OPENING AND BALANCING THE BOOKS

The New Zealand Experience

Hon. Ruth Richardson, New Zealand's Minister of Finance 1990-1993

The Fiscal Responsibility Act defines the attributes of good fiscal management, and ensures the Government meets these criteria by requiring a pre-budget opening of the books and a post-budget review of fiscal strategy. The Government is therefore more open and more accountable. The Act creates an incentive for the politicians to pursue policies in the country's long term interests, rather than to suit short-term political ones.

New Zealand's budget - presented in late June - projects a string of budget surpluses.

Building on the milestone of a financial surplus achieved in the 1993-94 financial year, this is the first time in a generation (some 20 years) that surpluses, not deficits, are the budget norm.

New Zealand's fall from fiscal grace is as well documented as it has been damaging. Persistent deficits, culminating in dangerous levels of debt, proved (unsurprisingly) to be an enormous drag on the growth and development of the economy and severely compromised growth in income and employment opportunities for New Zealanders.

For the best part of a decade New Zealand has made a determined effort to reverse these negative trends and to build a platform for sustainable non-inflationary growth.

BUILDING SUSTAINABLE GROWTH

In the early 50's New Zealand had the 5th highest standard of living in the western world. Over the ensuing decades New Zealand failed to tackle the causes of our structural decline, consequently slumping to 25th by the late 80's. The imperatives for change in New Zealand were three fold -

- Sick economy - one of the worst performers in the OECD
- Sick public institutions - lack of efficiency and effectiveness in government agencies
- Sick social policy - neither fair nor affordable

In essence New Zealand suffered from two deficits -

- **Financial deficit** - in continuous deficit for two decades (70s and 80s) pushing net public debt levels up from 5% of G.D.P. to over 50% of G.D.P.
- **Performance deficit** - while public expenditure levels climbed from 30% of G.D.P. to over 42% of G.D.P. over those two decades, the standard and quality of performance in our public institutions and agencies dropped.

The turnaround of New Zealand's economic and social performance hinged directly on overcoming those two deficits. Public sector reform was an integral part of the wider economic and social policy reform effort.

The essential building blocks of the New Zealand recovery are these:

- price stability - a statutory commitment to low inflation
- fiscal responsibility - a statutory commitment to fiscal prudence
- labour market flexibility - a statutory deregulation of the labour market
- non distortionary taxation regime - a broad base:low rate taxation statute

- openness to internal and external competition - a deregulated environment free from subsidies and government preferences
- targeted social entitlements - social transfers strictly on the basis of need
- a market-style public sector - financial and management reform subjecting the public sector to the same management, employment and accounting disciplines as prevail in the private sector.

The fact that New Zealand has one of the highest growth rates in the Organization for Economic Co-operation and Development (OECD) (some 6 per cent) with one of the lowest inflation rates (some 2%), accompanied by a rise in employment and a fall in unemployment (some 6%) speaks volumes about the success of this policy setting.

The adjustment programme has seen a wide range of legislative budgetary and public policy initiatives.

The legislative initiatives fall into three main categories:

- Improving private sector performance:
  - ⇒ Employment Contracts Act 1991 - securing flexible labour markets.
- Improving public sector performance:
  - ⇒ State Sector Act 1988 - securing accountability of state sector managers;
  - ⇒ Public Finance Act 1989 - a true government balance sheet;
  - ⇒ State-Owned Enterprises Act 1986 - corporatizing state businesses.
- Securing Macro-economic performance:
  - ⇒ Reserve Bank Act 1989
  - ⇒ Fiscal Responsibility Act 1994.

A FISCAL FRAMEWORK

The newly passed Fiscal Responsibility Act is landmark legislation which establishes a statutory framework for the responsible conduct of fiscal policy. As Parliamentarians around the world know only too well, fiscal responsibility is hard won and so easily lost. The Act seeks to reverse the usual bias in budgeting that lamentably leads to a deterioration in the fiscal position.

The very first submission to the Finance and Expenditure Select Committee on the measure described it as "one of the most important pieces of economic and fiscal legislation in New Zealand since 1840". The submission went on to urge "the leadership of Parliament" to guarantee that the government's approach to expenditure and revenue is one that will "reduce debt and restore the government's financial position rather than seeing a dissipation of the position in more immediately popular ways".

The Bill, as introduced, was designed to achieve for fiscal policy what the Reserve Bank Act has achieved for monetary policy - a statutory framework that promotes sound, credible policy and which acts as a bulwark against policy stances that would compromise that credible policy setting.

