

New Zealand Business Roundtable

**Submission to the
Finance and Expenditure Committee
of the
House of the Representatives
on the
Fiscal Responsibility Bill**

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Summary

High levels of government spending, taxation and deficits have proven endemic in the developed nations, and in many countries in the third world. Attempts amongst OECD countries to solve fiscal problems have been largely unsuccessful. General government outlays, for example, averaged 51.2 percent of gross domestic product in 1993, up from 45.6 percent in 1989 and 42.6 percent in 1979. In addition, while most voters and commentators around the world have agreed that deficits are too high, few countries have managed significant deficit reductions.

In New Zealand, government current spending on goods and services and on transfer payments, which ranged between 22 and 25 percent of gross domestic product from 1950 to 1974, lifted sharply to reach 38 percent by the late 1980s. Real taxation per capita more than doubled from the early 1970s to the early 1990s – a period of very limited growth in real incomes. Even so, the measured fiscal balance on current account moved heavily into deficit at the end of the 1970s and has remained in deficit since. Real gross public debt per capita in 1993 dollars rose from a post-World War II low point of around \$7,500 in 1974/5 to above \$13,000 by 1985. It remains above \$13,000, despite the asset sales programme in recent years.

High levels of government expenditure, taxes and debt have political and economic costs. Politicians are therefore naturally motivated to balance the benefits to voters from government expenditure against the costs which arise from having to finance that expenditure. This process inevitably constrains the size and quality of government spending. However, it does not necessarily constrain them optimally.

Theorists have drawn attention to a number of reasons why the democratic process might tend to produce inefficient or undesirable fiscal outcomes. Problems arise from deficiencies in voter preferences and voting systems and from conflicts between voter interests and the interests of politicians and bureaucracies when information is costly to obtain.

Pressures for *excessive spending* can arise in areas where benefits are highly concentrated amongst voters whereas costs are spread over a diffuse majority. This tends to create a 'free rider' problem because it is not worth the while of any small group of voters to incur the expenses associated with mobilising the majority. (Symmetrically, the same 'free-rider' argument suggests that there could be too little spending on public goods such as national defence.) In addition, the self-interest of politicians and bureaucrats may favour excessive state spending because it increases their power and standard of comfort.

Pressures for *excessive deficits* may arise if present voters put narrow self-interest ahead of the interests of future generations.

Pressures for *excessive taxation* follow directly from the pressure for excessive spending, except where that excessive spending is entirely covered by excessive deficits.

United States empirical research has found some evidence of excessive spending and taxes in that voters tend to migrate to states which have relatively low levels of spending and taxes and the presidents who raise taxes while in office perform poorly in subsequent elections.

The nature of the costs of excessive taxation and spending is clear and uncontroversial amongst experts. There is more debate about the effects of fiscal deficits, but there is widespread professional concern about the dangers of chronic large deficits which can create unstable debt situations. In New Zealand, the high indebtedness resulting from large ongoing fiscal deficits, at a time when interest rates were well above the growth rate in incomes, has been both a threat to stability and a concern from an intergenerational perspective.

The failure of fiscal policy in New Zealand during the last 20 years is evident in: the sharp rise in real expenditure, taxation, debt and debt servicing costs; the fall in public sector net worth; the repeated down-rating of sovereign debt; and the poor outcomes evident from much government spending. Interestingly, population growth from net immigration also slowed markedly from the mid-1970s. Meanwhile, reflecting the emergence of serious structural problems, unemployment has risen sharply.

Scholarly research on New Zealand's fiscal policy during the 1960s and 1970s found that fiscal policy was often pro-cyclical rather than counter-cyclical and became significantly more erratic after the 1973 oil shock. The research pointed to the need for a much more stable, medium-term focus for fiscal policy, with less "resort to over-generous Budgets in election years".

Specific policies underlying the deterioration in fiscal policy and creditworthiness in the last two decades include the move to open-ended transfer programmes, 'Think Big' and repeated failures to sustain efforts to eliminate deficits.

Given the fragility of the fiscal situation, the New Zealand Business Roundtable strongly supports the concept of seeking institutional changes designed to improve fiscal outcomes. The range of measures examined in this submission which could be taken encompasses:

- (a) measures designed to increase transparency and accountability;

- (b) requiring the minister of finance to specify the government's fiscal targets explicitly;
- (c) requiring the minister of finance to explain differences between the government's fiscal objectives and benchmark targets which would generally characterise sound fiscal policies;
- (d) the imposition of mandatory fiscal targets, barring special circumstances such as war or a major recession; and
- (e) other constitutional constraints such as supra-majority limitations and referenda.

The Business Roundtable strongly supports the measures contained in Part I of the Bill to improve accountability and transparency. We also believe that the Bill would be enhanced by further measures of this type. In particular, we believe that it would be desirable for the economic and fiscal updates to incorporate sections concerning:

- (a) ~~trends in the size of the government sector in New Zealand in relation to competitors,~~ including a comparison of average and marginal tax burdens;
- (b) trends in fiscal ratios, compared to those for AAA-rated countries and those which prevailed in New Zealand before the onset of chronic large deficits following the 1973 oil price shock;
- (c) trends in the yields in secondary market trading of New Zealand sovereign-rated bonds, compared with those of other sovereigns and relative to accepted benchmarks, with a commentary on the explanation for changes in New Zealand's position;
- (d) the degree to which fiscal forecasts may have an optimistic bias if expenditure projections are on a no-policy change basis, as distinct from a most-likely basis;
- (e) the degree to which recent economic fluctuations might properly be regarded as cyclical, and therefore the degree of confidence that can be expressed about the extent to which a current fiscal balance outlook can be regarded as cyclically self-correcting;
- (f) the criteria which have been used to determine provisions in the Crown's Financial Statement in respect of:
 - (i) public sector capital expenditures which have been justified on macroeconomic rather than microeconomic grounds (e.g. as part of the government's growth strategy, or counter-cyclical policies); and

(ii) contingent liabilities in respect of government involvement in major private sector works programmes.

These suggestions are designed to:

- address benchmark-related questions about the appropriate size of the government sector (refer to (a));
- improve the transparency of external financial constraints (refer to (b) and (c));
- reduce the scope for overly optimistic 'borrow and hope' policies during economic downturns (refer to (d) and (c)); and
- improve the transparency of the fiscal risks arising from state involvement in large, politically-driven, capital works programmes.

We consider that these provisions would give Treasury a good incentive to make use of external auditors and to determine the degree to which accountability for some of the above proposals should properly be shifted to such auditors.

In addition, we recommend amending the Bill to require the government to set explicit fiscal targets for itself. Since such targets would be self-imposed and could be changed by a government as circumstances change, the risks of perverse outcomes from policy substitution appear to be relatively low.

In setting such targets, the Business Roundtable remains of the view that the existing government should adopt explicit fiscal targets for government expenditure, the financial balance and public debt to be achieved by the year 2000. In our opinion, the share of total government expenditure in national income should be reduced to between 25 and 30 percent by 2000. To achieve this target, the ratio should be reduced by an average of between 1 and 2 percentage points a year. The financial balance as a percentage of GDP should be improved by around 2 percentage points a year on average until surpluses in the range of 2-4 percent a year are achieved and sustained over a period which restores the Crown to a positive net worth position. Net public debt relative to GDP should be reduced to the average ratio for OECD countries by 2000. Beyond that time, net debt should be further reduced to a level which is consistent with recognised indicators of financial stability and strength. On the growth and other assumptions for the fiscal outlooks presented in the 1993 Budget, these targets are clearly feasible even without radical policy changes.

The government should continue to improve its underlying financial balance throughout economic cycles. It is particularly important that the current upturn be used to commence and maintain fiscal surpluses so as to reduce net indebtedness while demographic and economic conditions are relatively favourable.

The Business Roundtable also favours including in the Bill a section which characterises the fiscal outcomes which should result from the consistent pursuit of sound fiscal policies and requires the minister of finance to comment on differences between the government's actual targets and this benchmark list.

In our view, the following *fiscal objectives* would characterise responsible fiscal policies in normal circumstances:

- (a) the achievement and maintenance of a prudent level of positive net worth in the Crown's balance sheet;
- (b) the achievement and maintenance of ratios for fiscal indicators for New Zealand which are in line with those achieved by longstanding AAA- rated countries, taking into account New Zealand's particular economic characteristics;
- (c) once objectives (a) and (b) have been achieved, the maintenance of a balanced budget, on current account, over the economic cycle, so that policies are clearly geared to ensuring that any deficits incurred during economic downturns are matched by projected fiscal surpluses well within the proposed 10-year projection horizon. The best measure of budget balance would be the operating balance in the Crown's Financial Statements;
- (d) limiting the burden of government spending by ensuring that government spending programmes produce benefits which exceed the cost to the nation of the taxes required to fund them;
- (e) promoting stability by avoiding erratic changes in tax rates and other policy parameters which effect long-term private sector savings and investment decisions; and
- (f) ensuring that the above objectives are achieved without compromising the quality of regulatory or other policies, or the integrity of the Crown's accounting systems.

We believe that there is scope within the Bill for requiring the Crown to comment on the degree to which its self-selected fiscal objectives, as required under clause 6 (2) (a), depart from such a list. Such comments should encompass the reasons for any departures. We envisage that a government could well wish to depart from the benchmark list, at least in the short term, during times of war,

major recession or political instability. The sole intention of the suggested approach is to require these departures to be made transparently at an early stage.

Applying characteristics (a) and (b) above would require technical interpretation. In our view such technical judgements would best be made between the Treasury and the government, aided as required by experts in sovereign debt rating issues. The Secretary to the Treasury's formal endorsement of the consistency of any long-term targets set for net worth and fiscal ratios with the government's long-term target credit rating for New Zealand sovereign debt could also be required. Such a requirement would no doubt oblige Treasury to formally consult experts in sovereign ratings.

This approach leaves it to the incumbent government to determine its long-term targets for net worth and other fiscal variables, including the target credit rating used as a guide for these variables. Prudent levels for these ratios would vary with changes in the economic environment.

A survey of public opinion (reported in Appendix 3) suggests strong public support for the idea of a government being required to aim for a high credit rating and to ensure that its current expenditures do not exceed its current revenues.

We have given lengthy consideration to the case for imposing mandatory fiscal targets. However, notwithstanding the fiscal difficulties which many governments get themselves into, attempts to prevent irresponsible fiscal policies by imposing mandatory fiscal targets on governments are fraught with difficulty. Targets are inevitably partial indicators of the broader attributes desired of government policies. The risk is that targets can be met with unsound fiscal policies and even worse regulatory policies. Targets have induced many governments to shift to off-budget activities such as off-budget spending, the granting of explicit and implicit guarantees and the use of regulations to force the private sector to directly fund government-mandated programmes. Strikingly, New York City, which is famous for the state of bankruptcy it reached in the 1970s and for its fiscal crises, has ostensibly had a strict fiscal constitution for most of its existence. The American Gramm-Rudman-Hollings Act (formally known as the Balanced Budget and Deficit Reduction Act of 1985) which mandated a balanced federal budget within five years has also failed.

Imposing a mandatory *balanced budget target* can induce off-budget spending and policy substitution. In addition, forcing budget balance every year could be bad politics and bad economics. In addition, the balanced budget outcome depends on factors beyond the government's direct control. Failure to meet a target may simply reflect a forecasting error. Given the inevitability of such errors, attempts to penalise governments for them could have unintended and undesired results. Most importantly, the balanced budget approach does not target primarily the burden of government spending on the economy or of excessive debt or contingent liabilities.

Nor do mandatory *targets for public sector debt or net worth* avoid the fundamental difficulties confronting balanced budget targets. The measurement of net worth is disputatious in respect of the valuation of assets and the scope of the assets and the liabilities to be included in the balance sheet.

A mandatory *credit rating target* has some attractions in that it should be relatively robust against recourse to off-budget spending, reclassifications of accounts and policy substitution. There is also an economic argument in favour of a high rating in normal circumstances, namely that it avoids the externality of a poor sovereign rating raising the cost of borrowing for all resident borrowers who would otherwise enjoy a higher rating. A high rating is also consistent with the intuition that a strong Crown and national balance sheet is desirable in normal circumstances as a cushion to cover times of war or severe recession.

Despite these advantages, a mandatory credit rating target has serious, and probably fatal, flaws. Like the balanced budget restriction, targeted credit ratings confuse symptoms and causes. Clearly ~~all commentators would agree that an AAA credit rating is a symptom of a sound economy and a responsible government.~~ The governments of the wealthiest and most stable countries in the world have AAA credit ratings. But many governments have combined high credit ratings with poor economic policies. Given the long time frame for reforms, plus the time needed to demonstrate to the outside world that the reform will not be reversed, economic policy improvements cannot be counted to improve credit ratings in the short term. Fiscal policy is not the only factor which affects a sovereign rating. A government which used such a target to justify unpalatable measures could be disappointed.

Such considerations lead us to recommend against the imposition of mandatory fiscal targets in the Bill.

Finally, we would not rule out the possibility that part of the problem lies with voters, voting procedures, the absence of constraints on the ability of the majority to exploit a minority and/or the ability of a well-organised minority to exploit a majority. To the contrary, we do see some justification for supra-majority rules or greater use of referenda in respect of proposals by parliament to increase its powers and its command over private resources. Such issues are also relevant to a bill of rights.

We also consider that there is scope to do more to curb low quality expenditure programmes and investments by such measures as:

- requiring assessments to be published as to the degree to which the benefits from these programmes exceed their costs, including the deadweight costs of taxation;
- reducing the scope of public sector activity by privatisation of SOEs and of pensions;
- considering spending caps in areas in which government has clear control of total expenditure; and
- presenting assessments of the adequacy of the performance of SOEs in commercial terms.

These remain areas for further work.

Section 7 relates these suggestions to particular clauses in the Bill.

1 Introduction

High levels of government spending, taxation and deficits have proven endemic in the developed nations, and in many countries in the third world. Attempts amongst OECD countries to solve fiscal problems have been largely unsuccessful. General government outlays amongst OECD countries, for example, averaged 51.2 percent of gross domestic product in 1993, up from 45.6 percent in 1989 and 42.6 percent in 1979.¹ In addition, while most voters and commentators around the world have agreed that deficits are too high, few countries have managed significant deficit reductions.

In New Zealand, government current spending on goods and services and on transfer payments, which ranged between 22 and 25 percent of gross domestic product from 1950 to 1974, lifted sharply to reach 38 percent by the late 1980s. Real taxation per capita more than doubled from the early 1970s to the early 1990s – a period of very limited growth in real incomes. Even so, the measured fiscal balance on current account moved into heavily into deficit at the end of the 1970s and has remained in deficit since. These deficits, plus losses from large capital expenditure commitments, have contributed to the negative net balance between Crown assets and liabilities recorded in the Crown's financial statements from 1991. Despite the asset sales programme in recent years, real gross public debt per capita in 1993 dollars had risen from a post-World War II low point of around \$7,500 in 1974-75 to nearly \$14,000 by 1990. The only periods in New Zealand's history in which per capita debt appears to have reached comparable levels are during the 1930s and immediately after World War II. New Zealand lost its AAA credit rating on external sovereign debt in 1983 and has since been downrated a further two notches to its current AA- rating.

Meanwhile, unemployment has become a major problem for many OECD countries, including New Zealand. The opening up to foreign capital of Eastern Europe, Asia, China and, increasingly, India and Latin America exposes workers in the OECD area to fierce competition from abundant low-cost labour.

The combination of apparently intractable fiscal problems and high unemployment suggests that the problems faced by many of these countries are structural, rather than cyclical. Such countries have to reduce costs, raise productivity and/or accept lower average standards of living. During this process, consideration must be given to the costs of government. Excessive government spending imposes economically damaging costs on resident businesses and individuals, reducing their competitiveness; so does poor quality spending, unduly distortive regulations and poorly-designed taxes. Although a review of the factors driving fiscal trends could be justified independently, the government presence in many countries is now so intrusive that any review of how a nation can

¹ OECD Economic Outlook, December 1993, table 16, page 33.

improve its competitiveness must encompass the effects on competitiveness of the government's own activities.

Unless existing institutional arrangements unduly restrict choices, change should occur without the need for new constitutional arrangements. However, the continuing pressure from debt, deficits and unemployment in many countries, including New Zealand, indicates that institutional (structural) changes are required. Determining the changes that may be desirable requires a careful assessment of precisely which arrangements are currently undesirably inhibiting adjustment. Since many countries are showing common symptoms of inadequate structural change, the international debate about changes in fiscal policy arrangements is likely to be relevant to New Zealand.

Section 2 reviews the reasons put forward in the economic literature as to why fiscal policy can go wrong, and stay wrong, for a long time. Section 3 reviews the United States and New Zealand experience from this perspective. Section 4 considers the costs of sub-optimal spending, taxes and debt levels, because change is only justified if these costs are greater than the costs of change. Section 5 looks at the difficulties associated with attempting to constrain future governments to achieve particular fiscal goals, including a credit rating target. It considers the international experience with such attempts.

Section 6 applies these considerations to the Fiscal Responsibility Bill ("the Bill").

Section 7 presents our recommendations.

2 The Case For Changed Fiscal Arrangements

High levels of government expenditure lead to high rates of taxation and/or high levels of public debt. Both taxes and debt have political and economic costs.² Politicians are therefore naturally motivated to balance the benefits to voters from government expenditure against the costs which arise from having to finance that expenditure. This process inevitably constrains the size and quality of government spending. However, it does not necessarily constrain them optimally.

Theorists have drawn attention to a number of reasons why the democratic process might tend to produce inefficient or undesirable fiscal outcomes. Arrow's impossibility theorem, in relation to decision making by a simple 50 percent majority vote, indicates that unstable, and even universally deficient, outcomes are possible when the decision involves choosing between more than two options. Formal and informal constitutional constraints on the application of a simple majority rule to decision making may be necessary to permit debate, compromise and stable policy outcomes.³ Noting the dangers of delegating undue discretion to an agent (as when voters delegate decision making powers to parliament), Niskanen⁴ comments that:

"All of us are willing to delegate many decisions within a family, firm, and other voluntary organizations to realize the benefits of comparative advantage and the reduction of decision making costs. For the same reason, many nations have chosen a representative government with a majority voting rule. Such delegations, however, are almost always subject to substantive, quantitative, or procedural constraints on the group to which the decisions are delegated. Moreover, there is an important relation between the voting rule and the several types of constraints: the lower the voting rule the lower the probability that a specific decision will suit one's interests, the more important are the constraints on the authorised powers of the organisation."

