



A quarter of a century of fiscal responsibility: The origins and evolution of fiscal policy governance and institutional arrangements in New Zealand, 1994 to 2018

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**A quarter of a century of fiscal responsibility:
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Abstract

The foundations for New Zealand's current fiscal policy governance and institutional arrangements were established nearly 25 years ago by the Fiscal Responsibility Act 1994 (FRA). This Act placed an emphasis on fiscal principles and reporting provisions which were regarded as world-leading fiscal reforms when first introduced. These fundamental reforms have been embraced by successive New Zealand governments, and in 2005 were incorporated into the Public Finance Act 1989. This paper traces the evolution of the principles and reporting provisions during the past quarter of a century in response to the fiscal challenges posed by intergenerational issues and population ageing, avoiding unsustainable government expenditure growth during economic booms, the coordination of fiscal and monetary policy, recognition of the economic and social importance of the Government's balance sheet, and the demands for greater transparency in fiscal policy decisions and performance. The paper concludes with a discussion of contemporary issues and challenges.

Key words: Fiscal policy, budget policy, public debt, policy institutions, transparency, credibility, sustainability.

JEL classifications: H1 Structure and scope of government; H3 Fiscal policies and behaviour of economic agents; H6 National budget, deficit and debt.

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1. Introduction

The foundations for the current institutional framework for New Zealand fiscal policy were established nearly 25 years ago by the Fiscal Responsibility Act 1994 (FRA). This Act specified the fiscal responsibility provisions which contained three dimensions. They specified a set of principles for responsible management of fiscal policy; they required regular public reporting by the government on the extent to which fiscal policy is consistent with these principles; and they provided for regular and independent economic and fiscal updates of the current economic and fiscal situation and the outlook over the medium and long terms by the Treasury, including a pre-election update.

The fiscal responsibility provisions were not prescriptive of fiscal strategy but required governments to be transparent about their objectives and intentions, whether they have changed, and how they accord with responsible fiscal management. At the time they were introduced the provisions were regarded as a world-leading institutional reform and have subsequently been cited as international best practice by agencies, such the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (See IMF, 2007). Since 1994, several other countries have implemented legislation specifying principles of responsible fiscal policy and reporting. Examples are the Australian Charter of Budget Responsibility Act, 1998 and the United Kingdom Charter for Budget Responsibility 2011¹. Formal frameworks embedding principles of sound fiscal policy have come to be regarded as mainstream amongst many OECD economies, particularly amongst countries in the European Union.

The principles and reporting requirements laid down by the original FRA have been adopted by all subsequent New Zealand governments, although modifications have been made in light of experience since 1994. In 2005 the original principles and reporting provisions were integrated into the Public Finance Act 1989 which laid the original foundations for reform of New Zealand's public finances (Scott, 2001). The 2005 legislative changes also introduced additional reporting requirements on the part of Treasury pertaining to the long-term fiscal situation and required that government annual Budgets include a statement of tax policy changes. Further amendments were introduced in 2013. The principles were extended to capture the spirit of the 2005 amendments pertaining to reporting requirements on taxation policy and the long-term fiscal position and intergenerational issues, and new principles were introduced to strengthen the focus on stabilisation aspects of fiscal policy and to give emphasis to the management of and reporting on the components of the Government balance sheet.

This paper traces the evolution of the principles and reporting provisions during the past quarter of a century in response to the fiscal challenges posed by intergenerational issues

¹ The Treasury (2012) includes a comparison of the legislated principles for fiscal policy in New Zealand, Australia and the United Kingdom.

and population ageing, avoiding unsustainable government expenditure growth during economic booms, the coordination of fiscal and monetary policy, recognition of the economic and social importance of the Government's balance sheet, and the demands for greater transparency in fiscal policy decisions and performance. The remainder of the paper is structured as follows. Section 2 discusses the historical background to New Zealand's fiscal policy reforms in 1994. Section 3 provides an explanation of the issues influencing the design of the original Fiscal Responsibility Act and the reasons for the emphasis on principles and transparency. The subsequent evolution of the principles and reporting provisions and the factors influencing those decisions are discussed in Section 4. Contemporary issues and challenges are discussed in Section 5, while Section 6 provides concluding comments.

2. Historical background to the introduction of the Fiscal Responsibility Act 1994

The introduction of principles to guide fiscal policy and mandatory reporting requirements ushered in by the Fiscal Responsibility Act of 1994 was a relatively late but important component of the package of extensive economic reforms in New Zealand that prevailed during the decade that followed the 1984 general election. These reforms were comprehensive, pursued relatively quickly, resulted in an initial reduction in the relative size of the public sector, and introduced what were at the time, radical new institutional arrangements and principles to guide public sector management and public policy². These new institutional arrangements and principles were designed for the purpose of improving the transparency and accountability of public sector management and the efficiency and sustainability of public policy. The reform of fiscal policy had its origins in the principles of public sector reform laid out in the State-Owned Enterprises Act 1986, the State Sector Act 1988 and the Public Finance Act 1989. These principles sought to improve public sector performance by clarifying objectives, strengthening incentive structures, increasing transparency and accountability, and measuring performance against clear expectations. Nevertheless, the reform of the institutional setting for fiscal policy had its own motivation and required its own characteristics.

The motivation for the FRA was borne out of New Zealand's history of continuous government budget deficits and increasing public debt since the mid-1970s. This history of poor fiscal management was considered to be a result of several compromising features of fiscal management. These included a focus on short-term fiscal management, poor policy coordination that was compromising other policy objectives, the assignment of fiscal policy directed at objectives that were better approached by other policy

² For comprehensive explanations of the scope of the New Zealand economic reforms of the late 1980s and early 1990s see Bollard and Buckle, 1987; Silverstone, Bollard and Lattimore, 1996; Evans, Grimes, Wilkinson and Teece, 1996; and OECD, 1999.

instruments, and a lack of transparency that compromised the scope for public scrutiny and for new policy initiatives by incoming governments.

The traditional approach to fiscal policy in New Zealand prior to the mid-1980s has been characterised by Wells (1987) as one based on Musgrave's theory of fiscal policy. Musgrave's approach distinguished between the allocation, distribution and stabilisation branches of the public household (Musgrave, 1959; and see New Zealand Monetary and Economic Council, 1976 for an example of the application of this approach). Wells has argued that the way this approach was applied in New Zealand exhibited a dualism concerning budget policy whereby decisions on resource allocation and distribution issues tended to be analysed in terms of partial and individualistic behaviour, whereas decisions on stabilisation policy were not built explicitly on these foundations. Fiscal policy therefore involved a compromise between the disciplinary and allocative function of taxes and public goods and the requirement to adjust these fiscal instruments to manipulate the state of aggregate demand.

During the decades prior to the mid-1980s, an array of regulations and price controls had been introduced in New Zealand to the extent that from a fiscal policy perspective, Wells (1987, p. 284) described the New Zealand fiscal policy as having only 'one degree of freedom'. There was heavy reliance on the use of taxes, subsidies and government asset management to promote economic activity which was indistinguishable from traditional demand management, rather than using these instruments and changing relative prices to influence the allocation of resources. This resulted in persistent fiscal deficits and growing public debt. Coupled with a short-term focus for stabilisation policy, this led to a perception that fiscal policy was not sustainable, which undermined the credibility and effectiveness of demand management policies.

The first wave of fiscal reforms during the mid-1980s involved a change in emphasis toward more efficient allocation of resources and a rejection of fiscal instruments for short-term stabilisation of aggregate demand. This reform wave also included a shift toward announcing more policies in advance; an early example was the pre-announcement of the proposal to reform the tax system. The process of tilting fiscal policy more toward its resource allocation role involved the removal of a wide range of subsidies and other incentives, and reform of the taxation system. It also involved changes in the ownership structure of public sector assets, the establishment of government trading departments as state-owned enterprises (Jennings and Cameron, 1987) and reform of public sector management (Scott, 2001).

