of the government. Examples where asset impairments can arise include tax receivables and the student loan portfolio.

Box 2: Other design elements considered

Other design elements were considered and not included in the proposed policy.

A revenue cap – on the annual growth in core Crown revenue was considered. The volatility and uncertainty around revenue flows through the economic cycle is a major drawback. A key problem with a revenue cap is the 'ratchet effect' in recessions, where a drop in the level of revenue is locked-in because the annual growth rate is applied to a lower base.

Tax mix provisions – it would also be possible to use the referendum mechanism in the Spending Cap (People's Veto) Bill to provide citizens with greater say over changes to tax policy. Governments could be required to use referenda to seek approval for the introduction of any new tax and for increases in existing taxes. This option risks inhibiting the opportunities for growth-enhancing shifts in the structure of taxation, and risks distracting from the focus on expenditure control at the heart of the proposal. For these reasons, this option was not pursued further.

3.3 Operation of the spending cap

Setting the cap

In practice, the spending cap for a fiscal year beginning 1 July would be set in the annual Budget Policy Statement, usually released in the previous December (but required by 31 March under the Public Finance Act 1989). The cap would be based on the latest actual data for annual inflation and population growth and could be expressed as a percentage increase and a nominal dollar amount. The Minister of Finance would be required to deliver a Budget where the forecast for core Crown expenses for the year ahead is within the announced cap. The Budget could also include an indicative 'forecast cap' for the next three years based on forecasts for annual inflation and population growth.

Use of 'excess' revenue

If a government receives, or is forecast to receive, more revenue than required to fund the level of core Crown expenses allowable under the cap, there are options for using that 'excess' revenue. A government could opt for a mix of tax cuts, debt reduction, or capital expenditure. A government can also hold a referendum on increasing the spending cap for the coming year.

Consistency of fiscal strategy with the cap

If a government sets out a fiscal strategy that is inconsistent with the spending cap beyond the Budget year ahead, it can seek a referendum to lift the cap to accommodate those plans, or explain the reasons for the inconsistency and the intended approach for resolving the inconsistency over a stated timeframe.

Responding to an unplanned breach of the cap

There is risk of an unplanned breach of the cap due to actual expenses being higher than forecast, for example, because of higher uptake of demand-driven programmes. A breach may not be confirmed until the end the fiscal year.

In the event of an unplanned breach, a "back on track" rule would apply. Under this rule, the Minister of Finance is required to explain to Parliament the reasons for the unplanned breach of the cap and to outline what actions will be taken to ensure expenses remain within the spending cap in future years. The Budget Policy Statement is an opportunity to explain and record those actions. Furthermore, the spending cap for subsequent years will continue to be based on the level of core Crown expenses that should have been achieved under the cap, rather than the actual level due to an unplanned breach.

Holding a referendum

The design and conduct of a referendum is an issue yet to be fully worked through. Referenda would be conducted as government-initiated referenda under the Referenda (Postal Voting) Act 2000. The form, layout and required text of the voting paper are set out in the Act, but the Act does not specify a process for developing the question, only that it needs to be specified by Order in Council. Recent experience suggests a referendum would take around six to eight months from start to finish – including time to assemble and update a referendum roll of qualifying voters, preparing the question, printing and distributing the postal voting material, the voting period itself (21 days in the Act), and counting and returning of the results.

4 Regulatory impact assessment

4.1 Assessment against key criteria

The addition of the spending cap to the fiscal policy framework is assessed against four key criteria that a well-designed fiscal rule should meet. These criteria were used for assessing the design of a spending cap developed by the Treasury in 2009-10. The criteria reflect literature about best practice with respect to the objectives and design fiscal rules (e.g. IMF, 2009[9]; Ljungman, 2009; Ter-Minassian, 2007)

Table 1: Design criteria for a fiscal rule

Criteria	Rationale
Fiscal sustainability	• Support fiscal discipline by helping to control government spending – to ensure that the paths of expenses, revenue and debt are sustainable over the long term (in the context of an ageing population and associated pressures). Fiscal sustainability matters for economic growth and overall welfare (e.g. not placing a greater tax burden on current or future generations to fund higher current spending)
Macroeconomic stability	• Support macroeconomic stability by reducing the likelihood of expansionary fiscal policy during periods of economic expansion (i.e. pro-cyclical fiscal policy). Macroeconomic stability, particularly in terms of inflation and exchanges rates, provides certainty for individuals businesses to plan – thereby supporting economic growth.
Simplicity	• Being simple enough to ensure transparency and build confidence that it represents a credible fiscal rule. • Being an unambiguous and stable link between a numerical target and the fiscal objective (of spending restraint).
Durability	• Being flexible enough to be durable across governments.