A major problem which arises when powers are delegated from a principal (e.g. the voter) to an agent (e.g. the elected politician) is that agent's interests may diverge from the principal's. Conceptual research illustrates how the optimal constitutional arrangements and constraints may vary with the probability that politicians will act uncooperatively (e.g. Cooter⁵) or opportunistically (e.g. Laffont and Tirole⁶).

² See section 4.

³ Inman and Fitts (1990, page 82).

⁴ Niskanen (1992, page 16).

⁵ Cooter (1992).

⁶ Laffont and Tirole (1992).

While it is clear that political outcomes will be less than ideal, it is less clear as to whether the outcome will be too small a government or too large a government. Several theories have been put forward to suggest why government spending may be too large, absolutely, or in relation to revenue.

2.1 Governments Systematically Run Deficits at the Expense of the Future

According to this argument, future generations are at a serious disadvantage because they do not, and cannot vote. Vote-maximising politicians therefore may prefer deficits (future taxes) over present taxes, when they must finance government spending. Future generations are not directly represented by any lobby or interest group, and thus possess little political power.⁷

While members of the present generation clearly possess some degree of altruism for their descendants, they still may put their own interests first. In addition, the incentive to exert political pressure against future taxes may require altruistic feelings for the entire future generation, not just for one's immediate descendants. The latter, or in turn their descendants, may be able to escape future debt by emigrating. Finally, not all individuals have children.

Of course, the link between deficits and inter-generational transfers is not straightforward. Future generations can be adversely affected by a reduction in national savings and investment, without a *fiscal* deficit. Conversely, a fiscal deficit does not *necessarily* imply any reduction in national savings and investment; even a balance of payments deficit on current account may simply indicate that the deficit nation is rightly a net importer of capital for profitable investment projects, or it might mean that individuals are rationally rebalancing their lifetime consumption pattern in favour of the present. Nevertheless, fiscal deficits on current account which are associated with a fall in gross fixed capital formation and/or a consumption- rather than investment-driven lift in the current account deficit in the balance of payments would raise inter-temporal concerns.

However, for the purposes of the argument in this section, what counts is how politicians actually behave in these respects. The excess deficit argument does not assume that deficits do *in fact* burden future generations. It only assumes that some individuals believe that proposition, which is evidently the case.

2.2 Governments Favour Excessive Public Expenditure

Lobbies that favour additional spending are likely to have more political clout than lobbies that favour less spending. Excessive spending arises as politicians accommodate the pressure groups.

⁷ Buchanan and Wagner (1977).

The logic of government favours policies that produce highly concentrated benefits and highly diffuse costs. The recipients of the highly concentrated benefits, because they are smaller in number, have lower costs of organisation and face a less serious free-rider problem. Those who bear the costs, if they are large in number, will find it difficult to organise. In this situation, the private return to lobbying is small. Any political effort expended would rebound to the benefit of many other people, not just to one individual or firm or to a small circle of industry associates. An industry or firm targeted for a potential government subsidy will find it worthwhile to lobby Wellington; no single taxpayer will put in the same effort.⁸

Other incentives also favour excessive spending. Not all of the funds spent by the government are distributed back to taxpayers. Higher levels of government spending imply larger perquisites of office; the tendency of bureaucracies to maximise their budgets, for instance, is well known. Governments prefer higher spending because it increases their power and standard of comfort.

2.3 Governments Tend to Favour Excessive Taxation

This proposition follows directly from the second. If governments tend to spend too much they will also tend to tax too much, to finance that spending. Excessive taxation fails to result only under the special case where the excessive spending is financed exclusively by deficits. Unless the bias towards deficit spending is absolute, excessive taxation will occur.

The bias towards excessive taxation is strengthened by voters' imperfect understanding of the costs of taxation. Most voters understand that dollars have left their pocket, and react negatively to this fact. Far fewer understand the concomitant 'deadweight losses' or 'rent-seeking costs' (see below) imposed by taxation. Taxes skew our decisions of how much to work, to save, to spend, and to invest. Market prices are distorted and resources are invested less efficiently than otherwise.

2.4 Discussion

The first proposition suggests that we get fiscal deficits because politicians are faithfully reflecting electoral preferences. In contrast, the second and third propositions assume that such electoral constraints operate only imperfectly. In a perfect world voters would prefer less spending and lower taxes, but they cannot effectively enforce their will on the government.

Several factors may account for the political slack assumed in the second and third propositions. First, voters will not punish misbehaving politicians with certainty. Voters know that any political successors might engage in the same recalcitrant behaviour, for the same reasons that the

⁸ See Mancur Olson for the classic statement of this thesis.

incumbents did. Second, voters are imperfectly informed about the effects of policies and the platforms of politicians. Given the near-zero probability that a single vote will actually affect the electoral outcome, voters have no selfish incentive to unravel the complexities of public policy. The costs of monitoring and information may thus create only a loose link between public preferences and enacted policies. Third, politicians care about more than their chances of re-election. Even if they face an increased probability of an electoral penalty, politicians may nonetheless reap higher perks, higher status, or perhaps simply the opportunity to shape New Zealand in the way that they desire.

To properly evaluate proposals for a fiscal constitution, we must first consider if there is evidence of persistently inappropriate fiscal policies and the costs of such policies. These aspects are considered in sections 3 and 4 respectively.

3 Fiscal Policy in Practice

This section considers the relationship between observed fiscal policy outcomes and the theories concerning the sources of possible fiscal policy failure. The international literature on this topic appears to be US-dominated, so we focus on that experience first.

3.1 United States

Niskanen (1992) motivates his analysis by observing that for the first 140 years of US history, the federal budget was limited by two fiscal rules: a formal constitutional limit on the federal government's spending powers and an informal rule that the government could only borrow during recessions and wars. He identifies what appear to be significant events in the process by which these two rules have broken down this century. Federal expenditures have risen from 2.6 percent of GDP in the 1920s to nearly 25 percent and debt has risen from 16 percent of GDP to around 50 percent while the general price level has risen around 9 times. He notes that the federal budget has now been in continuous deficit since 1969.

Niskanen reviews some empirical findings which indicate that, at the state level, observed spending patterns are inconsistent with the view that voter preferences are being met. To the contrary, the findings suggest that state governments over-spend and over-tax so that, other things being equal, Americans tend to migrate to low-tax, low-expenditure states.

At a global level Niskanen argues that the state sector will be smaller in federal systems, such as in Switzerland and the United States, where formal checks and balances are in place in order to restrain federal rights. Independent cross-country analyses, cited by Schultze in the same journal, do indeed indicate that the total of all public sector spending in the United States is not excessive in relation to other countries, once differences in population density, demographic structure and income per capita are allowed for.

Alternatively, Niskanen suggests that the state sector is also likely to be smaller in jurisdictions, such as the American states, the Swiss cantons and the national government of Finland, in which a supra-majority rule or a referendum requirement may constrain taxes and/or debt issuance. For example, he reports that Finland's constitution requires a two-thirds majority in parliament to increase taxes for more than one year and a five-sixths vote to approve any measure that restricts property rights.

Finally, Niskanen suggests that the democratic countries most likely to experience large national state sectors will be those with majority rule and plenary powers. New Zealand would clearly fall into this category.

3.2 New Zealand

Section 3.2.1 identifies the extent to which the state sector has grown in recent decades and puts this into a longer-term historical perspective. Section 3.2.2 reviews historical developments in the transparency and accountability of successive governments for spending and deficits. It is clear that developments in the last decade have (more than) reversed the erosion in transparency and accountability which occurred around the middle of this century. Section 3.2.3 reviews the sharp growth in spending, taxes, deficits and debt during the last two decades, for evidence of political failure.

3.2.1 Historical Review

This section briefly reviews the history of fiscal policy in New Zealand. A more detailed, chronological account is given in Appendix 1.

The Size of Government

Chart 1 summarises the history of real taxation per capita since 1891. After taking close to 50 years to reach \$1,000 per capita (in 1988 dollars) by 1940, total taxation rose dramatically to around \$6,500 per capita by 1989. The chart is imperfect as a measure of the change in the scale of government activities, but a long history of government expenditure, on a consistent and comprehensive basis, is not readily available. Not apparent from the chart were the effects of significant increases in the scope of government activity during the 1890s and the 1930s.

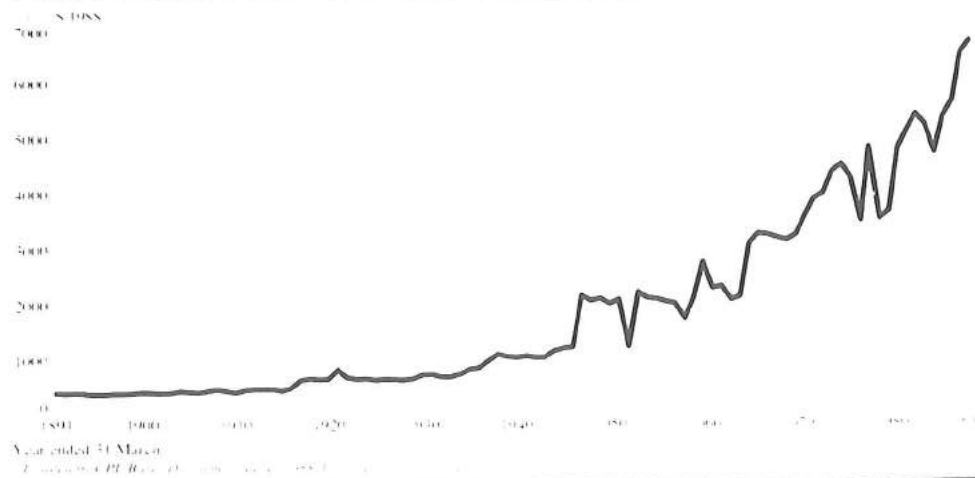
Chart 2 depicts growth in real government expenditure per capita since 1950. It indicates a lift from around \$3,000 per capita in the earlier 1950s to peak at \$9,000 per capita, confirming that both expenditure and taxes have been rising sharply on this basis during this period.

Chart 3 shows that government current spending has also risen dramatically relative to gross domestic product since the early 1970s. Government current spending on goods and services and on transfer payments between 1950 and 1974 moved in the 22-25 percent range. It then rose sharply to around 38 percent by the late 1980s. As is well known, there has been strong growth in debt servicing and transfer payments. The latter reflect strong growth in existing programmes, such as the number on unemployment benefits, and the effects of some notable extensions in the scope of transfer programmes (such as the domestic purposes benefit and national superannuation).

TAXATION PER CAPITA

Adjusted for inflation*

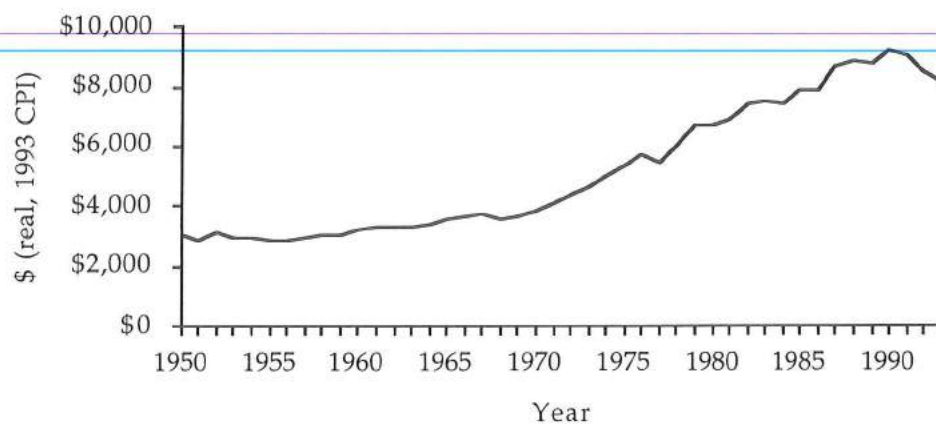
Chart 1



Source: 1990 Official Yearbook, page 664.

Chart 2

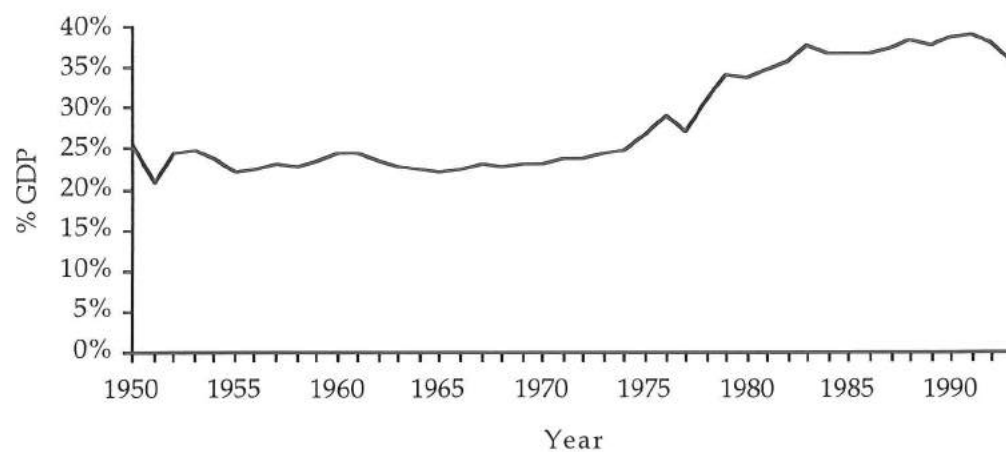
Government Current Expenditure Per Capita



Source: CS First Boston

Chart 3

Government Current Expenditure % GDP



Source: Department of Statistics, SNA, central government, includes transfer payments.

Fiscal Deficits

No satisfactory data on a consistent basis appear to exist concerning the fiscal deficits which prevailed back into the last century. Until recent times, the dominant accounts during this period – i.e. those for the consolidated revenue account and its precursors – show a surplus of revenues over payments in all but the most extreme of circumstances. It appears that the debt which was built up from time to time during this long period was primarily associated with wartime expenditures (notably last century's land wars and this century's two world wars), capital spending and state lending. Two probable exceptions were the deficits in the consolidated fund and its precursors in the 1870s, 1880s and 1930s.

In contrast, during the last ten to fifteen years the debt burden has clearly been increased by fiscal deficits on current account. Table 1 illustrates the move from fiscal surplus to deficit between the 1970s and 1980s, using a variety of statistical measures. The move to deficit is more dramatic than these figures indicate, because they take no account of revenue from the inflation tax during the 1970s.

Public Debt

Chart 4 summarises the history of real gross public debt per capita in New Zealand since 1874. Real public debt was high in New Zealand last century reflecting government borrowing to finance infrastructure expenditures and the land wars. A major development during this period was the heavy borrowing during the 1870s to finance immigration and a large works programme. (The 1990 Yearbook has a special article on the Julius Vogel period on page 647.) As a result, the real public debt, in 1993 dollars, was around \$6,500 per capita at the turn of this century. It rose appreciably to peak at \$15,600 in the first half of this century, following the second world war, after which it was reduced markedly by inflation and population growth to below \$8,000 by the 1973 oil price increase. This reduction was subsequently reversed as large fiscal deficits and the aftermath of heavy state commitments in relation to 'Think Big' spending lifted debt on this basis back to its earlier post-war peak.

Public Sector Net Worth

It is clear that the need to evaluate the appropriateness of debt levels in relation to assets has a long history. For example, an extract from an 1875 article published on page 667 of the 1990 Yearbook noted that the servicing cost of the total public debt then in existence was equal to about 2.4 percent of the average earnings of the population, which compared with 2.4 percent in the United Kingdom and 2.8 percent in the United States. The same article commented that the value of the assets in the form of Crown land held on account of provincial debt alone was four times the

amount of those debts. Since the same article indicates that the debt servicing costs of provincial debt were one third of total public debt servicing costs, this suggests that the value of Crown land alone exceeded the total public debt. Debates at the time also noted that the public works being created would benefit future immigrants who could properly be asked to contribute to their cost. The successful moves during the 1920s to adopt a state sector balance sheet approach are outlined below. The first such balance sheet, published in 1930, indicated that assets exceeded debts by £10.5 million (approximately \$600 million in 1993 dollars) and around 2 percent of assets.

Chart 5, from the 1991 Crown Financial Statement, illustrates how the large deficits in recent years have substantially reduced public sector net worth. The 1993 statement indicates that Crown debt alone exceeds the Crown's combined account assets, even disregarding unfunded pension liabilities.

The rise in state indebtedness has undoubtedly reduced economic flexibility and contributed to the deterioration in the credit ratings accorded non-New Zealand dollar-denominated sovereign debt since 1983.

Table 1

Measures of Crown Dis-Saving on Current Account

March Year	SNA Current Account Balance	GFS Current Account Balance	GFS Net Financial Deficit	CFS Core Crown Operating Balance	CFS Combined Crown Operating Balance
	\$m	\$m	\$m	\$m	\$m
1972	263	281	87		
1973	227	149	-85		
1974	370	280	18		
1975	435	410	18		
1976	100	22	-370		
1977	461	409	7		
1978	566	372	-79		
1979	-294	-127	-613		
1980	-46	-37	-512		
1981	-244	-375	-925		
1982	-473	-685	-1,321		
1983	-909	-967	-1,674		
1984	-1,260	-1,602	-2,384		
1985	-1,106	-1,554	-2,451		
1986	-202	-498	-1,397		
1987	-984	-871	-1,866		
1988	-321	77	-1,147		
1989	-642	-187	-1,332		
1990	-498	-383	-894		
1991*	-2,242	-1,330	-1,627		
1992*	-3,094	-1,633	-1,982	-5,149	
1993*	-1,740	-1,037	-1,698	-1,616	-819
1994f*	-1,107	-400	-2,280		

* Years ended June

Notes:

1. Prior to 1992, the SNA data is essentially based on cash expenditures and so excludes depreciation of core Crown assets.
2. The net financial deficit for 1992 has been adjusted for the forest sales.

