New Zealand Business Roundtable

SUBMISSION

on

The Spending Cap (People's Veto) Bill

December 2011

1. Overview

1.1 This submission on the Spending Cap (People's Veto) Bill (the Bill) is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand firms. Our interest is in sound public policies reflecting overall national interests, not simply the interests of the business sector.

1.2 The Bill would require a voter referendum to approve any real per capita increase in core Crown operating spending (excluding spending on finance costs, the unemployment benefit, national emergencies and asset impairments). This referendum requirement was a central feature of the taxpayer bill of rights for New Zealand that we proposed in a 2004 research report that reviewed the international experience with expenditure control measures.

1.3 We strongly support the Bill. If it had been in place from 2004, the fiscal situation and the New Zealand economy would likely have been in much better shape today.

1.4 We also recommend strengthening the Bill. Tax revenues per capita could also be capped and excess revenues returned to taxpayers to prevent them from being frittered away. It should require a supra-majority of voters to approve increases in real per capita spending or tax burdens. Other possibilities include a ratchet mechanism for reducing the spending base from its existing inflated level and a referendum requirement for new taxes and certain changes in the tax structure.

1.5 Even a strengthened Bill would need complementary supporting arrangements. In particular there is a need for much greater discipline and transparency in the evaluation of individual spending proposals. Otherwise governments may be tempted to maintain politically expedient spending at the expense of socially valuable operating or capital spending in order to live within the spending cap. By the same logic, controls on ill-justified capital spending and the use of regulations would need to be improved if the full benefits from the Bill were to be realised.

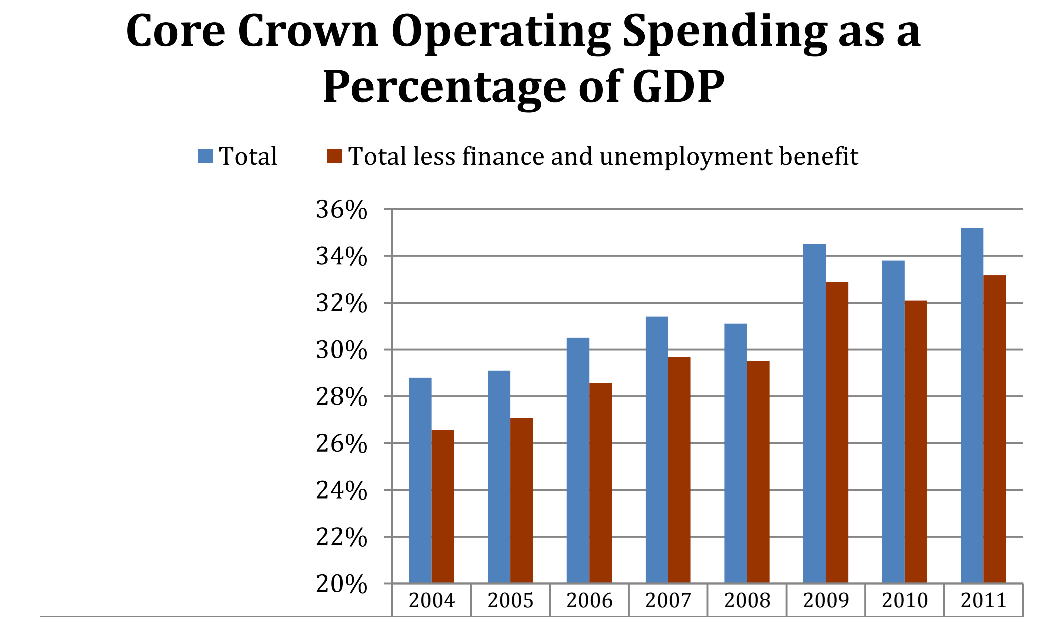
1.6 This submission assesses the Bill in the context of the big jump in government spending between 2004 and 2008. It analyses Treasury's reasons in the last page of its Regulatory Impact Statement for its opposition to the Bill and concludes that Treasury has failed to answer the question of whether the Bill would enhance the public interest if it proved to be politically sustainable. In addition, Treasury's preferred alternative for preventing a future expenditure does not seem likely to be effective. We recommend that the select committee seek greater clarity from Treasury on these aspects.

1.7 The submission calculates that the government's current spending plans to 2015-16 lie within the proposed cap, but considers that nonetheless the existence of the cap would improve national economic outcomes by increasing confidence in future spending and tax trends.

