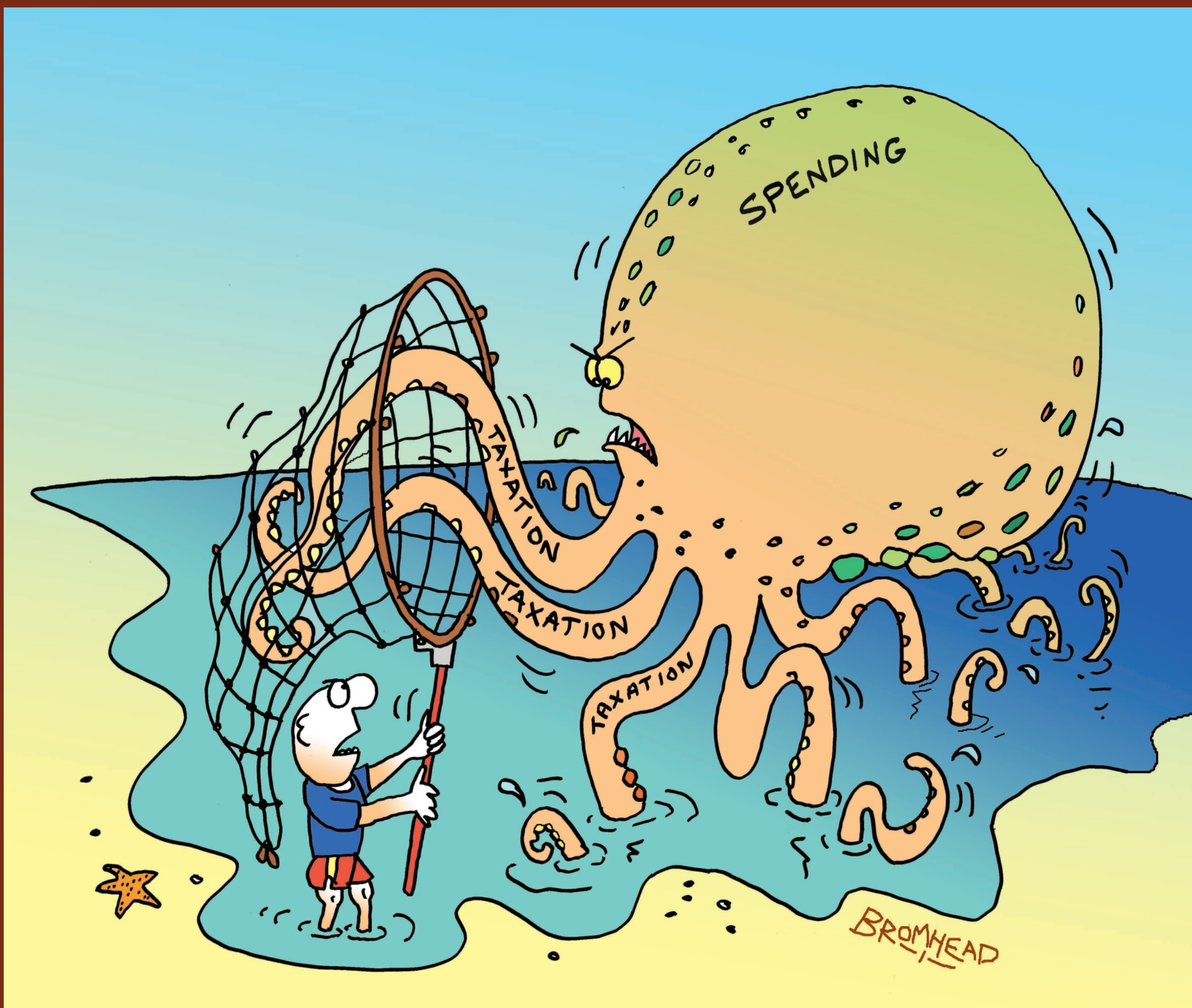
Restraining Leviathan

A Review of the Fiscal Responsibility Act 1994



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New Zealand Business Roundtable

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LIST OF ACRONYMS

CARFA	Commission on the Accountability and Review of Federal Agencies (United States)
CFS	Crown Financial Statement
CPI	Consumers Price Index
FRA	Fiscal Responsibility Act 1994
GAAP	Generally accepted accounting principles
GDP	Gross domestic product
GFS	Government Financial Statistics
GSA	General Services Administration (United States)
GST	Goods and services tax
IMF	International Monetary Fund
MMP	Mixed Member Proportional voting system
OBERAC	Operating Balance Excluding Revaluations and Accounting Changes
OECD	Organisation for Economic Cooperation and Development
R&D	Research and development
SNA	System of National Accounts
TEL	Tax and expenditure limitations

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EXECUTIVE SUMMARY

For the last decade, the Fiscal Responsibility Act 1994 (FRA) has been a key element of New Zealand's framework for sustaining fiscal surpluses and reducing net indebtedness. It has served as a model for several other countries.

