THE TREASURY
Kaitohutohu Kaupapa Rawa

An Introduction to

New Zealand's Fiscal Policy Framework

New Zealand Government

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Contents

Fiscal Policy refers to how governments manage revenue, expenses, assets and liabilities. This pamphlet describes New Zealand's fiscal policy framework. A fiscal framework is a set of rules that governments must adhere to when setting fiscal policy.

How does our fiscal policy framework operate?

New Zealand's fiscal responsibility provisions are set out in the Public Finance Act (PFA) and have three key elements:

1. The provisions specify a set of principles of responsible fiscal management in the conduct of fiscal policy.
2. The provisions require regular public reporting by governments on their *short-term intentions* and *long-term objectives*, and the extent to which these objectives and intentions are consistent with the principles of responsible fiscal management.
3. The provisions provide for regular and independent economic and fiscal reporting by the Treasury, including updates at Budget time and between budgets, a pre-election update, a statement on the long-term fiscal position at least every four years, and an investment statement on the Crown's balance sheet at least every four years.

New Zealand's fiscal policy framework is based on transparency. It emphasises disclosure of information rather than compliance with detailed rules set out in law. Behind this transparency-based framework is a judgment that a framework of this kind is likely to provide effective incentives for New Zealand governments to conduct responsible fiscal policy. The provisions require each government to come to its own decision about, among other things, what level of Crown debt is *prudent*. By setting their own targets, governments are more likely to commit to meeting them.

New Zealand's fiscal policy framework is based on transparency

This transparency-based approach contrasts with the more common international approach of adopting legislated fiscal rules. A legislated rule specifies in the law a numerical limit or goal in respect of one or more budget aggregate. Fiscal rules are often expressed as limits on spending, revenue, budget balances, or debt.

Fiscal rules have become more popular internationally over the last decade or so. In 2009, of the 186 member countries of the International Monetary Fund (IMF), 80 had some sort of fiscal rule, up from only seven in 1990. In general, fiscal rules tend to be associated with improved fiscal performance relative to how well a particular country was performing prior to adopting a fiscal rule.

From time to time, the question arises as to whether we should adopt a legislated fiscal rule. Successive New Zealand governments have rejected any change to the status quo. This position reflects the judgements that:

» Political commitment to a particular fiscal path is the most important factor that influences whether a government actually sticks to it. By requiring governments to come up with their own assessment of what constitutes good fiscal policy, New Zealand's fiscal responsibility provisions increase the likelihood that governments will then stick to the fiscal path they have set themselves.

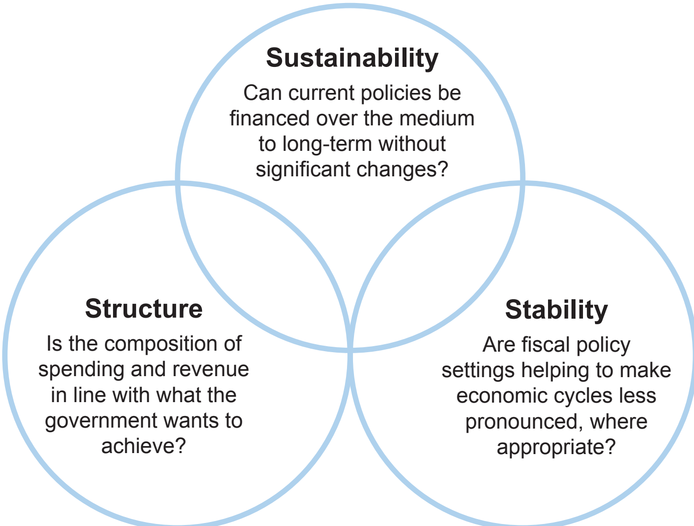
» A legislated fiscal rule will not necessarily reflect the government of the day's assessment of what constitutes good fiscal policy and, accordingly, is more likely to be breached when it does not align with the government of the day's fiscal priorities.

» A transparency-based framework will usually be more flexible than a legislated fiscal rule. For example, a limit on Crown borrowing could require a government to cut spending even if the evidence suggests that doing so would have negative consequences for economic growth or living standards more generally.

The principles of responsible fiscal management

At the core of the PFA's fiscal responsibility provisions are a set of principles of responsible fiscal management. These principles aim to capture the dimensions of good fiscal policy, which we might categorise as sustainability, stability, and structure:

Dimensions of responsible fiscal policy



While the principles of responsible fiscal management aim to produce a clear statement on what constitutes good fiscal policy, they do not prescribe any rigid approach to fiscal management. Nor do they set out targets or limits for spending, taxes, debt, or operating balances. Instead, the principles of responsible fiscal management use words like "prudent", which give governments considerable flexibility to determine the fiscal path that they judge to be consistent with the principles within the context of current and forecast economic decisions.

A summary of the principles of fiscal responsibility

To address fiscal sustainability, governments must:

» Achieve and maintain prudent public debt levels.

» Ensure that, on average, Crown operating expenses do not exceed Crown operating revenues.