Disillusionment with the stabilisation role of fiscal policy stemmed from several factors. There were concerns over the appropriate timing of stabilisation policies which were considered to have exacerbated the volatility of business cycles (see for example, Deane and Smith, 1979). Furthermore, interventions to offset the initial contractionary effects of

shifts in global relative prices (arising for example from large movements in pastoral commodity prices and oil prices during the 1970s) had resulted in subsidies and large-scale investments by government. These decisions committed tax revenue to support heavy investment in pastoral production and industrial projects which, with the benefit of hindsight, proved to be much more expensive and produced much lower returns than expected. These ‘stabilisation’ interventions often imposed long-run costs to society which were difficult to reverse, in-part because of the lack of transparency with incentives resulting in information being controlled by politicians and officials (Wells, 1987).

Despite the shift in focus of fiscal policy in the mid to late 1980s, a fundamental problem persisted. In contrast to the earlier liberalisation reforms in the United Kingdom where the emphasis was macroeconomic, the early emphasis of New Zealand’s reform process was “distinctively microeconomic” (Blyth, 1987, p. 16). But New Zealand also faced dire macroeconomic and fiscal positions which were well known. The International Monetary Fund had described New Zealand’s fiscal situation in 1984 as ‘a major imbalance in the economy that had become more serious and threatened to have a severe destabilising effect on the economy’ (Scott, 1995, p. 6). Gross public debt increased from around 40 per cent of GDP in 1974 to a peak of 78 per cent in 1987; net public debt was just below 5 per cent of GDP in 1974 and rose to 52 per cent by 1992 and real gross public debt per capita had nearly doubled since the early 1970s (Janssen, 2001). New Zealand’s credit rating slipped during the 1980s from AAA to AA, and a single A rating was narrowly avoided in 1991 only because after the 1990 election the incoming government took decisive action to contain a deficit that was forecast to expand to 5 or 6 per cent of GDP (Scott, 1995, p. 6).

The reasons for the delay in government expenditure and public debt reforms are complex. Wells (1996, pp. 226-232) attributes it to two key factors: One was the electoral politics of reform which compromised the willingness of the Labour Government to reduce spending in core areas of health, education and social welfare. The other was the dynamics of debt accumulation combined with higher interest rates on public debt as a result of financial market deregulation.

The level of government spending, persistent deficits and high public debt posed a serious threat to the progress of policy reform. The high level of government borrowing on domestic financial markets resulted in higher domestic interest rates, and a higher exchange rate (which had been floated in March 1985). Instead of an exchange rate reflecting real cost advantages from reform, it reflected interest rate differentials and in turn threatened the international competitiveness of local industries, including agriculture and manufacturing, competing on international markets. Some argued that the delay in scheduling budgetary reform was a potential threat to the aims and even the sustainability of the economic liberalisation reform programme (Blyth, 1987, pp. 9-16; Buckle, 1987).

Furthermore, if not checked, the fiscal situation had the potential then, and in the future, to compromise the aims of achieving and sustaining low inflation and to undermine the aims of the RBNZ Act 1989. The RBNZ Act 1989 was designed to promote time-consistent monetary policy. It provided the central bank with operational independence and a clear mandate to maintain price stability (Grimes, 1996 and 2013). Theoretical research had demonstrated that a conflict between monetary and fiscal policy could impact on inflation and the broader macroeconomic situation through the government budget constraint (Sargent and Wallace, 1984) or through a competitive inter-active game between the fiscal and monetary authorities (Buckle and Stemp, 1991).

Despite the intentions of the mid-1980s switch in the emphasis of fiscal policy, by the early 1990s, and in contrast to monetary policy, there were no institutional arrangements to mitigate the risks of future governments reverting to the fiscal policy practices of the past. This concern was heightened by two further issues. One focused attention on the implications of the lack of full fiscal and financial information being available on the eve of an election, and the implications for financial markets and future government policy options. In 1990, as in 1984, the incoming government found the situation to be much worse than it had been led to believe because in this instance it had not been aware of insolvency of the Bank of New Zealand (BNZ), which was owned by the Government (see Scott, 1995, p. 4). This problem was not new. A similar situation had occurred in October 1989 with the failure of the Development Finance Corporation, a financial institution owned by the statutory body which managed public servants' pension funds.

The second issue was the political economy of democratic systems. Rising budget deficits and inflation internationally during the 1970s and 1980s had renewed interest in how the institutional arrangements, including political institutions, could affect fiscal and monetary policy choices. Buchanan and Wagner (1977) for example, proposed that the gains and losses in terms of constituent support for alternative spending and taxation programmes shaped budgetary outcomes in a democratic system of political competition. They argued that this created a bias toward financing public expenditure through the process of creating debt rather than raising taxation. Similarly, Buchanan, Rowley and Tollison (1987) argued that the political process in democracies was myopic and that politicians reacted to incentives established by democratic institutions by acting as if they applied a high discount to the future consequences of their decisions.

Decisions to change New Zealand's electoral process gave added force to the relevance of these ideas. A referendum held in 1990 endorsed the introduction of mixed member proportional (MMP) representation which was to be introduced in the 1996 election. A critical concern was the potential for fragmentation of political parties and the impact this would have on fiscal decision making (for reasons discussed for example in Alesina and Perotti, 1995). The potential for these public choice concerns to be accentuated with the introduction of MMP was prominent in public debate in New Zealand during the early

1990s and leading up to the introduction of the FRA in 1994 (see for instance, Bollard, 1993; The New Zealand Business Roundtable, 1994).

3. Design of the Fiscal Responsibility Act 1994

The original Fiscal Responsibility Act (FRA) came into effect from 1 July 1994. Scott (1995, p. 3) explains that the principal aims of the FRA were to tilt the balance of fiscal decision-making away from the short-term economic and political considerations towards strategic and long-term fiscal objectives. It was designed to establish ownership of a broad fiscal strategy within the government with the oversight of parliament, and to create more transparency in the determination of government budgetary policy. The FRA was thereby intended to promote more informed debate about the trade-offs associated with strategic fiscal objectives and in doing so, help hold governments accountable and therefore improve the credibility of fiscal policy.

The FRA legislated a set of principles for responsible fiscal management in the conduct of fiscal policy, required regular public reporting by the government on the extent to which fiscal policy is consistent with those principles, and required regular and independent economic and fiscal updates by the Treasury. The original Act legislated five principles of responsible fiscal practice that successive governments were required to adopt, and it formalised several fiscal reporting requirements, some of which had evolved during the years immediately preceding the passing of the Act, including the shift to Generally Accepted Accounting Practice (GAAP) for financial reporting purposes. The Act required governments to follow these principles and publicly assess their fiscal policies against these principles.

Although the change to the governance arrangements applying to monetary policy that had been introduced by the RBNZ Act 1989 involved specifying a target inflation range (as agreed between the Minister of Finance and the Reserve Bank Governor), the new governance arrangements for fiscal policy eschewed the use of targets. Scott (1995, pp. 14-15) explained that although the experience of institutional reform to create credible monetary policy formed part of the background to the development of the FRA, it was felt that “fiscal policy goes to the very heart of a government’s development strategy and political priorities, and cannot be delegated in the same way.”

