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New Zealand's Fiscal Policy Framework: Experience and Evolution

John Janssen*

Abstract

Fiscal policy in New Zealand has seen a consolidation of the Government's position and continuing refinements to the institutional framework and Budget processes. The key institutional change has been the introduction of the Fiscal Responsibility Act 1994. The paper sets out the background to the fiscal policy framework, including fiscal history and various institutional changes in the public sector. This paper is a companion paper to Treasury Working Paper 01/24 by Angela Barnes and Steve Leith.

The key elements of the fiscal policy framework are explained and compared to various "fiscal rules" used internationally. The New Zealand framework differs from that used elsewhere, especially in its use of legislated "principles of responsible fiscal management" as opposed to mandatory targets. However, the Fiscal Responsibility Act 1994 does require Governments to set short-term fiscal intentions and long-term fiscal objectives for a range of fiscal aggregates.

The paper discusses the experience with the framework including a comparison of fiscal outcomes with fiscal objectives. The New Zealand experience has seen the evolution of specific operational targets (the fiscal provisions) to help improve the consistency of short-term intentions with longer-term fiscal objectives. The paper concludes with a set of challenges facing the framework, both short- and long-term.

JEL classification: E62 Fiscal Policy, H61 Budget.

Keywords: Fiscal policy, Fiscal Responsibility Act.

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NEW ZEALAND'S FISCAL POLICY FRAMEWORK: EXPERIENCE AND EVOLUTION [*]

1. Introduction

Over the past 15 years New Zealand has been paying considerable attention to the "rules of the game" for monetary, fiscal and regulatory policies. This new focus has been an integral part of New Zealand's economic reforms that have been well documented elsewhere and which have received considerable international attention.[1]

Prior to 1985, New Zealand labour and product markets were extensively regulated, effective tax rates were high and variable, and production of a narrow range of traded products left the economy vulnerable to shifts in world demand and shocks to commodity prices. A sustained period of fiscal deficits had seen a build-up in public debt, the current account deficit was close to 9% of Gross Domestic Product (GDP) in 1986, and inflation and inflationary expectations were high.

Institutional changes have separated and clarified the roles and responsibilities for monetary and fiscal policy. The Reserve Bank of New Zealand Act 1989 stipulates that the Bank is to formulate and implement monetary policy directed to the objective of achieving and maintaining stability in the general level of prices. The Fiscal Responsibility Act 1994 aims to improve fiscal performance and management and to bring a long-term focus to budgeting.

This paper discusses New Zealand's fiscal policy framework, experience and evolution. The paper is set out as follows:

- Section 2 provides a brief fiscal history and describes the various factors influencing the development of the fiscal policy framework. These factors include lessons from New Zealand's fiscal history and broader public sector reform.

- Section 3 outlines the key institutional change, namely the Fiscal Responsibility Act 1994.

- Section 4 compares the "fiscal rules" implied within New Zealand's framework with those used internationally.

- Section 5 sets out the experience with the framework. It includes a comparison of fiscal outcomes with fiscal objectives and sets out three key policy themes.

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[1] For example, see Bollard and Buckle (1987), Evans, Grimes and Wilkinson with Teece (1996), Silverstone, Bollard and Lattimore (1996). The latest IMF Article IV Staff Report and OECD Economic Survey provide further assessments, including recent policy developments.

- Section 6 describes the evolution of fiscal forecasting and refinements to the Budget process.

- Section 7 summarises some of the challenges facing New Zealand's fiscal policy framework and Section 8 concludes.

2. Background

A series of reforms between 1984 and 1994 saw significant changes to the institutional arrangements governing fiscal policy in New Zealand.[2] At a "macro" level, the Fiscal Responsibility Act (FRA) 1994 reflected a change in the focus of overall fiscal policy. The FRA needs to be set in the context of earlier "micro" reforms that altered the arrangements for management and decision-making in public sector organisations. Analysis of New Zealand's fiscal history helps identify some of the key influences behind the institutional changes.

2.1 Fiscal history

New Zealand's fiscal history is documented elsewhere, especially as a sub-set of the broader economic reform process (see for example Wells, 1987; 1996). Some of the key themes include:

- Government expenditure on final goods and services, benefit transfers and debt servicing was below 30% of GDP in the 1960s and early 1970s. By the early 1990s the ratio had increased to around 40% of GDP.[3] Average tax rates increased, but tax receipts lagged spending growth during the 1970s and 1980s. The rise in spending largely reflected rising benefit expenditures and higher debt servicing caused by persistent fiscal deficits (see Figure 1).

- Gross public debt increased from around 40% of GDP in 1974 to a peak of 78% in 1987. Net public debt was just below 5% of GDP in 1974, increasing to 52% of GDP in 1992. The net public debt ratio declined in some years as privatisation proceeds were largely used to repay debt (see Section 5.1 below). This reduction in the debt ratio from asset sales did not reflect a matching improvement in net worth.

- New Zealand's sovereign credit rating was downgraded through the 1980s and early 1990s. The Standard and Poor's rating of triple A was removed in 1983 and was AA– by 1991.

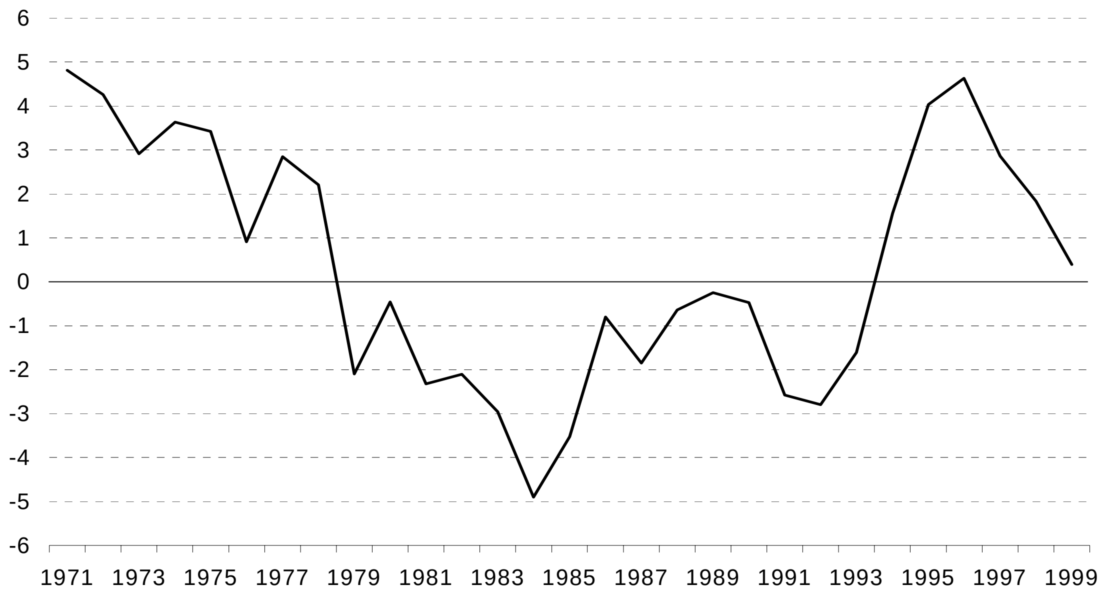
- In the 1970s and early 1980s New Zealand was a relatively active user of discretionary fiscal policy. Over the period 1973 to 1984 New Zealand's structural deficit increased by an average of 0.5% of GDP per year. The standard deviation

[2] See "Putting it Together – An Explanatory Guide to the New Zealand Public Sector Financial Management System" (August, 1996) available at www.treasury.govt.nz.

[3] See the discussion of historical expenditure trends in the 1997 Budget Policy Statement. Information for this period is cash based. This information, together with all other data on fiscal outcomes reported in the text, is effectively for "central government" only.

of New Zealand's structural deficit was the fourth highest in a sample of 19 OECD countries (Wheeler, 1991).

Figure 1 – Fiscal balance (% GDP)



Source: Buckle, Kim and Tam (2001).
Note: The fiscal variable used in this ratio is (central) government net cash flow from operations. It is on a March year basis up until 1989, June years from 1990 to 1999. It differs from other long-run measures of the cash balance (e.g., "Table 2") in that it excludes non-operating flows due to investing and financing activities. See Appendix Two in Buckle, Kim and Tam (2001) for details. From 1992 onward the series is the net cash flow from operations series in the Crown Financial Statements.

