The Treasury

Budget 2011 Information Release

Release Document

June 2011

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Fiscal policy, the 2025 Taskforce, and the Savings Working Group

Date:	7 February 2011	Report No:	T2011/152

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** the Treasury views on the recommendations of the 2025 Taskforce and the Savings Working Group for fiscal policy.	15 February 2011

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
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Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

Treasury Report: Fiscal policy, the 2025 Taskforce, and the Savings Working Group

Executive Summary

Recent reports from the 2025 Taskforce and the Savings Working Group raised a number of issues relevant to your fiscal strategy. The 2025 Taskforce argues that fiscal deficits are contributing to the build up of economic imbalances, that the government is too large and is a drag on economic growth, and that institutions do not ensure sufficient fiscal discipline. The Savings Working Group argues that the fastest way to lift national savings is to return the fiscal balance to surplus earlier than currently projected. The table below summarises their high-level fiscal policy recommendations, and the Treasury's views and upcoming work.

Recommendation for fiscal policy	The Treasury's view and upcoming work
Returning to fiscal surplus *2025 Taskforce* Announce policy decisions to accelerate the reduction in the fiscal deficit. A well-signalled consolidation would allow a lower official cash rate, thereby reducing the real exchange rate, and encouraging output in the tradables sector. *Savings Working Group* Improve national savings by returning to surplus earlier than projected and maintaining a surplus of no less than 2% of GDP in the medium term.	We agree that a well-signalled and materially faster return to fiscal surplus would assist with rebalancing the economy. We will provide you with advice in the coming weeks on: fiscal savings in Budget 2011, including options for KiwiSaver and Working for Families; a net zero capital allowance; and a process for further savings post-Budget 2011, including a spending review approach and efficiency dividend. We agree that the main way in which the Government can improve national savings is through an early return to fiscal surplus.
Size of government *2025 Taskforce* Reduce the size of government – by reducing core Crown expenses from the forecast of 34.9% of GDP in 2010/11 to 29% of GDP by 2014/15 – the level achieved during 2005.	We agree that the direction of travel for core Crown expenses should be downward – to enable a return to surplus. Core Crown expenses are forecast to fall to 31.7% of GDP in 2014/15. Faster consolidation would result in further reductions. The type and quality of expenditure matter as much as the level. We emphasise the need to set a clear expenditure direction and process for ensuring that reductions are made in the 'right' areas and that efficiency improvements are made. We plan to release a paper to inform debate about the relationship between size and structure of government and economic performance.
Institutional change *2025 Taskforce* Consider a stronger mechanism for scrutiny of fiscal policy and the enforcement of discipline, e.g. a taxpayer rights bill, an independent fiscal council, or a long-term target for expenses. Wind up the New Zealand Superannuation Fund. *Savings Working Group* Retain the New Zealand Superannuation Fund.	We intend to review the Public Finance Act in 2011 to determine whether it has ensured sufficient discipline and whether changes would improve New Zealand's fiscal and economic outcomes. We will also look at the role of the New Zealand Superannuation Fund in 2011. The Public Finance Act allows you to express your existing expense objective in quantifiable terms, such as a share of GDP. You may wish to consider this ahead of your 2011 Fiscal Strategy Report – to further anchor your fiscal strategy.

Recommended Action

We recommend that you **note** the Treasury views on the recommendations of the 2025 Taskforce and the Savings Working Group for fiscal policy.

Bill Moran
Manager, Macroeconomic Policy
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Treasury Report: Fiscal policy, the 2025 Taskforce, and the Savings Working Group

Purpose of Report

1. This report briefs you on the recommendations of the 2025 Taskforce and the Savings Working Group that relate to your fiscal strategy. It outlines the Treasury's views and our ongoing work on fiscal consolidation, the balance sheet and fiscal institutions.

Context

2. The second 2025 Taskforce report, released 3 November 2010, focuses on policies to close New Zealand's income gap with Australia by 2025. The Treasury has provided you with a high-level briefing from an economic growth perspective (T2010/2085).

3. The Savings Working Group presented its final report to you on 31 January 2011. The Treasury has provided you with advice on Group's recommendations for KiwiSaver (T2011/72) and tax policy (T2011/76 – a joint report with Inland Revenue).

2025 Taskforce and fiscal policy

4. The 2025 Taskforce argues that there are a number of pressing issues with fiscal policy – relating to ongoing fiscal deficits, the size of government, and the underlying institutions. Table 1 summarises these issues and the Taskforce's reasoning.