The reasons for the New Zealand parliament ultimately choosing principles rather than targets are further discussed by Janssen (2001). Janssen explains that the final form of the original FRA was changed and the preference for principles reinforced as the parliamentary Bill passed through the Finance and Expenditure Select Committee process, a committee that includes Government and opposition members of parliament. Some of the reasons why principles were preferred to targets for fiscal policy governance were: (i) a perceived lack of sound theoretical justification for any particular fiscal target; (ii) that judgements about appropriate targets for fiscal aggregates can vary over time and

across economic circumstances and the inflexibility of targets would make it difficult for fiscal policy to respond appropriately to changing economic circumstances; (iii) as a consequence, the use of targets could pose a risk to the credibility of fiscal policy; and (iv) despite the advances made in transparency of fiscal policy and improving the availability of fiscal information, it was felt that targets could still be evaded. The desire to encourage a stronger focus on medium to long-term fiscal performance and to allow sufficient flexibility if the electoral system changed to a Mixed Member Proportional (MMP) system were also factors influencing the choice of principles over targets. (see Janssen, 2001; Scott, 1995, pp. 12-14; Report of the Finance and Expenditure Committee, 1994, pp. 13-14).

New Zealand's fiscal framework has continued to prevail without legislated numerical fiscal targets. The flexibility of the framework allows governments to set broadly similar debt objectives but with differences in the make-up of government expenditure and taxes. This may have been a factor contributing to successive governments of differing political persuasions embracing the fiscal framework and political commitment to self-imposed fiscal targets. Nevertheless, some have argued that the lack of fiscal targets is a weakness, and some have proposed legislated expenditure rules (see for example Wilkinson, 2004; Wilkinson and Acharya, 2014).

The merits of fiscal targets to supplement fiscal principles has been re-visited by officials and others on a number of occasions since the FRA was passed, but the original issues raised during the design of the FRA and the experiences of regimes that have experimented with fiscal targets have tended to be more persuasive (see Mears, Blick, Hampton and Janssen, 2010; The Treasury, 2012). Following a review of New Zealand's fiscal framework, Ter-Minassian concluded "While such rules could help strengthen inter-temporal consistency in the conduct of fiscal policies, they would limit the scope for countercyclical fiscal measures, and could even hinder the operation of the automatic fiscal stabilizers during severe recessions. They might also weaken governments' ownership of the fiscal targets, and create incentives for governments to comply with the rules through policies that would weaken other parts of the Crown's balance sheet." (Ter-Minassian, 2014, p. 2).

Under the FRA, all financial statements included in reports required by the Act are prepared under Generally Accepted Accounting Practice (GAAP). In 2007 the New Zealand public benefit entity (PBE) international financial reporting standard (IFRS) came into place, with an update in 2014 to base PBE standards on the International Public Sector Accounting Standards (PBE IPSAS) (Janssen, 2018, p. 9). Fiscal reporting follows a set of consistent accounting rules established independently by the Accounting Standards Review Board (which sets accounting standards that are mandatory for both the public and private sector). The use of accrual accounts means that the full cost of any policy must be disclosed, including non-cash items such as depreciation and future

obligations arising from for example, changes to government employee pension rights. New Zealand also pioneered the introduction of a complete audited balance sheet for the public sector, and it remains one of only a few countries to do so systematically (Janssen, 2015).

The shift from cash-based to GAAP based financial statements accommodated externally set and audited standards. This has helped ensure consistent treatment of cash-based and accrual-based flows of expenditure and revenue and avoid some of the boundary problems that affected previous fiscal forecasts. For instance, GAAP has ameliorated the risks of using expected future revenue flows contingent on realising certain rights or contractual conditions, to offset current expenditure flows when reporting annual budget balances. (See the example, of the treatment of forestry cutting rights in the early 1990s discussed by Janssen, 2001 p. 10 and Scott, 1995).

The aim of the FRA and subsequent amendments that are now incorporated in the Public Finance Act 1989, is to influence government behaviour by requiring governments to be transparent about certain aspects of fiscal policy. The FRA was introduced at a time when awareness of the inadequacies of fiscal reporting and fiscal policy practice in New Zealand had become much more apparent to politicians. As early as 1978, the Auditor-General had been critical of the government's financial management information systems, but was largely ignored (Scott, 1995, p. 8). Nevertheless, some of the reporting practices legislated by the FRA had commenced in some form during the early 1990s and prior to the passing of the Act. Hence the FRA did not represent a completely new change to reporting practice, but it did ensure more suitable reporting was a requirement and that improved transparency was more likely to be sustained practice.

The fiscal responsibility provisions are not prescriptive of fiscal strategy but require governments to be transparent about their objectives and intentions, and there is no legal sanction for breaching the provisions of the Act. The success of the fiscal responsibility provisions therefore depends on the level of acceptance and support they receive across governments. Although there have been amendments to the original Act, to date successive governments have endorsed the principles and reporting requirements.

The first major test of the acceptability and durability of the spirit and intentions of the FRA came about in 1999 with the change from a National-led government (which sponsored the Act in 1994) to a Labour-led government. Following a review of the public management system in 2001, which included a review of the FRA, the new Ministers of Finance and of State Services concluded that although some improvements could be made (and were eventually made) to enhance the management and reporting of public finances "the fundamentals of the PFA and the Fiscal Responsibility Act (FRA) are sound" and the changes proposed sought to "reinforce the existing objectives and principles of the PFA and FRA" (Cullen and Mallard, 2003, p. 5).

The second test of the acceptability and durability of the fiscal framework came about with the next change of government in 2008. The 2008 National-led government also embraced the spirit and intentions of the fiscal responsibility provisions now included in the Public Finance Act 1989, and also undertook a review which led to an extension of the principles and reporting requirements. After a quarter of a century, governments are now explicitly stating their fiscal policy obligations with reference to the fiscal responsibilities denoted by the Public Finance Act. The first Fiscal Strategy Report tabled by the Labour-led government elected in 2017 is the most recent example (see Robertson, 2018). The acceptance and common interpretations of the fiscal responsibilities by successive governments of different political persuasions is demonstrated by the similarity of the fiscal objectives stated by the Labour-led government elected in 2017 with those of the immediately preceding National-led government as demonstrated by Gill (2019, Box 4).

4. The principles and reporting provisions and their evolution

The current Public Finance Act includes eight principles of responsible fiscal management, shown in Table 1, and five fundamental reporting provisions, shown in Table 2. The original Act included the Principles 1 to 5 in Table 1. The original reporting provisions required governments to publish a ‘Budget Policy Statement’ (BPS) by the end of March, and a ‘Fiscal Strategy Report’ (FSR) to be tabled with the Budget. It also required Treasury to prepare an ‘Economic and Fiscal Update’ at the time of the Budget (usually mid-year) and each December; and a ‘Pre-election Economic and Fiscal Update’ before each general election. Definitions of terms included in the principles such as “prudent” level of debt, or “reasonable” degree of predictability are not specified in the Act. It is left to the Government of the day to interpret the relevant fiscal terms. Governments may depart temporarily from the principles and if they do so, they are required to publicly explain the reasons for the departure and explain how and when they intend to return to conforming to the principles.

The principles and reporting provisions have evolved during the past 25 years as successive governments have been able to assess their adequacy as a result of the experiences of fiscal management during markedly changing economic circumstances. These circumstances have included the Asian Financial Crisis and a series of severe droughts during the late 1990s that generated a sharp recession, a sustained period of economic expansion during the early 2000s, a sustained slowdown in economic growth commencing in the late 2000s and with the impact of the global financial crisis, and subsequently the demands of heavy infrastructure investment as a result of major earthquakes in 2011 and 2013 in the Canterbury region. Overlaying these economic shocks were the challenges of coordination with monetary policy operating under a regime of operational independence and inflation targeting, and the increasing evidence of the economic and fiscal implications of demographic changes. Changes to the

principles and reporting conditions have also been informed by new research on the economic effects of fiscal policy.