In his assessment of New Zealand fiscal policy during the 1970s and 1980s, Wheeler (1991) concluded that:

- Extensive use of fiscal policy in a demand management role did not produce sustainable growth.

- Expansionary fiscal policy led to a rapid deterioration in the net debt position.[4]

By the early 1990s, policy advice was oriented toward fiscal consolidation and a medium-term focus (see Treasury, 1990; Wheeler, 1991).

2.2 Public sector management reform

Public sector management reform provided Ministers with new tools for the examination of spending priorities amongst departments and for reviewing departmental efficiency (Treasury, 1990). Two distinctive but overlapping sets of ideas

[4] For a further discussion on the role of discretionary fiscal policy in New Zealand see Deane and Smith (1980) and Scott (1994).

influenced this reform. One derived from management theory, the other from institutional economics (the principal-agent issue).[5]

Management reform was grounded on the principle that for public sector managers to be held responsible for results, they needed the freedom to allocate resources within a given budget and run their organisations without external *ex ante* control (subject to delivering the required quantity and quality of goods and services).

Institutional economics suggested that the manager's (or agent's) interest might diverge from the owner's (or principal's) interest resulting in poor and inefficient outcomes. To facilitate appropriate behaviour, *ex-ante* performance criteria for managers were specified with performance evaluation contingent on delivery.

Three Acts cover the legislative framework underpinning the public sector management reforms.

2.2.1 The State-owned Enterprises (SOE) Act 1986

Where government services could be managed along commercial lines, the SOE Act allowed the Government to provide these services through organisational forms similar to private sector enterprises. The SOE Act embodies principles of management autonomy, clarity of objectives and transparency of process. Previously, SOEs had multiple and often conflicting objectives.

2.2.2 The State Sector Act 1988 (SSA)

The SSA established the accountability relationship between departmental chief executives and their Ministers. Departmental chief executives were placed on renewable contracts. These contracts made provision for annual performance agreements and made chief executives responsible for employing staff and determining their remuneration.

2.2.3 The Public Finance Act 1989 (PFA)

The PFA set out the way Parliament appropriates funds and gave chief executives powers and responsibilities in relation to financial management. The Act imposed budgeting and reporting requirements for departments and the government as a whole. It also changed the basis of appropriation from inputs to outputs or services, and from a cash basis to an accrual basis.

2.3 Fiscal policy reform

The public sector management reforms altered institutional arrangements at a "micro" level with the intention of achieving a more efficient and accountable provision of government services. The fiscal policy experience discussed in Section 2.1 above highlighted a number of broader fiscal policy lessons.

First, the impact of fiscal policy on economic activity in the short-term was difficult to predict and New Zealand's practical experience had not been positive. In normal

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[5] Clark and Sinclair (1986), Treasury (1987) and Holland and Boston (1990) provide further discussion of these ideas.

circumstances it was considered not desirable to make fiscal decisions with a view to managing real aggregate demand (Treasury, 1987).

Second, the presence of some overarching target or ceiling was seen as a way of improving the control of public expenditure (Treasury, 1990). For example, an overarching target could strengthen the incentives on Ministers to co-operate in setting priorities and to follow an agreed fiscal strategy. However, it was recognised that such targets usually had no strong analytical basis and had disadvantages if interpreted mechanically (e.g., policy inflexibility).

Third, better fiscal outcomes would require mechanisms for more regular information to the public on the medium-term fiscal outlook and the decisions that underpinned that outlook (Treasury, 1990).

Although there are differences, notably in the ability to assign the implementation of monetary policy to an independent authority, some of the ideas that influenced the Reserve Bank Act 1989 also influenced the design of institutional arrangements surrounding fiscal policy.[6] These ideas included the importance of transparency and credibility, and the need for institutional design to take into account the time consistency problem.[7]

2.3.1 The Fiscal Responsibility Act 1994 (FRA)

The FRA became effective from 1 July 1994 and reflected the lessons and thinking discussed above. Importantly, the Act also codified a number of developments that had evolved in previous years, especially on the reporting and transparency side. These developments included the shift to Generally Accepted Accounting Practice (GAAP) together with the publication of regular short-term fiscal forecasts and a pre-election economic and fiscal update. The final form of the Act was shaped by the views of a select committee of Government and opposition members of parliament (see Report of the Finance and Expenditure Committee, 1994).

As introduced, the Finance and Expenditure Committee saw the Fiscal Responsibility bill as neutral with respect to the fiscal stance that a government might choose to adopt. However, the Government would be required to provide a fiscal strategy report that would set out overall fiscal objectives and ten-year (minimum) fiscal projections.

The Committee determined that the weight of evidence presented to it supported the view that transparency alone was insufficient and recommended that the bill be strengthened in three ways:

- Inclusion of legislated principles of responsible fiscal management.

- Publication of a Budget Policy Statement.

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[6] The Reserve Bank Act 1989 sets out the objective of price stability. The precise target of monetary policy and the definition of price stability are set out in the Policy Targets Agreement (PTA). The PTA is an agreement between the Reserve Bank and the Minister of Finance. The Bank has "instrument independence" and its Governor is accountable for achieving the targets set out in the PTA. See Reddell (1999) for a discussion of how the public sector management reforms discussed in Section 2.2 influenced the formulation of institutional arrangements for monetary policy.

[7] See for example, Chari, Kehoe and Prescott (1988).

- Providing for the Budget Policy Statement and other reports required under the legislation to be referred to a parliamentary committee.

Although the Committee considered the role of mandatory targets, the then Government rejected them, giving the following reasons (see Report of the Finance and Expenditure Committee, 1994, pp.13-14):

- There is no solid theoretical justification for any particular fiscal target that can be maintained over a period of time. Judgements on the appropriate level of fiscal aggregates vary over time and depend on the economic circumstances currently prevailing.

- Other countries' experience of legislated targets suggests that there are substantial risks attached to their use. In particular, rigid adherence can seriously distort decision-making and, unless carefully handled, minor variations from target can result in significant but unnecessary damage to credibility.

- Their inherent inflexibility makes it difficult for fiscal policy to respond appropriately to the inevitable volatility of economic circumstances. While targets in principle could be expressed in cyclically-adjusted terms, in practice these are difficult to measure effectively.

- Despite the advances made in terms of the availability and transparency of fiscal information, human ingenuity has yet to find a way of specifying fiscal targets that cannot be effectively and often comprehensively evaded. Furthermore, without the political will to achieve targets, ways are inevitably found to avoid them.

The Committee considered that legislated principles provided a number of advantages over mandatory targets. These included the encouragement of a medium to long-term perspective with recognition that governments may have to depart from the principles, but requiring this to be justified. It was also considered important that institutional change designed to improve fiscal performance should be sufficiently "flexible" so as to endure through the shift to a Mixed Member Proportional (MMP) electoral system.[8]

The FRA does not prescribe fiscal targets in legislation. However, it does require Governments to set short-term fiscal intentions and long-term fiscal objectives (see Section 3.2 below). Short-term fiscal intentions for key aggregates still create issues when interpreting results given cyclical changes and valuation changes. These issues explain further evolution of the framework, including the role of the fiscal provisions as a key anchor in the short-term (see Section 6).

[8] The New Zealand electoral system changed from First Past the Post to MMP in 1995, following a referendum in 1993. The 1996 election was the first to be held under MMP.

3. The Fiscal Responsibility Act 1994

The FRA aims to improve fiscal policy by specifying principles of responsible fiscal management and strengthening reporting requirements.[9]

3.1 Principles of responsible fiscal management

Governments are required to follow a legislated set of principles and publicly assess their fiscal policies against these principles. Governments may depart temporarily from the principles but must do so publicly, explain why they have departed, and indicate how and when they intend to conform to the principles. The five principles of responsible fiscal management are:

(a) Reducing total Crown debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total Crown debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the Crown in each financial year are less than its total operating revenues in the same financial year.

(b) Once prudent levels of total Crown debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues.

(c) Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future.

(d) Managing prudently the fiscal risks facing the Crown.

(e) Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

Definitions 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.

Importantly, although a Government can depart from the principles, the FRA requires any such departure to be temporary and that the Minister of Finance specify the reasons for departure, the approach to be taken to return to the principles and the period of time this is expected to take.