2. What can happen without this Bill: – 2004-2008

2.1 Core Crown operating spending increased from 28.8 percent of GDP in 2004 to 34.5 percent in 2009. (All the fiscal figures in this submission are for years ended June unless stated otherwise.) Excluding spending on finance charges and the unemployment benefit, the increase was an even more remarkable 6.4 percent of GDP, increasing the adjusted spending to GDP ratio from 26.5 percent in 2004 to 32.9 percent in 2009. (See chart 1.)

Chart 1



	2004	2005	2006	2007	2008	2009	2010	2011
Total	28.8%	29.1%	30.5%	31.4%	31.1%	34.5%	33.8%	35.2%
Total less finance and unemployment benefit	26.5%	27.1%	28.6%	29.7%	29.5%	32.9%	32.1%	33.2%

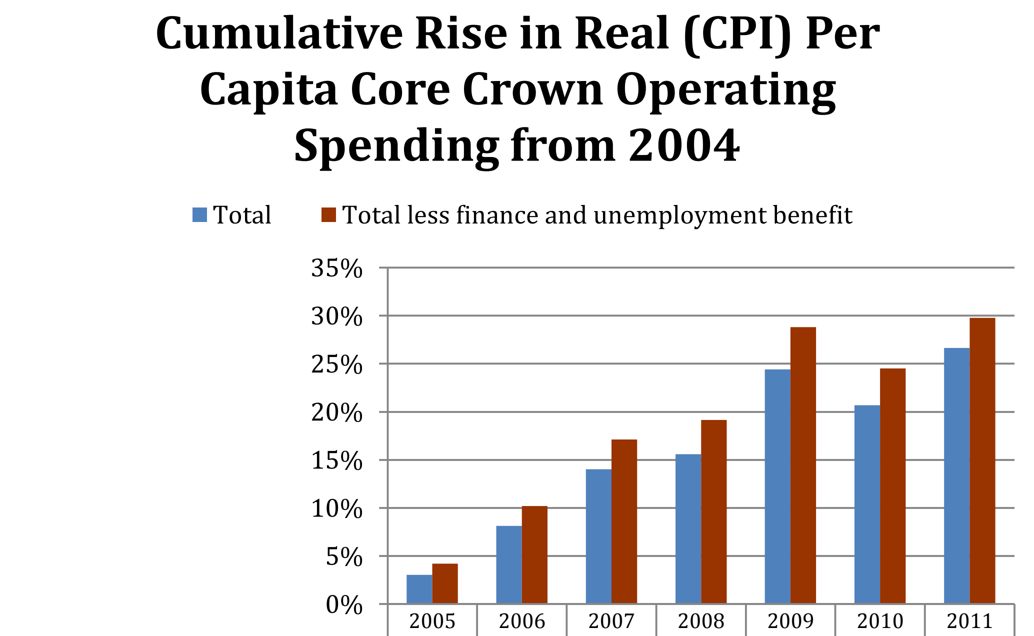
Source: Financial Statements of the Government of New Zealand, Year Ended June 2011

2.2 Between 2004 and 2009 core Crown operating spending per capita rose 24.4 percent faster than the consumers price index. Excluding spending on finance charges and the unemployment benefit it rose 28.8 percent faster than the CPI. (See chart 2.)

2.3 The dollar increase during this period was $3,336 per person (in year ended June 2011 dollars). This would be one of the largest inflation-adjusted dollar increases in per capita central government current or operating spending, excluding finance charges and unemployment benefits, in any five years in New Zealand's history.

2.4 This increase has been accompanied by a squeeze on production of tradable goods, implying a loss of international competitiveness. Economists expect there to be a link between increases in government spending on goods and services and a loss of international competitiveness if the government spending increase is concentrated on goods and services that are not traded internationally. For example, wage increases in the public sector can make it harder for the exposed sectors to compete for labour and, as monetary policy leans against the inflationary pressure, the exchange rate may be higher than it would otherwise be, further putting pressure on the exposed sector.