Table 1: Principles of responsible fiscal management

<p>The Government must pursue its policy objectives in accordance with the following principles of responsible fiscal management:</p> <p><i>Debt and fiscal balance:</i></p> <ol style="list-style-type: none"> 1. Reducing total debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total debt in the future by ensuring that, until those levels have been achieved, total operating expenses in each financial year are less than total operating revenues in the same financial year; and 2. Once prudent levels of total debt have been achieved, maintaining those levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues; and <p><i>Net worth</i></p> <ol style="list-style-type: none"> 3. achieving and maintaining levels of total net worth that provide a buffer against factors that may impact adversely on total net worth in the future; and <p><i>Fiscal risks</i></p> <ol style="list-style-type: none"> 4. Managing prudently the fiscal risks facing the Government, and <p><i>Predictability and stability of tax rates</i></p> <ol style="list-style-type: none"> 5. When formulating revenue strategy, having regard to efficiency and fairness, including the predictability and stability of tax rates; and <p><i>Interaction between fiscal and monetary policy</i></p> <ol style="list-style-type: none"> 6. When formulating fiscal strategy, having regard to the interaction between fiscal policy and monetary policy; and <p><i>Intergenerational effects</i></p> <ol style="list-style-type: none"> 7. When formulating fiscal strategy, having regard to its likely impact on present and future generations; and <p><i>Management of Crown resources</i></p> <ol style="list-style-type: none"> 8. Ensuring that the Crown's resources are managed effectively and efficiently.
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Source: Public Finance Act 1989 (as at 28 September 2017), Part 2; Fiscal responsibility, Section 26F. PP 51-52.

4.1. Population ageing and intergenerational effects of fiscal policy

The first set of changes to the original Act were introduced by the Labour-led government elected in 1999. These changes followed a “Review of the Centre” in 2001, which made recommendations to address fragmentation and improve alignment of public services and encourage a greater focus on outcomes (see Cullen and Mallard, 2003). Following this Review, the original five principles and three reporting provisions were integrated into the Public Finance Act in 2004 and became operational in January 2005³.

Other changes that were introduced involved the reporting provisions. These included a clearer differentiation of the requirements of the Budget Policy Statement and the Fiscal Strategy Report. The requirement that the BPS cover high-level fiscal strategy was removed so that it focuses more on the priorities for the upcoming Budget. This meant that the FSR became the main instrument for conveying high-level fiscal strategy. The

³ These amendments were implemented on 25 January 2005 with the passing into legislation of the Public Finance Amendment Act 2004.

changes also required that sensitivity analysis be conducted on fiscal aggregates to illustrate how government finances might respond to changing economic conditions, introduced additional reporting requirements on the part of the Treasury pertaining to the long-term fiscal situation, and required that government annual Budgets include a statement of any significant changes to taxation policy and revenue.

The introduction of additional reporting provisions relating to the long-term fiscal situation (reporting provision 3 in Table 2) was the culmination of a series of initiatives that had taken place over the previous two to three decades. A stronger emphasis on the intergenerational effects of fiscal policy was an important motivation for introducing the original FRA (Scott 1995, p. 8). The long-term and intergenerational effects of high public debt and high interest rates experienced during the 1970s and 1980s had been sobering for governments of all political persuasions. Although the reduction in the level of New Zealand's public debt during the 1990s was ameliorating this immediate concern, the potential fiscal implications of population ageing was becoming more evident, particularly through its expected impact on future public pension and health costs.

The fiscal risks of a public pension scheme interacting with an ageing population had been exposed in the late 1970s as a result of electoral competition between the two main political parties during the 1975 election (see Wells 1996, pp 217-218). The Todd Task Force was subsequently established to evaluate superannuation options. Its Reports of 1992 and 1997 drew attention to the importance of demographic influences on future public pension costs and government budgets. The issue attracted sufficient attention to prompt a national referendum in 1997 on alternative superannuation schemes. The New Zealand Treasury had also commissioned research to supplement its own work on the fiscal implications of an ageing population. Reports by Cook and Savage (1995) and Polackova (1997) were influential and helped inform Treasury's policy advice. The future fiscal implications of rising pension costs were the main motivation for government to establish the New Zealand Superannuation Fund in 2001. The scheme was designed to smooth out over time the fiscal impact of a higher proportion of the population becoming eligible for New Zealand Superannuation (see McCulloch and Frances, 2001).

Meanwhile, reporting practices in countries such as Australia (Intergenerational Report) and the United Kingdom (Fiscal Sustainability Report) had already incorporated long-term fiscal reporting into their fiscal frameworks, and OECD and academic research was highlighting the fiscal effects of population ageing in a range of countries. The New Zealand Treasury had begun during the 1990s to include long-term fiscal projections in its briefings to incoming governments and the issues were occasionally recognised in government documents such as the 1999 Fiscal Strategy Report. However, the interest from politicians varied over time. Hence, there was benefit in regularly codifying and publishing these projections and embedding them within the fiscal reporting requirements.

Table 2: Fiscal reporting requirements

The Minister (of Finance) must present to the House of Representatives a report on the Government's:

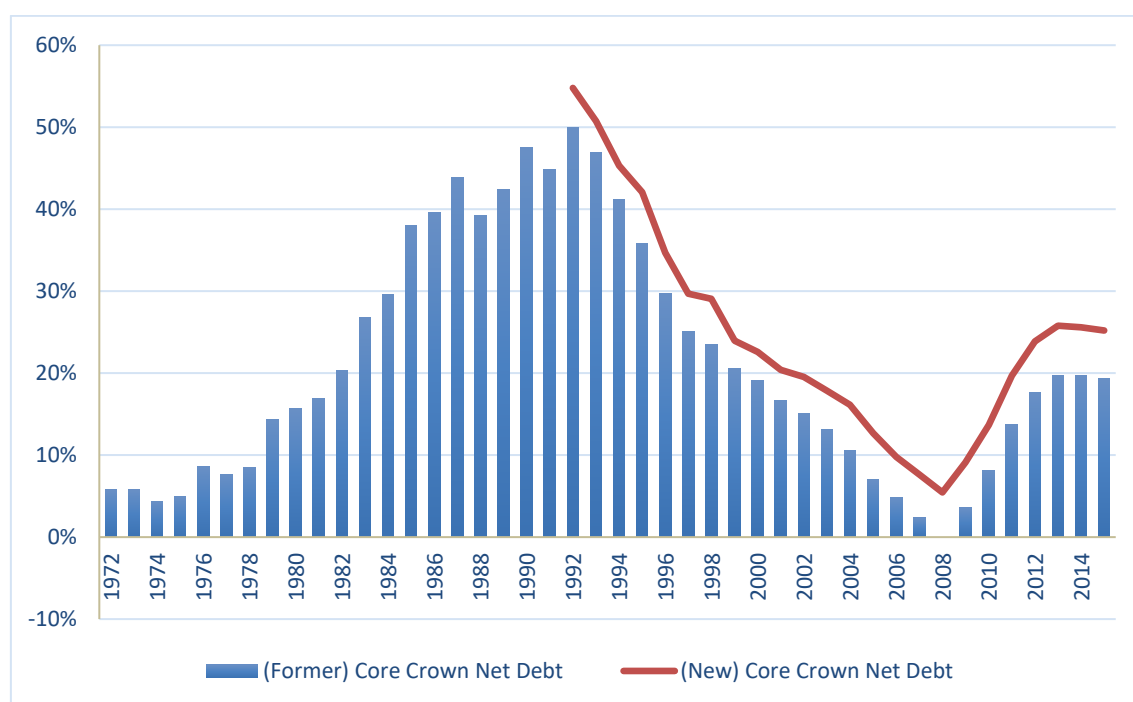
1. *Budget Policy Statement:*
To be presented no later than 31 March in each (June) financial year. It must state: the broad strategic priorities and the overarching policy goals by which the Government will be guided in preparing the Budget; the policy areas that the Government will focus on in that year; how the Budget for that year accords with the short-term intentions, long-term objectives, and the Government's strategy for managing expenditure, assets, and liabilities as specified in the most recent fiscal strategy report; and explain how they accord with the principles of responsible fiscal management.
 2. *Fiscal Strategy Report:*
To be presented immediately after each annual Budget (or at any time prior to that date on the same day). This Report must contain: (a) Government's long-term objectives for fiscal policy, explain how those long-term objectives accord with the principles of responsible fiscal management, and state the period to which those long-term objectives relate (which must be a period of 10 or more consecutive financial years); (b) For at least the next 2 financial years, indicate explicitly, by the use of ranges, ratios, or other means, the Government's short-term intentions for operating expenses, operating revenues, balance between total operating expenses and total operating revenues, the level of total debt, the level of total net worth, how they relate to the principles and long-term fiscal objectives. The FSR must also explain the Government's strategy for managing expenditure, assets, and liabilities and intended outcomes for at least 3 financial years.
 3. *Statement on long-term fiscal position:*
Prepared by Treasury and presented at intervals not exceeding four years, a statement on the long-term fiscal position relating to a period of at least 40 consecutive financial years commencing with the financial year in which the statement is prepared, and stating the assumptions underlying any projections included in the statement.
 4. *Investment Statement:*
Prepared at intervals not exceeding 4 years describing the value of the Crown's significant assets and liabilities, how they have changed in value over time, how they are expected to change in value in each of at least the next 2 financial years and identifying any significant differences between the actual and previously forecast values and the equivalent information reported in the most recent previous investment statement.
 5. *Economic and Fiscal Updates:*
These are to be prepared on three occasions:
 - (a) Annually immediately after delivery of the Government's annual Budget (Budget Economic and Fiscal Update or BEFU);
 - (b) Annually between 1 November and 30 December (Half-yearly EFU);
 - (c) Prior (20 to 30 days prior) to any general election of Members of the House of Representatives (PREFU).
 These statements are required to contain: economic and fiscal forecasts that relate to the financial year to which the update relates and each of the next 2 financial years and a statement of tax policy changes during the past year and approved for the future. These statements must also include a disclosure of any policy decisions and other circumstances that may influence the future fiscal situation (with the exception of decisions or circumstances that may prejudice New Zealand's economic or security interests or result in material loss of value to Government). the Minister of Finance to communicate all of the Government's policy decisions to the Treasury so that the forecasts are based on relevant and comprehensive Government policy intentions, and to refer all reports required under the Act to a parliamentary select committee.
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Source: Public Finance Act 1989 (as at 28 September 2017), Part 2; Fiscal responsibility, Sections 26I to 26Z. PP 53-66.