3.2 Reporting requirements

Governments must publish a Budget Policy Statement (BPS) before the annual Budget and a Fiscal Strategy Report (FSR) at the time of the Budget (see Box 1). These publications must demonstrate the consistency of the Government's short-term fiscal intentions and long-term fiscal objectives with the principles of responsible fiscal management (Table 1 provides more detail). The Act requires the FSR to include fiscal

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[9] See "Fiscal Responsibility Act 1994 – An Explanation" (September, 1995) available at www.treasury.govt.nz.

projections (the “Progress Outlooks”) covering a minimum of 10 years for the variables specified as long-term fiscal objectives.[10]

The Treasury is required to prepare regular economic and fiscal forecasts (see Box 1). Having the timing and broad nature of the overall forecasts specified in legislation raises their credibility.

Under the FRA, all financial statements included in reports required by the Act are prepared under Generally Accepted Accounting Practice (GAAP). 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 policy must be disclosed, including non-cash items like depreciation and changes to government employee pension rights.[11] The predecessor of GAAP was “Table 2” which was prepared on a cash basis.

GAAP provides externally set and audited standards and helps avoid some of the boundary problems that affected previous fiscal forecasts (e.g., the treatment of forestry cutting rights in the early 1990s).

The economic and fiscal forecasts are based on the Treasury’s best professional judgement about the impact of policy, rather than relying on the judgement of the Government. The FRA requires the Minister of Finance to communicate all of the Government’s policy decisions to the Treasury. The fiscal forecasts are also required to disclose contingent liabilities and other specific fiscal risks.

Finally, all reports required under the Act are referred to a parliamentary select committee that comprises representatives from the Government and opposition parties.

[10] The BPS and FSR are Government documents. The Progress Outlooks contained in the FSR use economic assumptions determined by the Treasury and fiscal assumptions agreed by the Government. The first years of the Progress Outlooks are the short-term fiscal forecasts. Beyond the forecast horizon, the Outlooks ignore cyclical effects and so the projected fiscal position is structural.

[11] In addition to a range of other financial statements, the Crown produces a statement of financial performance (operating statement), a statement of financial position (balance sheet), a statement of cash flows and a statement of borrowing. This provides a comprehensive set of accounts that reconcile operating, cash and balance sheet statements.

Table 1 **–** Short-term fiscal intentions, long-term fiscal objectives, and principles of responsible fiscal management

	Short-term fiscal intentions Expenses, revenues, operating balance, debt, net worth	**Long-term fiscal objectives** Expenses, revenues, operating balance, debt, net worth	**Principles of responsible fiscal management** (a) to (e) in text
Set by:	Current Government	Current Government	Specified in Act, Section 4(2)
Time horizon:	Three-years	Not specified	Not specified*
Required reporting:	Fiscal forecasts	Progress Outlooks (10-year minimum fiscal projections)	Specified in Act
Other reporting:	Cyclically-adjusted operating balance	“What if?” long-term fiscal scenarios (typically 50-years)	
Operational target:	Fiscal provisions (see Section 6 in text)		

* As a set, the principles endure with the Act. However, individual principles do not contain explicit time horizons.

3.3 The credibility of fiscal policy

Setting long-term fiscal objectives and ensuring consistency of short-term intentions with these requires governments to consider the long-term consequences of their decisions, including longer-term sustainability.

Overall, the FRA approaches the time consistency issue from the interaction of the long-term fiscal objectives, the short-term fiscal intentions and the longer-term fiscal projections. The credibility of fiscal policy will be undermined by:

- fiscal outcomes that consistently deviate from the stated path, or
- fiscal projections indicating objectives will not be met over a reasonable period of time given plausible economic and policy assumptions.

The longer-term fiscal projections provide a guide to the broad sustainability of fiscal policy. For example, an assumed tax reduction (spending increase) without a change to spending (tax) assumptions could see a rising debt profile through time. Although a Government could signal a future reduction in spending (increase in taxes), the projections increase the transparency around the implied policy change.

Box 1 – Key reports required under the Fiscal Responsibility Act 1994

The Budget Policy Statement is published by the end of March and is required to set out:[12]

- Long-term fiscal objectives for Crown operating expenses, revenues and balance, debt and net worth.
- Short-term fiscal intentions for the above variables for the Budget year and the following two financial years.
- Broad strategic priorities for the coming Budget.

The Fiscal Strategy Report is tabled with the Budget and must include:

- A comparison of the fiscal forecasts in the Budget Economic and Fiscal Update with the short-term fiscal intentions in the BPS.
- Progress Outlook projections for ten or more years of the variables specified for the long-term fiscal objectives.
- Assessment of the Progress Outlooks with the long-term fiscal objectives in the BPS.

Inconsistencies between the BPS and/or the FSR and the immediately preceding Statement or Report must be explained and justified by the Government.

The Treasury is required to prepare:

- An Economic and Fiscal Update at the time of the Budget and each December.
- A Pre-election Economic and Fiscal Update before each general election.

The Updates provide short-term forecasts for variables such as GDP, consumer price inflation, unemployment and the current account of the balance of payments. Fiscal information includes forecasts of the Crown financial statements.

[12] Fiscal years begin 1 July and the Budget must be presented by the end of July each year.

4. International Developments on Fiscal Policy Frameworks

The 1990s saw the development of a variety of fiscal policy frameworks internationally, including the Code for Fiscal Stability in the United Kingdom and the Australian Charter of Budget Honesty. The Maastricht Treaty imposes a deficit ceiling and a debt limit. The Stability and Growth Pact specifies particular circumstances where a deficit can be regarded as excessive.

In terms of reconciling short-run movements in deficits and debt ratios with long-term commitments, the OECD (1998) examines the potential role for limits such as the "golden rule" and "deficit or debt ceilings". The following sections compare and contrast some of these mechanisms with those implied in New Zealand's fiscal policy framework.

4.1 The golden rule

The golden rule links increases in debt to public investment. For example, the United Kingdom's golden rule requires current receipts to equal current expenditure over the economic cycle so that over a cycle the government borrows only for (net) investment.[13] The OECD (1998) suggests that although a golden rule may offer benefits through tax-smoothing, it requires a clear definition of public capital formation and strong public financial accounting standards.

The FRA principles of responsible fiscal management reflect a golden rule approach. Principle (b) requires balance between operating revenues and expenses (which are inclusive of depreciation) over a "reasonable period of time". This can, and has been interpreted as implying that the economic cycle is the appropriate period over which to balance the budget (see Wells, 1996). In practice, there are difficulties in measuring the economic cycle and the underlying fiscal position. Principle (e), pursuing policies consistent with a reasonable degree of predictability about the level and stability of tax rates, also acknowledges tax-smoothing arguments.

4.2 Deficit ceilings

Specific deficit ceilings are a feature of the Maastricht Treaty. Dalsgaard and de Serres (1999) have estimated "safe" budget balances for a group of European Union countries. These "safe" budgets are the target needed to ensure, at a given level of probability, that the three percent deficit limit required by the Maastricht Treaty is not breached over a particular time horizon. The estimated safe budgets are based on model estimates of the effect of disturbances on the fiscal position.

Under the FRA, short-term fiscal intentions are set by the current Government and must be consistent with objectives and principles. Short-term intentions have previously been expressed in terms of specific numerical targets. For example, "achieving fiscal surpluses of at least 3% of GDP" to provide a cushion for adverse events (see the 1996 BPS). More recently, the short-term fiscal intentions have tended to reflect the fiscal forecasts.

Along similar lines to the Dalsgaard and de Serres study, preliminary work by Buckle, Kim and Tam (2001) develops a procedure for identifying the *ex ante* fiscal balance

[13] Buiter (2001) provides further analysis of the UK golden rule. Note that both the UK and New Zealand also have debt goals.

required to achieve, with a given probability, a desired *ex post* budget balance for alternative time horizons.[14] The analysis indicates that to avoid a budget deficit at a 95% confidence interval, the (average) annual *ex ante* budget balance for New Zealand should be set at a surplus of 1.5% of GDP if the fiscal planning horizon is one year. This target rises to 1.8% and 2% of GDP for horizons of two and three years respectively as the probability of adverse shocks increases and the propagation process becomes more pronounced.

4.3 Debt ceilings

Unlike the Maastricht Treaty, the FRA does not prescribe numerical targets for debt. The "prudent" level of debt is not specified in the legislation and it is left up to the Government of the day to interpret the relevant level. The Act (implicitly) accepts that a range of factors will influence prudent debt levels, including the nature of likely shocks, structural features of the economy, the nature of the Crown's balance sheet and future developments affecting spending and taxes.