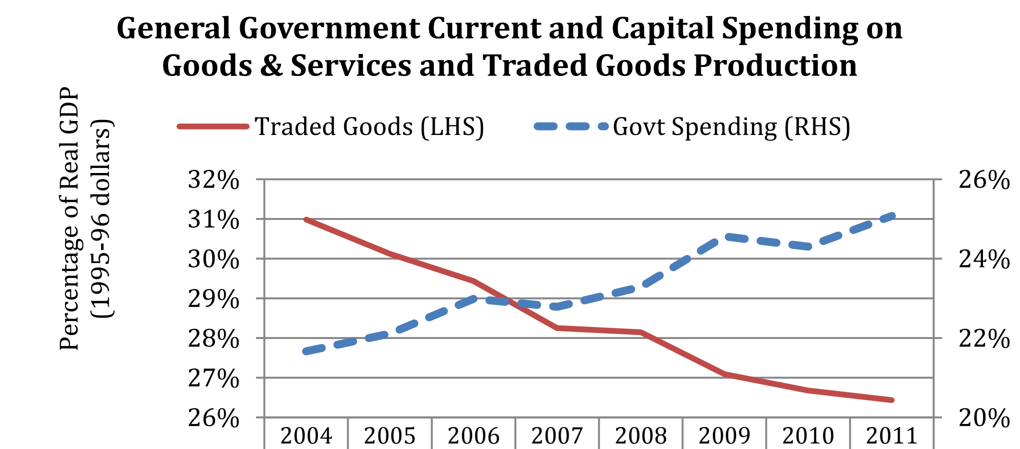
Chart 2



	2005	2006	2007	2008	2009	2010	2011
Total	3.0%	8.2%	14.0%	15.6%	24.4%	20.7%	26.6%
Total less finance and unemployment benefit	4.2%	10.2%	17.1%	19.2%	28.8%	24.5%	29.8%

2.5 Chart 3 compares the share of production of traded goods in real GDP from 2004 with the share of real general government spending on consumption and gross fixed capital formation in real expenditure on GDP. It shows that the marked rise in the share of government spending has been accompanied by a marked fall in the share of traded goods production in GDP.

Chart 3

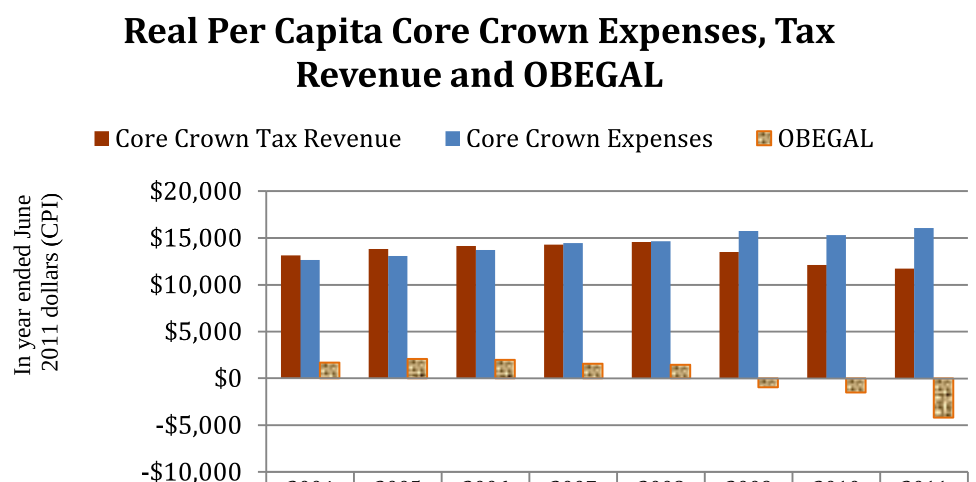


	2004	2005	2006	2007	2008	2009	2010	2011
Traded Goods (LHS)	31.0%	30.1%	29.4%	28.2%	28.1%	27.1%	26.7%	26.4%
Govt Spending (RHS)	21.7%	22.1%	23.0%	22.8%	23.3%	24.6%	24.3%	25.1%

Source: SNZ, RBNZ Classification for Traded Goods, Years Ended June

2.6 One reason for this big rise in spending in peace-time is that the money was there to spend. This was because real per capita tax revenues rose by 21 percent between the 2002 and 2008 financial years. Chart 4 shows that real tax revenues per capita dropped markedly after the 2008 financial year. Spending stayed high (partly because of the Christchurch earthquake) and it was the combination of these two factors that generated the fiscal deficit problems the country has faced since the 2008 general election. (OBEGAL in the chart is a measure of the fiscal deficit. It stands for the operating balance before gains and losses.)