The publication of long-term fiscal statements every four years commenced in June 2006. This reporting created greater public awareness of the influence of forces likely to impact on New Zealand's future fiscal position (see for instance Bell and Rodway, 2014). These statements highlighted the expected impact of population ageing on the cost of the universal public pension scheme and on the costs of health care, issues that had been previously highlighted by the Todd Task Force reports and by work within Treasury. The requirement to include in annual budgets a statement of significant changes to taxation policy and revenue prompted more reporting and disclosure on taxation expenditures.

In a Regulatory Impact Statement (RIS) published in 2012, the Treasury made the judgement that the fiscal responsibility provisions had supported an improvement in fiscal sustainability. As a result, New Zealand benefited from having relatively low public debt at the time of the global financial crisis and domestic recession in 2008–2009 (The Treasury, 2012, p. 3). As Figure 1 shows, as a percentage of GDP New Zealand core crown net debt declined continuously from the inception of the FRA in 1994 until 2008. However, in this RIS the Treasury raised a concern that the fiscal stability requirements in the Act were not adequate and that this could have adverse implications for fiscal sustainability.

Figure 1: Core Crown net debt as percentage of GDP: 1972 to 2015



Source: Data for this chart was supplied to the author by Norman Gemmell and is drawn from the database prepared for the paper by Gemmell, Gill and Nguyen (2018). Core Crown debt refers to the debt obligations of government departments and ministers, the Reserve Bank of New Zealand and the New Zealand Superannuation Fund (NZSF). Net Core Crown Debt is the difference between gross Core Crown Debt and liquid financial assets excluding those of the NZSF and advances (such as student loans) (see The Treasury, 2018c, p. 39). Data for advances are not available prior to 1992 (See Note to Figure 1, in Buckle and Cruickshank, 2014).

4.2. Pro-cyclical government spending and coordination with monetary policy

With the advent of central bank operational independence and inflation targeting since 1989, the New Zealand Reserve Bank has tended to assume primary responsibility for macroeconomic stability. Although it was acknowledged that broader government policy can influence real interest rates and the exchange rate, the principle macroeconomic stabilising influence of fiscal policy over the business cycle was assumed to be via the influence of ‘automatic stabilisers’ which operate through the effect of the business cycle on average tax rates and government taxation revenue, and on benefit payments associated with the business cycle.

The experience during the period of economic expansion from 2000 to 2008 suggested that the principles and reporting provisions were insufficient to prevent the strong growth in taxation revenues being used to finance permanently higher structural spending commitments. The concern expressed in the Regulatory Impact Statement by the Treasury (2012) was that unexpected gains in taxation revenue could be too easily converted into higher levels of structural spending and a potential future structural fiscal deficit, even though at the time the level of core crown debt could be at a prudent level. Furthermore, in these circumstances higher government spending could compromise monetary policy by contributing to higher real interest and exchange rates. As noted in section 2, these potential coordination difficulties between fiscal and monetary policies had been raised by academic researchers prior to the introduction of the Reserve Bank of New Zealand Act, 1989 and the FRA 1994, and it was a topic that had attracted renewed interest for countries that were members of the European Monetary Union (Bean, 2009).

The potential adverse effects of procyclical increases in government expenditure in New Zealand during the mid-2000s had been highlighted previously. Barker, Buckle and St Clair (2008) had drawn attention to the fact that unexpected revenue growth during the 2000s had been converted into higher levels of operating expenses which could compromise the stability and structural goals of fiscal policy. Subsequently, Brook (2013) marshalled a range of evidence supporting this conclusion and noted that the associated increases in government expenses had occurred against a backdrop of advice from the Treasury about the implications for macroeconomic stability. Similar experiences had been found in other countries. The European Commission had observed that “the available evidence seems to indicate that in most advanced countries pro-cyclicality is an issue that mostly arises in good times, when the economic activity is above potential or when growth is above trend.” (European Commission, 2007, p. 171).

Furthermore, the Treasury argued that these types of circumstances could also compromise economic structure objectives of fiscal policy. They considered that despite the requirements of the PFA, there were inadequate incentives to focus on the effectiveness of spending and a lack of a culture of continuous improvement in the

absence of fiscal pressures. The ease with which government spending plans could be revised upwards therefore contributed to a focus on adding resources at the margin rather than looking for opportunities to reprioritise or improve efficiency within operating baselines or balance sheets. Core Crown expenses increased by 4.8 per cent of GDP between 2004/05 and 2010/11 which was assessed to be largely structural in nature and only partly due to the economic downturn in the latter part of the cycle (See Mears, Blick, Hampton and Janssen, 2010).

The experience during the latter part of the 2000s decade raised three main concerns that prompted a second major review of the principles of responsible fiscal management and reporting provisions. The concerns were that there was an insufficient requirement to consider the stage of the economic cycle in formulating fiscal policy; that there was no requirement to focus on the efficient management of resources during periods of strong taxation revenue growth as well as during periods of slow taxation revenue growth; and there was no requirement to consider future generations when formulating fiscal policy. Nor were governments required to systematically report on past fiscal experiences.