The Bill as introduced by me in September 1993 relied heavily on the discipline that would automatically be imposed on governments who were required to operate fiscal policy in a highly transparent environment. The live issue before the Select Committee was "is transparency enough?"

The weight of evidence presented to the Select Committee supported a strengthening in three ways:

First, a set of explicit principles for the prudent conduct of fiscal policy were written into the law. These were more in the nature of characteristics of responsible fiscal policy rather than the mandatory "balanced budget" targets approach. Much more than a simple balanced budget, the principles target the burden of government claims on the economy as a whole; expenditure, deficits, debt and contingencies.

Second, a statutory framework for the responsible conduct of fiscal policy was sought. Statutory transparency requires frequent and full disclosure of the government's financial position, even extending to a statutory obligation to "open the books" before an election. The temptation to engage in an electoral auction in the run-up to a poll is not nearly so great when the true (often precarious) state of the government's books is required to be disclosed prior to an election.

Third, a set of new budget processes was urged on the select committee so that we might usher in an era of open budgeting and ensure parliamentary scrutiny of the key budget parameters before a budget is presented.

PRINCIPLES OF GOOD HOUSEKEEPING

The new statutory framework recommended by the Finance and Expenditure Select Committee for enactment sought to identify the key characteristics of responsible fiscal policy.

The principles of responsible fiscal management essentially involve good housekeeping. They provide benchmarks against which fiscal policy should be developed and judged.

The five chosen principles are these:

(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 finance year.

The first principle acknowledges that, currently, New Zealand's debt levels are too high and should be lowered significantly in order to reduce the economy's vulnerability to adverse factors. This should be achieved by running surpluses on the operating balance.

(b) Once prudent levels of 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;

The second principle implies that once debt has been reduced it should not (in general) be increased. In particular, a government should not borrow to "pay for the groceries". This principle is a medium to long-term one. In the short term, cyclical factors may well result in temporary, and desirable, deviations from balance.

(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.

The third principle recognizes that there are a wider-range of factors relevant to the fiscal position than a focus solely on debt would reveal. For example, the Crown's balance sheet includes a significant exposure to public service pension liabilities that are not caught within the usual definitions of public debt.

More generally, it is not just the level of debt which is important but also the assets which are backing it. As for the debt principles, the focus on Crown net worth also reflects the thought that, over time, governments should prepare for eventualities that may not be reflected in the current balance sheet.

For example, an aging population may imply impending increments to health and retirement income support.

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

The fourth principle also acknowledges vulnerability issues and requires that governments should actively manage the risks inherent in its assets, liabilities and off-balance-sheet items such as guarantees.

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

The fifth principle reflects the importance of stability in tax and expenditure levels for private sector planning and hence growth.

RESPONSIBILITIES RATHER THAN RESTRICTIONS

It is important to understand what these principles mean and do not mean.

They *do not* constrain a government from governing and pursuing its own policy programme. Under the legislation, a government will be free to specify the broad strategic priorities by which it will be guided in preparing the budget. Under the legislation, the Government can - and should - advance its broad economic and social policy ambitions. These are not proscribed in any way by the legislation - nor should they be.

What the injection of a set of fiscal principles into the Bill does do is to ensure that a government's objectives, whatever they may be, are pursued in a fiscally responsible manner.

And there's the rub, deliberately so.

The fiscal principles also recognize that, in a practical sense, governments may be forced to temporarily depart from principles of responsible fiscal management on occasions.
However, when they do so, the onus would be placed on governments to justify any departures and outline how responsible fiscal management would be restored as soon as possible.

The principles provide strong incentives for governments to operate fiscal policy in a responsible manner.

PROPER FINANCIAL ACCOUNTS

New Zealand now publishes government accounts similar to those of private sector firms, the only sovereign nation to do so. "New Zealand Inc" produces a balance sheet of assets and liabilities and an accrual-based operating statement of income and expenditure. These accounts, which are independently audited, have two benefits: they remove the scope for fiscal trickery, and they encourage governments to focus on the longer-term consequences of policies.

These reforms have been labelled the most far reaching and ambitious of any of their kind in the world, and are regarded as at the leading edge of central government systems internationally.

We accomplished these reforms in two steps.

The groundwork was laid with the passage of the Public Finance Act 1989. This measure which was passed with bipartisan support required a full set of financial statements from the government. Each government entity had to produce a:

- Statement of financial position
- Operating statement (revenue and expenses)
- Statement of cash flows
- Statement of objectives
- Statement of service performance
- Statement of commitments
- Statement of contingent liabilities
- Statement of unappropriated expenditure
- Statement of accounting policies
- Comparative actual figures for the previous year

Under this regime departmental managers became responsible for financial management, had the freedom to manage the balance sheet, achieved comparability with other service suppliers (paid tax, pricing and accounts) and managed all of this under tight budget constraints. Accounting expertise was typically recruited from the private sector and major changes occurred in the culture of the organisations.