Chart 4



	2004	2005	2006	2007	2008	2009	2010	2011
Core Crown Tax Revenue	$13,116	$13,803	$14,161	$14,304	$14,579	$13,467	$12,122	$11,742
Core Crown Expenses	$12,669	$13,055	$13,702	$14,445	$14,643	$15,763	$15,292	$16,045
OBEGAL	$1,686	$2,057	$1,970	$1,567	$1,448	-$959	-$1,509	-$4,190

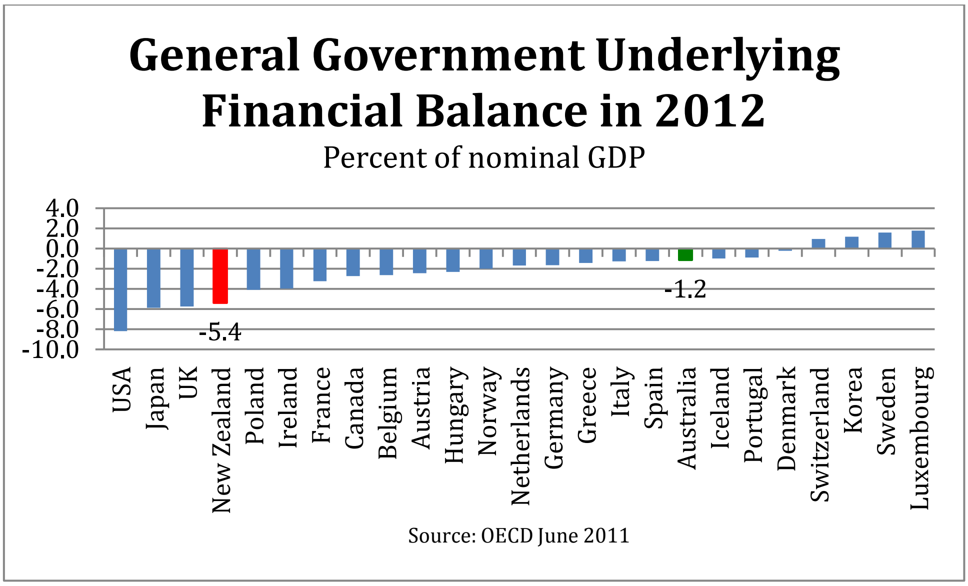
Source: Financial Statements of the Government of New Zealand, Year Ended June 2011

2.7 OECD secretariat June 2011 estimates indicate that New Zealand now has one of the largest structural fiscal deficits as a percentage of GDP in the OECD. For example, it estimates that New Zealand's general government (central and local government combined) underlying financial balance in 2012 will be 5.4 percent of potential GDP, compared to a previous high of 4.9 percent in 1986. (See chart 5.) Only three OECD countries (the USA, UK and Japan) are projected to have a higher underlying financial balance deficit to potential GDP ratio than New Zealand in 2012. Australia is in a much stronger position on this measure.

2.8 There is no external excuse for New Zealand to be in this position. Our external terms of trade (export prices relative to import prices) are very favourable in historical terms, yet New Zealand went into recession in 2008 before the full impact of the global financial crisis was felt.

2.9 It is obvious that New Zealand would not be facing the fiscal problems we face today if effective spending disciplines had been in place from 2005.

Chart 5



3. The Treasury's Regulatory Impact Analysis

3.1 The bulk of the Treasury's Regulatory Impact Statement (RIS) made a good case for the Bill. It volunteered that the loss of spending discipline during 2005-2008 was a prime cause of New Zealand's current fiscal problems.

3.2 It also considered that this contributed to New Zealand's loss of external competitiveness during this period:

> The Reserve Bank has cited fiscal policy in New Zealand as being among the factors that stimulated aggregate demand during the period of economic expansion over the mid-to-late 2000s, contributing to higher real interest rates and a higher exchange rate than would otherwise have been the case. These conditions are likely to have constrained activity in tradable sectors (which include exporting and import-competing industries) – thereby harming economic growth.

3.3 Whether because of reluctance to submit spending increases to a referendum or because voters would reject the increases, it considered that a measure like the Bill "would likely lead to smaller government than would otherwise be the case". It might have prevented much of the growth in revenue recorded in Budgets 2006-2008 from being used to fund ill-justified spending initiatives. "Depending on the mix of alternative choices, this could have meant less inflationary pressure in the economy and less pressure on monetary policy."