Fiscal sustainability

The Bill would likely lead to smaller government than would otherwise be the case – given that core Crown expenses have historically tended to grow faster than inflation and population growth. This assumes sustained political support for the Bill and that any referenda supported the constraint of the spending cap being maintained.

While the Bill would allow some nominal growth in core Crown expenses – maintaining those expenses in real per capita terms – it would also lead to those expenses declining as a share of GDP. This is because GDP tends to grow faster than inflation and population growth, on average over time, due to the gains from productivity improvements.

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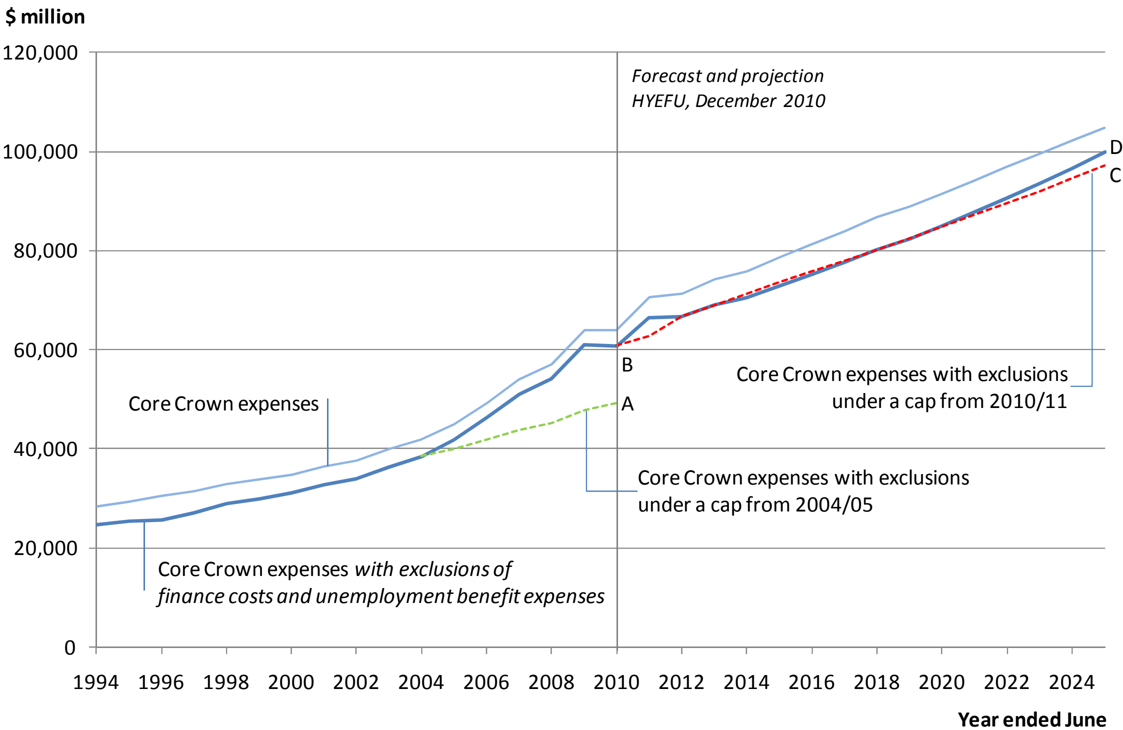
[9] International Monetary Fund. (2009) Fiscal Rules – *Anchoring Expectations for Sustainable Public Finance*. Washington: International Monetary Fund. www.imf.org/external/np/pp/eng/2009/121609.pdf

Figure 1, below, illustrates the level of expenses under the spending cap. If applied in 2004/05, the cap could have led to a lower level of core Crown expenses in 2009/10 – in the absence of any referenda approving higher increases. The cap could have prevented much of the growth in revenue at Budgets 2006-2008 from being locked into additional expense initiatives (despite some corporate and personal tax reductions). Instead, more of that that revenue could have been used for some mix of permanent tax cuts, debt reduction or capital expenditure. Depending on the mix of alternative choices, this could have meant less inflationary pressure in the economy and less pressure on monetary policy.