Table 1: Summary of issues raised by the 2025 Taskforce (2010)

Issue	**Taskforce reasoning**
Fiscal deficits are harming the performance of the economy and contributing to a build-up of imbalances.	• Fiscal deficits over the past two years "have likely materially increased interest rates and the real exchange rate, promoting a reallocation of economic activity from the tradable to the non-tradable sector and encouraged borrowing offshore to finance consumption." • The fiscal deficit is structural, and to date, has only grown larger. Spending pressures are only likely to increase as the economy recovers.
The current size of government is too large and is acting as a drag on economic growth.	• The share of the economy absorbed by central government expenditure has increased substantially, from 29% of GDP in 2004 to 34% of GDP in 2010. • That increase reduces economic efficiency because of the deadweight losses associated with raising taxes to finance higher expenditure. • The churn associated with taxation of middle income families to provide those families with benefits is a significant driver of the increased spending.
Fiscal institutions do not encourage a systematic focus on value for money and allow spending to increase too easily.	• The Public Finance Act stresses transparency around fiscal goals, but lacks binding external constraints on policymakers. As long as debt is low, or being brought down to prudent levels, government is able to increase spending when tax revenues increase. • There has been a tendency for public spending to increase more rapidly in the good times than proves to be sustainable in the medium term.

Taskforce recommendations

5. The Taskforce makes a number of recommendations for fiscal policy – aimed at addressing the issues outlined above.

   - Announce policy decisions to accelerate the reduction in the fiscal deficit. A well-signalled consolidation would be expected to result in the Reserve Bank setting interests rates lower than otherwise – thereby reducing the real exchange rate, and encouraging a rebalancing of output back to the tradables sector.

   - Reduce core Crown operating expenses to 29% of GDP by 2014/15 – the level achieved in 2005. To achieve this, the Taskforce envisages recent increases in social welfare being unwound. The Taskforce reasons that if the government could function with 29% of GDP in 2005, it should be able to do so three years from now.

   - Close down the New Zealand Superannuation Fund and use its assets to reduce government debt. Expense pressures associated with an ageing population should instead be addressed at their source.

   - Consider establishing a stronger mechanism for the scrutiny of fiscal policy and the enforcement of fiscal discipline. Potential models include a taxpayer bill of rights and an independent fiscal council. The Taskforce has also proposed that the Public Finance Act be amended to require the Minister of Finance to specify publicly a medium-term (5-10 years) target for core Crown expenses, in per capita terms or as a share of GDP, and to report annually on progress towards that goal.

Savings Working Group and fiscal policy

6. The Savings Working Group concluded that decisive steps are needed to increase national savings above the current gross level of 15% of GDP by some 2% to 3% of GDP. To that end, the Group sees that the first step should be to stabilise the ratio of net foreign liabilities to GDP at below 90% – and that the fastest way to achieve that is to return the fiscal balance to surplus earlier than currently projected.

7. The Savings Working Group recommended a return to fiscal surplus of not less than 2% of GDP earlier than the projected date of 2016 (as projected at the *Half-year Economic and Fiscal Update* in December 2010). The Group also recommended that level of fiscal surplus be maintained in the medium term.

8. Many of the consequent benefits of faster consolidation articulated by the Group are similar to those identified by the 2025 Taskforce, and include: helping lower interest rates and increase investment; helping lower the exchange rate and shift resources to the tradable sector; and increasing the resilience of the economy given the likelihood of further adverse shocks. The Group also noted that an earlier return to surplus is important to position the state sector to deal with pressures from an ageing population.

9. The Savings Working Group also recommended that the New Zealand Superannuation Fund be retained, with some consideration of transfers to the Fund to maintain the unfunded liability at a stable percentage of GDP – on average across the economic cycle.

Returning to fiscal surplus

10. The Treasury has advised you on the link between fiscal deficits, the build-up of external imbalances, and economic growth (T2009/1953 refers). We agree with the 2025 Taskforce that a well-signalled and materially faster return to fiscal surplus would help to rebalance output to the tradable sector – via a lower official cash rate and a lower real exchange rate than would otherwise be the case. In conjunction with tax and regulatory policy changes, a faster return to surplus would help to reduce New Zealand's economic imbalances and support a sustained increase in per capita growth.

11. We agree with the Savings Working Group that the main way in which Government can improve national savings is through an early return to fiscal surplus – supported by an economic policy focused on growth, competitiveness and productivity, and continuous efficiency improvements in the public sector (aide memoire of 28 January 2011 refers).

12. Ahead of the Budget Minister's meeting in September 2010, we advised you to reduce the operating allowance to $900 million from Budget 2011, the capital allowance to $700 million from Budget 2012, and to reduce baseline expenditure by $2.0 billion at Budget 2012 – to allow a return to fiscal surplus in 2013/14.