Sources of deviations from the Operating Balance:

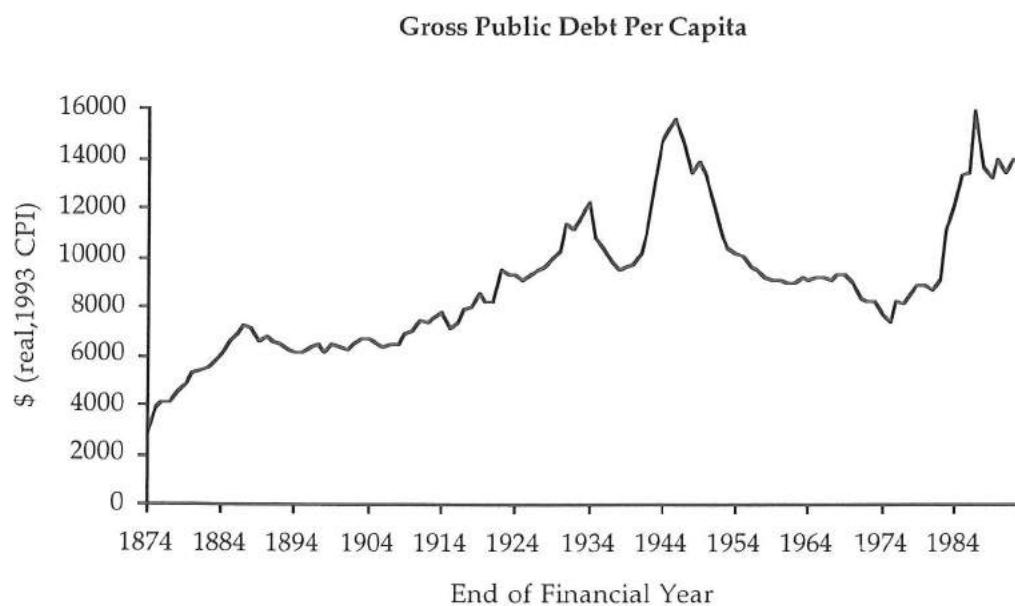
1. SNA: This is very similar in principle to the operating balance.
Both use an accrual basis and record depreciation of assets.
The SNA excludes exchange rate losses (which were \$1,767m in 1992).
Military expenditures are treated as current in SNA and as capital for operating balance purposes.
2. GFS: This cash-based system was introduced into the budget tables in 1984.
Like SNA and the Crown Financial Statements it distinguishes between current and capital items.
It makes no allowance for accrual items such as depreciation.
The net financial deficit may approximate the operating balance if capital expenditure roughly equals depreciation.

Discrepancies in particular years

1992: The high operating balance incorporated non-cash net foreign exchange losses of \$1,843m, an increase in pension liabilities of \$420m and write-down provisions of \$156m.

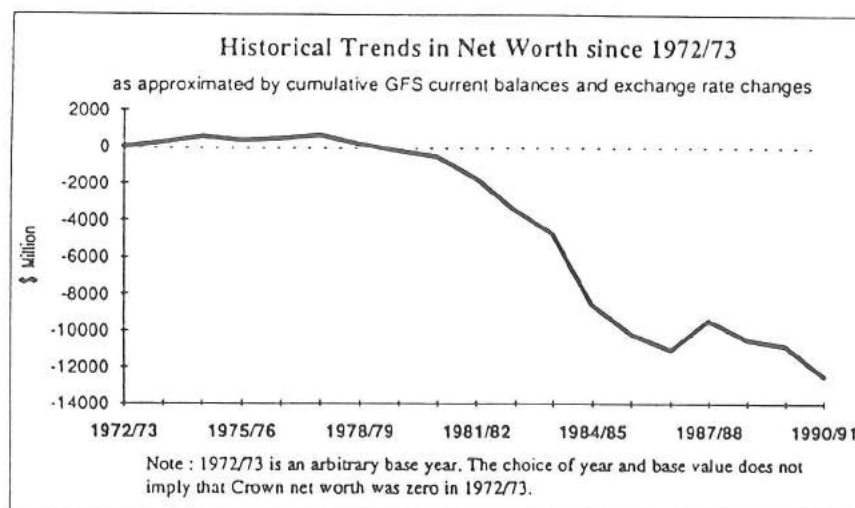
1993: The GFS data is from the pre-election economic and fiscal update.

Chart 4



Source: CS First Boston

Chart 5



Source: Financial Statements of the Government of New Zealand, 1991, page 87.

3.2.2 *Debt Limitations, Transparency and Accountability*

Historical documents establish a long history of attempts to improve government information systems, reduce or curtail debt and improve accountability.

For example, an article on pages 643-644 of the 1990 Yearbook reviews the development of public accounting systems since 1853 and draws attention to:

- the move to introduce the first accrual concepts in 1881;
 - the successful move to "departmental balance sheets on commercial lines" in 1921;
 - the production of the first state balance sheet in 1930;
 - legislation to make departmental balance sheets compulsory in 1932; and
-
- the expedient dropping of this last requirement during World War II.

As the article comments, the Public Finance Act 1989 represents, in some ways, a return to past practices.

As detailed in Appendix 1, concerns about debt levels led to remarkable legislative attempts in 1910 and 1925 to provide for the eventual repayment of all outstanding debt including subsequent borrowings. A more sustained practice was the publication of tables during the second half of last century and up to the 1980s which allocated debts to the activities against which the monies were borrowed. These activities were grouped according to broad categories, namely 'productive', 'semi-productive' or 'unproductive' as a guide to the degree to which such debts might be capable of being serviced from earnings from productive assets.

Early yearbooks also contain significant information comparing debt levels in New Zealand with those in related countries.

More formal constitutional limitations on government spending, taxes, debt or deficits are notable by their absence.

3.2.3 Problems Indicated by the New Zealand Experience

It is clear that there is a longstanding tradition in New Zealand for the Crown to own a significant share of the nation's assets and to have a significant amount of public debt outstanding in respect of those assets. It also appears that there is a long tradition of total debt not being covered fully by the book value of productive assets. On the other hand, there is evidence from the 1930 Yearbook that this situation was defended on the grounds that the market value of assets exceeded the value of the debt.

In general terms, the repeated debt crises in the past 150 years demonstrate the need to rebuild borrowing capacity in buoyant times. Further, the marked deterioration in the fiscal and debt situation which occurred after the 1960s, along with sharply rising unemployment, clearly indicates economic inflexibility and a failure of policy to adjust adequately. The reduced prospect for strong, effective government at present, exemplified by the recent decision to introduce a minimum youth wage, could be entrenched by the advent of proportional representation. This augurs ill for future economic flexibility.

Specific policies underlying the deterioration in fiscal policy and creditworthiness in the last two decades include the move to open-ended transfer programmes, 'Think Big' and repeated failures to sustain efforts to eliminate deficits. The growth in the size of government since 1950 has largely taken place since 1973/74 and it is evident that very vocal interests support the transfer, health and education expenditures which dominate government spending.

New Zealand's current difficulties undoubtedly reflect at least in part the insecurities which underlie the inward-looking, protectionist, cradle-to-grave welfare state elements of past policies, along with a degree of wishful thinking which is reflected in the 'borrow and hope' approach to deficits and in the significant element of the electorate which appears to think that it can 'vote itself rich'.

These policies, along with the 'Think Big' expenditures in the 1980s and ongoing fiscal deficits, were highly visible and have been debated, and voted on, in successive elections. As is indicated by developments since 1984, to the degree that the median voter forms the view that those policies have failed, politicians will be motivated to change them. Information, transparency and open debate can clearly be very important factors in allowing an electorate to decide earlier rather than later to reverse unsound policies. In an open, democratic society, such policies arguably owe more to voter failure than to failure of political institutions, although well-entrenched protections for individual rights and minorities might curb the powers of the state to unduly direct economic activity.

Even so, the phenomenon of fiscal deficits in difficult times, without equally stoutly-maintained and cumulatively offsetting surpluses when the economy is growing, is a distinctive problem. It is striking, given the evidence that the underlying problems are structural, that some countries at present are actively expanding their fiscal deficits ostensibly to reduce unemployment and the New Zealand government is under some pressure to do the same. Judgments about the degree to which a current or projected depressed level of economic activity is cyclical or structural and whether or not a larger deficit would significantly affect national output and employment, at least in the short term, are technical and contentious amongst experts. For example, fiscal deficits are often justified initially as a counter-cyclical device, but the judgment as to whether or not an economic downturn is structural or cyclical, and whether or not deficits will affect employment significantly, is a highly technical one.

In New Zealand, the massively increased fiscal deficits following the first oil shock were initially justified in Keynesian terms but, as Deane and Smith (1979) noted, it soon became apparent that the problems exposed by the terms of trade decline had a more durable character. More generally, Deane and Smith found evidence that fiscal policy did not appear to be soundly based for a prolonged period of time covering the 1960s and 1970s. In particular they commented that:

"It is probably fair to say that for many years up until the middle of the 1970s government expenditure was generally pro-cyclical. Since then, the pattern has become mixed, with some periods of counter-cyclical activity being interspersed with a period of pro-cyclical activity (particularly around 1976/77)."

Deane and Smith found that fiscal policy became significantly more erratic after the 1973 oil shock and recommended a much more stable, medium-term focus for fiscal policy, with less "resort to over-generous Budgets in election years".

Nevertheless, it is clear that pressures to expand fiscal deficits, particularly when unemployment is high, remain hard to resist.⁹ After cutting back heavily on the fiscal deficit in its 1976 Budget, the Muldoon administration found unemployment, or at least the fear of even greater unemployment, too much of a problem. It restored high fiscal deficits in time for the 1978 general election, when it was clear amongst informed observers, as Deane and Smith recorded, that New Zealand faced the need for significant structural adjustment. In the event, rising terms of trade and modest economic growth helped a little until the second oil shock – when it all fell apart. The Lange/Douglas administration made great strides in reducing the enormous deficits it inherited following the 1984 general election, but fiscal policy was allowed to loosen in 1989-90 when the

⁹ Rogoff (1990). On pages 21-36 Rogoff develops a formal argument to show why a government may use an election-year deficit to signal its views concerning the future growth of the economy.

Palmer administration was registering abysmally in the public opinion polls and facing a general election.

The issue here is that adverse shocks are used to justify deficits, but there is an asymmetry; rather than run fiscal surpluses in the upturn, governments hope for growth and/or inflation to reduce the debt burden (i.e. 'borrow and hope' policies). Although there may be a consensus about the need to reduce a fiscal deficit, there may be no consensus amongst voters as to how this should be done. It is notable that, following past episodes of heavy indebtedness in New Zealand, real debt burdens have been reduced by inflation, economic growth and immigration – rather than by fiscal surpluses large enough to impact on nominal gross debt.

Given the need today to preserve low inflation, it is particularly important to make a break from the past by reducing debt burdens through fiscal surpluses on current account. The political pressures today to modify the Reserve Bank Act illustrate the power of the incentives to resort to inflation and highlight the importance of the constituency for a more responsible approach given the potential instability which arises when fiscal policy and monetary policy are not mutually supportive.

At times like the present, when high unemployment illustrates the need for structural change, it is particularly likely that fiscal deficits will be counter-productive from a medium-term perspective. The problem with delaying adjustment is that the odds increase that the adjustments will eventually be forced upon us in even more difficult circumstances; governments which do not adjust in economic upturns will eventually be forced to do so in downturns.

Where difficult structural changes are required, the political reluctance to take direct action and to seek recourse to debt and inflation instead may reflect, in part, the difficulties involved in trying to compensate the losers from change. More transparency, greater ingenuity in compensating losers, and better-structured contributions on technical matters by experts may assist in guarding against inferior policies.

The experience to date with the Reserve Bank Act supports the inference that greater transparency can be beneficial in New Zealand. The Reserve Bank Act simply serves to force politicians who wish to inflate to be specific about that goal. Its success so far suggests that there was indeed an information/transparency problem affecting monetary policy during the late 1960s through to the mid-1980s. Possibly the public accepted inflationary policies, in part because governments optimistically or opportunistically told it that interest rates were being brought down enough to stimulate growth, but not inflation. In the event, opposition parties did not persuade enough voters to reject these policies and growth was low and inflation high. The Reserve Bank Act enshrines a method of making the Reserve Bank accountable for the technical judgments as to how far interest

rates can be brought down without stimulating inflation. Analogously, with respect to fiscal policy, governments optimistically or opportunistically told the public that the fiscal deficits (and 'Think Big') were there to generate growth and employment, thereby preventing a debt spiral. Again this is a technical judgment, but one which is being formed by the government's expert advisers and the market place on a continuous basis.

In principle, market perceptions of an irresponsible monetary policy would be reflected, *ceteris paribus*, in a higher yield gap between nominal bonds and indexed bonds. Similarly, market perceptions of an irresponsible fiscal policy would be reflected, *ceteris paribus*, in a widening margin between yields on NZ government, non-NZ dollar-denominated bonds and other government bonds in the same currency. Rating agencies will move more slowly. In both cases, experts will commonly differ at least in emphasis in their interpretations of developments.

In such circumstances, given the medium-term orientation of fiscal policies, it may be important to assign accountability for advising on technical matters to an institution which has an ongoing institutional reputation to preserve over a medium-term period.

Given the importance of professional interpretations concerning these matters, and the medium-term orientation of fiscal policies, it would be desirable to put in place some mechanism by which an institution which has an ongoing professional reputation to uphold, for the quality and consistency of its opinions, can be held accountable for quality advice on these matters. At present, Treasury is best placed to fill this role, but we also see some possibility for making use of external technical experts, at Treasury's discretion.

4 The Costs of Poor Fiscal Policy

The discussion in section 2 suggests reasons why we might expect fiscal policy failure. Section 3 argued that the New Zealand experience with fiscal policy in the last 20 years is of serious concern in this respect. The nature of the desired fiscal reforms depends upon which kind of government failure is most likely, and which kind of government failure is most costly, the issue to which we now turn. We start with the costs of excess spending, because spending is the most direct measure of the burden of government.

4.1 The Costs of Spending

Government spending represents a shift of resources out of the private sector and into the public sector. This resource shift is the most direct burden that an activist government places on the private sector. While much of government spending is returned to the private sector in the form of transfers (e.g. welfare benefits), incentives can be markedly altered. In addition, much of government spending leads to resource consumption and shifts in the composition of output.

The point is not that government spending has no benefits; governments supply many valuable public goods. Rather, spending is the critical variable that accounts for most of the costs usually associated with deficits. The real quantity of resources consumed by the government makes up the primary fiscal burden of the state.

Government spending can also take resources away from future generations (depending upon the nature of that spending). When government spending takes today's capital stock and converts those resources into present consumption, there is less left for the future. If democracy creates a bias in favour of the present and gives politicians a short time horizon, this bias will show up in the pattern of spending. Under this assumption, the government will use too high a percentage of its funds for consumption, and too low a percentage of its funds for long-term investment in long-term projects.

Government spending also gives rise to outlays on lobbying and influence, called 'rent-seeking' or 'influence-seeking' costs by economists. When governments spend large sums of money, private interests devote time and resources to influencing the content and amount of that spending. The resources invested in such influence-seeking are unavailable for engaging in productive activities.

The costs of spending are not particularly controversial. Economists and policymakers may disagree about whether the benefits of various programmes exceed their costs in specific instances, but the nature of the respective benefits and costs is accepted by all of the parties to the debate.

4.2 The Costs of Taxes

Like spending, the costs of taxes are clear-cut and non-controversial. The first of the costs of taxation is the distortions resulting from resource misallocation, discussed above. These are the costs that economists label 'deadweight loss'. Income taxes, for instance, may cause individuals to work less (or more) than would otherwise be the case. In extreme cases individuals may even migrate to avoid paying especially high taxes. Capital gains taxes discourage investment, sales taxes discourage consumption, and excise taxes discourage the purchase of particular products. Many estimates place the deadweight burden of taxation at 20 percent or more of the money raised.

Economies also incur tax avoidance costs. Individuals will put time and resources into efforts to avoid taxes (e.g. secret overseas bank accounts) or cheat on their taxes. A larger number of individuals will choose self-employment or cash businesses, for instance, because individuals in these lines of work have greater opportunities to cheat and under-estimate their tax assessments.

4.3 The Costs of Deficits

Although there is an active debate concerning the case for deficit spending, and the degree to which deficits affect interest rates and national savings and investment, the consensus within the profession is that prolonged deficits are a concern.

In surveying this debate and the sharp rise in United States federal government budget deficits and indebtedness, Professor Janet Yellen, the overall reviewer at a 1989 symposium on the budget deficit in the United States, commented that:

"In the view of most of the nation's economists these developments are profoundly disturbing. Harvard economist, Benjamin Friedman (1988), summarizes the majority opinion when he writes, We are living well by running up our debt and selling off our assets. America has thrown itself a party and billed the tab to the future. The costs, which are only beginning to come due, will include a lower standard of living for individual Americans and reduced American influence and importance in world affairs."

This comment focuses on intertemporal issues which encompass both intergenerational equity and the possible inefficient crowding out of private sector savings and investment.

In part, the active debate arises because the crowding out view has not received strong support from the evidence. Most studies fail to find a systematic relationship between the budget deficit and any other economic variable of importance, including real interest rates, savings, GNP growth, or the rate of inflation. We can observe particular instances where high budget deficits have been

correlated with low savings rates and high real interest rates. But when we look at the entire span of the data, the predicted relationship fails to hold more generally. One typical anomaly is the experience of Japan, which ran huge deficits throughout most of the post-war years but nonetheless had a very high rate of saving (and output growth).

In a small open economy, fiscal deficits may be more likely to bring in capital from abroad than to push up domestic interest rates. If the effect is to expand domestic consumption the deficit will eat into the future consumption of residents.

Another possible reason for the difficulty of establishing that fiscal deficits have a strong, direct relationship to interest rates, savings and investment may be that deficits which are seen to be prudent and justified in terms of wars, national catastrophe, depression or just a cyclical downturn may be regarded very differently from chronic deficits.

Chronic fiscal deficits cannot be justified by the rather discredited Keynesian notion that cyclically-adjusted deficits are appropriate in a downturn – because the same theory would require offsetting surpluses in upturns.

Regardless of the size of a current deficit, the cumulative effect of excessive debt from large past deficits is likely to be to reduce economic flexibility and therefore the sovereign credit rating for external debt. Reduced economic flexibility implies greater country risk from the point of view of non-resident lenders. High debt burdens raise political and inflation risks. When interest rates exceed the rate of income growth, as can easily occur during recession, high debt levels can be destabilising. For these reasons, the cost of capital to residents can be adversely affected by the effects of chronic deficits on sovereign and country risk. For a discussion of the externality associated with sovereign debt ratings, see Wells (1991).

5 Examining Possible Fiscal Constitutions

A fiscal constitution should be designed to prevent governments from choosing non-optimal fiscal policies with high costs. Fiscal policy, however, is an extremely complex topic, and this end is hard to achieve. Nevertheless, most proposed policy reforms mandate a specific fiscal target of some sort. In effect, these proposals write an actual fiscal policy into law, or into the constitution (broadly defined).