Legislative amendments to the fiscal principles and reporting requirements were introduced in 2013 to address these concerns. Three further principles of responsible fiscal management were added: the interaction between fiscal and monetary policies, intergenerational effects, and management of Crown resources (principles 6, 7 and 8 respectively in Table 1). Principle 5 relating to taxation was rephrased to also include an emphasis on efficiency and fairness of tax rates when formulating taxation policy. The fiscal reporting provisions were extended to include the requirement that an Investment Statement be prepared at intervals not exceeding 4 years describing the financial features of the Crown's balance sheet and how they have changed and how they are expected to change in the near future (reporting requirement 4 in Table 2)⁴.

4.3. Management of Crown resources and investment statements

The first official Investment Statement was published in 2014 and the second in 2018. As occurred with the reporting of economic and fiscal updates and long-term fiscal projections, the Treasury had earlier prepared investment statements which were published as a government document in 2010 and as a supplement in 2011. These were prepared before they were legally required as a way of testing their acceptability and value.

The investment statements are intended to improve transparency by revealing in more detail about the composition of the government's balance sheet. They are also intended to highlight the significance of the composition of government assets for the delivery and

⁴ The amendments discussed in this paragraph were implemented on 4 September 2013 with the passing into legislation of the Public Finance (Fiscal Responsibility) Amendment Act 2013.

quality of public services, to provide an assessment of the performance of the government's assets, to assess their sustainability, and to promote improved management of the governments investment portfolio.

The statements provide a valuation of the government's financial and physical assets, including the portfolios of social, financial and commercial assets. They provide information about the government's liabilities including borrowing, insurance and retirement plan liabilities. This information is not unique to the investment statements, and regularly appears in economic and fiscal updates. But the investment statements include much more information about the performance of government assets and risks. Included in the risk analysis is a selection of 'stress tests' that assess the impact of a range of adverse events (such as a major earthquake or a significant international recession) on the value of the governments balance sheet and its ability to sustain the delivery of public services. The Treasury (2018a) has suggested that the production of investment statements has prompted more requests for advice and reporting by government officials on the alignment of the government's investment portfolio to intended outcomes, and that they have prompted agencies to pay more attention to delivering benefits from these assets and to invest in the capability to manage assets over time.

5. Contemporary issues and challenges

5.1. Approaches to assessing New Zealand's fiscal responsibility framework

New Zealand was a pioneer in specifying principles and reporting provisions to improve fiscal transparency in order to strengthen fiscal accountability and support improved fiscal policy. There has subsequently been growing international recognition of the importance of fiscal transparency and improved fiscal reporting and surveillance as a means of strengthening policy accountability and the quality of fiscal policy.

In 1998 the IMF introduced its "Code of Good Practices on Fiscal Transparency" in response to shortcomings exposed by the Asian financial crisis. This was one of several new standards and codes designed to improve the functioning of the international financial system. This first code of fiscal transparency was reviewed in 2012 after the global financial crisis (GFC) revealed that many countries had substantially underestimated the risks to their fiscal position, especially the risks arising from the financial sector. In response to that review, in 2014 the IMF released its current Fiscal Transparency Code (FTC), and this code is supported by several other standards and diagnostic tools. The FTC comprises a set of principles based on four pillars: Fiscal reporting; Fiscal forecasting and budgeting; Fiscal risk analysis and management; and Resource revenue management (IMF, 2018). The FTC is supported by a process of assessing country practices against the code (Fiscal Transparency Evaluations, FTE). FTEs are carried out by the IMF at the request of member countries and they form part of the policy dialogue with those countries.

New Zealand has not undertaken an FTE by the IMF. Nevertheless, a perspective provided by Ter-Minassian who undertook an assessment at the request of the New Zealand Treasury, suggests that New Zealand's fiscal responsibility provisions and reporting requirements align closely with the requirements of the four pillars of the IMF Fiscal Transparency Code. Ter-Minassian (2014, p. 2) concluded "This framework has served New Zealand well in many respects. It has promoted a responsible conduct of fiscal policies under different governments, resulting in levels of the net public debt that look modest in international comparisons; and it has provided flexibility to accommodate the adverse fiscal consequences of the global financial crisis and the heavy fiscal cost of rebuilding Christchurch, following two devastating earthquakes in 2010 and 2011. The strong culture of transparency and official accountability, promoted by the Public Finance Act, is widely regarded as an example of international best practice."

Another approach that can be applied to assess the adequacy of New Zealand's fiscal responsibility framework is to use a taxonomy of the roles of fiscal policy and judge the effectiveness of New Zealand's fiscal policy framework in pursuing these roles. Drawing on the international evolution of fiscal policy management practice and research, Barker, Buckle and St Clair (2008) suggested three fundamental roles or functions of contemporary fiscal policy: the sustainability, stability and structural roles. This taxonomy has been applied by the New Zealand Treasury to assess fiscal policy and the adequacy of New Zealand's fiscal responsibility principles and reporting provisions and inform the developments discussed in section 4 (see for example, The Treasury, 2012; Brook, 2013). In the remainder of this section, this taxonomy is used to assess the adequacy of New Zealand's fiscal policy framework.

5.2. The pursuit and reporting of fiscal sustainability

The principles and reporting provisions impinging on fiscal sustainability have probably been the most successful outcome of New Zealand's fiscal responsibility framework. Fiscal sustainability, which is grounded in the intertemporal budget constraint, has been a principal motivation for the original FRA and its principles and reporting provisions (including maintaining "prudent" debt levels over time), and the inclusion in 2005 of a statement on the long-term fiscal position. Since 1994, successive governments have stated their objective for prudent debt, discussed the implications of current policy, and made progress towards realising that objective.

As an illustration of the progress toward fiscal sustainability, it is instructive to compare the ability of respective governments to cope with the fiscal implications of adverse events in the late 1990s with those that occurred in the late 2000s. The New Zealand Treasury have judged that New Zealand's fiscal position and level of net debt in the late 1990s was not adequate to provide sufficient scope to allow the full operation of automatic fiscal stabilisers to buffer the economy in response to the Asian financial crisis

and severe droughts that occurred at that time. In contrast, a more gradual macroeconomic adjustment was feasible after 2008 in response to the failure of several finance institutions, the global financial crisis and a series of destructive earthquakes. In their review of the fiscal policy adjustments during this period Bose, Philip and Sullivan (2016, p.12) concluded that “New Zealand’s strong fiscal institutions have played a significant role in the achievement of the surplus. The interaction of the Public Finance Act 1989, the fiscal management approach and state sector reform were key to the ability to reduce expenses without major cuts to services.” The earlier pursuit and maintenance of a “prudent” level of public debt had created a fiscal buffer that had enabled the automatic fiscal stabilisers to operate. This helped the government to manage the fiscal consequences of this series of adverse shocks that occurred after the mid-2000s, and achieve fiscal savings through efficiency initiatives and expenditure re-prioritisation.

Nevertheless, there are several improvements that could be made to the way fiscal sustainability is evaluated and how it’s reported in the statements on long-term fiscal sustainability. The usual definitions of fiscal sustainability are derived from the intertemporal budget constraint. But one of the practical limitations of these definitions is that the expectation that governments will not exceed a specified terminal net public sector debt (NPSD) target is insufficient to ensure fiscal sustainability if, for instance, the evolution of debt during intervening years exceeds the level that creditors would be prepared to finance or if the ensuing interest rate charges change the sustainability calculus. Hence, prudent levels of NPSD are likely to be state dependent (OECD, 2015).

In those circumstances there are a number of factors relevant to determining a prudent level of NPSD to act as an anchor for fiscal policy. Since 1994 New Zealand governments have set as an anchor for fiscal policy, net debt targets ranging between 15 and 30 percent of GDP (see Buckle and Cruickshank, 2014, Figure 1, p. 116). It is not clear why this range and the current target of 20 per cent were chosen. This target rate for net core Crown debt aligns with the results in Fookes (2011) which suggest that a starting net debt level of 20 per cent may be sufficient to manage a selection of adverse supply and demand shocks.