Credit Suisse First Boston (1995) analyse the "optimal debt" question given the key characteristics of the New Zealand economy (i.e., small, open, presence of distorting taxes, openness to world capital markets, emigration and local demographics). In a deterministic setting they conclude that current and capital spending plans should be determined independently of the debt decision. Optimal tax policy would plan for a constant average tax rate through all future periods.

However, the judgement in the mid-1990s was that New Zealand's debt levels were imposing significant economic costs and debt reduction was a policy priority. One of the practical considerations influencing the specification of long-term debt objectives into the future is the approach taken to the fiscal consequences of population ageing (see Section 7.8 below).

4.4 Conservative assumptions

Prudent or conservative economic assumptions have been used in a number of countries to avoid the problem of overestimating the strength of the fiscal position.[15] Canada provides an example where fiscal targets have been set with projections based on "conservative" economic assumptions and a contingency reserve. For the purposes of projecting the public finances on a "cautious and prudent basis", the United Kingdom has assumed trend rates of economic growth that differ from what might be considered the neutral estimate.

Although such assumptions may generate initial credibility benefits, once credibility is established financial markets are likely to adjust their expectations. They could therefore incorporate the degree of conservative bias and assess governments relative to this bias-adjusted outlook. Similarly, spending Ministers and departments are also likely to adjust their actions through time to offset the bias. The FRA requires short-

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[14] A structural vector auto-regression is estimated over the period 1971 to 1999 and includes real GDP, the fiscal balance-to-GDP ratio, the sum of real private consumption and real private investment, and the GDP deflator. Due to data limitations, the fiscal variable uses net cash flows from operations rather than the operating balance. The *ex ante* targets cited here are based on simulations where fiscal policy shocks are "switched off".

[15] OECD (1998, Annex 2).

term forecast and medium-term projection assumptions, and hence any safety margins, to be published.

5. Experience with New Zealand's Fiscal Policy Framework

Fiscal outcomes over the 1990s provide insights into the strengths and weaknesses of the fiscal policy framework.

5.1 Fiscal outcomes

New Zealand's fiscal position improved substantially during the first half of the 1990s. To gauge the extent to which the economic cycle influenced the fiscal position, Figure 2 provides an estimate of the cyclically-adjusted, or structural balance.

With revenue remaining broadly stable as a share of GDP, the change in the fiscal balance was achieved largely through the expense side.

The decline in expenses partly reflects lower finance costs as interest rates fell, and fiscal surpluses and asset sales reduced the level of debt. (Expenses excluding finance costs were around 38% of GDP in 1992 and 32% of GDP in 2000.) Approximately NZ$19.2 billion was raised from the sale of government businesses and other assets between 1987 and 1999. Proceeds contributed to the repayment of public debt, and a zero net-foreign currency debt goal was reached in 1996. Progress against stated long-term objectives for net debt is given in Figure 3.[16]

Although significant progress was made in reducing operating expenses as a share of GDP from the levels evident in the early 1990s (see Figure 4), progress against the stated long-term objective stalled during the mid- to late-1990s.[17]

In addition to the decline in finance costs, the decline in expenses through the 1990s also partly reflects the economic upswing and the associated fall in unemployment benefit expenses. The increase in the age of eligibility for New Zealand Superannuation (NZS) and fiscal discipline in the core public sector also contributed to the decline in expenses-to-GDP. Changes in the profile of the major components of total expenses (by functional classification) are illustrated in Figure 5.

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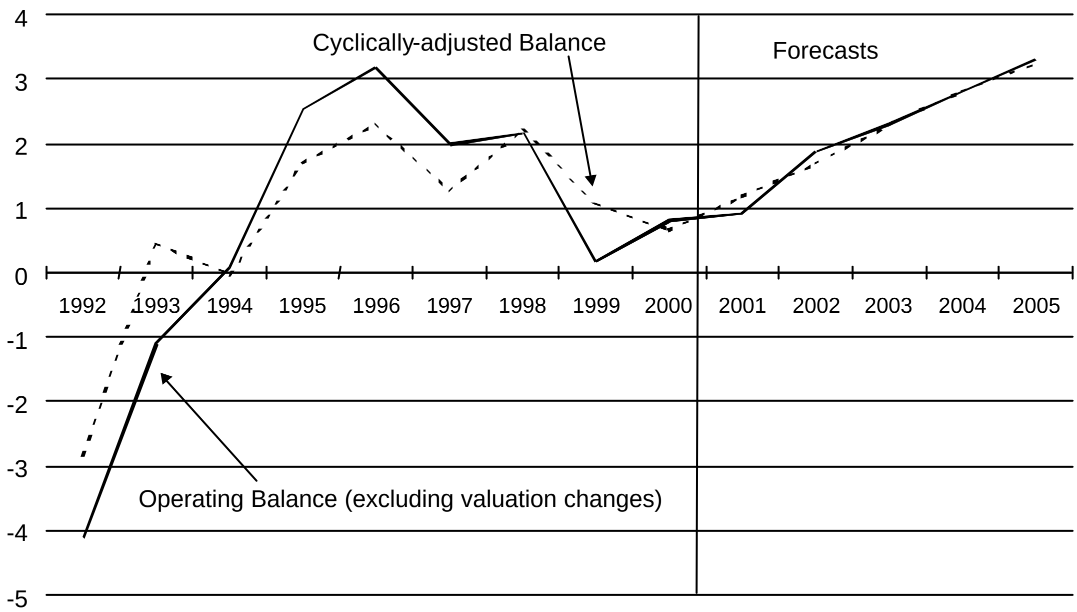
[16] The general trend in net debt tends to match operating balance trends. However, the operating balance is an accrual measure and recognises non-cash items (e.g., retained surplus of SOEs and Crown entities). The relationship between net debt and the operating balance is reconciled in each Economic and Fiscal Update. The 1994 FSR expressed the long-term objective for net debt as between 20% and 30% of GDP. This was changed to below 20% of GDP in the 1995 BPS and to 15% of GDP in the 1998 FSR. An objective for gross debt was introduced in the 1997 BPS and is currently 30% of GDP. The current formulation of the net debt objective is 20% of GDP (excluding assets accumulated for the purpose of funding future public pension expenses).

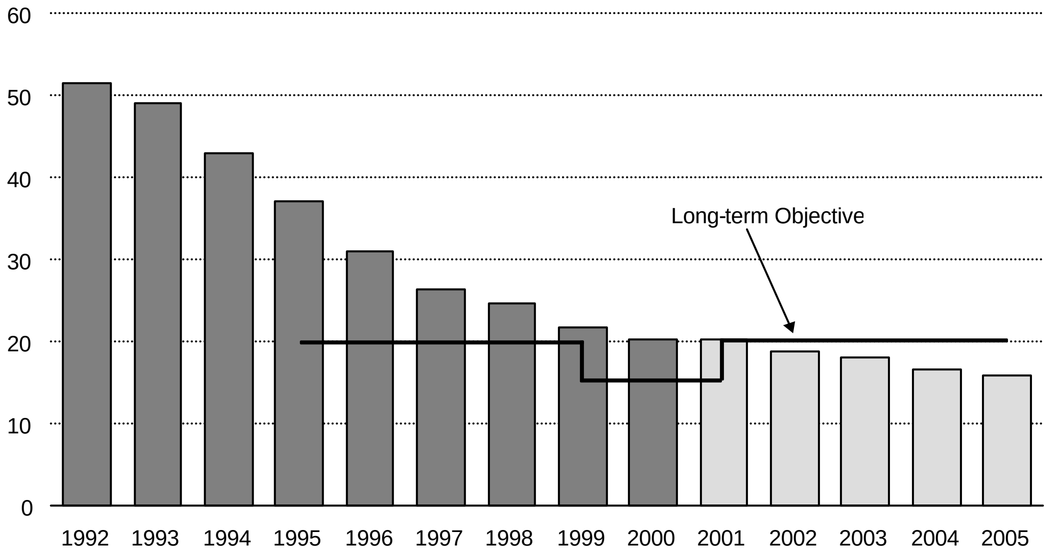
[17] The long-term objective for expenses was changed in the 2000 BPS to "Expenses around current levels of 35% of GDP". Note that the historical trend in expenses is somewhat distorted by the effects of valuation changes and foreign exchange losses/gains (see Note to Figure 2). For example, foreign exchange losses in 1992 were around $1.8 billion (2.4% of GDP).