Figure 1: Core Crown expenses and limits under the Spending Cap (People's Veto) Bill



If applied in 2010/11, this spending cap would mean a level of core Crown expenses broadly in line with current fiscal strategy for the next five to seven years, before gradually forming a tighter track. The key difference is that the cap will lock-in the relatively small operating allowances under the current fiscal strategy, providing greater certainty that this level of restraint will be maintained. Delivering the Government's priorities within this limit would require ongoing efficiency gains and reprioritisation of existing spending.

This assessment assumes that the spending cap is successfully implemented and maintained. There are risks to this outcome. For example, slower growth of expenses may result in reductions in relatively high quality expenditure, on the basis that it is easier to reprioritise. This could weaken the credibility of the spending cap and may increase the likelihood that governments and/or voters will seek to undermine the cap.

The cap has no floor, or view about a minimum or sustainable level of govt services. It relies on governments using referenda, and on the approval of voters to reset the cap – on the basis that a higher increase in spending is required for delivering a given bundle of services.

Macroeconomic stability

Fiscal policy also has an important role to support monetary policy to deliver macroeconomic stability.[10] Revenue from some tax bases increases faster than the economy in a boom and fall quicker in a recession (e.g. property taxes and corporate and personal income taxes). Likewise, some expenditure grows in a recession (e.g. social welfare). Together this has the effect of generating a counter-cyclical fiscal policy position – adding stimulus in a recession and leaning against a boom. These automatic stabilisers support macro-economic stability and monetary policy, so that inflation targets can be met with smaller swings in interest rates (and hence smaller swings in the exchange rate). Macroeconomic stability provides certainty for individuals businesses to plan – thereby supporting economic growth.

The spending cap is designed to allow fiscal policy to continue playing a stabilising role in response to the economic cycle and shocks. Unemployment benefit expenses, also referred to as an automatic stabiliser, are excluded from the cap so that they can continue to expand and contract through the cycle, without placing pressure on other expenses under the cap. Tax revenues, also seen as an automatic stabiliser, remain free to contract and expand in a counter-cyclical manner. Furthermore, in an economic recession a government could still take on debt in the short term to provide timely, targeted and temporary stimulus in the form of capital expenditure, e.g. on productivity enhancing infrastructure.

On balance the limits on annual growth in core Crown expenses may make it less likely that cyclical revenues would be locked into structural and ongoing spending plans and further stimulate the economy during period of sustained economic expansion (although revenue increases could still be used for capital expenditure, tax cuts, or tax expenditures).

Simplicity

The simple design of the Bill means that its aims, operation and effects can be communicated relatively easily. The numerical basis of the cap is comprised of well-known measures of inflation and population growth. But the simplicity of numerical targets can mean that it is relatively straightforward for governments to create ways to circumvent the rule – potentially driving Budget decisions and raising the risk of unintended or perverse outcomes.

As Ter-Minassian (2007) notes, numerical rules...

> "...introduce policy inflexibility and may create incentives to resort to low-quality measures to meet numerical targets. For example, in some countries the application of numerical rules has led to creative accounting practices aimed at circumventing the rules, including reclassification of expenditures, accumulation of arrears, and the use of public entities off-budget to perform government operation."[11]

These same risks apply to New Zealand. A variety of ways to circumvent or undermine the impact of the cap could be envisaged – for example, targeted tax concessions or rebates (known as tax expenditures) could be used to deliver policy goals without placing pressure on the spending cap. Such measures would mean the letter of the cap but not the spirit – as they could lead to increased complexity in the tax system and increasing compliance costs on individuals and/or businesses.

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[10] Reserve Bank of New Zealand and The Treasury, "Testing stabilisation policy limits in a small open economy: proceedings from a macroeconomic policy forum", October 2006.