» Achieve and maintain levels of Crown net worth to provide a buffer against shocks.

» Manage fiscal risks facing the Crown prudently.

» Consider the likely impact of fiscal strategy on present and future generations.

To address economic stability, governments must:

» Have regard to the interaction between fiscal policy and monetary policy.

To address fiscal structure, governments must:

» When formulating revenue strategy, have regard to efficiency and equity, including the predictability and stability of tax rates.

» Ensure that the Crown's resources are managed effectively and efficiently.

Reporting on whether fiscal policy is consistent with the principles

The fiscal responsibility provisions require governments to set out, in the *Fiscal Strategy Report* (published alongside each Budget), their short-term fiscal intentions and long-term fiscal objectives for fiscal policy. These intentions and objectives must be expressed in terms of five variables:

- Total operating expenses.
- Total operating revenues.
- The balance between total operating expenses and total operating revenues.
- Total debt.
- Total net worth.

...government must also explain how their fiscal strategy is responsible

These intentions and objectives in many respects approximate the legislated fiscal rules of other countries, with the difference being that specific targets are not set down in law. As well as setting out these intentions and objectives, the government must also explain how its fiscal strategy is responsible.

The fiscal responsibility provisions explicitly anticipate that at times, governments will need (or want) to pursue fiscal strategies that are not consistent with the principles. In those cases, governments must give reasons for their departure from the principles, and explain how and when they expect to return to them.

The provisions also require the government of the day to look back and assess the extent to which its fiscal performance was consistent with its published fiscal strategy.

Independent updates

Alongside the requirement for government to produce a *Fiscal Strategy Report* every year, the fiscal responsibility provisions also provide for regular independent reports by the Treasury. The degree of independence that Treasury has to produce these reports is unusual by international standards and a key feature of New Zealand's fiscal framework. The required reports are:

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- **Fiscal and economic updates** containing forecasts for the next four financial years following the current fiscal year. These forecasts must include a range of specific fiscal and economic data. The Treasury must produce them each Budget, every half-year between Budgets, and prior to a general election.
- **Statements on the Long-term Fiscal Position,** published at least every four years, which look at the 40-year trajectory of government finances, assuming current spending and revenue policy remains the same.
- **Investment Statements,** published at least every four years, which look at the assets and liabilities on the Crown balance sheet and how they are expected to change over time.

History and amendments

Fiscal responsibility provisions have been part of New Zealand law since 1994. Initially they were a stand-alone piece of legislation: the Fiscal Responsibility Act. However, this Act included fewer principles of responsible fiscal management than today's legislation. Those that it included were primarily focused on fiscal sustainability.

In 2004, the Fiscal Responsibility Act was incorporated into the Public Finance Act as Part 2. At the same time, the requirement for the Treasury to produce a four-yearly Statement on the Long-Term Fiscal Position was introduced.

In 2013, Part 2 of the Public Finance Act was substantively amended. Three new principles of responsible fiscal management were introduced. These additions broadened the definition of good fiscal policy from a predominant focus on sustainability to also emphasise the importance of economic stability and fiscal structure.

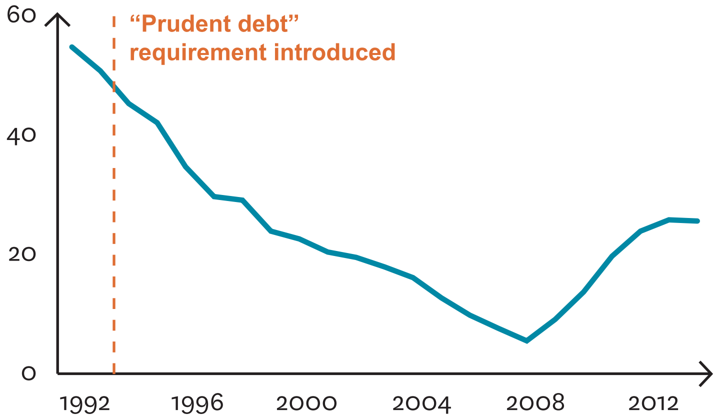
The amendments also introduced the requirement for the Treasury to produce a four-yearly investment statement.

The effectiveness of the fiscal responsibility provisions

Until the substantive amendments in 2013, the provisions were very much focused on the sustainability dimension of good fiscal policy, in particular, the need to keep public debt low.

Certainly, New Zealand governments have been committed to achieving and maintaining prudent levels of public debt since the introduction of the fiscal responsibility provisions. Figure 1 shows the path of public debt from shortly before the introduction of the principles until now.

Net core Crown debt as a % of GDP



It would be inaccurate to suggest the reduction in public debt since the early 1990s is solely due to the fiscal responsibility provisions. Multi-party commitment to, and understanding of the importance of fiscal sustainability, plus public expectations that governments will be good fiscal managers, have also played a critical part. The fiscal responsibility provisions are part of a self-reinforcing circle that encourages multi-party commitment to prudent fiscal policy in order to underpin New Zealand's living standards.

Further reading

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