Figure 2 – Operating balance and cyclically-adjusted operating balance: Estimate and forecasts (June years, % GDP)



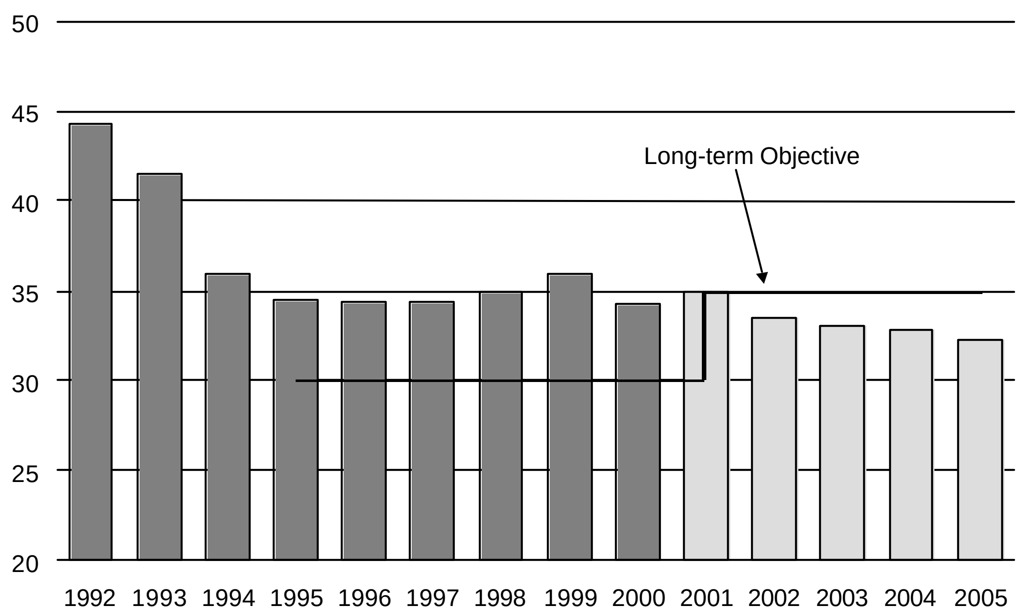
Source*:* The Treasury, December Economic and Fiscal Update, 2000.
Note: This analysis removes the effect of valuation changes (including changes to the liability of the pension scheme for government employees, the liability of the accident compensation scheme, losses/gains on sale of assets, and foreign exchange losses/gains). The estimate requires assumptions about potential output and the responsiveness of revenues and unemployment expenses to output. These assumptions are based on, and are sensitive to the latest available information. The estimate of potential output is derived using a Hodrick-Prescott filter.

Figure 3 – Net Crown debt: Actual and forecasts (June years, % GDP)



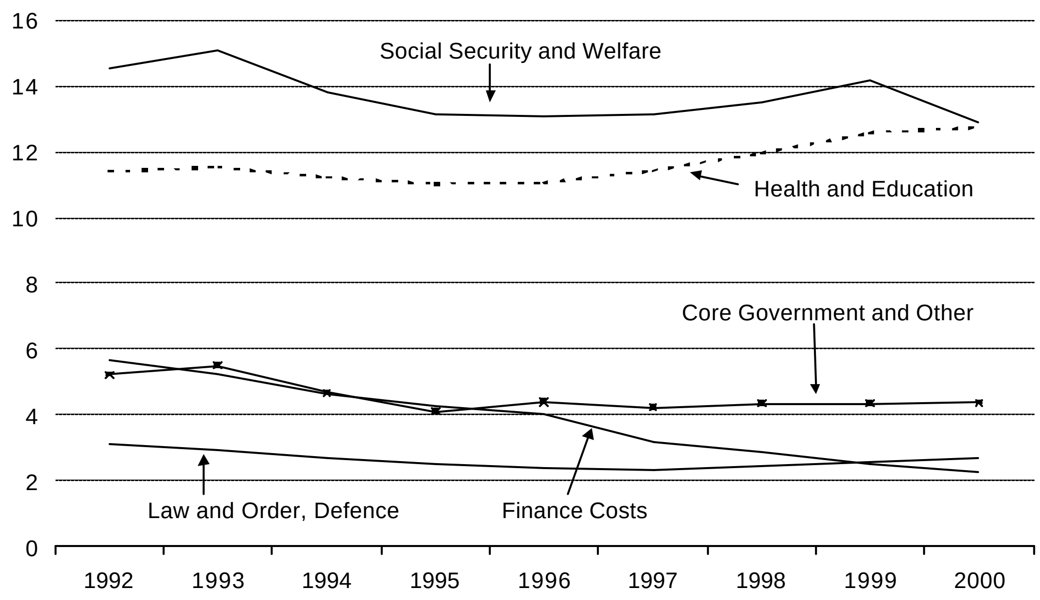
Source: The Treasury, December Economic and Fiscal Update, 2000.

Figure 4 – Expenses: Actual and forecasts (June years, % GDP)



Source: The Treasury, December Economic and Fiscal Update, 2000.

Figure 5 – Expenses: Functional components (June years, % GDP)



Source: The Treasury.

Longer-term (10-year) fiscal projections in the mid-1990s suggested rapid progress toward the then long-term fiscal objectives. For example, the baseline projection in the 1996 FSR indicated the elimination of net debt by 2001/02. This degree of debt reduction (and eventual asset accumulation) represented a higher level of government saving than the then Government considered desirable. A "structural" fiscal correction aimed at longer-term economic and social objectives became an option. Personal income tax reductions and additional spending plans were announced in early 1996. This structural correction was predicated on relatively strong assumptions regarding expenditure control that are discussed below and in Section 6.2.

5.2 Key themes from the experience of the 1990s

Three key themes emerge from the experience with the fiscal framework during the 1990s.

5.2.1 Setting and achieving long-term fiscal objectives

The FRA does not specify the timeframe for the long-term fiscal objectives and in practice the implicit timeframes for the objectives were different.[18] For example, when debt was at relatively high levels in the early 1990s, the focus was on the debt and operating balance objectives rather than the expense objective. Debt and operating balance objectives could be met with a range of possible revenue and expense tracks.

As noted above, progress against the stated expense objective slowed during the mid- to late-1990s. Indeed, even if the 30% of GDP objective had been reached it was not clear that it could be sustained given the projected demographic changes that would begin to emerge after around 2010.

The implicit timeframes associated with the long-term fiscal objectives during the 1990s reflect an over-specification issue within the FRA (the requirement to specify long-term objectives for expenses, revenues, the operating balance, debt, and net worth). The FRA does not specify which variable is the binding constraint nor does it require governments to explicitly state a preference ranking.

5.2.2 An increasing focus on longer-term fiscal issues

The second half of the 1990s saw an increasing focus on longer-term fiscal issues. This was assisted by the shift to a more sustainable fiscal position and more information on the implications of demographic change, in particular, the consequences of population ageing for public pensions and health spending.[19]

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[18] The framework does not preclude a government from specifying a particular time frame or convergence path toward long-term objectives.

[19] 50-year spending scenarios have generally been included in each Fiscal Strategy Report (with the first report published in 1994). The potential consequences of population ageing on the longer-term fiscal position were a factor influencing the debt reduction strategy during the first half of the 1990s.

Further detail is provided in Section 7.8, but examples of this longer-term focus include:

- Reports on retirement income policy (e.g., Periodic Report Group, 1997). The 1997 Report reviewed the framework for private and public provision and included long-term projections of NZS costs.

- The 1997 referendum on a compulsory Retirement Savings Scheme (RSS).

- A comparison of alternative financing methods in the 1999 Fiscal Strategy Report ("tax-smoothing" versus "balanced budgets").

- The establishment of a Superannuation Task Force in late 1999 (disestablished in 2000).

- The proposed New Zealand Superannuation Fund, which is giving effect to a tax-smoothing approach for a part of future public pension expenses. [20]

5.2.3 Setting short-term fiscal policy

Changes to fiscal policy settings in the mid-1990s involved some difficult judgements about short-term pressures on aggregate demand, the size of supply-side responses (primarily through labour supply) and likely spending increases.

The size and timing of tax reductions depended on a number of conditions being met. These included net debt being under 30% of GDP and no risk of a return to fiscal deficits in the foreseeable future. The conditions also included the avoidance of balance of payments and inflationary pressures (see FSR 1995).

The Treasury and Reserve Bank assessments were that the outlook for aggregate demand was such that tax reductions could be accommodated without causing significant inflationary pressures. However, the economy evolved differently from the initial assessment with aggregate demand stronger than expected in 1996.[21] The episode provides an example of the complex issues involved when adjusting fiscal policy in an environment of uncertainty about the evolving nature of the economy.