Options encompass:

- (a) the imposition of mandatory goals which can only be set aside in special circumstances (e.g. a supra-majority rule);
- (b) measures to promote transparency and accountability for departures from sound fiscal policies, while not attempting to impose goals or targets.

5.1 Possible Guidelines or Goals for Fiscal Policy

In our view, in normal circumstances, prudent fiscal policies would have the following characteristics:

- government spending to be limited by consideration of the costs of taxation and the proper role for government;
- stability and a medium-term focus; and
- the preservation of borrowing capacity and economic flexibility to cover contingencies.

The first and third of these promote competitiveness and living standards. The second facilitates business and household planning. It implies stability in tax rates and policies affecting longer-term savings and investment decisions. The third also reduces the risks of political instability and inflation of times of stress. Lower net indebtedness assists in respect of the first and third characteristics.

In general terms, the fiscal policies with these desirable characteristics might be reflected in:

- (a) positive net worth in the Crown's balance sheet, low net indebtedness and a high credit rating for sovereign debt;

- (b) balanced budgets on current account, thereby maintaining stable net indebtedness (budget deficits could move cyclically, however);
- (c) relatively low total tax burdens on resident businesses and households in relation to countries with similar characteristics; and
- (d) stability in tax rates, user charges and regulatory policies, once appropriate levels have been reached.

As the next section indicates, it is difficult, and potentially risky, to convert these *desiderata* into rigid, specific goals.

5.2 Difficulties with Mandatory Fiscal Targets

5.2.1 *Balanced Budget Constraints*

The most commonly discussed fiscal target requires a national government to balance its budget on a yearly basis. This requirement can be passed into law, or into the constitution.

This idea has found special favour in the United States. On 12 February 1994, *The Economist* reported that the US Senate is due, once again, to debate whether to amend the constitution to require the federal government, like 49 of the 50 state governments, to balance its (appropriately defined) budget.

The attraction of a balanced budget target is easy to see. A balanced budget would, by definition, eliminate the deficit, and thus eliminate whatever costs are associated with it. Nonetheless, the weight of evidence and argumentation does not favour such an approach.

Attempts to impose a balanced budget could have perverse results.

One concern is *policy substitution* - governments will find other means of affecting the economy that do not involve spending but are inefficient nonetheless. Regulations, mandatory levies, requirements for private provision and loan guarantees will be used to a greater degree. The burden of government on the economy may only shift, rather than decline. Rather than spending a certain sum of money to provide a particular kind of welfare benefit, for instance, the government might instead stipulate that private businesses must provide the same benefit for their employees. Faced with a budget crisis, a government might choose to guarantee student loans from banks, rather than increase financial aid directly. Rather than cleaning up the environment with its own funds, a government might place obligations on private businesses. A balanced budget amendment would be

likely to increase the regulatory powers of the government substantially. Non-budget regulations of this sort increased considerably in the United States after the passage of the Gramm-Rudman-Hollings Act.

A second concern is that forcing budget balance every year could be bad politics and bad economics. A balanced budget constraint would often require governments to engage in pro-cyclical policy. Specifically, tax increases/spending cuts would be forced during downturns. Even those not enamoured of Keynesian economics doubt that such counter-cyclical policies are a good idea. They can deliver a negative shock to an economy that is already reeling.

Third, a balanced budget is, at the time of enactment, nothing but a forecast. Inevitably, these forecasts are based on existing policies, taking no account of likely changes to existing policies. Given that all expected future revenues will rise with forecast future economic growth but forecast expenditures may not, this could result in long-term forecast deficits which were biased downwards. Further, parliament can only pass a balanced budget *ex ante*, not a balanced budget *ex post*. If the budget predictions in any one year are sufficiently inaccurate, a balanced budget *ex post* might require draconian or unexpected increases in taxation, with immediate collection. This result is undesirable for both economic and civil liberties reasons.

If we rule out the use of such taxes, a balanced budget amendment no longer guarantees a balanced budget at all; it only requires a forecast of balance. The postulated advantages of a balanced budget are no longer achieved with certainty.

We might, in the interests of greater transparency and accountability, penalise governments for making inaccurate budget forecasts. Such measures, however, are neither necessary nor sufficient to meet the balanced budget constraint. More accurate forecasts, in the absence of improved fiscal policy, are unlikely to yield considerable benefits. Nor would the incentive for a better fiscal policy increase substantially. It is already public knowledge if the budget ends up in deficit, and a New Zealand government has no one to blame but itself for the initial forecast. The United States has attempted to reform its budgetary procedures many times in this century, but has never succeeded in significantly improving the quality of fiscal decisions through procedural changes alone.

A further potential problem is that a mandatory balanced budget requirement would create strong pressures to expand off-budget activities. The history of the United States shows that a fiscal system can have a very flexible definition of 'the budget'. The Social Security system, for instance, was defined as off-budget from its inception in 1936 until 1968. The US Postal Service has been made an off-budget item by its nominal transformation into a private corporation.

With the passage of the Gramm-Rudman-Hollings deficit limitation act in 1985, the pressure for redefining the budget increased sharply. Numerous expenditures of all sorts have now been classified as off-budget, such as the savings and loan bailout, Medicare and the Persian Gulf War.

More generally, the ineffectual Gramm-Rudman-Hollings experience described in Appendix 2 illuminates very clearly the potential costs of adopting a fiscal constitution.

As is also described in Appendix 2, the experience of the many individual American state governments with mandatory balanced budget targets is similarly discouraging. Perhaps most strikingly, New York City, which is famous for the state of bankruptcy it reached in the 1970s, and for its fiscal crises, has ostensibly had a strict fiscal constitution for most of its existence. The City is 'required' to maintain a balanced budget, which prohibits borrowing to finance current expenditures. All long-term municipal debt issues must be approved by referendum, and total debt cannot exceed 10 percent of the total value of taxable real estate. Yet, at the peak of its crisis in the 1970s, the City could not pay its bills or obtain credit from any source whatsoever.

The institution of such a constraint in New Zealand would induce excessive substitution into policies that do not require expenditures, undesirable counter-cyclical macroeconomic policies, and the reclassification of spending into off-budget categories. Evidence from the American states, and from the Gramm-Rudman-Hollings Act, indicates that all of these fears have been borne out by experience.

Most importantly, the balanced budget approach does not target primarily the burden of government spending on the economy or of excessive debt or contingent liabilities. And clearly it is not economically sound to require a balanced budget year-in, year-out.

The criticisms of balanced budget requirements are not meant to clash with our strong intuition that a balanced, cyclically-adjusted budget is a good thing. Indeed, a balanced budget is often a symptom of a healthy economy and a healthy fiscal position. Unfortunately, it is difficult to estimate the cyclically-adjusted deficit and the imposition of even that balanced budget requirement would suffer from the problems of policy substitution and off-budget spending. The problem with all such approaches is that they force the symptom to be produced even when the causes are not present. It is somewhat akin to a doctor who, when reading a high temperature on his or her patient, sticks the patient in ice water.

5.2.2 *Cap on Net Worth*

This proposal specifies a target level 'net worth' position that the government must meet. Net worth, in its simplest form, is defined as the value of government assets minus the value of

government liabilities. A cap could either be set at zero or above, or the government could be required to produce a net worth within a given range.

Proponents of the net worth standard seek to attain the goal of fiscal responsibility, but they believe that a so-called 'balanced' budget does not offer a true statement of the government's fiscal position.

Net worth reforms attempt to improve on the balanced budget requirement but do not address the fundamental defects of that approach. We saw above that the primary problems with the balanced budget requirement were excessive substitution into policies that do not require expenditures, undesirable counter-cyclical macroeconomic policies, and the reclassification of spending into off-budget categories. The net worth standard, at best, avoids only the last of these three problems. And like the balanced budget requirement, net worth standards pay little heed to the burden of government spending, the primary fiscal problem that needs to be addressed.

The net worth standard, while avoiding some of the definitional problems of the balanced budget approach, also creates new ones. Accountants often disagree strongly about how the net worth of a corporation should be measured. Different accounting standards for amortization, depreciation, and inventories, for instance, can produce wildly varying definitions of net worth. We can expect the same disputes, and perhaps even stronger ones, to arise in measuring the net worth of the government.

Opportunistic governments will tend to change the definition of net worth to suit their own ends. Even in the absence of opportunistic behaviour, political participants are likely to have honest, but serious, disagreements about how to define net worth. Given the imprecision of the issues involved, and the difficulty in explaining them to the broader public, the net worth standard would probably suffer an erosion of political support. No single net worth standard is likely to develop a strong constituency, or a high degree of credibility.

We can even imagine proposals for classifying different kinds of government spending into net worth categories. Expenditures on education and roads, for instance, might be treated as producing entries in the positive side of the balance. Such a classification is consistent with the spirit of the net worth standard. Even if the government does not create an asset that it owns, it has invested in the future of the community. Yet it is obvious that broadening the definition of net worth in this manner would open a political Pandora's Box and even further broaden possible measures of net worth.

5.2.3 *Cap on Gross Debt*

Rather than requiring a balanced budget, we might simply restrict the quantity of gross debt that a government can issue in forthcoming periods. Many of the American states have adopted precisely this kind of restriction. Both in concept and in practice, however, this proposal does not differ from the balanced budget requirement. If the government can issue debt to only a limited degree, it is in effect required to maintain a balanced or near-balanced budget.

5.2.4 *A Credit Rating Target*

A further reform would require the New Zealand government to aim to restore and then maintain the triple A credit rating it lost in 1983.

A higher credit rating would benefit New Zealand citizens. Their government could borrow abroad at lower rates of interest, and the credit ratings of New Zealand corporations may improve also. Corporations based in a country with a low credit rating are unlikely to attain AAA ratings themselves, because lenders always fear that an irresponsible or fiscally desperate government might confiscate their resources.

Like the balanced budget requirement and the net worth requirement, the credit rating target attempts to impose fiscal responsibility on a government. Yet the credit rating target provides a superior measure of fiscal responsibility. Both the balanced budget and net worth approaches were found to be subject to serious, perhaps fatal, problems with defining and measuring net worth. The credit rating target avoids these problems to considerable degree by placing the judgment in the hands of the marketplace, specifically in the hands of international credit rating agencies.

Credit rating agencies are likely to provide better measures of fiscal responsibility than any legislation can achieve. Credible legislation can specify only a few simple targets or measures. Governments can then evade the specified goals with relative ease (see above). Furthermore, these targets or measures can later be changed in subtle ways that the public probably will not understand.

A triple AAA credit rating, in contrast, is a highly visible and easily understood target. At the same time, it reflects a wealth of subtle information. Credit rating agencies, however imperfect they may be, possess more expertise about fiscal soundness than other sources. Furthermore, the profit-maximising nature of these agencies gives them strong incentives to provide reliable information to their clients. Off-budget expenditures, for instance, are unlikely to fool these external monitors.

Despite these advantages of the credit rating target, this policy reform also possesses major flaws. Like the balanced budget restriction, targeted credit ratings confuse symptoms and causes. Clearly all commentators would agree that an AAA credit rating is normally a symptom of a sound economy and a responsible government. The governments of the wealthiest and stablest countries in the world have AAA credit ratings. But this does not mean that mandating that rating, without also mandating its underlying determinants, is likely to be beneficial.

Governments required to maintain a AAA credit rating target will react by some combination of cutting spending and raising taxes. However, few governments have the courage to make large-scale spending cuts – so a tax increase is far more likely. Even in New Zealand, one of the most reformist Western governments in the 1980s, it has proven far easier to raise taxes and deregulate than to cut aggregate government spending. The credit rating target is most likely a recipe for a tax increase.

Even then, a government which used such a target to justify unpalatable measures could be disappointed. Fiscal policy is not the only factor which affects a sovereign rating. For example, a government may be running fiscal surpluses, but find that its credit rating is under pressure because the country is building up external debt through a large, private sector funded deficit in the current account of the balance of payments.

It is unlikely that the credit rating target, by itself, would induce significant improvements in economic policy. As New Zealand's own experience has so painfully shown, there is a lengthy and uncertain path between the initiation of a reform and the final fruits of that reform. In fact, the more important a reform, the longer the time frame required to make it pay off. Important reforms are those which redress serious misallocations of resources yet the more serious the initial misallocation, the longer the time required for adjustment. In the meantime resources will be unemployed and the government will lose revenue, thus worsening its fiscal position.

Given the long time frame for reforms, plus the time needed to demonstrate to the outside world that the reform will not be reversed, economic policy improvements cannot be counted to improve credit ratings in the short term. In a country with a three-year, or even a four-year, electoral cycle, credit rating targets could even weaken rather than strengthen the incentive to undertake such reforms.

Many governments have combined high credit ratings with poor economic policies. In 1986, for instance, the former Soviet Union had a higher credit rating than Saudi Arabia, South Korea, Greece, and Chile, and only a slighter lower ranking than New Zealand. In the 1988 country rankings it scored higher than New Zealand. The Soviets were renowned for paying their bills on time, but obviously they achieved creditworthiness by draconian resource conscription rather than through sound economic policy.

The New Zealand experience shows that credit ratings do not respond immediately to changes in the quality of economic policy. It might be many years, or even decades, before the cumulative effects of poor quality policies adversely affect published ratings. New Zealand had an AAA rating up until April 1983, although the economy was clearly in the throes of a crisis. One reason the rating held up for as long as it did was that the government did not hesitate to intervene and command the resources of citizens. Starting in 1984, the Labour government undertook numerous beneficial reforms, but these could not prevent New Zealand's rating falling from AA+ to AA (December 1986), and from AA to AA- (January 1991). A credit rating target, had there been one at the time, might have been used by opponents of the reforms to attack them. Credit rating targets may discourage governments from releasing their grip on the resources of the private sector. But the government's ability to capture the resources of the economy (i.e. the ability to repay debt) should not be confused with the economy's ability to produce wealth.

The general problem is this: we would like to mandate the determinants of a superior credit rating, not the rating itself. Forcing a government to aim to achieve the rating, regardless of the quality of the measures adopted, is an extremely blunt weapon that is likely to backfire and simply increase the rate of taxation. If we could simultaneously induce the causes of a high credit rating, the credit rating target itself would not be necessary.

5.2.5 Caps on Tax Rates

Economically appropriate limits on statutory tax rates would not be objectively determinable. Further, statutory tax rates can differ markedly from effective tax rates. Limits on effective tax rates would have to be set very high, if they were not to be in gross conflict with the policy of income-testing benefits. Again such approaches address symptoms rather than causes and invite policy substitution and off-balance sheet funding.

5.2.6 Caps on Spending or Total Revenue

Caps on year-by-year total revenue or total expenditure also suffer from forecasting errors, policy substitution and off-budget financing problems. These could also inhibit desirable cyclical fluctuations in these items. Since government is already arguably too large on competitiveness grounds, caps on total expenditure and revenue might have to be phased down, which would also be arbitrary. The absence of an economic rationale for any particular level for the cap would make it difficult to create a constituency which would defend it.

5.2.7 Concluding Comments on Mandatory Targets

All the reservations about making any one or more of the above targets mandatory arise from the difficulties associated with trying to impose a selected subset of the characteristics of good economic policies. The basic problem arises from the attempt to impose manifestations of good policies rather than prevent the causes of bad policies.

5.3 Guidelines as an Alternative to Mandatory Targets

The risk of perverse outcomes from fiscal targets could be reduced if those targets were not mandatory. For example, one option would be to specify a range of targets in the Bill (such as the achievement of positive net worth and a high credit rating) and have the Bill require the government of the day to set out any reasons for departing from those targets and, where it retained the original targets as an ultimate goal, its medium-term policies for eventually achieving those targets.

This approach would allow a government to set its own targets, but be cross-examined on its reasons for those settings. As such, it reduces the incentive on an incoming government to use policy substitution and off-budget funding early in its term of office. However, pressures to do so would arise later in its term of office should it start to become likely that its self-imposed target would otherwise be violated.

5.4 Self-Imposed Explicit Targets

A more limited option would be for the Bill to require a government to specify explicit targets, in respect of, for example, the share of government spending, tax rates, net worth, gross debt or its target credit rating. It would then have to set out its reasons for choosing these targets and explain subsequent deviations from them.

This goes one step beyond the framework in the present Bill which does not require targets to be explicit.

Given that such explicit targets would be self-imposed, and could be varied by an incumbent government in accordance with changing circumstances, the risks of adverse policy substitution should be low.

5.5 Constraints on Powers, Without Guidelines and Disclosure Requirements

A further constitutional option would be to avoid requirements to set targets or guidelines and to directly constrain executive power by such devices as requiring a supra-majority vote or having a bill of rights which limits the power of the government by enhancing protections for private property. Some contributors to this literature have suggested the imposition of a requirement that an element of user-pays be always imposed on those who would benefit from new spending initiatives.

Variants of this approach would include *disclosure requirements* concerning the costs and benefits of government on- and off-budget expenditures, taking deadweight losses from taxation into account.

Other disclosure requirements could be introduced through obtaining, and publishing, expert critiques of technical aspects of fiscal policy. For example, expert opinions could be obtained on:

- (a) the credit rating implications of the government's economic policy with a particular focus on the implications of its fiscal policy; and
- (b) the degree to which fluctuations in economic activity or the terms of trade could be regarded as cyclical rather than structural.

A further measure to reduce the risks that deficits will be expanded in a downturn, but not offset by commensurately persistent surpluses in periods of faster economic growth, could be to require a government to publish its policy intentions with regard to deviations in out-turns from forecasts. The aim here would be for it to commit to corrective action at an earlier stage should an expected recovery turn out to be delayed, or weaker than expected.

Finally, more could be done to prescribe the disclosure of comparative fiscal data on the size of the public sector in New Zealand and the efficiency of its activities.

6 Implications for the Fiscal Responsibility Bill

6.1 The Need for Further Measures

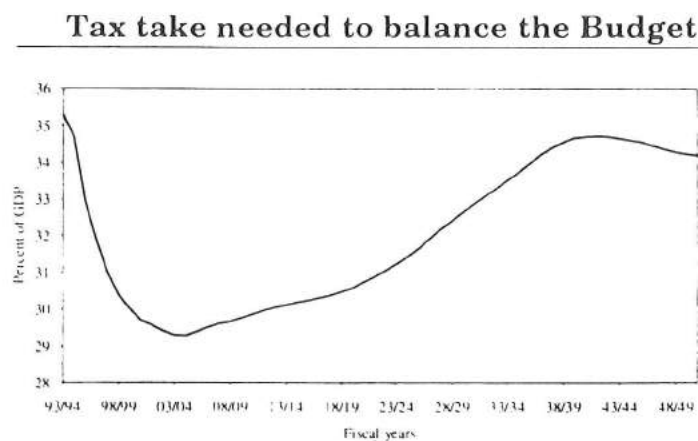
Fiscal trends during the last 20 years validate concerns about policy failure – real expenditure, taxation, debt and debt servicing costs have risen sharply, public sector net worth has declined, sovereign debt has been repeatedly downrated, poor outcomes are evident from much government spending and unemployment has risen sharply.