However, the calculus required to adequately assess the Crown’s contingent liability risk is probably changing. The potential impact on economic growth and government contingent liabilities arising from destructive geological and climate generated events may be becoming more acute. The depletion of the National Disaster Fund as a result of claim obligations of the Earthquake Commission following the Canterbury and Kaikoura earthquakes since the mid-2000s highlighted the vulnerability of the adequacy of the fund (see for example Earthquake Commission, 2017). The growing frequency and magnitude of extreme weather events and the complex manner in which they can cause damage, seem likely to be changing the calculus required to assess the Crown’s contingent liability risk (see Fleming, Noy, Pastor-Paz and Owen, 2018). Similarly, the uncertainty

associated with the economic impact of policies implemented to mitigate climate and environmental change creates greater uncertainty of future income growth and therefore growth in the Crown's tax revenue base and social expenditure obligations (see Frame, Rosier, Carey-Smith, Harrington and Dean, 2017). Therefore, it is surprising that despite the importance that the target level of net debt can have for determining the probability of changes in government expenditure and tax rates and the of trade-offs involved, the procedure used to specify a "prudent" level of net debt is not made more transparent.

Another area that warrants further attention is the modelling method used by the Treasury to evaluate the sustainability of contemporary fiscal policy and the trade-offs involved. The approach used by Treasury has to date relied predominantly on deterministic projections of government expenditure and revenue using contemporary policy settings (see Bell and Rodway, 2014). While this approach has generated useful insights about the potential future changes in the levels and composition of government expenditure and is a method used by other countries (see Office for Budget Responsibility, 2018), it does not capture the full implications of the government budget constraint and the associated feedback effects. These feedback effects would include for example, changes in interest rates, private investment, private savings, and labour supply in responses to changes in tax rates, government expenditure, etc. Nor do the deterministic projections necessarily capture the full implications of demographic change for budget finances which, as discussed above, was a key motivation for introducing this reporting provision. Similar observations have been made by the New Zealand Controller and Auditor-General (2016) in reviews of the Treasury's 2013 and 2016 long-term fiscal statements, and Ter-Minassian (2014) who recommended several areas where fiscal modelling, forecasting and risk assessment could be improved.

Recent research has illustrated the importance of these types of modelling improvements. Creedy and Ball (2014a) have demonstrated that population ageing is likely to have significant implications for the future evolution of the composition and level of taxation revenue in New Zealand. To date these demographic effects on the tax base have not been captured in the official long-term fiscal projections. Understanding the uncertainty associated with the future path of expenditure and revenue components of the government budget and their implications for the optimal timing of alternative policy adjustments is another area for that warrants improvement (see for example Ball and Creedy, 2014b; and Ball, Creedy and Scobie, 2016). A potential basis for developing a "second generation" approach to assessing New Zealand's fiscal sustainability that embodies many of these important features is provided by Creedy and Scobie (2017).

The two areas of government expenditure and transfers that regularly feature as threats to fiscal sustainability are superannuation and health. Proposals to address them continue to be politically contentious. Improvements in modelling that enhance understanding of the

trade-offs involved would help inform public debate and may strengthen the political scope to improve fiscal sustainability.

5.3. The stabilisation role of fiscal policy

The stabilisation role of fiscal policy in New Zealand today relies predominantly on allowing automatic stabilisers to take effect during fluctuations in the business cycle. As previously mentioned, concern over the potential time-inconsistency of traditional stabilisation policies was mitigated somewhat by the RBNZ Act 1989 which specified price stability as the primary goal of monetary policy and provided the Bank with operational independence to pursue that goal. This has created a situation where monetary policy has tended to smooth macroeconomic fluctuations and keep output and employment close to potential levels. However, the reliance on automatic fiscal multipliers during upswings in the business cycle can be problematic. Principle 6 in Table 1 was included in 2013 to mitigate this risk, but it has yet to be tested. The challenges of avoiding procyclical fiscal injections to demand during periods of economic buoyancy and growth of government revenue are not trivial. As Alesina (2000) has noted in the context of USA policy, there are usually strong political economy constraints at work which result in governments being prepared to provide counter-cyclical fiscal stimulus during downturns, but the political difficulty of sustaining large budget surpluses tends inevitably to lead to pro-cyclical fiscal expansion during business cycle upswings.

Given the susceptibility of the New Zealand economy to international financial and commodity price movements, and to climatic conditions it is unsurprising this has been a topic of frequent enquiry in New Zealand. Recent examples are the policy forums held in 2006 and 2013 for the purpose of appraising the adequacy of New Zealand's policy frameworks to deal with macroeconomic stabilisation issues (Buckle and Drew, 2006; Smith, Hall and Janssen, 2013). In those forums, proposals that were evaluated included schemes to use the tax system and to implement stabilisation funds to strengthen automatic fiscal stabilisers. For example, Buiter (2006) proposed a scheme to implement pro-cyclical variations in the rate of the Goods and Services Tax and delegating this to an operationally independent committee. Siklos (2006) critiqued this and other ideas advanced to strengthen automatic fiscal stabilisers. The suitability of structural government spending rules and stabilisation funds were evaluated by Schmidt-Hebbel (2006). Stabilisation funds are used in some countries to absorb unexpected revenue gains and are applied as an inter-generational transfer instrument, as in Norway, or to smooth spending over time, as in Chile. Ter-Minassian (2014) has suggested that stabilisation funds should be considered by New Zealand. Most of these ideas, including setting expenditure targets and introducing stabilisation funds, were evaluated prior to the revision of the fiscal principles and reporting requirements introduced in 2013 (Treasury, 2012; Brook, 2013).

Cecchetti (2018) has also drawn attention to the potential importance of fiscal and monetary coordination in the context of public debt management. Cecchetti explains that this coordination can in some circumstances be of significance because the maturity structure of privately held government debt is determined by the combined actions of the fiscal authority's debt management decisions and central bank purchases and sales of securities issued by the fiscal authority. He notes that while most of the time this interaction may not be a problem, during periods of quantitative easing as occurred during the post-GFC period, a lack of coordination between the fiscal and monetary authorities can result in conflicting influences on the term structure of interest rates, as has apparently occurred in the USA (see Greenwood, Hanson, Rudolph and Summers, 2014).

New Zealand governments have to date decided to rely on the implementation of principle 6 in Table 1 to mitigate the risks of procyclical government expenditure which, as remarked earlier, has yet to be fully tested. Improvements in transparency and more timely public information of government revenue growth during economic upswings and other sources of unexpected taxation revenue growth may be necessary to strengthen the effectiveness of principle 6. Greater emphasis on conveying to governments the uncertainty associated with fiscal variables and developing procedures to support fiscal management in an environment of uncertainty may be another way to help mitigate this type of risk.

5.4. Fiscal policy and economic structure

The fiscal structure role, which captures Musgraves 'allocation and distribution branches', refers to the level and composition of tax revenue, expenses, and the composition of the government balance sheet. Empirical research associated with the role of fiscal policy in theories of endogenous growth has highlighted the significance of this aspect of fiscal policy (see for example, Barro, 1990; Kneller, Bleaney, and Gemmell, 1999). However, the original FRA was not intended to be prescriptive of fiscal strategy and the PFA continues to rely on transparency, via the reporting provisions, to influence responsible management of fiscal structure.

The scrutiny of the structural role of fiscal policy therefore also relies on the adequacy of the reporting provisions revealing successive governments' objectives and intentions, in particular in the Fiscal Strategy Report. A sound approach to this aspect of fiscal policy relies on robust policy evaluation processes and incentives to continuously improve capability, productivity within the public sector, and improved information and processes to evaluate current and future government spending and taxation proposals. This is a vulnerable aspect of New Zealand's fiscal policy framework and is an area that has received regular critical scrutiny.