13. Since that time, you announced your intention in *Budget Policy Statement 2011* to return the operating balance, before gains and losses, to a material surplus no later than 2015/16. The Prime Minister's speech, which announced a reduced operating allowance of $800-$900 million for Budget 2011, has brought forward the return to a material surplus by one year – to 2014/15. You have also requested options to reduce the Government's borrowing requirement by $10 billion by 2015, including a net zero capital allowance. We will provide you with further advice in the coming weeks with specific policy choices that would enable the fiscal deficit to be reduced more quickly. This will include advice on:

    - fiscal savings in Budget 2011, including options regarding KiwiSaver and Working for Families;
    - implementing a net zero capital allowance at Budget 2011 and beyond; and
    - how to improve existing processes to identify fiscal savings post-Budget 2011 – including options for an expenditure review approach and the potential role for an efficiency dividend across the state sector.

Size of government

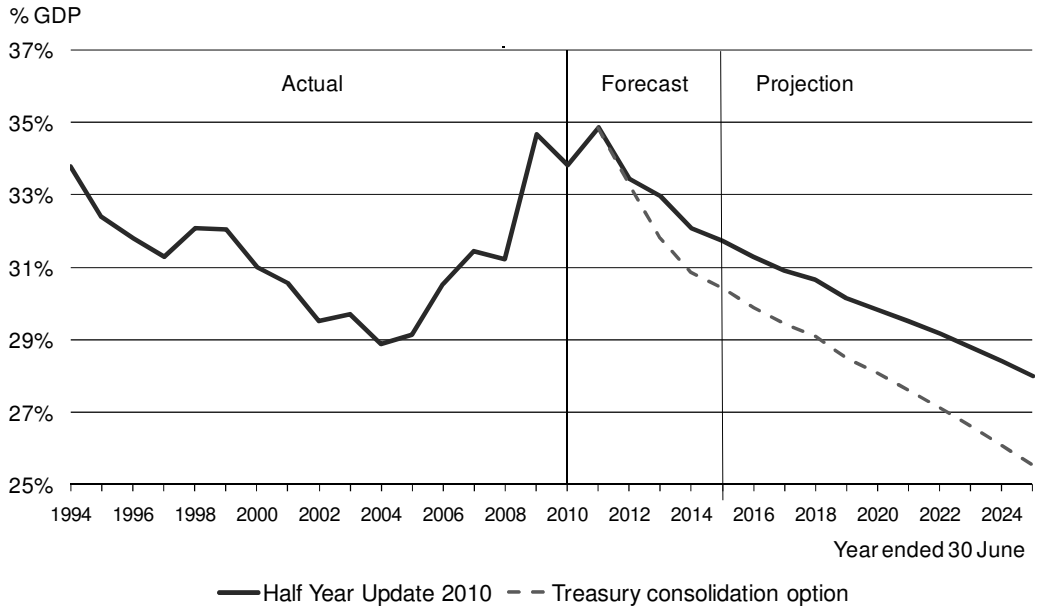
14. The Treasury agrees with the Taskforce that the level and structure of government expenditure matters for economic growth. There is strong evidence that taxes reduce economic growth through their negative impact on incentives to work, save and invest. The government has to balance this economic cost against the benefits of expenditure, much of which contributes to economic growth, for example, spending on infrastructure and education. However, the high economic costs of taxation mean that the benefits of existing spending and any new spending proposals need to meet a high burden of proof. As economic growth is a key driver of living standards, it is critical to ensure that the contribution of expenditure to government economic objectives is significant enough to outweigh its economic costs.

15. We see scope to improve New Zealand's economic growth by constraining spending growth – as a way of minimising the economic burden of taxation and of reducing the fiscal deficit. This approach will better position the Crown to deal with long-term

expenditure pressures without increasing the tax burden, while also helping lift national savings and reduce vulnerabilities. The economic cost of financing expenditure could also be reduced by continued improvements in the efficiency of the tax system to reduce our reliance on growth-impairing personal and corporate income taxes.

17. Your fiscal strategy involves a reduction in the size of government relative to the size of the economy. As figure 1 shows, core Crown expenses are forecast to fall from 34.9% of GDP in 2010/11 to 31.7% of GDP in 2014/15 – part way towards the 2025 Taskforce recommendation of 29% of GDP by 2015. This is an outcome of your fiscal strategy, in which the planned return to fiscal surplus is enabled by ongoing restraints on spending growth. Figure 1 also shows the Treasury's September 2010 consolidation option.

Figure 1: Core Crown expenses as a share of GDP



18. It is important that reductions in expenditure are made in way that is supportive of economic growth and the government's other objectives. This is reinforced by the significant "bottom-up" pressures on government expenditure from rising expectations, demographic change, and public sector inflation – as outlined in our advice on better aligning expenditure and priorities (T2010/1446 refers). These expenditure pressures mean that efficiency savings alone are unlikely to enable the government to continually constrain expenses in line with either the fiscal strategy or the faster fiscal consolidation scenarios – policy decisions will likely be required.