3.4 The RIS assesses the proposal from the viewpoints of fiscal sustainability, macroeconomic stability, simplicity, durability, property rights, the rule of law, legal soundness and constitutionality, and its assessment based on the application of each of these criteria are generally very supportive.

3.5 The RIS correctly identifies a concern that the benefits from a binding spending constraint depend on the quality of the decisions taken instead of increasing total spending. That depends of course on the nature of decision makers' incentives at the time, which depend in part on the constraints they would face if they tried to replace poor quality on-budget operating spending with poor quality regulation, capital spending or off-budget operational spending.

3.6 The RIS identifies three alternatives to the Bill for imposing greater control over the growth of spending. None of them would make use of a formal external check and balance, such as a voter referendum. They all take the form of a self-nominated, self-imposed discipline.

3.7 After this encouraging exploration of the issues and the alternatives, it was a surprise to read in the last page of the RIS that "Treasury does not support imposing constraints on the ability of the government to set fiscal strategy via hard parameters in legislation". Its first reason for this conclusion was that legislated constraints on government could lead to unintended or perverse outcomes when a government wished to circumvent them. Its second, and alternative, objection is that the Bill would not be effective if it is "likely to be overturned, shortly after its introduction, because it lacked widespread and enduring political support".

3.8 Treasury's first reason does not justify its conclusion because it does nothing to establish that the feared undesired outcomes would outweigh the likely benefits. After all, a referendum-backed rule should be effective in stopping spending increases that do not pass the test of public opinion, as the Treasury's own analysis, cited above, acknowledged. The proposed rule is surely more likely to cause some ill-justified spending proposals to be still-born than a more ineffectual rule. This is clearly a benefit. To justify recommending against a rule with this potential benefit, the Treasury must make a plausible case that in practice allowing the public to reject such spending increases would make it worse off than a softer rule that might allow spending to increase by, say, over 6 percent of GDP, as it did between 2005 and 2009. The proposition is counter-intuitive. Perhaps this is why the RIS did not attempt to articulate it. To create costs relative to a more ineffectual rule, Treasury must argue that the perverse effects from ill-justified proposals that proceed nonetheless are significantly greater than if government spending increases were less constrained. Yet, if that were so, what is the point of the Public Finance Act and Parliamentary scrutiny of the Annual Appropriations Bill? Why would they not, by the same argument, lead to perverse outcomes that outweigh the good that justifies their existence? It is very strange to see the Treasury, the key expenditure control agency, arguing, in such general terms, that rules imposing unwanted spending disciplines can be assumed to do more harm than good.

3.9 The second reason is at once a questionable political judgment, an abandonment of a duty to advise, and a counsel of despair. If a measure is in the public interest, if sustained, Treasury needs to advise its minister that this is the case. Doing so would assist the minister to assess whether it is worth committing political capital to winning the public debate about the proposal. Further, the minister is surely better placed that public servants to assess the political sustainability of a measure. The minister will also take into account the likelihood that if the measure is a good one, the public will learn about the policy's benefits from experience. Even politicians who initially opposed the measure will respond to changes in public opinion. For example, the National Party opposed GST when it was first introduced, but subsequently accepted its continuing existence. How did the RIS factor the likely experience with the Bill into its recommendation? In the absence of any guidance on these matters, the RIS seems to be proposing that any measure that is likely to be opposed in the short term by opposition parties does not merit a supporting Treasury recommendation.

3.10 Another major concern with the RIS is that, having conceded that the jump in government spending from 2005-2008 has had serious economic costs, it recommends a course of action that will fail to prevent this from happening again. If there is anything to be learnt from the 2005-2008 experience it is that a system of self-selected spending and other targets does not stop large spending increases. The current spending goal is to get operating spending down to 30 percent of GDP. Such goals may mean little in practice. The goal in the 1996 Budget Policy Statement was to "steadily reduce expenses as a percentage of GDP from current levels of around 35 percent to below 30 percent". That (unachieved) goal still applied in 1999, but the 2000 Budget Policy Statement arbitrarily replaced it with the long-term goal of holding operating expenses to "around current levels of 35 percent of GDP". Experience to date indicates that these goals are a signal to favoured constituencies about attitudes to government spending rather than an independent constraint on spending increases.