[11] Ter-Minassian, T. (2007) "Fiscal Rules for Subnational Governments: Can They Promote Fiscal Discipline?" *OECD Journal on Budgeting*, Vol 6, No. 3 www.oecd.org/dataoecd/26/6/43469443.pdf.

Durability

The effectiveness of any fiscal rule depends on political commitment over time. A legislated spending target or cap would require successive governments to accept a constraint on their ability to set their fiscal strategy – through the cap on growth in core Crown operating expenses.

Ljungman (2009) examines spending rules in three countries – Finland, the Netherlands, and Sweden – and found that each has the status of a political commitment with no predefined sanctions in the event of a breach, other than reputational costs for the Government. Ljungman concludes that any spending rule that is not perceived as serving the interest of the Government and Parliament will inevitably be circumvented, and that "in the absence of this widespread political support, it is doubtful that the legislative status of a spending rule will have any impact on actual policy formulation".[12]

Without widespread political support a government could overturn the rule by amending the legislation – potentially raising the prospect of ongoing changes to what has been a stable and enduring the fiscal framework with a high degree of cross party support.

The durability of the cap may be enhanced in that it provides some flexibility for governments to respond to shocks – via the emergency provisions allowing for a temporary waiver.

4.2 Other implications

This proposal does not impair private property rights, market competition or the incentives on businesses to innovate and invest. The proposal does not override fundamental common law principles (as referenced in Chapter 3 of the Legislation Advisory Committee Guidelines), but it may affect our constitutional arrangements – namely, limiting the ability of Parliament to grant supply to the governments. It is possible that the proposal to cap expense growth could lead to additional costs being imposed on businesses – if governments become more likely to use other measures to pursue their policy objectives (e.g. tax concessions, regulation measures).

Economic growth

To the extent that the spending cap could support fiscal sustainability and macroeconomic stability – as outlined above – it could also support economic growth. But the size and composition of government also matter for growth – as outlined in a Treasury working paper:

> "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."[13]

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[12] Ljungman, G. (2008) "Expenditure Ceilings – A Survey", *IMF Working Paper* WP08/282 http://imf.org/external/pubs/ft/wp/2008/wp08282.pdf

[13] New Zealand Treasury (2011) "Government and economic growth: Does size matter?" *New Zealand Treasury Paper 11/01* http://www.treasury.govt.nz/publications/research-policy/tp/govtsize/tp-govtsize-apr11.pdf

The paper goes on to conclude that although "it is difficult to draw firm conclusions about the scope for changes in the 'size' of New Zealand's government... there appears to be scope to lower the tax take as a share of the economy or, alternatively, to better position the Crown to deal with long-term expenditure pressures without increasing the tax take". The paper notes that this could be achieved by reducing or limiting growth in expenditures that do not measurably contribute to raising the economy's potential economic growth rate (while acknowledging that the economic benefits of lower taxes need to be balanced against other Government objectives).

To achieve a positive economic growth impact, the Spending Cap (People's Veto) Bill proposal would need to generate reductions in relatively high cost taxes and reductions in relatively low value spending. This would require the Bill to be enduring over time and that governments not try to circumvent the spirit of the spending cap. It also assumes that any referenda held on spending would not approve higher increases.

Empirical analysis of the Taxpayer Bill of Rights (TABOR) in Colorado suggests that the combination of a cap on expenses and revenue and a referendum mechanism was successful in reducing the size and scope of Colorado's state government relative to its economy. However, that analysis also suggests that the reductions in tax and spending generated by the TABOR did not have a positive effect on Colorado's economy, in part because Colorado reduced relatively high value areas of spending, including education and infrastructure.[14,15] The extent to which comparisons can be drawn with the TABOR is somewhat limited by the fact that Colorado, as a state, is responsible for a more limited bundle of services than a nation.

Legislative

The Bill proposes that government-initiated binding referenda on proposed increases in core Crown expenses above the spending cap be held under the provisions of the Referenda (Postal Vote) Act 2000. As that Act only provides for indicative referenda, a consequential amendment to the Referenda (Postal Vote) Act 2000 is required to provide for binding referenda with respect to the spending cap.