Furthermore, pre-1997 forecasting assumptions for expenses involved a tension between setting appropriate assumptions for macroeconomic management purposes (e.g., impact on aggregate demand) and the political economy of incorporating a specific amount for new spending (e.g., an explicit amount might set a "floor" rather than a "ceiling" on spending demands).

Valuation changes and cyclical movements also complicated the interpretation of short-term intentions for fiscal aggregates against outcomes. In particular, the pension scheme for government employees and the outstanding claims liability of the accident compensation scheme fluctuate from year to year due to changes in long-term financial assumptions and other factors. For example, movements to the liability valuations for

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[20] Details are available at www.treasury.govt.nz/release/super.

[21] See the Reserve Bank of New Zealand submission to the Independent Review of the Operation of Monetary Policy, supporting document on "Fiscal and monetary coordination" (www.rbnz.govt.nz/monpol/review).

these two items boosted the operating balance in 1999/2000 by around $700 million (the actual operating balance was $1.5 billion or 1.4% of GDP).

By the late 1990s, debt-to-GDP ratios were significantly lower and there was increased scope to allow for the operation of automatic fiscal stabilisers. Policy-makers were in a better position to assess the nature and likely duration of economic shocks.[22] Nonetheless, the maintenance of operating surpluses was seen as important given the size of New Zealand's current account deficit and net external liabilities. For example, the Asian financial crisis saw the then Government make incremental adjustments to short-term fiscal plans during 1998 as new information emerged.

By the time of the 1999 BPS (published in December 1998), longer-term fiscal projections indicated four years of fiscal deficits. Although the fiscal position was projected to eventually move into surplus, there was a limited "buffer" against further adverse events and the achievement of longer-term debt and expense objectives was pushed out. The "Policies for Progress" programme included steps to improve the medium-term economic and fiscal outlook.

6. The Evolution of Fiscal Forecasting and Budget Processes

In response to the experience with the framework in the mid-1990s, there have been refinements to fiscal forecasting and Budget processes. The following description on the top-down management of government spending is drawn from Barnes and Leith (2001). The two key tools for ensuring overall fiscal control and effectiveness are fixed nominal baselines for departmental spending and the fiscal provisions framework.

6.1 Fixed nominal baselines

The early 1990s saw a change whereby Government spending could be characterised as being split into two tracks: "formula-driven" (i.e. indexed) and "fixed" (i.e. no change to nominal baseline amounts). Previously, departmental funding was split into three main input-based streams: personnel, operating costs and capital. Personnel costs were regularly adjusted for movements in wages, and the other two streams were generally adjusted annually to reflect expected cost movements. The Public Finance Act enabled a baseline approach.

Formula driven indexation applies to non-departmental spending on benefits (e.g., inflation indexation of unemployment payments) and to New Zealand Superannuation. Health and education spending are adjusted through formulas that take into account demographic change. A specific policy decision is required to change the amount spent on non-indexed spending.

6.2 Forecasting assumptions

A key issue to emerge from these changes was the relationship between fixed nominal baselines and the short-term fiscal forecasts. Three-year budget forecasts prepared under GAAP between 1994 and 1996 would include increases in government spending

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[22] See Fowlie (1999) for a discussion on the operation of automatic fiscal stabilisers and their relationship with the FRA. Tam and Kirkham (2001) provide further analysis on the calculation and size of automatic fiscal stabilisers.

only for those areas affected by indexation. All other spending was assumed to remain constant over time.

This approach provided what might be described as a policy neutral forecast. Cost pressures and new initiatives were "assumed" in the forecasts to be funded from savings and efficiency gains. However, because the fiscal forecasts did not allow for new spending in future Budgets, they understated the likely spending profiles. An example of this "forecast bias" is illustrated in Table 2 below.[23] The left-hand column sets out the forecasts for the 1997/98 year operating balance at different points in time, starting from the first time it was forecast through to the actual result. The right-hand column decomposes the change into its forecasting and policy components. The "forecasting" component includes changes attributable to different macroeconomic conditions than forecast, and revised tax and welfare bases.[24]

The analysis indicates that there was significant policy change ($3.7 billion) with respect to the forecast assumption. This "slippage" against forecast reflects the tension mentioned in Section 5.2.3 – between setting realistic assumptions and the political economy of incorporating a specific amount for new spending.

***Table 2* –** Operating balance for 1997/98: forecast and policy changes

Forecast 1997/98 operating balance ($billion)		**Policy and Forecast changes from 1994 DEFU to actual result ($billion)***	
1994 DEFU	7.6	Revenue: Policy	– 1.0
1995 Budget	7.8	Revenue: Forecasting	– 1.1
1996 Budget	3.3	Expenses: Policy	– 2.7
1997 Budget	1.5	Expenses: Forecasting	– 0.6
1998 Budget	2.8	SOE/CE surplus: Policy	–
1998 Actual	2.5	SOE/CE surplus: Forecasting	0.2
		Total: Policy	– 3.7
		Total: Forecasting	– 1.5
Actual less DEFU forecast	– 5.1		– 5.2

* Change is expressed in terms of the impact on the operating balance. DEFU refers to December Economic and Fiscal Update. CE refers to Crown entity. Totals do not sum due to rounding.

Source*:* Adapted from Table 1.4, OECD (1999).

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[23] If fixed nominal baselines and indexed spending are strictly interpreted as representing current policy, then increases in spending reflect a change in fiscal policy rather than "forecast bias".

[24] Some of the forecasting change may reflect changes in fiscal policy and so could arguably be allocated to the policy change component. The decomposition used does not allow for these effects.

The approach resulted in optimistic projections of progress towards the long-term fiscal objectives.[25] This created a number of issues, including those mentioned previously around macroeconomic management as well as discipline on the annual Budget process. Further, the approach raised credibility problems about likely progress towards long-term fiscal goals (see for example, OECD, 1999).

On the political side, there were also pressures to find a better way to represent spending intentions. For example, New Zealand's first coalition government sought a mechanism to demonstrate fiscal prudence and reduce the possibility that portfolio Ministers from different coalition parties would bid up spending in their sector. The response was a statement incorporated into the Coalition Agreement committing to a (cumulative) $5 billion cap on new spending over a three-year term of government to 1999/2000.

Importantly, this cap was on top of expenses already included in the fiscal forecasts (i.e. on top of the fixed nominal baselines and formula-driven indexed items). The cap evolved into a mechanism now known as the fiscal provisions.

6.3 Fiscal provisions

The fiscal provisions were introduced into the forecasts during the 1997 Budget.[26] The provisions framework consists of a pre-determined fiscal limit across the parliamentary cycle (three years), and a set of rules for "counting" against that limit.

The *operating* provisions are recorded in the Statement of Financial Performance as expenses. However, they are available for decisions that relate to changes in revenue, expenses or the surpluses of SOEs and Crown entities. The provision is defined as a cumulative, three-year total. For example, a decision taken to increase a department's baseline in 2000/01 will generally represent a permanent increase (i.e., annual increases "roll out" into the following years).

A *capital* provision, which links to the Government's debt objectives, exists alongside the operating provisions. The capital provision covers both physical assets and financial assets (e.g., loans). The provision generally provides for new investments or where maintaining current operations cannot be funded from accumulated depreciation on balance sheets. The provision also covers capital savings, including capital withdrawals (special dividends) from SOEs and Crown entities.

Establishing fiscal provisions requires a Government to consider its long-term objectives for the operating balance, debt reduction/asset accumulation, and future expense pressures.

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25 The Progress Outlooks in Fiscal Strategy Reports did include higher spending scenarios and so provided some indication of alternative paths towards stated long-term fiscal objectives.

26 Repeating the analysis in Table 2 for the 1999/2000 operating balance (first forecast in the 1996 Pre-Election Economic and Fiscal Update) yields an actual less forecast difference of minus $5 billion. This comprises a forecasting difference of $2.2 billion and a policy difference of $2.8 billion. This policy difference is lower than that in Table 2 ($3.7 billion), reflecting the increasing role of the provision after 1997.

6.3.1 Operating provisions

The operating provisions focus on the operating balance impact of changes to existing policy (including cost increases) or the introduction of new policy. The framework focuses on decision-making and, therefore, only discrete policy decisions.[27] The focus on discrete policy changes builds on and extends the past practice of having fixed nominal baselines for most departmental spending, while allowing forecasting changes to fluctuate with the state of the economy.