Ter-Minassian (2014) considered there was a need to improve the information base required to further strengthen the assessment and management of performance of

spending programmes and of the Crown's assets. While applauding the “enhanced monitoring framework” that was under development at that time, Minassian suggested there were lessons from the international experiences and literature that could be applied to New Zealand's fiscal framework, and recommended ways to strengthen spending reviews.

Wilkinson and Acharya (2014) suggested New Zealand's fiscal rules are weak in guarding against failures to reduce poor quality spending, the impulse to increase spending during revenue upturns, incentives to use ‘bracket creep’ from inflation to increase tax revenue and spending, and the lack of transparency about the quality of general election campaign spending promises. The significant expansion in the scope of government expenditure and services during the last 100 years highlighted by Wilkinson (2004 and 2018) means that it is imperative that government agencies apply robust evaluation processes to assess policy proposals and systematically monitor performance of agencies and programmes. Wilkinson (2018) observes that while New Zealand ranks highly in international comparisons of the efficiency of some public services, there are many areas that appear to be well below the international frontier, that there is a lack of focus on productivity in the state sector, and there are inadequate processes in place to guard against unsustainable and efficiency compromising election campaign pledges.

In a recent inquiry into improving state sector performance, the New Zealand Productivity Commission (2018a) also considered there was insufficient focus on productivity and performance improvement. During its inquiry, the Commission reported that it encountered poor performance monitoring and inadequate use of programme evaluations, risk averse behaviour and restrictive rules and funding systems that are constraining innovation, and inadequate systems to reward improvements in performance. The Commission recommended more systematic measurement of performance and productivity in the public sector. The Commission also concluded that there has been a reliance by the state sector on increasing labour inputs to provide more social services without necessarily improving the quality of performance. In response to these observations, the Commission has demonstrated that the measurement of productivity of state sector services is feasible, has developed a guide to assist state sector agencies to measure productivity, and is in the process of creating a support network to assist state sector officials (New Zealand Productivity Commission, 2018b).

The challenge of ensuring adequate processes for considering structural policy issues may become more acute in the future if governments embrace a broader “Living Standards Framework” (LSF) to guide its policy analysis and decisions, as is being proposed by the Treasury (The Treasury, 2018b). The proposed LSF is based on the OECD's *How's Life?* Analysis (OECD, 2017). In one sense this approach is simply an extension of the traditional economic approach to the evaluation of policy options. It requires a view about the contents of a social welfare function and therefore an understanding of what

maximises intertemporal wellbeing. It also requires the determination of how institutional arrangements and policy interventions can improve the intertemporal flow of benefits. And to ensure sustainability, it is necessary to understand the appropriate intertemporal maintenance of the capital stocks required to sustain or realise the intertemporal maximisation of wellbeing. However, as is evident from Smith (2018), the LSF has not developed to the point of determining the components of a social welfare function (or “wellbeing”) nor identifying a robust integration of the relevant flows and stocks required to understand intertemporal trade-offs required to guide public policy.

New Zealand fiscal governance and effective accountability therefore relies heavily on adequate transparency. This in turn depends on successive governments accepting the fiscal principles and compliance with the reporting provisions developed over the past 25 years. The dependence on transparency highlights the importance of appropriate governmental and non-government institutions and processes to monitor fiscal policy and government service performance to strengthen government accountability.

The Office of the Controller and Auditor-General in New Zealand has a responsibility to comment on the accuracy of the government’s accounts and it comments on the quality of reports by government agencies, such as the long-term fiscal statements prepared by the Treasury. But it does not review a government’s performance in respect of meeting the reporting requirements of the fiscal responsibility provisions of the PFA. There are regular reviews by international financial institutions such as the OECD and IMF which can provide a source of scrutiny and commentary, although they can be dependent on support for information from government agencies. The establishment in 2007 of the New Zealand Productivity Commission to investigate government directed inquiries into the adequacy of institutional and policy arrangements for a range of fiscally related activities has been a valuable step. Their reports are published and the investigations typically involve considerable public engagement. But the focus of the work of the Commission is largely determined by government.

There is therefore an important role for private and university research institutes to monitor how well governments adhere to the fiscal principles and reporting provisions. However, resources to support fiscal policy specialists outside the public sector are limited in a small economy. The establishment of independent fiscal councils (IFC) has gathered momentum during the last 20 years, particularly in Europe where they have been propelled by new European Union laws on fiscal governance (see Beetsma and Debrun, 2018). 26 of the 35 OECD countries now have an IFC of some type. The roles of IFCs can vary, but typically they are established to promote financially sustainable policies. They can raise the political costs of deviating from well-defined principles or rules and thereby contribute to better fiscal performance. But the design is crucial for their effectiveness and they require legal and operational independence and sufficient

resources otherwise they can be inherently fragile, especially considering their dependence on the will of politicians to fund their activities.

Wilkinson and Acharya (2014) and Ter-Minassian (2014) have recommended that New Zealand consider establishing an IFC. Minassian suggested that a New Zealand IFC should probably have a more limited role than in most other countries because of the degree of operational independence of the Treasury and its well-established non-partisan reputation. This option is currently under consideration by the New Zealand government. In its first Fiscal Strategy Report, the current government stated that it will “engage with the public on the creation of an Independent Fiscal Institution (IFC).....to establish a body independent of Ministers of the Crown which will be responsible for determining if these [Budget Responsibility] rules are being met” (Robertson, 2018, p. 13).

6. Conclusion

New Zealand’s fiscal management framework is based on a legislated set of fiscal responsibility principles and reporting provisions which are now set out in the Public Finance Act, 1989. The framework introduced by the original Fiscal Responsibility Act in 1994 has shown remarkable resilience and is a one of the stand-out successes of the wide-ranging economic policy reforms introduced during the decade from 1985 to 1995. This resilience has been a consequence of successive governments consistently endorsing the legislated fiscal responsibility principles and reporting provisions throughout the last quarter of a century.

The resilience of the framework is also attributable to the constant evolution of the principles and reporting provisions during the past 25 years in response to experience, emerging research, and insights from fiscal management and reporting ideas applied overseas. Embedding the principles and reporting provisions in legislation and the fiscal improvements the legislation has promoted, has encouraged officials and successive governments to continuously review the effectiveness of the provisions and promote improvements.

Nevertheless, as discussed in this paper, there remain many areas where the principles and reporting provisions can be strengthened and where the processes applied by public sector agencies in pursuit of the fiscal responsibility provisions can be improved. These areas include improvements in modelling of fiscal sustainability, enhancing understanding of the trade-offs associated with policy options to achieve fiscal sustainability, strengthening the requirements and consistent application of robust evaluations of policy proposals, strengthening requirements for monitoring and reporting on programme and agency performances, and measuring productivity of programmes and agencies. Strengthening institutional arrangements to enhance transparency and the capability to provide robust monitoring and reviewing of fiscal strategy and performance

is another area that could strengthen fiscal accountability of successive New Zealand's governments.

The fiscal responsibility principles and reporting provisions first introduced by the Fiscal Responsibility Act of 1994 and now embedded in the Public Finance Act 1989, ushered in an era of vastly improved fiscal performance for New Zealand compared to the preceding decades. This policy innovation strengthened the effectiveness of New Zealand's fiscal policy governance and lead to improvements in fiscal sustainability, fiscal stabilisation and fiscal structure. If the history of steady adaptation and improvement that has occurred during the last quarter of a century is a suitable guide for the future, there must be a reasonable prospect of future governments adapting the fiscal framework to ensure it remains adequate to cope with future fiscal challenges, including risks associated with traditional international economic and financial shocks and those arising from the emerging challenges associated with climate change and the environment.

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