19 The Treasury's judgement is that there is evidence of existing expenditure that does not make significant contributions to stated Government objectives, including economic growth, or is not well targeted (T2010/1446 refers). Cutting spending in such areas will be possible if the Government is able to set a clear path for future expenditure and a clear process for bottom-up analysis of existing expenditure. We will be reporting to you on how a spending review and efficiency dividend approach could support the identification of fiscal savings in Budget 2012 and beyond in the coming weeks (see T2010/2626 for an overview of the UK comprehensive spending review approach).

16. We plan to release a Treasury working paper in February 2011 to inform public debate about the relationship between the size of government and economic performance. We will provide you with an opportunity to see a draft paper in the coming weeks, and will be available to discuss any issues you may wish to raise.

Institutional changes

17. The question of a systematic review of the Public Finance Act arose during your 'ambitious priorities' discussion with the Treasury board in November 2010. We are developing proposal to review the Act in 2011 – with the aim of advising you later in the year and informing our post-election briefing. The review will look at whether the fiscal responsibility provisions have ensured sufficient fiscal discipline and whether changes would improve New Zealand's fiscal and economic outcomes. Ideas raised by the 2025 Taskforce and/or the Savings Working Group – discussed below – will be considered.

New Zealand Superannuation Fund

18. The 2025 Taskforce's recommendation that demographic pressures should be addressed at their source is consistent with the Treasury options discussed in 2009 *Long-Term Fiscal Statement* – such as reducing cost pressures by making incremental and well-signalled policy changes to existing programmes.

19. Ahead of Budget 2009 we advised you on suspending contributions to the New Zealand Superannuation Fund until the fiscal balance returns to a sufficient level of surplus. During 2011 we will examine our position on 'prudent' levels of net debt and net worth and what constitutes an appropriate fiscal buffer, given short/long-term risks. This work will involve looking at the role of the Fund and on prefunding in general. This work also has linkages with your balance sheet strategy, macroeconomic stabilisation objectives, and New Zealand's long-term fiscal challenges. This work is likely to inform the review of the Public Finance Act and the Treasury's post-election briefing.

An independent fiscal council

20. An independent fiscal council refers to an arms-length public entity that analyses and publicly reports on aspects of fiscal policy, such as the implications for economic stability or long-term fiscal sustainability. As well having a macroeconomic focus, these institutions may, in some cases, assess and cost proposed or existing programmes (e.g. the Congressional Budget Office in the United States). Fiscal councils generally do not make policy and have no power – beyond publicising their assessments.

21. A number of OECD countries have established an independent fiscal institution (e.g. United Kingdom in 2010, Sweden in 2007), or are considering proposals to do so (e.g. Ireland, Australia). The growing interest in how an independent institution can complement existing rules and improve fiscal discipline is partly due to the widespread deterioration in fiscal positions, following the global financial crisis and the consequent need for ongoing fiscal consolidation. Whether an independent institution would be appropriate for New Zealand will be examined in the review of the Public Finance Act.

A taxpayer rights bill

22. We are assisting Minister Hide with developing the ACT Party's Taxpayer Rights Bill as a Government Bill for select committee consideration (T2010/2326 refers). The Bill is intended to limit annual increases in government spending to the rate of population growth plus the rate of inflation. Any further increase would require the annual agreement of taxpayers via a binding referendum.

23. A Taxpayer Rights Bill could be effective in reducing the size of government – if governments were willing to accept constraints on their ability to set fiscal policy, and if society accepted the trade-off between lower levels of government spending and taxation. The Bill is scheduled for introduction to Parliament in mid-2011. We will provide advice to you and Minister Hide on the Bill before the end of March 2011.

Quantifying your long-term expense objective

24. The Public Finance Act requires the government to state long-term objectives for five fiscal variables – revenue, expenses, budget balance, debt and net worth. The debt objective has, in recent times, been the only variable to be quantified – due to its role as the fiscal anchor. Your fiscal strategy states the long-term expense objective as being to *"reduce the growth in government spending to ensure operating expenses are consistent with the operating balance objective".*

25. The Public Finance Act gives you the flexibility to phrase your expense objective as a share of GDP – as was the practice between 1994 and 2003. Your fiscal strategy has an expense track, partly determined by your commitment to restrain the operating allowance to no more than $1.1 billion per annum. Given this, core Crown expenses are projected to fall as a share GDP (see figure 1 above). Therefore it would be straightforward to tag your expense objective with a quantifiable statement, e.g. *"...and so that over time, expenses are reduced to around 30% of GDP"*. You may wish to consider an option like this ahead of your 2011 Fiscal Strategy Report.

26. Potential benefits could include helping to shift the focus onto total spending, sending a signal of the Government's intended spending restraint, and providing a way to monitor progress against the fiscal strategy (along with the debt and fiscal balance measures). In making such a change, risks around over-specification (of both the target and timing) would need to be considered – given the potential for unexpected shifts due to the economic cycle or re-measurement. We are available to discuss this issue, and any of the above issues, with you.