4. Supplementary arrangements

4.1 As noted above, the Bill will not be as effective as it could be unless it is strengthened and supported by supplementary arrangements aimed at making it hard to circumvent its intentions. The first point to make here is that the Bill omits some important features of the earlier taxpayer bill of rights proposals. These omissions include the requirements for:

- spending increases above the cap to be approved by a supra-majority of voters rather than a simple majority;
- increases in planned real tax revenues per capita to be subject to a similar referendum;
- excess tax revenues to be returned to taxpayers;
- a mechanism to reduce real per capita spending through time; and

- new taxes or measures that increase existing tax rates or broaden the tax base to be subject to a referendum.

4.2 A supra-majority of voters for increases in spending or taxes is needed in principle for conflict of interest reasons. (Voters who expect to benefit from a spending proposal but to contribute little or nothing to the additional taxes have a conflict of interest.) International research also indicates that a supra-majority requirement is important if the restraint is to be effective.

4.3 A cap on real tax revenues per capita with a requirement that excess revenues be returned to taxpayers would reduce the ability of governments to use windfall revenues from high nominal income growth to increase capital spending while still meeting a given public debt target. We consider that the Treasury's concern for a measure that has widespread and enduring support strengthens the case for a taxation cap as there is commonly stronger community opposition to tax increases than to spending increases.

4.4 A cap on the currently inflated level of spending does not address the problem of reducing that level of spending. The 2004 report proposed a mechanism for ratcheting down the taxation cap in recessions. This would increase the pressure on governments to restrain spending growth when economic growth resumed. In our view the quantum of wasteful and ill-justified government spending has become so large as to be a major impediment to the ability of New Zealanders to get ahead. We documented the basis for such concerns in a 2006 paper *The Dilemma of Public Spending: Getting the Quantity and Quality Right*. A 2011 book *Government versus Markets: The Changing Role of the State*, by ex IMF director of fiscal affairs, Vito Tanzi, records that New Zealand was ranked only 16th out of 23 OECD countries for public sector efficiency, based on socioeconomic outcomes per unit share in GDP of public sector spending.

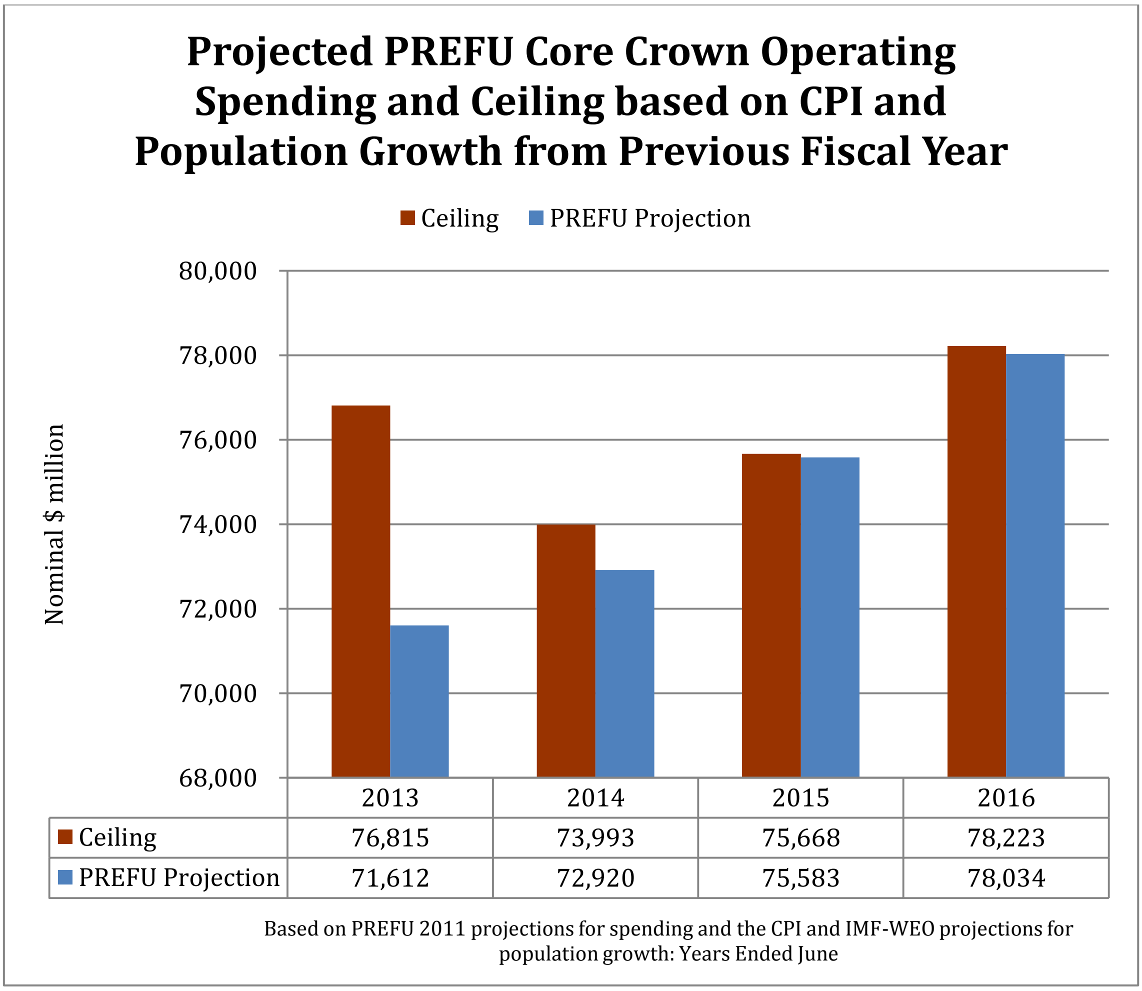
4.5 The case for submitting proposals to voters for new taxes, increases in tax rates, or broadening the tax base is less related to the need for spending control and more driven by the need to protect minority groups from being unfairly taxed by a simple political majority.