Pressures on politicians to adopt more responsible fiscal policy measures in future have undoubtedly increased following deregulation of financial markets, the free float of the exchange rate, the much needed reforms to the public sector and the improvements to date in public access to information about government finances and spending programmes.

Nevertheless, continuing high unemployment, widespread electoral dissatisfaction and the realignment of political parties with the approach of MMP create a fragile situation for macroeconomic policies. This is evident in the existing pressures to amend the Reserve Bank Act and to relax spending constraints, even before a fiscal surplus has been achieved. Currently, demographic factors provide a window of opportunity during which fiscal surpluses should be achievable without putting pressure on tax rates (refer to Chart 6). Should this opportunity be missed, much higher tax rates could be required.

For these reasons the Business Roundtable strongly supports further measures to improve fiscal policy outcomes. Given the difficulties with establishing the precise underlying causes of the macroeconomic policy failures of recent decades, and the evident risks of perverse outcomes from mandatory goals or targets for partial indicators of the outcomes expected from sound fiscal policies, we support the thrust of the Bill towards further improving transparency and accountability.

Chart 6



These projections assume current expenditure and revenue policy settings are maintained. Demographic projections are from Statistics New Zealand.

Source: The Treasury: Briefing to the Incoming Government, 6 November 1993, page 93.

6.2 Points of Agreement with the Bill

In particular, we agree with the measures in the Bill to improve accountability and transparency by requiring:

1. the minister of finance to report annually to parliament on the government's:
 - (a) fiscal objectives;
 - (b) policy approaches;
 - (c) progress review; and
 - (d) progress outlooks for the next 10 years;
 2. twice-yearly, 3-year ahead, economic and fiscal updates to be prepared by the Treasury, but containing full information about government policy decisions;
 3. the publication of a pre-election economic and fiscal update;
-
4. the publication of a detailed current year fiscal update, with the Supplementary Estimates;
 5. the publication of monthly financial statements on the fiscal outcomes for the year to date;
 6. more accessible formats for the Estimates; and
 7. all the Crown's financial reporting to be consistent with generally accepted accounting practice.

We note that the Financial Reporting Act 1993 gives the force of law to accounting standards, defining "generally accepted accounting practice" and creating an Accounting Standards Board, as a Crown entity, to review and approve accounting standards for all private and public sector entities. This process will undoubtedly constrain the ability of future governments to conceal deteriorations in the Crown's accounts.

6.3 Scope for Additional Transparency Measures

Our review of the experience in the United States with the imposition of mandatory fiscal targets suggests that it is desirable to:

- (a) improve accountability and transparency simultaneously in respect of all government policies since too much emphasis on fiscal policies and too little on off-budget and regulatory policies could actually make matters worse;
- (b) ensure that the emphasis is on the overall quality of fiscal policy objectives, and the consistency of actual policies with those objectives, rather than on quantitative measures which may be attainable by perverse policy actions; and
- (c) allow governments to freely depart from sound fiscal policies, in a transparent and accountable manner, at times of war or major recession or even when they perceive that political constraints are so severe that the electorate will not sustain either a reduction in spending or a lift in taxes. It is important to design institutional constraints which are not discredited, to the point of being removed altogether, in such circumstances.

We have given considerable thought to ways in which accountability and transparency could be further improved in the Bill, in the light of our review of the circumstances surrounding New Zealand's fiscal position in recent decades. First we suggest requiring the minister of finance to relate the government's actual fiscal deficits to a set of objectives which are intended to characterise sound fiscal policy principles. Second we suggest a number of additions to the prescribed content of the economic and forecast updates. Finally, we comment on the desirability of making use of external auditors so as to reduce the risks of internal tensions from the increased accountability and transparency embodied in these recommendations.

6.3.1 Fiscal Objectives

In our view the following fiscal objectives would characterise responsible fiscal policies in normal circumstances:

- (a) the achievement and maintenance of a prudent level of positive net worth in the Crown's balance sheet;
- (b) the achievement and maintenance of ratios for fiscal indicators for New Zealand which are in line with those achieved by longstanding AAA- rated countries, taking into account New Zealand's particular economic characteristics;
- (c) once objectives (a) and (b) have been achieved, the maintenance of a balanced budget, on current account, over the economic cycle, so that policies are clearly geared to ensuring that any deficits incurred during economic downturns are matched by projected fiscal surpluses well

within the proposed 10-year projection horizon. The best measure of budget balance would be the operating balance in the Crown's Financial Statements;

- (d) limiting the burden of government spending by ensuring that government spending programmes produce benefits which exceed the cost to the nation of the taxes required to fund them;
- (e) promoting stability by avoiding erratic changes in tax rates and other policy parameters which affect long-term private sector savings and investment decisions; and
- (f) ensuring that the above objectives are achieved without compromising the quality of regulatory or other policies, or the integrity of the Crown's accounting systems.

We believe that there is scope within the Bill for requiring the Crown to comment on the degree to which its self-selected fiscal objectives, as required under clause 6 (2) (a), depart from such a list. Such comments should encompass the reasons for any departures. We envisage that a government could well wish to depart from the benchmark list, at least in the short term, during times of war, major recession or political instability. The sole intention of the suggested approach is to require these departures to be made transparently at an early stage.

Characteristics (a) and (b) above would require technical interpretation because the values which would be prudent for fiscal policy settings in normal circumstances depend on the broader economic risk characteristics of the New Zealand economy. In our view such technical judgments are best made between the Treasury and the government, aided as required by experts in sovereign debt rating issues. The Secretary to the Treasury's formal endorsement of the consistency of any long-term targets for net worth and fiscal ratios with the government's long-term target credit rating for New Zealand sovereign debt could also be required. Such a requirement would no doubt oblige Treasury to formally consult experts in sovereign ratings.

Note that this approach leaves it to the incumbent government to determine its long-term targets for net worth and other fiscal variables, including the target credit rating used as a guide for these variables. Prudent levels for these ratios would vary with changes in the economic environment. There is no question of imposing mandatory targets on the government regardless of circumstances.

Further, the targets would have a long-term orientation, reducing the risks of gaming during intervening years.

6.3.2 *The Content of the Economic and Fiscal Updates*

Regardless of whether or not the proposal in (1) is adopted, we believe that it would be desirable for the economic and fiscal updates to incorporate sections which promote transparency concerning:

- (a) trends in the size of the government sector in New Zealand in relation to competitors, including a comparison of average and marginal tax burdens;
- (b) trends in fiscal ratios, compared to those for AAA-rated countries and those which prevailed in New Zealand before the onset of chronic large deficits following the 1973 oil price shock;
- (c) trends in the yields in secondary market trading of New Zealand sovereign-rated bonds, compared with those of other sovereigns and relative to accepted benchmarks, with a commentary on the explanation for changes in New Zealand's position;
- (d) the degree to which fiscal forecasts may have an optimistic bias if expenditure projections are on a no-policy change basis, as distinct from a most-likely basis;
- (e) the degree to which recent economic fluctuations might properly be regarded as cyclical, and therefore the degree of confidence that can be expressed about the degree to which a current fiscal balance outlook can safely be regarded as cyclically self-correcting;
- (f) the criteria which have been used to determine provisions in the Crown's Financial Statement in respect of:
 - (i) public sector capital expenditures which have been justified on macroeconomic rather than microeconomic grounds (e.g. as part of the government's growth strategy, or counter-cyclical policies); and
 - (ii) contingent liabilities in respect of government involvement in major private sector works programmes.

It should be clear that the above suggestions are designed to:

- address benchmark-related questions about the appropriate size for government (refer to (a));
- improve the transparency of external financial constraints (refer to (b) and (c));

- reduce the scope for overly optimistic 'borrow and hope' policies during economic downturns (refer to (d) and (c)); and
- improve the transparency of the fiscal risks arising from state involvement in large, politically-driven, capital works programmes.

6.3.3 *The Role for External Auditors*

The ability of the government to function effectively in its relations with Treasury would be impaired by measures which cast the Treasury in the role of public critic of the government. For this reason we have sought to find arrangements which will increase the transparency of technical judgments affecting fiscal policy without isolating the Treasury or subjecting it to damaging attacks of a party-political nature.

Reasonably objective external audit sources include:

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- (a) financial market interest rate differentials;
 - (b) the major credit rating agencies;
 - (c) international agencies such as the OECD; and
 - (d) specialist academically-oriented economic institutions which could be competent to assess the degree to which recent economic fluctuations can be safely regarded as self-correcting in a small number of years.

We consider that Treasury has a good incentive to make use of such external auditors and to determine the degree to which accountability for some of the proposals above should properly be allocated to such auditors.

6.4 Other Specific Comments on the Bill

Fiscal Strategy

Section 6(2)(d) requires the minister of finance to report progress in meeting the fiscal objectives. We recommend that it be expanded to include a requirement to comment on the implications for policy of departures from earlier projections, particularly in the event that those departures persist.

Section 6(e)(iii) requires the minister of finance to explain any difference in projections from previous outlooks. We recommend that it be similarly expanded to include a requirement to comment on what, if any, corrective action would be contemplated on the revenue or expenditure sides if differences persist.

The rationale for these suggestions is to make it more difficult for an incumbent government to lapse into 'borrow and hope' practices if an economic downturn turns out to be more prolonged than expected as an election year approaches.

Section 6(3) specifies that these broad fiscal projections will be for 10 or more consecutive years. It is not clear under the Bill whether the minister or the Treasury is responsible for these forecasts. They will have more credibility if they are the Treasury's projections. This should be clarified.

Economic Forecasts

Publication of forecasts should be understood to encompass material relating to cyclical fiscal issues and sovereign (country risk) developments.

Fiscal Forecasts

Section 9(3) should also incorporate a requirement for a statement concerning provisions made in respect of Crown commitments and contingent liabilities.

6.5 Mandatory Targets

In our view the measures proposed above, in addition to those already in the Bill, will greatly increase accountability and it would be unwise to go further by imposing mandatory targets because of the poor economic rationale for many mandatory targets and the risk of perverse outcomes.

This could be reviewed at a later date, particularly if the risks of policy substitution are reduced in the interim by measures which improve transparency for regulatory and other policies.

6.6 The Role for Other Constitutional Arrangements

The essence of the above recommendations is that tightening constraints on politicians, by improving transparency and accountability, will usefully improve fiscal policy.

Two questions to be considered in this respect are: "to what extent will the greater transparency improve outcomes?"; and "what further measures should be taken?"

In considering these questions we note that the discussion in section 2 suggests the fiscal policy failures could have the following sources:

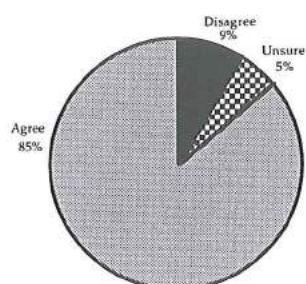
- (a) voter preferences (e.g. myopia or self interest);
- (b) voter ignorance, given information costs;
- (c) flawed voting systems and constitutional arrangements;
- (d) political/bureaucratic principal/agent problems.

The returns from greater transparency will only be high if (b) and (c) are significant sources of New Zealand's policy failures. Grounds for thinking they could be significant include:

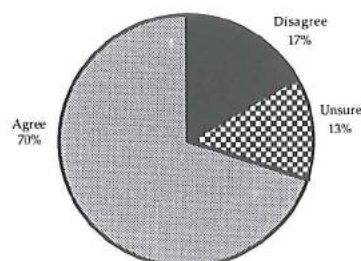
- The success to date of the Reserve Bank Act. In essence this Act simply requires politicians to be honest with the electorate if they want to inflate. So far politicians haven't dared to be that honest. Similarly politicians in the past have not dared to admit that they intended to sustain deficits for so long that New Zealand's credit rating would be impaired, or its net indebtedness put at risk.
- A feature of the chronic fiscal deficits incurred in recent years has been the political willingness to interpret a downturn as cyclical, justifying a large deficit, and an upturn as a statistical trend, meaning that no tough fiscal decisions need to be taken. The upshot is a build-up of debt which eventually forces harsh decisions in the first post-election year following a serious downturn, and long-misconceived growth strategies of which 'Think Big' was just one manifestation. Since the cyclical/trend issue is a technical one, ensuring a more visible contribution to public discussion from experts could make it more difficult for politicians to make opportunistic assertions in this respect.
- The experience with the price stability objective and the survey results, summarised in the following charts and explained more fully in Appendix 3, provides grounds for hope that voters support prudent fiscal policies such as balanced budgets and high credit ratings as a norm. The survey found that, excluding the undecideds, there is 81 percent agreement with the proposition that the government should be required to aim to restore New Zealand's AAA credit rating and 90 percent agreement that the government should be required to balance its budget (in the sense that its current spending does not exceed its current revenue).

Survey of Public Opinion: February 1994

Balanced Budget Requirement?



Restoration of AAA Credit Rating?



These perspectives provide grounds for some optimism that getting greater transparency into the credit rating and cyclical deficit/surplus issues might make it harder for politicians to mislead the electorate, and the effects could be significant. But they are unlikely to be as significant as with the Reserve Bank Act because the technical judgments about cyclical deficits would still lie with the politicians. Fine-tuning government expenditures and tax rates, within government-determined global fiscal parameters cannot be delegated.

However, it seems probable that greater transparency will not suffice on its own because of voter preferences and voting problems (a) and (c). Problem (a) arises in two ways. The first is the large constituency now voting to maintain their privileges. The second is that there may well be majorities in favour of smaller deficits, more spending and lower taxes, taken individually. Alternatively voters may agree that total spending needs to be cut, but not produce a majority in favour of any individual cut. This, in conjunction with the problem of the absence of adequate protection for minorities (i.e. high income earners) against expropriation of property by the majority, leads to problem (c). MMP complicates the situation further. Consequently, in worst case scenarios all the Bill might do is make a politically-driven fiscal blowout a bit more transparent, perhaps helping the external constraints to bite sooner rather than later.

Options for addressing fiscal policy failures arising from problems (a) and (c) include:

- supra-majority requirements for proposals which would expand the domain of government and/or further undermine rights to private property; and
- greater use of referenda, particularly veto referenda in respect of such legislation.

This is not to rule out the possibility that part of the problem lies with voters, voting procedures, the absence of constraints on the ability of the majority to exploit a minority and/or the ability of a well-organised minority to exploit a majority. To the contrary, we do see some justification for supra-majority rules in respect of proposals by parliament to increase its powers and its command over private resources. Such issues are also relevant to a bill of rights.

However, these matters arguably go beyond the present Bill, so we do not pursue them further here.

7 Recommendations

The New Zealand Business Roundtable:

1. **strongly supports** the measures in Part I of the Bill to improve the transparency and accountability of fiscal policy;
2. **agrees** that the Bill is correct, as it stands, to exclude mandatory fiscal targets from its provisions, at least until greater transparency can be brought into the use of regulatory and other off-budget policies;
3. **suggests** that the bill be modified as follows;

a Explicit Fiscal Targets

Section 6 (2) (a), replace "setting its objectives" by "setting explicit, quantitative objectives".

b Fiscal Guidelines

A new section 6 (2) (b) be inserted to read as follows:

- 6 (2) (b) Comment on the consistency of the specified objectives with the following fiscal objectives, noting the reasons for any differences:
- (a) the achievement and maintenance of a prudent level of positive net worth in the Crown's balance sheet;
 - (b) the achievement and maintenance of ratios for fiscal indicators for New Zealand which are in line with those achieved by long-standing AAA- rated countries, taking into account New Zealand's particular economic characteristics;
 - (c) once objectives (a) and (b) have been achieved, the maintenance of a balanced budget, on current account, over the economic cycle, so that policies are clearly geared to ensuring that any deficits incurred during economic downturns are matched by projected fiscal surpluses well within the proposed 10-year projection horizon. The best measure of budget balance would be the operating balance in the Crown's Financial Statements;

- (d) limiting the burden of government spending by ensuring that government spending programmes produce benefits which exceed the cost to the nation of the taxes required to fund them, including the deadweight losses associated with those taxes;
- (e) promoting stability by avoiding erratic changes in tax rates and other policy parameters which affect long-term private sector savings and investment decisions; and
- (f) ensuring that the above objectives are achieved without compromising the quality of regulatory or other policies, or the integrity of the Crown's accounting systems.

c Reasons for Departures

- (i) Sections 6 (2) (d) be expanded by adding after the words "under this section", the clause:

"commenting on the implications for policy of departures from previous expectations"; so that the revised section reads:

6 (2) (d) Report progress to date towards meeting the fiscal objectives specified in the previous report laid before the House of Representatives under this section:

- (ii) In section 6 2(e) (iii) add after "outlooks" the words "and comment on their implications for policy settings" so as to read:

6 (2) (e) (iii) Explain any differences from previous progress outlooks and comment on their implications for policy settings.

d Sustainability of Economic Trends

- (i) Section 8 be expanded to include the following:

8 (3) "The economic forecasts shall also include an assessment of the degree to which the economic growth outlook provided by these forecasts is cyclical."

(ii) Section 9 be expanded to include the following new subsections:

9 (6) The fiscal forecasts shall also include sections commenting on:

- (i) trends in the size of the government sector in New Zealand in relation to competitors, including a comparison of average and marginal tax burdens;
- (ii) trends in fiscal ratios, compared to those for AAA-rated countries and those which prevailed in New Zealand before the onset of chronic large deficits following the 1973 oil price shock;
- (iii) trends in the yields in secondary market trading of New Zealand sovereign-rated bonds, compared with those of other sovereigns and relative to accepted benchmarks, with a commentary on the explanation for changes in New Zealand's position;
- (iv) the degree to which fiscal forecasts may have an optimistic bias if expenditure projections are on a no-policy change basis, as distinct from a most-likely basis; and
- (v) The risks for the 10-year fiscal outlook arising from demographic pressures, lower-than-expected economic growth and the potential need for provisions arising from Crown risk exposures.

Appendix 1

A Chronological Review of Fiscal and Debt Trends in New Zealand

1840-1890

Until 1890, government expenditures funded from loans were chiefly concerned with railways, roads, the land wars and the assumption by central government of the loan liabilities of the provincial councils on their abolition.