Once all the Government departments and agencies had moved onto an accrual basis, the Crown was then able to prepare consolidated statements. Most valuably, for the first time, we were able to begin to interpret our net worth. Not surprisingly it was very negative, but at last we had a reliable measure of improvement over time.

The second step came during my term as Minister of Finance when again for the first time, it was possible to apply these accounting concepts and disciplines to the budget process and fiscal management. The Government's determination to apply sustained fiscal discipline was hugely aided by the availability of such sophisticated and effective accounting tools. The Budget of 1991 yielded a huge fiscal dividend extracted from the application of these modern tools.

The credibility of our fiscal policy framework was further boosted by the requirement that all this accounting and budgeting had to be conducted in compliance with generally accepted accounting practice. Maintenance and enforcement of those accounting standards is entrusted to a private entity independent of the Government. In this way a government, were it to be so tempted, is denied the ability to engage in self-serving interpretations. Again New Zealand is breaking new ground with this practice, as no other sovereign in the world subjects government financial reporting to an independent agency.

OPEN TO SCRUTINY

Just as important as the principles that set the scene for responsible fiscal management are the new processes that will govern the preparation and presentation of budgets.

In a world of coalition governments, open budgeting will be a must. By that I mean that those responsible for pulling together a budget will, of necessity, want to have a high degree of public and parliamentary understanding of the parameters within which the budget is being prepared.

It may well be that governments need to get their budget not just presented, but passed, before the beginning of a financial year in order to secure supply in the year that follows.

The beauty of the new process is that it will expose the basis on which the Government is preparing the budget to parliamentary gaze and private contestability before the budget is finally put to bed. It will lead to a welcome and wider sense of ownership of the budgetary issues that the Government must address.

Parliament and the public will become accessories before the fact, not after the fact.

The Act requires the Minister of Finance to publish a Budget Policy Statement (BPS) no later than 31 March each year. The BPS shall:

- specify the government's long-term objectives for fiscal policy;
- confirm that these meet the principles of responsible fiscal management;
- specify the broad strategic priorities which will guide the preparation of the budget for that financial year;
- indicate explicitly the intended track for key fiscal aggregates over the budget planning period;
- indicate compliance of the intended track for key fiscal aggregates with the legislative principles of responsible fiscal management and the long-term objectives;
- justify any departure of the intended track from these principles and objectives;
- compare the long-term objectives and fiscal intentions with those specified most recently and to justify any departure.

The Act requires referral to the Finance and Expenditure committee of a Budget Policy Statement and other reports required under the Fiscal Responsibility Act.

It is intended that there be Standing Orders requiring the Finance Expenditure Committee to review and report back to the House on the Budget Policy Statement, Fiscal Strategy Report and the Budget Economic and Fiscal Update.

REGULAR REPORTING

Not only is full disclosure required under the financial management reforms, but under further refinements passed in 1994, frequent disclosure is also expected. In what some would regard as staggering speed, the Government is required to produce a set of accrual based financial statements within 6 weeks of year's end. Again the discipline of disclosure has a salutory and significant effect on government fiscal decisions when all involved in taking those decisions know that their impact will be revealed in the financial statements within two months at the most.

IMPROVED PERFORMANCE AND CONFIDENCE

The principles of fiscal responsibility, together with the pre-budget opening of the books and the post-budget review of the fiscal strategy by the select committee, provide strong incentives for governments to operate fiscal policy in a responsible manner.

The Act will give taxpayers and investors greater confidence in the management of the Crown's finances and public resources, making New Zealand a more attractive place for investment. Further, it will help sustain good fiscal policy, which, in turn, is necessary to sustain strong economic growth.

FISCAL RESPONSIBILITY ACT

WHAT IT MEANS FOR THE CONDUCT OF FISCAL POLICY

ACT
sets fiscal policy framework

GOVERNMENT
decides detailed fiscal policy which can be assessed against the Act's framework

PARLIAMENT
initiates, from pre-budget examination of budget parameters and assumptions and post-budget, reconciliation of the outcome with the announced fiscal strategy

GENERAL PUBLIC
is better informed and better able to judge the merit and credibility of the Government's fiscal policies

Ruth Richardson,
Principal,
Ruth Richardson [NZ] Ltd.