The provision requires principles that determine which items will be treated as forecast changes, and which would be treated as specific policy decisions that "count". The development of the principles has evolved considerably since the framework was introduced (for details, see Barnes and Leith, 2001).

The operating provisions are not a direct mechanism to control the operating balance in the short-term. For example, under accrual accounting there are fluctuations due to liability valuations.

The effects of the economic cycle are also beyond the immediate control of the Government. The general approach taken is that as forecasts change through time, the fiscal provision limit is unaltered. This allows other fiscal variables to change as the automatic fiscal stabilisers operate through the cycle. Analysis for New Zealand indicates that cyclical effects operate mainly through the revenue side. Unemployment is the major cyclical expense.

Beyond the three-year parliamentary cycle, the fiscal forecasts have included "technical provision/s" to represent potential future policy decisions to be made as part of future Budgets.[28]

The Government's operating provision at the time of the December Economic and Fiscal Update 2000 was $5.9 billion (inclusive of Goods and Services Tax, GST). The provision is phased across the three year period in accordance with the expected profile of policy decisions. (The $5.9 billion provision covers four years as the election was held in November 1999, and the new Government undertook a number of initiatives in the 1999/2000 year.)

The provision was based on the Government's broad fiscal goals and the most recent set of fiscal forecasts (those in the Pre-Election Economic and Fiscal Update, October 1999. See Barnes and Leith 2001 for details). Figure 6 provides a graphical representation and Table 3 details the dollar amounts.

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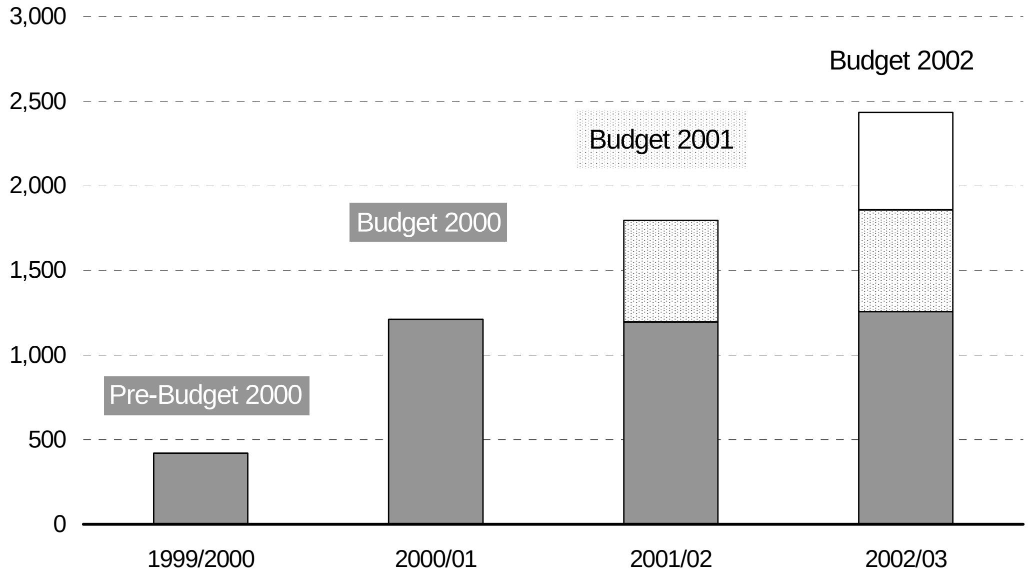
[27] For example, an increase in benefit payments due to higher unemployment would not impact on the provisions. In contrast, a decision to increase the amount of the benefit payment (over and above any automatic inflation indexation) would impact on the provisions.

[28] In the current Progress Outlooks the amount assumed beyond the fiscal forecast horizon is termed a "fiscal allowance" and provides a broad indication of fiscal flexibility rather than a specific policy commitment. The Outlooks also include an allowance for capital.

Figure 6 – Fiscal provision allocation as at December Economic and Fiscal Update, 2000 (June years, $ millions)



Source: The Treasury.

Table 3 **–** Fiscal provisions as at December Economic and Fiscal Update, 2000

Operating provisions ($million, GST inclusive)	**1999/00**	**2000/01**	**2001/02**	**2002/03**	**Total**
Budget 2000 decisions	420	1,050	1,060	1,120	3,650
Inter-Budget contingency*	–	161	136	138	435
Budget 2001 provision	–	–	600	600	1,200
Budget 2002 provision	–	–	–	575	575
Total	**420**	**1,211**	**1,796**	**2,433**	**5,860**

* Within Budget 2000, the Government committed $3.65 billion of the $5.9 billion fiscal provision. It also set aside a contingency for further initiatives over three years. Approximately $240 million of this has been committed.

Source: The Treasury.

7. Challenges facing New Zealand's Fiscal Policy Framework

Challenges and ongoing developments can be grouped into short-term fiscal policy (primarily the fiscal provisions) and longer-term issues associated with population ageing.

7.1 Provisions beyond the parliamentary term

The provisions framework is established for the three-year parliamentary term. However, the fiscal forecasts extend beyond the parliamentary term, more so as the term progresses. Technical provisions are included to ensure a realistic expense profile is maintained.

The technical provisions present issues about the transition to the next three-year provision, for example, when a government makes decisions that impact beyond the horizon of its fiscal provisions. If the decisions are rising in cost, then these are not "counted" against any technical provisions. This is termed the "bow wave" effect (effectively expenditure creep). In addition, the transition beyond the three-year term may result in large changes in provisions as they are finalised.

7.2 Capital provision

Currently the capital provision is largely based on a bottom-up assessment of likely capital requirements. Uncertainty around long-term investment needs has led to changes in the provision as specific needs emerged. The "sanctions" around the capital provision are less transparent than those around the fiscal (operating) provisions. The Government is currently addressing the need for a more comprehensive framework that will guide capital investment decisions within sectors and across the whole of government.

7.3 Decisions at the margin

The fiscal provisions focus on the margins of new activity rather than existing spending. This may provide weaker incentives on overall spending control depending on whether existing programmes are subject to the same degree of scrutiny as proposals under the new initiatives spending limit. These issues are linked to the more generic issue of budget management in a surplus environment.

7.4 Institutionalising the fiscal provisions framework

The provisions provide the Government with an opportunity to credibly demonstrate that it is following through on its short-term fiscal intentions. The operating balance is subject to a number of other factors in the short-term and the provisions provide a controllable operational target.

Nonetheless, the provisions framework is an informal control mechanism. For example, in 1999 it was uncertain whether the incoming Coalition Government would agree to continue to use the fiscal provisions framework. Institutionalisation could help maintain continuity of the framework from one term of government to the next. However, institutionalisation of an informal mechanism that may (and will likely need) to change to reflect a changing could be inappropriate.

Given the "forecast bias" discussed in Section 6.2, the provisions framework has enhanced the credibility of short-term fiscal forecasts. However, in contrast to GAAP, which is externally monitored, the provisions framework is internal to the Government and the Treasury. This creates the potential that increases in spending pressure could be met through non-transparent changes in the definition of the provision rather than transparent changes in the quantum. The credibility of the framework may be enhanced by an external monitoring mechanism.

7.5 Allowing for uncertainty

The current provisions were initially set with reference to the fiscal forecasts in the 1999 Pre-Election Economic and Fiscal Update. Setting the provisions with reference to the "central" forecast does not adequately allow for the inherent uncertainty associated with those forecasts. The experience of the Asian financial crisis demonstrates that while a reaction function can be used to adjust the provisions *ex post*, there may be benefits in allowing for some uncertainty *ex ante*.

The *ex ante* budget target framework developed by Buckle *et. al.* (2001) may provide an additional guide to setting both the level and phasing of the fiscal provisions. Buckle *et. al.* caution that the degree of certainty surrounding the *ex ante* targets is based on the frequency and magnitude of past shocks to the economy. The FRA and current budgetary frameworks may have altered the nature of the fiscal response and shock generation mechanisms. Nonetheless, some reference to historical shocks would augment the current forecast scenarios, which are largely based on judgements about situation specific conditions.

7.6 Short-term fiscal policy

Managing within the provisions requires the Government to more explicitly develop a policy approach that looks beyond each year's Budget, so reducing the likelihood of pro-cyclical fiscal policy. The general approach is to allow automatic stabilisers to operate and alter the provisions on the basis of what are judged to be longer-lasting changes.