From the earliest days of organised colonial settlement, the public finance accounts drew a distinction between capital and current expenditures, as is illustrated by exhibit 1 which covers the 1840-1847 period.

The first Loan Act in New Zealand was passed by the General Assembly in 1856. Under this authority, £500,000 was raised. A sinking fund of 2 percent per annum was established to provide for the repayment of the loan (1930 Official Yearbook, page 646). Considerable borrowing followed to fund initial public works and the so-called land wars in the North Island. Following these hostilities, large amounts were spent in expanding the road and rail system. Much of these expenditures were controlled by the provincial governments.

By 1870, central government debt totalled £4.3 million and provincial council debt totalled £3.2 million. The ultimate redemption of the combined £7.6 million debt was provided for by sinking funds, part at 2 percent p.a., part at 1 percent p.a. The sinking fund policy was abandoned in 1870 due, according to the 1930 Official Yearbook (page 646), to the feeling that it was unnecessary in respect of durable, long-lived, wealth creating public works.

According to the 1930 Official Yearbook (page 636), the divided responsibility for public works schemes prior to 1870 meant that no general and comprehensive public works programmes could be carried out. This changed with the passing of the Immigration and Public Works Act 1870, which provided for large scale immigration and for a loan of £10 million for the construction of main trunk roads and railways and other public works of national importance. This controversial scheme, associated with Julius Vogel, was subsequently greatly expanded with the state opening up lands in advance of settlement and retaining the ownership and control of facilities for transport and communication. By 1880 the gross public debt had risen to £28.6 million; in the next decade it rose further to £38.8 million (see exhibit 2). Essentially all the public debt was external, being raised in London. Note that this exhibit also indicates that the public accounts drew a distinction between (works) expenditures which were funded by loans, and other expenditures which were funded by

(largely current) revenues, but that there were deficits on this quasi-current account basis in 10 of the 13 years between 1875 and 1887.

The accounting system in this period also provided a quasi-balance sheet perspective on the public debt, allocating debt to the activities in respect of which it had been incurred. In so doing, it clearly brought some transparency to the issue of the degree to which the debt was covered by assets which were capable of servicing it. For example, exhibit 3 presents an allocation of the public debt into "directly productive" assets (e.g. railways), "investments" (e.g. loans to settlers), "indirectly productive" assets (e.g. roads) and an "unproductive" residual category (e.g. public buildings, war and defence expenditures and "deficiencies, charges and expenses of raising loans"). It appears, however, that this allocation of debt to asset categories did not, in general, extend to valuing the assets against which the debt was allocated.

By 1890 the gross public debt per capita was around £59, which would be around \$6,800 in 1993 dollars, based on movements in the consumers price index. From the figures in exhibit 3, 28 percent of the 31 March 1891 debt could be attributed to war, defence, deficiencies and loan-raising expenses.

From 1890 to the First World War

The functions of the state were expanded substantially during the period from 1891 to the onset of World War I, as the government repurchased alienated lands, lent to settlers (the Advances to Settlers Act 1894), workers (the Advances to Workers Act 1906) and local authorities, developed hydro-electric power and coal mines, and established the state fire and accident insurance offices.

The effect was to raise gross public debt to £100 million by 31 March 1915, which would have probably been more than 150 percent of gross domestic product (see table 2) and would have amounted to around \$7,000 per capita in 1993 dollars. However, assets had largely matched the rise in debt, reducing the portion of the debt attributed in exhibit 3 to "unproductive" war, defence, scenery preservation, and deficiencies and loan-raising expenses to 14.8 percent of the total. During this period, annual reported government revenues invariably exceeded reported non-works programme payments, perhaps indicating a preference to be seen to be 'balancing the books' on a current account basis (see table 2).

Interestingly, in 1906 the sinking fund approach was reinstituted for the repayment of the land wars debts and defence loans, including that raised to purchase H.M.S 'New Zealand'. Sinking funds, which the 1930 Official Yearbook reported might be "more accurately described as an 'internal reserve fund'" were also established in respect of advances to settlers and workers.

The Public Debt Extinction Act 1910 provides a further indication of heightened concern during this period about the need for prudent management of the debt. That Act aimed to provide for the repayment of the entire public debt, excluding Treasury Bills and amounts already subject to reserve or sinking funds, over a prolonged period. It required an amount to be paid to a special branch of the state-guaranteed Advances Office which would be invested in interest-bearing advances to settlers, workers and local authorities. That amount was initially calculated as that amount which, if invested for 75 years at 4 percent p.a. compound interest, would equal the total public debt, excluding Treasury Bills and amounts already subject to reserve or sinking funds, at the end of the preceding March. (This calculated amount would have been slightly over 5 percent of the public debt total.)

Subsequent to this Act, special sinking funds were provided in respect of a considerable number of loans.

1915-1930

All but the most pressing public works were postponed during the first world war. War-related expenditures mainly accounted for the public debt doubling in nominal terms to £201 million by 1920. Following the war, there was a need for a resumption of capital works and assistance to returning soldiers. By 1929, the total public debt had reached £264 million of which almost 30 percent (£79 million) was attributed in those times to World War 1 debt, the land wars, other defence expenditures and £2.4 million of "revenue deficiencies". During this entire period, there were only two years (1922 and 1929) in which reported revenues did not exceed non-works expenditures.

Gross public debt was over 170 percent of estimated GDP in 1918 and had reduced, in part through inflation, to around 150 percent by 1930. Inflation was an important factor during this period with the consumers price index rising 33 percent from 1915 to 1918. Real gross public debt per capita rose only fractionally from 1914 to 1920, but then rose strongly to reach \$10,000 in 1993 dollars by 1930.

Another relevant feature of the wartime period was the heavy issuance of domestic war loans. At 31 March 1914, New Zealand public debt domiciled in London totalled £78.5 million, dwarfing the £17 million raised locally, in part from the emerging local savings market. By 1920, the New Zealand component had risen to £102 million (50.7 percent of gross debt) whereas the London component was only £96 million (47.8 percent). After 1920, the Dominion returned to the London market for its major financing.

Despite the large wartime expenditures and the heavy debt in relation to national income, the 1930 Official Yearbook (page 643) was able to present a table of reportedly conservatively-valued assets which indicated that state assets exceeded the total debt by £10.5 million. The surplus was

calculated after including in assets £38 million in public sector cash and investments (a category which was not included in undertakings against which debt was allocated) and after valuing the Crown's holdings in lands and forests at £71 million against debt allocated to that category of £24 million. These two adjustments allowed reported total assets to cover the £79 million "non-productive" debts referred to above. No provision was made in this early net worth calculation for the present value of any net superannuation obligations to state servants.

The Repayment of the Public Debt Act 1925 repealed the Public Debt Extinction Act 1910 and substituted, for the long-term sinking fund system, a capital fund (the Public Debt Redemption Fund). Into this fund would be paid annually an amount equal to 0.5 percent of the eligible pre-existing debt (which was 76 percent of the total debt at 31 March 1925), whether or not it was subsequently repaid under this Act, plus the savings in interest, calculated at 3.5 percent per annum on debt paid off under the scheme. Further details are provided in the 1930 Official Yearbook, page 647, which notes that the provisions in this Act meant that the "debt existing at the commencement of the scheme will be liquidated in about sixty years, while all future loans will be liquidated within a similar period from the date of their inception."

1930-39

This period covers the major depression and recovery, the creation of the Reserve Bank and the 1938 foreign exchange crisis. The consumers price index actually fell to 1933, but then rose to be only 1.5 percent higher in 1939 than in 1930. During the recession real debt per capita rose slightly to peak at \$12,300 (in 1993 dollars) in 1934. Inflation then eroded it to a low point of \$9,600 in 1938, prior to the foreign exchange crisis. As a percentage of GDP, gross public debt rose to 226 percent in 1933, before dropping remarkably to 120 percent by 1939 under the influence of inflation and strong post-depression economic growth. Public external debt fluctuated around 70 percent of total public debt during this period.

Interestingly, the public accounts revealed that non-works expenditures were permitted to exceed revenues in 1929, 1931 and 1932 and 1934, with the annual deficiency peaking at 9 percent of total revenue in 1932. Cumulative surpluses, in the remaining years before World War II, had not offset the £5.0 million cumulative deficit incurred in these four years.

1939-50

The consumers price index rose 18 percent from 1939 to 1945 and 42 percent from 1939 to 1950. Real gross public debt per capita rose very sharply from \$9,678 in 1939 to peak at \$15,577 in 1946 (145 percent of GDP), before easing back to \$13,491 by 1950 (120 percent of GDP).

More remarkable was the absolute nominal reduction in external public debt during this period, no doubt reflecting a determination to reduce reliance on the London market following the humiliations of the 1938 foreign exchange crisis. New Zealand reduced non-essential imports sharply during the war years allowing the government to build up substantial sterling reserves. These were used after the war to reduce sterling debt. Nominal public external debt fell from a peak of \$398 million in 1933 to \$168 million in 1950, reducing it dramatically from 78 percent of the total public debt to 13 percent. This represents a radical change in view about the optimal currency composition of the public debt since the real total public debt actually rose during this period.

Central government consistently reported surpluses of revenue over non-works expenditures during this period (exhibit 5).

1950-1973

Many years of buoyant growth from 1950 to 1973 (notable exceptions occurring in 1958, 1961-62 and 1967-68) and moderate inflation saw the gross public debt rise in nominal terms, but fall markedly in real terms and relative to income during this period. By 1974, just after the first oil shock, it was down to 42 percent of GDP and was only \$7,722 per capita in 1990 dollars. External public debt bottomed out at 12.3 percent of the total in 1953 (when the terms of trade were at a peak from the Korean War), crept up to around 16 percent by the mid 1960s, rose further to 21 percent by 1972 and then fell back to 12.5 percent of total debt (5.2 percent of GDP) in 1974, following the pre-oil shock commodity boom.

As late as 1970, the Official Yearbook was still able to publish tables (see exhibit 6) allocating the public debt to activities. Only 12 percent of this debt was termed "non-productive".

A notable feature of this period was the slow breakdown in the apparent need to report an excess of government revenue over non-works expenditure. Exhibit 5 indicates expenditure excesses in 1958, 1963 and 1964. From 1 April 1964, expenditures in the Consolidated Fund, the Social Security Fund and the Gas Industry account were consolidated into the Consolidated Revenue Account. It is possibly not coincidental that this distinction was dropped as these accounts would have moved into chronic large deficits.

Post 1973

As is well-known, New Zealand responded to the 1973 oil shock with large deficits in the balance of payments and in the government accounts. They were largely financed by overseas (non-New Zealand dollar) public borrowing, under the fixed but adjustable exchange rate system.

The debt and deficit problems were compounded by the fiscal cost of the 'Think Big' expenditures in the 1980s. By 1985 the external public debt was back up to over 50 percent of total public debt and the total public debt peaked during this period at 77 percent of GDP in 1987. Real gross debt per capita rose only 15 percent from 1974 to 1980 but then rose 80 percent to a 1987 peak of \$15,995 in 1993 dollars. Since then these figures have been reduced.

Large fiscal deficits on current account have prevailed during this period, although high rates of inflation have created measurement difficulties. It would be fair to say that developments in these years led to increasing dissatisfaction, amongst experts, with the quality of the Crown's accounts. By the early 1980s, the Budget tables did not:

- have to conform tightly to any external accounting standards;
- distinguish between current and capital expenditures;
- incorporate accrual accounting principles, for example expenditures on frigates financed by leasing arrangements would not necessarily be reflected in government expenditure, unless the subsequent lease payments were classified as expenditure rather than debt payments;
- relate debt to assets; and
- present a balance sheet.

The increased emphasis during the mid-1980s on an IMF-based classification of the public accounts reflected expert dissatisfaction with the traditional table 2 format. These accounts, while still being cash-flow based, did distinguish between current and capital expenditures and did have an external agency which was responsible for attempting to get a degree of cross-country conformity into the statistical classifications used for common items of expenditure.

Subsequent developments have vastly improved even that situation, so that New Zealand now arguably enjoys the most transparent and comprehensive accounting system in its history. This is not to rule out the possibility of further improvements.

Concluding Comments

The following main points appear to arise from the foregoing survey:

- the data strongly suggest that past New Zealand governments felt constrained to present accounts showing that current year revenues exceeded non-capital expenditures, except in the

most recessionary years. However, these accounts no doubt represented a partial view of the total of central government activities on current account;

- periods of sharply increasing public debt have arisen from war expenditures or capital expenditure shocks, rather than from current account shocks (e.g. the land wars, Vogel, World Wars I and II and 'Think Big');
- the gross public debt has ranged enormously, from over 200 percent of GDP to 42 percent, since 1918, but it has kept within the range of \$6,000 per capita to \$16,000 per capita since 1890 (in 1993 dollars). Per capita debt on this basis was at the high end of this range in 1946 (after World War II) and in 1987 (after 'Think Big');
- the currency composition of the public debt has varied greatly since the 1840s, reflecting an early reliance on the London market, considerable recourse to domestic savings during the world wars, the flexibility introduced by a growing domestic savings market, the Labour government's shattering confrontation with external capital market disciplines in 1938, and the recourse to large balance of payments deficits following the 1973 oil price shock;
- it appears that there have been only three occasions in the history of New Zealand in which the nominal gross public debt has been reduced in any financial year. In two cases (1891/92 and 1922/23) the reduction was around £0.1 million, in 1988 it was substantial. The important reductions in the real debt burdens which have occurred after peaks in indebtedness have arisen from a combination of inflation and the growth in population and in incomes per capita. Inflation is an off-budget tax, so the public finance accounts of the time understate the underlying fiscal surpluses during such periods;
- legislative attempts to provide for reductions in the public debt in 1910 and 1925 were not notably successful, although the sinking fund concept has clearly commanded some support and significant amounts were built up in these funds from time to time. It appears that the sinking fund approach had more support where debt was not backed by assets which could service that debt;
- until the 1970s there was a longstanding tradition of relating public debt to activities, according to the debt servicing capabilities of those activities. It is clear from parliamentary debates and from the 1930 Official Yearbook that there was also a consciousness of the need to measure debt levels against the value of assets while allowing the burden of the debt to be extinguished during the future life of those assets;

- official material on the public finances which used to be put into the public domain included comparative data on Australian and New Zealand debt levels and what appear to be secondary market price ranges for New Zealand stock in London (e.g pages 651 and 644 of the 1930 Official Yearbook); and
- arguably, the moves in the last 10 years to improved and more comprehensive public accounts reflect as much a return towards past concepts of transparency and accountability as a path-breaking new direction.

Appendix 2

US Experience with Balanced Budget Constraints

This appendix comments on the experiences in the United States at federal level with the Gramm-Rudman-Hollings Act and at state level with balanced budget and other statutory fiscal limitations.

The Gramm-Rudman-Hollings Act

The Gramm-Rudman-Hollings Act (formally known as the Balanced Budget and Deficit Reduction Act of 1985) mandated a balanced budget within five years, leaving no outs or exceptions. Today, nine years later, the US budget deficit is still massive. Senator Warren Rudman of New Hampshire, one of the act's original sponsors, has personally repudiated the legislation.¹⁰

The initial bill required five-yearly sequential across-the-board reductions in federal spending, until the deficit was reduced to zero. If the specified reductions were not made in any year, automatic, across-the-board budget cuts were to take effect. Congress, in effect, passed the legislation to force itself to address the deficit issue. The automatic cuts were designed to give the President and Congress a hitherto absent incentive to make painful political decisions.

The Act encountered several problems from the start. First, the final version of the Act exempted much of the budget from these automatic cuts. Transfer payments and social security, for instance, were to be treated as sacrosanct. Few doubted the necessity of such exemptions, but it turned out that only 27 percent of the budget – mostly defence spending – was fully available for the automatic cuts.

The second problem was that the Act could only specify that the budget be balanced *ex ante*, at the time the budget was proposed. Congress, with the cooperation of the President, simply ignored the Act by pretending that the budget was meeting the true target when in fact it was not.

Fiscal year 1987 was the first year when the Act applied in full force. President Reagan submitted a budget that came in at \$143.6 billion, just below the mandated target. This figure was reached by the now-famous method of "blue smoke and mirrors." The government sold assets, postponed pay raises, deliberately under-estimated agricultural payments and engaged in other forms of creative accounting. The first-year goal was met, although the actual deficit came in more than \$30 billion higher.

¹⁰ Suits and Fisher, (1985).

Meeting the mandated budget for the next year, fiscal 1988, was even more difficult. President Reagan proposed a budget that met the target only by making wildly unrealistic assumptions. The target for that year was \$108 billion. Unable to reach this number with any kind of plausible budget, Congress, with the blessing of the President, redefined the target to \$144 billion. The inability of the President and Congress to adhere to budgetary limits is often cited as one reason for the stock market crash of October 1987.

The proposed deficit for fiscal year 1989 involved even more ridiculous assumptions and projections. With the further use of smoke and mirrors, Congress and the President drew up a budget that supposedly met the \$136 billion target. By year's end the official deficit was \$152 billion; the actual amount of money the government had to borrow to meet the 'real' deficit was \$265 billion.

The Gramm-Rudman-Hollings charade effectively came to an end with the Budget Enforcement Act of 1990. With this legislation, Congress revised the deficit-cutting schedule once again, this time even more drastically, redefined what counted as government spending, and revoked the so-called 'across-the-board' provision of Gramm-Rudman-Hollings (which was only 27 percent to begin with). Gramm-Rudman-Hollings was now a dead letter. The lesson: if a government is not imbued with fiscal discipline in the first place, attempts to enforce such discipline will not merely be ineffective, they will be counter-productive.

US Experience at State Level

Related problems with the balanced budget requirement can be found in the experience of the American states. No nation in the world has a balanced budget requirement, but many of the American states do. 18 of the 50 American states have constitutional or statutory requirements that the budget be balanced as proposed. 20 states require that nascent deficits be eliminated by fiscal policy before year's end. The remaining states have constitutional debt limitations. In effect, all of the states but Vermont are effectively forced to balance their budgets, at least on paper.

These balanced budget requirements have not ensured healthy fiscal policy among the states. State policies have horrified those who take a fiscally conservative position and favour minimal government intervention. In nearly all states revenues and expenditures are frequently reclassified to give the budget an illusory balance. Pennsylvania alone has created 2500 off-budget enterprises.