The Bill would impact the process for setting fiscal policy, as governed by the Public Finance Act 1989. No amendment to the Public Finance Act is required.

Constitutional

Under New Zealand's constitutional arrangements Parliament has the authority to levy or increase taxes, to appropriate expenditure, and to undo those decisions. A binding referendum on higher expenses than provided for under the spending cap, will give voters a direct say over some of those decisions.

The spending cap and the results of any referenda will bind the government only to the extent that Parliament continues to agree to remain within these constraints. A future Parliament has the ability to amend the level and/or operation of the expenditure cap or to repeal it outright.

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[14] Martell, C. and P. Teske (2007) "Fiscal Implications of the TABOR Bind", *Public Administration Review*, July/August 2007. http://clem.mscd.edu/~rpreuhs/IGR/teske.pdf

[15] McGuire, T. and K. Reuben (2006) "The Colorado Revenue Limit: The Economic Effects of TABOR", *Economic Policy Institute Briefing Paper*, March 2006, www.epi.org

Compliance costs

The Spending Cap (People's Veto) Bill proposal could result in lower levels of expenses that may drive efficiency gains and the reprioritisation of lower value spending. Over time, lower spending could allow for shifts in the structure of taxation to favour lower cost tax bases that could result in a lower burden of government on the economy.

However, lower levels of expenses and revenue may also force reductions in the direct delivery of public services and will create incentives for governments to find other ways to deliver their objectives. This could result in greater use of tax concessions, regulation, activities funded by fees or levies, local government, state-owned enterprises, and/or public private partnerships or other forms of contracts to achieve these objectives. All of these approaches can impose relatively higher compliance burdens on individuals and businesses to achieve similar outcomes, relative to expenditure programmes.

There are also risks that the compliance costs around the tax system will also increase – depending on where and how tax revenues are reduced over time and, in particular, if there is greater use of tax concessions to deliver government objectives.

5 Alternative options

There are alternative non-regulatory approaches that could help with the Bill's aim of greater control over the growth of expenses. Three approaches were considered alongside the development of the Bill during 2010-11: a self-imposed spending cap; quantifying a long-term expense objective; and tightening the Fiscal Management Approach.

Each of these alternative options could help to place some resistance in the system to automatic spending increases in response to revenue increases. Although markets can also impose a degree of fiscal discipline, via credit downgrades and higher borrowing costs, these can occur with lags and tend to create abrupt and potentially disruptive changes.

A self-imposed spending cap

Description

Treasury designed a self-imposed spending cap during 2009-10 as an addition to the government's fiscal management approach.

The government would specify its short-term operating expense intentions, as required under the Public Finance Act 1989. Those intentions would be portrayed as a cap to which it is committed – effectively pre-committing to an upper level of operating expenses over a rolling three-year horizon. The cap would relate to core Crown expenses – excluding finance costs, unemployment benefit expenses, and asset impairments – due to the volatile and/or cyclical nature of those items.

The government would commit to explaining and rectifying any breaches of the cap through the existing model of Budget Policy Statements and Fiscal Strategy Reports.

Status

This proposal was considered for Budget 2010, and was not pursued – largely due to complexity and communication reasons. Mears et al (2010) describe this proposal, and the Government's reasoning for not pursuing it further, in more detail.

Considerations

The cap could have provided a greater degree of certainty about spending plans over a three-year rolling window. It could have applied a degree of constraint over the items of core Crown operating spending that are currently financed outside the operating allowance (such as New Zealand Superannuation, KiwiSaver and welfare benefits) and/or forced trade-offs with discretionary items.

The cap would only have been effective as long as governments chose to continue with it.

Quantifying a long-term expense objective

Description

The Public Finance Act requires the government to state long-term (>10 year) objectives for five fiscal variables – revenue, expenses, budget balance, debt and net worth. In recent times, the debt objective has been the only one quantified – usually as a share of GDP. The long-term expense

objective has often portrayed in more general terms, such as “reduce the growth in government spending to ensure operating expenses are consistent with the operating balance objective".

The government could choose to set an explicit long-term (>10 year) objective for expenses – such as a share of GDP or in real per capita terms. Quantifying an objective could make use of the projected track implicit in the existing fiscal strategy.