4.6 Supplementary arrangements need to increase the constraints on alternatives to ill-justified operational spending. The Regulatory Standards Bill would make it harder to get around a spending cap by regulatory means. Better arrangements for vetting capital spending would make it harder to replace poor quality operating spending by poor quality capital spending.

5. What effect would the Bill have in the short term?

5.1 Chart 6 below compares core Crown operating spending for each year from 2013 to 2016, as projected in the Pre-Election Economic and Fiscal Update 2011 (PREFU), with a ceiling for that year that is calculated by increasing PREFU core Crown operating spending in the previous year, excluding spending on finance charges and the unemployment benefit, by by the combined effect of the projected increases in the Consumers Price Index and in the population between the two years, and adding to this amount, the projected PREFU spending on the unemployment benefit and the finance charge for the year in question. (The PREFU does not apear to publish population projections so the chart uses IMF-WEO population projections for New Zealand to 2016.) The chart shows that the growth in projected spending each year is less than would be permitted in that year if an inflation and population growth rule applied to the previous year's outcome.

Chart 6



5.2 It is important to be aware that the Bill proposes a different formula for calculating the ceiling. The ceiling in the Bill would grow from an unchanged 'year 1' initial level at the product of the rates of consumer price index growth and population growth.

5.3 Since projected core Crown spending between 2012 and 2016 is projected to fall by of the order of 9 percent in real per capita terms, the government's planned spending to 2016 would lie well inside any ceiling determined by any choice of a 'year 1' level for the ceiling between 2011 and 2013. It follows that the Bill's short term effect would be mainly to boost confidence in the government's determination to keep broadly to its spending intentions and to improve fiscal disciplines beyond 2016.

5.4 While we understand the view of the 2009-2011 government that it did not need a spending cap bill because it was already disciplining spending growth, we suggest that entrenching a spending cap could help sustain private sector investment, particularly in activities most exposed to international competition, by raising confidence that the government is committed to its spending targets and reducing doubts about whether it or subsequent governments would stay the course.

6. Concluding comment

6.1 In conclusion, we strongly support the Bill but recommend that the select committee consider extending its provisions in the directions listed in paragraph 4.1 above. We also strongly urge the government to improve the disciplines applying to capital spending and regulatory initiatives, both in their own right and to improve the effectiveness of improved spending disciplines.

6.2 By making enduring fiscal discipline more credible, the Bill should help the government to rebalance the economy in favour of activities most exposed to international competition and improve economic growth prospects more generally by increasing investor confidence in the predictability of government spending and taxation policies.