The state-level balanced budget requirements have not decreased or even reined in the costs of government. Most government growth in America over the last fifteen years has come at the state level, precisely where balanced budget requirements have been in effect. State taxation and

expenditures have risen dramatically, without any notable improvements in fiscal efficiency. In fact, state after state has faced fiscal crises that required exorbitant tax hikes. In both New Jersey and California, these tax increases have seriously exacerbated initially negative economic conditions.

A number of particular state episodes illuminate the problems with fiscal constitutions. The state of Michigan, for instance, approached bankruptcy in the early to mid 1980s, even though the budget was nominally balanced. The state of New York has also run massive true deficits, again despite a nominal budget balance. Each of these states used budgetary legerdemain and reclassification of items into off-budget categories.

One study which examined the 1967-77 period found that state-level off-budget enterprises had increased by 285 percent over that period, nearly twice the 145 percent growth in state spending over the same time.

The increase in off-budget expenditures has been particularly pronounced in states that have had severe expenditure or taxation restrictions. In the 1970s, for instance, five states - Montana, Indiana, Kansas, Minnesota, and Wisconsin - enacted relatively stringent constitutional restrictions on taxes and expenditures. Between 1972 and 1978, off-budget debt increased by 249 percent for these states, against a comparable rate of 112 percent previously. States with no such restrictions experienced much slower rates of growth for off-budget debt.

The experience of New York City casts further doubt on the enforceability of constitutional fiscal restrictions. New York City is famous for the state of bankruptcy it reached in the 1970s, and for its fiscal crises that have continued to this day. At the peak of the crisis in the 1970s, the City could not pay its bills or obtain credit from any source whatsoever. Only a bailout from the state government kept the City government afloat at all.

It is less well known, however, that New York City has had a ostensibly strict fiscal constitution for most of its existence. The City is "required" to maintain a balanced budget, which prohibits borrowing to finance current expenditures. All long-term municipal debt issues must be approved by referenda, and total debt cannot exceed 10 percent of the total value of taxable real estate.

Yet these restrictions did not halt the fiscal decline of the City. Off-budget expenditures grew continually. Furthermore, the City frequently amended its constitution to exempt certain items - such as water supply, docks, rapid transit, housing, hospitals, and schools - from the limits. Perhaps most disastrously, New York City used its off-budget agencies to finance current expenditures. In many cases current expenditures were reclassified as "capital expenditures" without any real justification or argument. When the crunch finally came, the City found itself

unable to control or even track many of its fiscal problems, which were now scattered and hidden in various ways. Clearly, the balanced budget restriction has not constrained New York City politicians, and only made their subsequent problems worse.

The ability to circumvent fiscal restrictions does not merely render the constraints irrelevant; the circumventions are likely to have harmful effects. When politicians take borrowing, spending or regulating off-budget, or seek accounting loopholes, transparency and accountability decline considerably. A larger portion of government activity is conducted under conditions of secrecy or without checks and oversight. The American states have had precisely these problems with their off-budget agencies, such as their credit agencies and Port Authorities.

Ironically, these effects are most harmful when the initial restrictions attempt to plug up loopholes very tightly. With few easy loopholes, those who circumvent fiscal rules must resort to especially creative means, very questionable methods of accounting and off-budget enterprises that are particularly far from government purview.

The experience of the American states also raises the question of whether fiscal restrictions can *ever* rule out off-budget solutions. Off-budget activity cannot easily be prohibited by law, precisely because the new off-budget activity is defined so as not to be an activity of government. The new off-budget agencies are legally private corporations, and as long as such corporations are not prohibited, off-budget activity will occur. The fiscal problems of American federalism result from the difficulty of constraining nominally legal activity, not from the unwillingness of constitution-makers to eliminate all of the loopholes.

Appendix 3

Survey of Public Opinion

The following questions were put to a nationally representative sample of 750 New Zealanders aged 18 years and over between 3 and 7 February 1994 by UMR Insight Ltd, as part of an omnibus telephone survey.

Excluding the undecideds, there is 81 percent agreement with the proposition that the government should be required to aim to restore New Zealand's triple A credit rating and 90 percent agreement that the government should be required to aim to balance its budget, in the sense that its current spending does not exceed its current revenue.

The relatively low proportion of undecideds was encouraging, particularly given the absence of much public debate on such targets. Reflecting this low proportion, the statistical margin for errors is so low as to put the dominance of the majority opinion beyond doubt. In particular, UMR Insight advise that the 95 percent confidence level, or margin of error, for the 81 percent figure (based on 650 respondents once the undecideds were excluded) is 3.02 percent. For the 90 percent figure the 95 percent confidence level is 2.21 percent, based on the adjusted sample size of 710.

In short, an overwhelming majority favours each of these two objectives. Support for the balanced budget target was stronger than for the rating target, as indicated by the smaller proportion of undecideds (5 percent versus 13 percent) and the higher level of support (90 percent versus 81 percent) amongst those who did express a view.

Of course it is not possible to infer any conclusions from these responses as to what sacrifices, or trade-offs, the public would support in the pursuit of such goals.

GOVERNMENT SHOULD AIM TO RESTORE TRIPLE A CREDIT RATING

As you may be aware, New Zealand lost its triple A credit rating in 1983. The credit rating affects the interest rate that the government pays when it borrows overseas. Do you agree or disagree that the government should be required to aim to restore New Zealand's triple A credit rating?

	GOVT SHOULD RESTORE AAA CREDIT RATING		
	Agree	Disagree	Unsure
ALL.....	70%	17%	13%
Auckland (29%).....	69%	19%	12%
Provincial (48%).....	70%	16%	14%
Christchurch (12%).....	75%	10%	16%
Wellington (11%).....	69%	21%	10%
SEX			
Male (49%).....	68%	20%	12%
Female (51%).....	71%	13%	15%
AGE			
Under 30 (22%).....	76%	13%	11%
30-50 (46%).....	70%	19%	11%
Over 50 (32%).....	65%	15%	19%
OCCUPATION			
Professionals, managers (16%)...	71%	21%	8%
Technicians, associate professionals (8%).....	68%	22%	10%
Clerks (7%).....	80%	9%	11%
Service and sales workers (10%)...	69%	19%	12%
Blue collar (21%).....	72%	16%	12%
Students (3%).....	66%	13%	21%
Retired (18%).....	66%	11%	23%
Not employed (8%).....	62%	19%	18%
Homemaker (5%).....	70%	22%	8%
Self employed (5%).....	79%	14%	6%
MAIN BREADWINNER INCOME			
\$15,000 or less (20%).....	64%	15%	21%
\$15-25,000 (16%).....	72%	15%	13%
\$25-35,000 (21%).....	75%	13%	12%
\$35-45,000 (16%).....	61%	27%	12%
\$45-55,000 (10%).....	78%	18%	4%
\$55,000 + (9%).....	79%	16%	5%
National voters (32%).....	76%	14%	10%
Labour voters (23%).....	72%	13%	15%
Alliance voters (23%).....	65%	22%	13%
NZ First voters (7%).....	69%	17%	15%
Soft/undecided voters (14%).....	72%	13%	15%
Union members (20%).....	71%	14%	14%
Employed non-union (46%).....	73%	19%	9%

GOVERNMENT SHOULD AIM TO BALANCE ITS BUDGET

Do you agree or disagree that as a general rule a government should be required to aim to balance its budget, that is, to ensure that its current spending does not exceed its current earnings?

	GOVT SHOULD BALANCE BUDGET		
	Agree	Disagree	Unsure
ALL.....	85%	9%	5%
Auckland (29%).....	84%	12%	4%
Provincial (48%).....	87%	7%	6%
Christchurch (12%).....	87%	10%	3%
Wellington (11%).....	80%	13%	7%
SEX			
Male (49%).....	85%	11%	5%
Female (51%).....	86%	8%	6%
AGE			
Under 30 (22%).....	83%	13%	5%
30-50 (46%).....	88%	7%	5%
Over 50 (32%).....	84%	9%	6%
OCCUPATION			
Professionals, managers (16%)...	90%	7%	3%
Technicians, associate professionals (8%).....	77%	20%	3%
Clerks (7%).....	80%	13%	7%
Service and sales workers (10%)...	87%	11%	1%
Blue collar (21%).....	84%	9%	8%
Students (3%).....	83%	17%	0%
Retired (18%).....	86%	7%	7%
Not employed (8%).....	89%	3%	7%
Homemaker (5%).....	85%	10%	5%
Self employed (5%).....	94%	3%	3%
MAIN BREADWINNER INCOME			
\$15,000 or less (20%).....	88%	5%	6%
\$15-25,000 (16%).....	83%	11%	6%
\$25-35,000 (21%).....	89%	7%	4%
\$35-45,000 (16%).....	85%	9%	6%
\$45-55,000 (10%).....	85%	13%	3%
\$55,000 + (9%).....	87%	8%	5%
National voters (32%).....	88%	8%	3%
Labour voters (23%).....	86%	10%	4%
Alliance voters (23%).....	83%	10%	7%
NZ First voters (7%).....	87%	6%	7%
Soft/undecided voters (14%).....	84%	8%	7%
Union members (20%).....	88%	6%	6%
Employed non-union (46%).....	84%	12%	4%

Table 2

Central Government Gross Public Debt

At 31-Mar	Nominal Public Debt \$m	Nominal Public Debt per capita \$	Real Public Debt per capita 1993 \$	Ratio Public Debt to GDP %
1874	\$26.73	\$77.49	\$2,979	
1875	\$34.80	\$93.97	\$3,930	
1876	\$37.36	\$93.98	\$4,156	
1877	\$41.38	\$96.99	\$4,170	
1878	\$45.22	\$98.72	\$4,526	
1879	\$47.92	\$99.40	\$4,845	
1880	\$57.17	\$112.67	\$5,365	
1881	\$59.32	\$111.08	\$5,456	
1882	\$60.47	\$109.89	\$5,577	
1883	\$62.77	\$110.70	\$5,808	
1884	\$65.72	\$112.47	\$6,055	
1885	\$71.58	\$118.88	\$6,630	
1886	\$75.17	\$121.16	\$6,945	
1887	\$76.45	\$121.35	\$7,295	
1888	\$76.65	\$119.83	\$7,203	
1889	\$76.97	\$118.50	\$6,608	
1890	\$77.33	\$117.44	\$6,793	
1891	\$77.66	\$116.48	\$6,676	
1892	\$77.43	\$114.87	\$6,549	
1893	\$78.51	\$113.98	\$6,330	
1894	\$79.65	\$112.43	\$6,212	
1895	\$80.77	\$111.39	\$6,186	
1896	\$86.10	\$116.76	\$6,451	
1897	\$88.73	\$118.41	\$6,475	
1898	\$89.93	\$117.62	\$6,180	
1899	\$93.88	\$120.50	\$6,556	
1900	\$95.75	\$120.82	\$6,443	
1901	\$99.18	\$121.13	\$6,272	
1902	\$105.93	\$128.48	\$6,496	
1903	\$111.80	\$132.22	\$6,716	
1904	\$115.04	\$132.23	\$6,717	
1905	\$119.82	\$133.87	\$6,493	
1906	\$124.38	\$135.11	\$6,436	
1907	\$128.36	\$135.16	\$6,497	
1908	\$132.91	\$136.53	\$6,562	
1909	\$141.88	\$141.78	\$6,908	
1910	\$149.78	\$146.04	\$7,019	
1911	\$162.16	\$155.07	\$7,521	
1912	\$168.71	\$157.69	\$7,413	
1913	\$180.12	\$164.27	\$7,557	

Table 2 (ctd)

Central Government Gross Public Debt

At 31-Mar	Nominal Public Debt \$m	Nominal Public Debt per capita \$	Real Public Debt per capita 1993 \$	Ratio Public Debt to GDP %
1914	\$199.46	\$177.20	\$7,816	
1915	\$200.12	\$174.77	\$7,195	
1916	\$219.27	\$190.62	\$7,357	
1917	\$259.67	\$225.95	\$7,898	
1918	\$301.68	\$261.71	\$8,081	172.6
1919	\$352.15	\$301.89	\$8,604	160.7
1920	\$402.34	\$333.16	\$8,229	164.7
1921	\$412.65	\$329.54	\$8,250	150.0
1922	\$438.11	\$341.33	\$9,581	162.6
1923	\$437.91	\$333.93	\$9,373	154.3
1924	\$443.23	\$332.25	\$9,326	148.6
1925	\$455.63	\$335.02	\$9,127	141.3
1926	\$477.71	\$342.43	\$9,329	147.7
1927	\$491.70	\$346.06	\$9,569	152.0
1928	\$502.79	\$348.30	\$9,631	149.6
1929	\$528.38	\$361.82	\$10,004	149.9
1930	\$534.77	\$361.81	\$10,312	156.9
1931	\$552.07	\$368.43	\$11,376	185.0
1932	\$511.50	\$336.97	\$11,148	206.9
1933	\$512.90	\$335.20	\$11,717	226.0
1934	\$553.20	\$358.60	\$12,303	217.9
1935	\$508.80	\$327.35	\$10,829	187.5
1936	\$512.70	\$327.55	\$10,462	164.9
1937	\$523.00	\$331.27	\$9,899	136.1
1938	\$528.00	\$331.19	\$9,587	124.9
1939	\$555.60	\$344.80	\$9,678	119.9
1940	\$593.40	\$363.28	\$9,754	119.3
1941	\$646.50	\$395.24	\$10,170	120.9
1942	\$718.40	\$440.62	\$11,031	124.6
1943	\$875.30	\$533.66	\$13,009	132.0
1944	\$1,001.10	\$611.33	\$14,708	135.5
1945	\$1,074.50	\$645.51	\$15,332	144.0
1946	\$1,136.30	\$664.24	\$15,577	145.1
1947	\$1,156.80	\$653.45	\$14,763	139.2
1948	\$1,156.20	\$639.63	\$13,466	122.7
1949	\$1,230.00	\$667.11	\$13,886	128.7
1950	\$1,287.80	\$684.52	\$13,491	120.5
1951	\$1,334.50	\$695.80	\$12,277	98.2
1952	\$1,307.30	\$667.42	\$10,942	92.8
1953	\$1,335.40	\$664.54	\$10,433	90.5

Table 2 (ctd)

Central Government Gross Public Debt

At 31-Mar	Nominal Public Debt \$m	Nominal Public Debt per capita \$	Real Public Debt per capita 1993 \$	Ratio Public Debt to GDP %
1954	\$1,408.70	\$683.38	\$10,210	86.3
1955	\$1,457.20	\$692.00	\$10,095	80.4
1956	\$1,470.40	\$683.81	\$9,670	77.0
1957	\$1,514.20	\$690.12	\$9,541	75.5
1958	\$1,564.20	\$696.41	\$9,215	72.8
1959	\$1,633.10	\$710.41	\$9,077	72.9
1960	\$1,689.00	\$720.07	\$9,137	70.5
1961	\$1,736.30	\$727.09	\$9,040	67.6
1962	\$1,807.70	\$740.44	\$8,966	65.2
1963	\$1,934.30	\$774.23	\$9,194	64.3
1964	\$2,021.70	\$792.79	\$9,122	61.6
1965	\$2,139.60	\$822.54	\$9,180	59.5
1966	\$2,256.00	\$852.22	\$9,233	58.2
1967	\$2,412.00	\$894.89	\$9,159	59.6
1968	\$2,616.60	\$956.00	\$9,371	61.9
1969	\$2,776.50	\$1,004.85	\$9,355	61.9
1970	\$2,887.10	\$1,033.67	\$9,033	58.3
1971	\$3,007.00	\$1,062.06	\$8,408	53.4
1972	\$3,186.60	\$1,108.19	\$8,212	48.0
1973	\$3,503.10	\$1,196.54	\$8,210	46.0
1974	\$3,734.50	\$1,250.50	\$7,722	42.2
1975	\$4,199.70	\$1,378.31	\$7,423	43.1
1976	\$5,557.90	\$1,794.32	\$8,269	49.3
1977	\$6,289.20	\$2,015.32	\$8,116	46.2
1978	\$7,483.80	\$2,391.83	\$8,604	49.9
1979	\$8,819.50	\$2,818.54	\$8,911	52.0
1980	\$10,346.40	\$3,297.13	\$8,904	52.3
1981	\$11,617.10	\$3,691.84	\$8,647	50.3
1982	\$14,381.40	\$4,548.05	\$9,168	51.4
1983	\$18,732.80	\$5,868.30	\$11,015	59.4
1984	\$21,878.70	\$6,791.04	\$12,016	62.7
1985	\$28,246.30	\$8,683.69	\$13,306	71.5
1986	\$32,002.20	\$9,782.12	\$13,432	70.4
1987	\$42,471.90	\$12,960.60	\$15,995	77.1
1988	\$39,068.00	\$11,825.89	\$13,720	63.1
1989	\$39,721.00	\$11,974.98	\$13,275	59.8
1990	\$44,346.50	\$13,316.62	\$14,048	61.6
1991	\$43,935.00	\$13,066.17	\$13,421	60.3
1992	\$47,105.00	\$13,829.19	\$14,023	63.6
1993	\$47,320.00	\$13,745.82	\$13,746	61.8

Table 2 (ctd)

Central Government Gross Public Debt

Sources:

- Debt: To 1932, Prichard, table 10, page 407 and table 30 page 428.
From 1932, primarily page 1064 of the 1970 Official Yearbook.
- Population: From 1874-1889, interpolated census data from page 127 of the 1990 Official Yearbook.
From 1889-1918, Prichard, table 23, page 418.
From 1918, primarily page 1047 of the 1970 Official Yearbook.
From 1983, Official Yearbook data is on a calendar year average basis.
- CPI: Prior to 1891, source is CS First Boston, based on the McIlraith and Rousseaux Series.
From 1891, the primary source is page 614 of the 1990 Official Yearbook.
- GDP: Unofficial, long-term series supplied by the NZIER.

Notes:

- (1) Debt data is 31 December basis before 1890 and 30 June from 1990.
- (2) Population data is typically on a year ended March basis.
- (3) Given the discontinuities in these series and other data limitations, the above table is indicative of trends and orders of magnitude, rather than a precise measure of the latter.

New Zealand as a Crown Colony 1840-1852

TABLE 16 (A).