The objective could be announced in a Budget Policy Statement or Fiscal Strategy Report with progress towards the objective being discussed at each subsequent update.

Status

The Public Finance Act provides for, but does not require, the expense objective being quantified. The current fiscal strategy, as articulated in *Budget Policy Statement 2011* (December 2010) does not quantify the medium-term expense objective.

Considerations

Potential benefits could include helping to shift the focus onto total spending, sending a signal of the Government’s intended spending restraint, and providing a way to monitor progress against the fiscal strategy (along with the debt and fiscal balance measures).

The objective would be open to revision – as are any elements of a government’s fiscal strategy. The Public Finance Act requires the government to explain why its objective is consistent with the principles of responsible fiscal management, explain any changes, or any departures from those principles.

Tightening the Fiscal Management Approach

Description

Tighten the Fiscal Management Approach – the set of rules that helps the government make expense and revenue decisions during the Budget process – to get more control over higher-than-expected increases in demand-driven items during a given financial year.

Status

The FMA was refined in 2010 to increase control over higher-than-expected increases in expenses that can occur outside the annual allowance for new operating initiatives. These increases tend to occur in areas with fluctuating demand and/or cost pressures that have historically been updated, and adjusted for, at each six-monthly economic and fiscal update – e.g. fluctuations in New Zealand Superannuation expenses. Higher-than-expected expenses can result in higher borrowing.

From Budget 2011 a portion of the operating allowance is being set aside for managing the net impact of this risk. If these expense revisions turn out to be lower than the portion set aside, the remainder of that portion can be used for other priorities, including deficit reduction.

Demand and cost pressures associated with the education sector were also brought inside the operating allowance. These pressures will be managed within the share of the allowance allocated for funding education services – mirroring the existing approach for the funding of health care services. This change will help to reduce risk to the forecast operating balance.

6 Consultation

Initial consultation has been with the agencies most directly affected have been consulted, including the Ministry of Justice, the Electoral Commission, and Inland Revenue.

Time constraints have not allowed for a public consultation process. We anticipate that the select committee process would provide an opportunity for wide public discussion, both on the Bill as a whole and on particular issues. An example of an issue for discussion is how the time required to prepare for, and conduct, a referendum might fit with the annual budget process.

7 Conclusions and recommendations

The Spending Cap (People's Veto) Bill prompts a useful discussion of the recent performance of the fiscal policy framework and how it might be improved.

The spending cap proposal has potential benefits that could address the fact that it has been relatively straightforward to increase spending in response to higher-than-expected revenue, especially when debt has already been reduced to prudently-low levels, in particular:

- the limits on annual growth in core Crown expenses may make it less likely that cyclical revenues would be locked into ongoing structural spending (although revenue increases could still be used for capital expenditure, tax cuts, or tax expenditures); and

- the spending cap would likely lead to smaller government than would otherwise be the case, given that core Crown expenses have tended to grow faster than inflation and population growth (this assumes sustained political support for the Bill).

The Treasury does not support imposing constraints on the ability of the government to set fiscal strategy via hard parameters in legislation. A legislated spending rule, which a government did not wish to be bound by, could lead to efforts to circumvent the rule – potentially favouring certain types of decisions (e.g. tax expenditures or regulatory changes) and raising the risk of unintended or perverse outcomes.

To be effective, the fiscal framework needs to be reasonably stable over time. This criterion would not be met if a legislated spending rule was likely to be overturned, shortly after its introduction, because it lacked widespread and enduring political support.

The Treasury's preferred approach is to focus on enhancing the transparency-based approach in the Public Finance Act 1989 – which requires the government to quantify its own long-term objectives and short-term intentions for key fiscal variables and to state how these fit with the principles of responsible fiscal management. A systematic review of the Act could identify opportunities to do this, for example, by:

- enhancing the reporting requirements of the Act, for example, by requiring a government to state its expense objective in numerical terms;

- looking at how the principles of responsible fiscal management could better support macroeconomic stability (e.g. by requiring governments to have regard to the risks of pro-cyclical fiscal policy, particularly during expansionary periods)

- supporting greater public discussion of intended government fiscal strategy and ex-post scrutiny of performance.