7.6.1 The role of the economic cycle

Fiscal reporting in New Zealand does not require the preparation of cyclically-adjusted information (unlike the United Kingdom), although cyclically-adjusted balances are published. The broad similarity of alternative measures of New Zealand's potential output over the 1990s has provided somewhat more confidence in the use of cyclically-adjusted fiscal balances.[29] Nonetheless, history and overseas evidence suggests that caution is required in the assessing the underlying fiscal position.

There has been increased international interest in the role of automatic stabilisers in cushioning shifts in private sector demand (in the US context, see Cohen and Follete, 2000; Auerbach and Feenburg, 2000). For OECD economies, van den Noord (2000) assesses the extent to which components of government budgets affected by the macroeconomic situation operate to smooth the business cycle.

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[29] For a review of alternative measures of New Zealand's potential output see Claus, Conway and Scott (2000).

For the United States economy, Taylor (2000) concludes that… “Given the more transparent and systematic approach to monetary policy that has been followed in recent years, it is more important than ever for fiscal policy to be clearly stated and systematic”. Taylor acknowledges the role of cyclical stabilisers and suggests the discretionary focus of fiscal policy should be on longer-term issues (e.g., marginal tax rates, population ageing).

7.6.2 Fiscal and monetary policy

It would not be unreasonable to suggest that the approach suggested by Taylor broadly holds in the current New Zealand context. In the case of the mid-1990s tax reductions there was active consultation between monetary and fiscal authorities. But, formal co-ordination between monetary and fiscal authorities does not take the form of the authorities acting to pursue joint objectives.[30]

New Zealand’s experience with discretionary fiscal policy during the 1970s and 1980s had a significant influence on the formulation of current institutional frameworks and the operation of fiscal policy through the 1990s.

Currently, “discretionary” fiscal policy changes are signalled via the three-year fiscal provisions and this is seen as assisting the task of setting monetary policy. In turn, the fiscal provisions are set with some reference to the implications for aggregate demand and hence monetary policy (see BPS 2000).

Nonetheless, a better understanding of how fiscal policy settings affect the economy may be warranted given recent studies investigating the dynamic effects of changes in government spending and taxes (for example, see Blanchard and Perotti, 1999).

7.7 Balance sheet issues and changes to financial reporting

The preparation of a balance sheet and use of GAAP present a number of issues for both the reporting of fiscal information and the setting of fiscal policy.

7.7.1 The Crown balance sheet and net worth

The Crown’s balance sheet includes a range of assets and liabilities. For example, for the year ending June 2000, the unfunded liability of the defined benefit pension scheme for government employees was $8.3 billion (compared to gross Crown debt at $36 billion).

With lower levels of debt there is increasing focus on the management of the Crown’s balance sheet, including the Crown’s attitude to risk. The emphasis on the balance sheet is likely to increase under the proposed NZS Fund, which will involve a build-up of financial assets that are currently excluded from the long-term net debt objective (net debt is the value of selected financial liabilities less selected financial assets).

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[30] See the Reserve Bank of New Zealand submission to the Independent Review of the Operation of Monetary Policy, supporting document on “Fiscal and monetary coordination” (www.rbnz.govt.nz/monpol/review). The supporting document also explores some of the institutional issues surrounding coordination.

A number of issues point to an increased focus on gross debt as opposed to net debt. These include the proposed build-up of NZS Fund assets plus the role of gross debt as an indicator of the amount of funding the government requires from capital markets.

In order to capture changes in the composition of the balance sheet, there may need to be clearer specification of the long-term objective for net worth (e.g., whether an increase in net worth reflects more financial assets or less debt).

Greater use of the net worth indicator will be assisted by the resolution of establishment issues that arose when the Crown's balance sheet was first prepared in 1992. Examples of establishment issues include liability recognition for the accident compensation scheme (1999), Public Trust reserves asset recognition (1999) and urban state highways asset recognition (the only remaining issue, to be resolved in 2001). Establishment issues have led to significant changes in the level of net worth and their resolution should facilitate an easier analysis of trends.[31]

7.7.2 Changes to financial reporting

Ongoing GAAP developments are likely to see the introduction of greater potential for fluctuations resulting from fair value assessments of assets and liabilities altering through time.

In accordance with GAAP, full line-by-line consolidation is due to be introduced in the 2002 Budget. Under full line-by-line consolidation, "Crown" will include state-owned enterprises and Crown entities. This will not affect reported net worth and the operating balance, but individual assets and liabilities will be recorded in the balance sheet (with individual revenues and expenses in the operating statement). This has implications for reporting and the specification of some of the long-term fiscal objectives (debt and expenses). A technical discussion document on the issues was released earlier this year.

7.8 Time horizons and demographic changes

Falling debt ratios across the OECD are ushering in a series of new challenges around fiscal management in a surplus environment. The New Zealand experience highlights the search for appropriate fiscal anchors and the challenges created by projected demographic change.

The Fiscal Responsibility Act does not define the time horizon for the long-term fiscal objectives. However, the Progress Outlooks covering a minimum of ten years require projections of the variables specified as long-term objectives.

Longer-term projections of the fiscal position are subject to considerable uncertainty. There is uncertainty regarding demographic trends, technological change, behavioural responses and the role of future governments. Nonetheless, population ageing is projected to generate a change in the growth of government expenses (see Polackova, 1997). Although not required by the FRA, longer-term fiscal scenarios over time periods long enough to capture demographic changes (e.g., 50-years) have been a feature of fiscal strategy documents.

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[31] For example, initial recognition of the outstanding claims obligation for the accident compensation scheme had a negative impact on Crown net worth of around $7 billion.

In terms of long-term fiscal indicators, generational accounting estimates for New Zealand suggest the burden on future generations is projected to fall slightly below that on current newborns (Baker, 1999).[32] However, the lack of focus on existing generations and the complexity of the methodology means the estimates have had limited impact on policy decisions. The FSR 2000 signalled ongoing investigation into long-term fiscal indicators, including the "fiscal gap" calculated by Auerbach (1994) and the Congressional Budget Office (1999).

The approach taken to funding a "given" future spending path will influence the setting over time of long-term fiscal objectives. For instance, a decision to tax-smooth may imply running substantial operating surpluses, followed by an extended period of operating deficits. This would require changes to the long-term operating balance, debt and expense objectives. A balanced budget approach, which entails changes to taxes and/or spending, would require modifications to the long-term objective for expenses.

These considerations may require Government's to signal specific time periods over which their long-term fiscal objectives are to hold, or that objectives may need to be adjusted as future expense pressures become clearer.

8. Conclusions

Fiscal policy in New Zealand has seen a consolidation of the Government's position and significant changes to the institutional framework, in particular, the introduction of the Fiscal Responsibility Act 1994.

New Zealand's fiscal policy framework is a function of both historical experience and wider public sector reforms. The framework differs from that used elsewhere, especially in its use of legislated "principles of responsible fiscal management" as opposed to mandatory targets. However, the Fiscal Responsibility Act does require Governments to set short-term fiscal intentions and long-term fiscal objectives for a range of fiscal aggregates.

The 1990s saw a shift to structural surplus and declining debt-to-GDP ratios. Progress toward the stated long-term expense objective, however, was more problematic. The experience of the 1990s highlights three key themes; the tensions created by timeless long-term objectives with no clear binding constraint; the uncertainties and tensions in adjusting short-term fiscal policy settings; and the emergence of longer-term fiscal issues associated with future demographic changes. With regard to the last of these, the FRA framework has increasingly been used to illustrate a range of fiscal issues that are broader than those that influenced its original formulation (e.g., fiscal consolidation and stabilisation).

The direct contribution of institutional change such as the FRA to the fiscal outcomes of the 1990s is unclear. The Act codified a number of earlier developments that may have improved fiscal policy regardless (e.g., through increased transparency). Nonetheless, by requiring Governments to be explicit about their short-term intentions and long-term objectives the FRA establishes a framework for annual Budget decisions.

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[32] These estimates are based on 1996 fiscal forecasts with adjustments for higher spending.

More recently, the experience of the 1990s has seen the evolution of specific operational targets (the fiscal provisions). The fiscal provisions provide a short-term anchor that avoids fluctuations caused by the economic cycle and valuation changes. Cyclical and valuation changes complicated the interpretation of outcomes against short-term fiscal intentions.

New Zealand's fiscal policy framework faces a number of challenges and is subject to ongoing developments. For example, the provisions may benefit from a more explicit institutional framework. Although the framework has "opened up" longer term fiscal issues, these will present ongoing challenges to the formulation of fiscal policy.

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