GOVERNMENT EXPENDITURE ON CAPITAL ACCOUNT 1840-1847 (£)

Item	1840	1841	1842	1843	1844	1845	1846	1847
1. Land purchases and charges on sales	152	1,511	1,455	113	1,045	—	471	3,030
2. Land claims commission	327	2,174	2,754	2,525	2,505	714	25	871
3. Public works	3,304	11,716	7,630	2,918	3,467	2,808	2,537	26,677
4. Charges on receipts in aid of	—	—	—	1,000	—	—	6,807||	3,738||
Total Capital Expenditure	5,864*	15,933**	17,193†	8,290††	7,017	4,833‡	10,164§	35,652¶
Total Current Expenditure	15,877	24,168	34,503	28,457	31,407	33,008	43,212	52,993
Total Expenditure	21,741	40,101	51,696	36,747	38,424	38,841	53,376	88,645

* Includes special establishment expenses £2,081.

** Ditto £532.

† Immigration expenses £3,929 and £1,425 for purchase of printing press.

†† Immigration expenses £1,734.

‡ £1,311 on account of New Zealand Company.

§ £324 for New Zealand Company settlements.

|| Interest at 8 percent on certificate and debentures.

¶ Payment for buildings and furniture £1,336.

It should be noted that in addition to cash paid in 1840, 1841, 1842, 1843 and 1844, the Government made over stores to the Maoris for land purchases valued at £215 in 1840, £776 in 1842 and £17 in 1843.

Source: C.C. Statistics of New Zealand.

Appendix

TABLE 10.

PUBLIC FINANCE. 1874 TO 1895

Calendar Year	Revenue		Total	Expenditure		Surplus (+) or Deficit (-)	Public Debt
	Ordinary	Territorial		Out of Revenue	Out of Loan		
	£000	£000	£000	£000	£000	£000	£000
1874	1,917	1,150	3,068	2,960	2,725	107	13,366
1875	2,125	688	2,813	3,431	3,107	- 618	17,400
1876	2,430	1,149	3,580	4,305	2,066	- 725	1,867
1877	2,340	1,575	3,916	3,882	1,827	33	20,691
1878	2,658	1,509	4,167	4,365	1,287	- 197	22,608
1879	2,816	318	3,134	3,845	1,973	- 710	23,958
1880	2,895	389	3,285	4,019	2,228	- 734	28,783
1881	3,206	550	3,757	3,675	1,069	81	29,659
1882	3,408	508	3,917	3,824	921	92	30,235
1883	3,470	401	3,871	3,924	1,191	- 52	31,385
1884	3,280	427	3,707	3,853	1,565	- 146	32,860
1885	3,464	395	3,859	4,045	1,178	- 185	35,790
1886	3,349	338	3,688	4,170	1,583	- 482	37,587
1887	3,141	321	3,463	3,954	1,572	- 490	38,225
1888	3,779	330	4,109	3,962	824	146	38,325
1889	3,635	356	3,991	3,981	515	10	38,483
1890	3,843	364	4,208	4,081	398	126	38,802
1891	3,804	341	4,146	4,135	518	19	38,844
1892	4,039	349	4,389	4,044	488	344	39,182
1893	4,063	344	4,407	4,170	852	237	39,729
1894	3,965	316	4,281	4,266	600	15	40,386
1895	4,264	291	4,556	4,370	972	185	43,050

Source: New Zealand Official Year Books (including 1896).

Note: Revenue and expenditure figures from 1891 are for financial year ending 31st March of year following.

For public debt prior to 1880 figures are for calendar years and after, for years ending following year. Public debt includes debentures and stock in circulation.

*An Economic History of New Zealand*TABLE 110.
EXPENDITURE ON REPRODUCTIVE AND NON-REPRODUCTIVE
UNDERTAKINGS 1891-1915

Head of Expenditure	Up to March 31st, 1891 £000	Since March 31st, 1891 £000	Total to March 31st, 1915 £000
A Directly Reproductive Undertakings			
Railways	14,580	13,841	29,128
Telegraphs and Telephones	769	1,439	2,385
Lighthouses and Harbours	484	128	623
Tourists and Health Resorts	—	168	174
State Coal Mines	—	225	228
Development of Water-power	—	218	259
Total	15,833	16,023	32,798
B Investments			
Advances to Settlers		8,677	9,355
Advances to Workers		2,536	2,507
Advances to local authorities		2,568	2,775
Land for settlements		7,230	7,317
Native Land Settlement		929	1,033
Guaranteed Mining Advances		15	23
Opening up Crown Lands		251	303
Hauraki Plains Settlement		100	109
Rangitaiki Drainage		45	62
Purchase of Native Lands	1,546	1,169	2,715
Loans to Local Bodies	325	3,182	3,507
Investment in N.Z. Consols	—	475	475
Bank of New Zealand pref. shares	—	500	875
Reserve Fund Securities	—	800	800
Total	1,871	28,481	31,885
C Indirectly Productive			
Roads, bridges, land improvement	5,106	2,969	8,434
Immigration	2,459	62	2,542
Development of gold fields and coal mines	571	325	898
Total	8,136	3,358	11,874
D Unproductive			
Public Buildings	1,800	4,643	6,708
Maori War	2,357	—	2,357
Defence	1,638	2,082	3,731
Scenery-preservation		74	84
Deficiencies, charges and expenses of raising loans	7,195	1,261	8,622
Total	12,990	8,061	23,052
GRAND TOTAL	38,830	55,923	100,059

Source: New Zealand Official Year Book, 1915.

Note:

1 The total for investments includes £14,000, advances to the kauri-gum industry and £11,500 advances to the fruit preserving industry.

2 The grand total includes £237,400 raised for redemption of debt.

TABLE 31.

REVENUE AND EXPENDITURE OF GENERAL GOVERNMENT

Year ended 31st March	Consolidated Fund			Payments Totals	Public Works Fund	
	From Taxation	Receipts From	Totals		Receipts	Payments
	Other Sources					
	000 £	000 £	000 £	000 £	000 £	000 £
1890	2,090	2,176	4,267	4,256	83	482
1891	2,173	2,322	4,496	4,369	4	334
1892	2,179	2,248	4,428	4,417	216	391
1893	2,339	2,330	4,669	4,324	215	462
1894	2,353	2,339	4,692	4,455	418	406
1895	2,300	2,147	4,447	4,352	353	504
1896	2,335	2,220	4,556	4,370	162	575
1897	2,521	2,276	4,798	4,509	540	601
1898	2,678	2,400	5,079	4,602	759	865
1899	2,707	2,551	5,258	4,858	935	916
1900	2,891	2,808	5,699	5,140	1,062	993
1901	3,042	2,864	5,906	5,479	1,401	1,309
1902	3,113	3,039	6,152	5,914	2,364	2,143
1903	3,277	3,169	6,447	6,214	1,398	1,514
1904	3,649	3,480	7,130	6,434	1,875	1,796
1905	3,754	3,592	7,347	6,635	1,908	1,354
1906	3,841	3,808	7,650	7,122	1,555	1,811
1907	4,264	4,214	8,478	7,774	1,918	2,168
1908	4,645	4,418	9,063	8,213	1,846	2,109
1909	4,377	4,623	9,001	8,785	3,628	3,363
1910	4,180	5,058	9,238	8,990	2,093	2,216
1911	4,837	5,459	10,297	9,343	3,396	2,058
1912	5,296	5,764	11,061	10,340	1,256	2,340
1913	5,606	6,127	11,734	11,082	3,300	2,548
1914	5,918	6,311	12,229	11,825	3,478	2,760
1915	5,880	6,571	12,451	12,379	2,224	2,737
1916	7,266	7,240	14,507	12,943	3,187	2,583
1917	10,549	7,805	18,355	14,058	1,105	1,775
1918	12,340	7,865	20,206	15,120	1,091	1,401
1919	13,801	8,550	22,352	18,673	1,240	1,387
1920	16,251	9,829	26,081	23,781	2,243	2,232
1921	22,184	12,076	34,260	28,068	5,012	3,658
1922	16,370	11,756	28,127	28,466	9,792	6,875
1923	15,594	11,985	27,579	26,263	3,968	4,729
1924	16,416	11,543	27,960	26,148	4,275	4,658
1925	16,172	12,470	28,643	27,399	4,833	5,482
1926	16,978	7,747	24,725	23,570	5,956	5,874
1927	16,899	8,043	24,943	24,355	5,931	5,505
1928	16,848	8,275	25,123	24,944	5,464	5,212
1929	17,832	5,767	23,599	24,176	9,028	5,696
1930	19,471	5,878	25,349	25,200	2,339	6,237
1931	18,597	4,471	23,068	24,708	7,356	6,547
1932	16,188	6,531	22,719	24,860	5,179	4,895
1933	15,604	6,964	22,568	22,528	1,958	2,277
1934	17,057	6,435	23,492	24,202	2,363	2,572
1935	20,176	5,949	26,126	24,499	3,000	2,714
1936	21,554	4,617	26,172	25,890	3,458	2,863
1937	26,939	4,207	31,147	30,675	6,743	6,601
1938	31,662	4,396	36,095	35,248	5,602	7,647
1939	32,303	4,278	36,582	35,772	11,372	11,145
1940	32,808	5,165	37,974	37,654	11,961	11,241

NOTE.—Commencing with 1925-26, railway revenue and expenditure, and with 1928-29, post and telegraph revenue and expenditure, were removed from the transactions of the Consolidated Fund. Revenue of the Consolidated Fund, however, now includes interest in respect of railway and post and telegraph capital liability, while the expenditure for the years 1925-26 to 1928-29 covers payment to the Working Railways Account in respect of losses on non-paying branch lines and isolated sections. From 1931-32, also, post and telegraph net profits are paid into the Consolidated Fund. Employment promotion taxation receipts (1930-31 to 1938-39), and social security taxation receipts (1939-40), were not paid into the Consolidated Fund.

HISTORICAL SERIES

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REVENUE AND EXPENDITURE OF CENTRAL GOVERNMENT

Year Ended 31 March	Receipts			Payments	Deficit	Surplus
	From Taxation	From Other Sources	Total			
\$(million)						
CONSOLIDATED FUND						
1920	32.5	19.7	52.2	47.6	...	4.6
1921	44.4	24.2	68.5	56.3	...	12.3
1922	32.7	23.5	56.3	56.9	0.7	...
1923	31.2	24.0	55.2	52.5	...	2.6
1924	32.8	23.1	59.9	52.3	...	3.6
1925	33.1	24.2	57.3	54.8	...	2.5
1926	34.0	15.5	49.5	47.1	...	2.3
1927	33.8	16.1	49.9	48.7	...	1.2
1928	33.7	16.6	50.2	49.9	...	0.4
1929	35.7	11.5	47.2	48.4	1.2	...
1930	39.0	11.7	50.7	50.4	...	0.3
1931	37.2	8.9	46.1	49.4	3.3	...
1932	32.4	13.1	45.4	49.7	4.3	...
1933	31.2	13.9	45.1	45.1	...	...
1934	34.1	12.9	47.0	48.4	1.4	...
1935	40.4	11.9	52.3	49.0	...	3.3
1936	43.1	9.2	52.3	51.8	...	0.6
1937	53.9	8.4	62.3	61.4	...	0.9
1938	63.3	26.3	89.6	88.0	...	1.6
1939	64.6	22.8	87.4	85.8	...	1.6
1940	65.6	28.2	93.8	93.2	...	0.6
1941	68.7	32.2	102.9	98.5	...	3.5
1942	70.3	38.7	109.1	105.8	...	3.3
1943	72.4	37.8	110.2	101.8	...	8.3
1944	84.0	31.1	115.1	110.7	...	4.5
1945	91.4	28.5	119.9	117.4	...	2.4
1946	96.7	31.1	127.8	125.3	...	2.5
1947	181.4	35.2	216.6	207.4	...	9.2
1948	192.2	42.0	234.2	230.7	...	3.6
1949	202.1	41.0	243.0	237.8	...	5.3
1950	207.7	42.3	250.0	241.4	...	8.6
1951	244.4	43.2	287.5	271.0	...	16.5
1952	313.9	47.7	361.6	336.3	...	25.3
1953	308.5	47.1	355.6	349.0	...	6.6
1954	312.4	52.2	364.6	361.0	...	3.6
1955	325.0	57.4	382.4	368.8	...	13.7
1956	334.9	60.0	394.9	386.6	...	8.3
1957	345.6	67.0	412.6	405.9	...	6.7
1958	317.9	69.3	387.2	387.5	0.3	...
1959	409.7	71.1	480.8*	480.0*	...	0.8
1960	552.9	76.8	629.7*	628.4*	...	1.3
1961	474.8	94.0	568.7*	567.9*	...	0.8
1962	508.3	93.0	601.3*	600.6*	...	0.6
1963	471.5	101.8	573.3*	581.2*	7.9	...
1964	512.6	120.6	633.2*	635.9*	2.7	...
CONSOLIDATED REVENUE ACCOUNT						
1965	783.2	120.5	903.7	894.5	...	9.2
1966	852.2	122.2	974.5	970.9	...	3.5
1967	918.8	132.5	1,051.3	1,050.6	...	0.7
1968	949.4	147.3	1,096.7	1,095.3	...	1.4
1969	992.1	162.5	1,154.6	1,146.9	...	7.7
1970	1,102.0	170.5	1,282.5	1,275.1	...	7.4

*Excludes duty on motor spirits refunded under the Transport Amendment Act \$1.9 million in 1958-59, \$4.7 million in 1959-60, \$2.0 million in 1960-61, \$0.8 million in 1961-62, \$0.8 million in 1962-63, \$0.8 million in 1963-64.

NOTE—The figures shown in the above table are not on a comparable basis over the whole period.

CONTINGENT LIABILITIES ON 31 MARCH 1969

							\$(000)	\$(000)	\$(000)
State Advances Corporation—									
Stock held by Government agencies .. .. .	..	..	..	..	..	..	342,108		
Stock held by banks, etc. .. .. .	..	..	..	..	..	..	10,823		
								352,931	
Loans for industry and other purposes .. .. .	..	..	..	..	..	..		16,143	
									369,074
Hospital boards: Stock and debentures .. .. .	..	..	..	..	..	..			95,690
Other local authorities—									
Stock, debentures and extended credits .. .. .	..	..	..	..	..	..		30,030	
Overdrafts .. .. .	..	..	..	..	..	..		61	
									30,091
Licensed trade—									
Licensing trusts: Debentures and overdrafts .. .. .	..	..	..	..	..	..		303	
Other overdrafts .. .. .	..	..	..	..	..	..		710	
Other loans .. .. .	..	..	..	..	..	..		7,350	
									8,363
Marketing authorities—									
Overdrafts .. .. .	..	..	..	..	..	..		61,800	
Loans .. .. .	..	..	..	..	..	..		968	
									62,768
Primary production: Overdrafts .. .. .	..	..	..	..	..	..			88
Secondary production—									
Timber and paper industry—									
Overdrafts .. .. .	..	..	..	..	..	..		200	
Steel industry—									
Loans and extended credits .. .. .	..	..	..	..	..	..		21,086	
Gas companies: Debentures .. .. .	..	..	..	..	..	..		1,046	
Miscellaneous—									
Overdrafts .. .. .	..	..	..	..	..	..		410	
Loans .. .. .	..	..	..	..	..	..		1,500	
									24,242
Aviation loans and extended credits .. .. .	..	..	..	..	..	..			36,318
Western Samoan Government loan .. .. .	..	..	..	..	..	..			2,000
International Finance Organisations—									
Notes portion of subscriptions .. .. .	..	..	..	..	..	..			94,801

CLASSIFICATION OF PUBLIC DEBT—A broad classification of the public debt according to nature or purpose is contained in the following table, the distinction being made on the basis of whether raised for ordinary purposes, war purposes, or housing.

Class	Gross Debt at 31 March					
	1950	1960	1966	1967	1968	1969
\$(thousand)						
Ordinary	716,534	1,170,828	1,888,012	2,089,998	2,304,496	2,456,711
Housing	114,662	239,658	289,134	299,930	312,073	319,769
War loans (1914–18)	53,514	—	—	—	—	—
War loans (1939–45)	403,052	278,546	78,819	22,026	—	—
Totals	1,287,762	1,689,032	2,255,965	2,411,954	2,616,569	2,776,480

CLASSIFICATION OF PUBLIC DEBT

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A more detailed allocation of the public debt as at 31 March 1969 is now given.

Allocation of Debt	Loan Capital	Interest on Loan Capital	Equity Capital*	Total Allocation
	\$(000)	Percent	\$(000)	\$(000)
(a) Loans and investments in trading undertakings—				
Air New Zealand Ltd.			12,600	12,600
Tasman Pulp and Paper Co. Ltd. ..	6,600	6½	4,000	
Tasman Pulp and Paper Co. Ltd. ..	1,571	4½	2,000	14,171
New Zealand Steel Ltd.†	6,000+	5½	3,343	
New Zealand Steel Ltd.	1,450	6½		10,793
New Zealand National Airways Corporation			6,500	6,500
Bank of New Zealand shares			12,656	12,656
Railways			179,265	179,265
Railways (IBRD Railway project) ..	27,898	6½		27,898
State Advances Corporation	410,523	4½		410,523
Tourist Hotel Corporation‡	8,699			
Tourist Hotel Corporation§	43	4½		8,742
State coal mines‡	28,407			28,407
Electric power	640,006	5		
Electric power (IBRD Interisland Transmission project)	25,920	5½		
Electric power (IBRD Marsden Point power project)	12,858	6½		679,784
Post Office	243,908	5		243,908
Housing under construction and land development¶	26,154	4½		26,154
Land settlement	196,308	4½		196,308
IBRD Harbour projects	5,623	5½		5,623
Natural Gas Corporation of New Zealand§	5,845	6		5,845
Earning interest but not at full rate—				
Housing Account (S.A.C.)	293,615	3		293,615
Sub-total				2,162,192
(b) Not earning interest though represented by permanent assets or development works—				
Airport development				7,842
Education buildings				83,569
Forests (State)				44,473
Roads and highways				46,206
General public works				79,461
International finance organisations—				
Cash portion of subscriptions				21,258
Sub-total				282,809
(c) Non-productive debt—				
Consolidated Revenue Account				15,119
Devaluation exchange adjustment account				39,315
Railway capital written off				140,000
Reserve Bank exchange adjustment				40,000
New loan moneys on hand—				
National Development Loans Account				56,991
Loans Redemption Account				40,054
Sub-total				331,479
Total				2,776,480

*The following dividends have been received during 1968-69.

(a) Tasman Pulp and Paper Co. Ltd. \$722,000.

(b) Bank of New Zealand \$1,429,687.

†Interest capitalised and payment deferred until such time as the industry has recovered its initial deficit and is operating profitably.

‡Interest on loan capital remitted each year.

§Wairakei Park Golf Course loan.

||Includes \$5 million being excess development costs not represented by sale value and not bearing interest.

¶Interest during construction to be capitalised.

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