This paper reviews the experience in New Zealand with the FRA in order to identify strengths and weaknesses of the Act and suggest improvements.

Summary of section 2

The FRA sought to bring a greater focus in annual budgets to issues of fiscal prudence and longer-term strategy. It represented a continuation of major efforts from 1984 to achieve and sustain fiscal consolidation following a serious public debt spiral.

The fiscal consolidation programme has been successful insofar as the last decade saw the achievement of large fiscal surpluses, positive Crown net worth, major reductions in net public sector indebtedness, and a progressive re-rating of Crown foreign currency debt.

Strong economic growth played a major role in this process. Between 1993 and 2003, real gross domestic product (GDP) grew at 3.6 percent per annum on average, or 2.5 percent per capita. This helped raise revenue sharply. By 2002–03, total taxes per capita had reached $10,223 in 2002–03 dollars. This is the highest per capita tax burden in New Zealand's history in absolute terms. The strong economic growth also meant reduced spending on unemployment benefits. These factors contributed to the large fiscal surpluses that reduced spending on interest on public debt.

Partly reflecting these developments, central government current spending fell from around 40 percent of GDP at the end of the 1980s to below 31 percent of GDP by 2000–01. It has not been as low relative to GDP since the late 1970s. However, it is still well above the ratio of around 23 percent that prevailed during the 1950s and 1960s.

These overall figures might give a misleading impression about the overall quality of expenditure control during the period since the FRA came into effect. Discretionary spending was tightly controlled by the 1990–93 National government. This is partly attributable to the system of fixed nominal baselines that imposed the burden of proof on spending agencies to establish that their productivity growth was slower than inflation. Real per capita current government spending fell 12 percent between 1990–91 and 1995–96. The large fiscal surpluses (over 4 percent of GDP) achieved in the mid-1990s reflected this expenditure control and the effect of strong economic growth on revenue.

In the mid-1990s, in an environment of increasing unwillingness to pursue privatisation and deregulation of statutory monopolies, governments moved to defer tax cuts and increase spending. The 1993–1996 government failed to keep expenditure for 1996–97 to anywhere near its 1994 budget night projections, the eventual discrepancy being over 2 percent of GDP. By 1998–99, the end of the first term of a parliament elected under the Mixed Member Proportional (MMP) voting system, the fiscal accounts on a System of National Accounts (SNA) basis were actually back in deficit as a result of increased discretionary spending and reduced revenues (from the economic slowdown associated with the 'Asian crisis'). Virtually no progress was made towards the government's goal of getting operating spending in the Crown Financial Statements (CFS) below 30 percent of GDP. The second term of MMP government (1999–2002) saw the return of strong economic growth. Real revenue per capita in 2002–03 was 16 percent up on 1998–99, while real spending per capita (Consumers Price Index deflated) rose 3 percent. The net result was a fiscal current account surplus of 3.6 percent of GDP (SNA basis) in 2002–03. The 2004 Budget established that the third term of MMP government would see a further marked lift in discretionary real per capita spending.

If governments had held per capita real spending (other than on interest and unemployment benefits) at around 1992–1993 levels, overall current spending in 2002–03 might have been 27 percent of GDP rather than over 31 percent (SNA basis).

The biggest concern that outside observers, such as the Organisation for Economic Cooperation and Development (OECD) and the New Zealand Business Roundtable (Business Roundtable), have about New Zealand's experience with the FRA is its failure to do more to impose adequate value-for-money disciplines on new and existing government spending. The OECD has suggested that the contribution of the FRA to expenditure constraint has been limited. It is noteworthy that the two devices that did appear to constrain spending tendencies at times during this period – the fixed nominal baselines and the fiscal provisions approaches – were both ad hoc, and neither endured. At present, governments can treat increased revenue from economic growth as a 'free cash flow' that they can spend at will to buy votes from favoured constituencies.

A related concern has been the failure of governments to accept that wasteful spending and excessive total spending could be contributing to the gap between their professed objectives for economic growth and the economic growth rates used to make budgetary projections. Indeed, the failure to acknowledge the gap between goals and forecasts, let alone propose corrective action, has been a major shortcoming of economic policies during the last decade.

Summary of section 3

It is highly implausible that, on current policies, New Zealand will be able to sustain even the 2.5 percent per annum growth rate in real GDP per capita of the last decade. A more realistic indicator of the underlying growth rate is the general consensus among professional forecasters that trend labour productivity growth is around 1.5 percent per annum. To the extent that population growth falls below 1 percent per annum (as is expected), real GDP growth will not reach the 2.5 percent level.

The claims of successive MMP governments that their policies will generate sustained per capita growth rates of 3 percent or more are a fraud on the electorate. They are historically implausible, inconsistent with professional forecasts, wildly optimistic compared with overseas norms and inconsistent with policy directions. There needs to be a far better understanding that even to raise the underlying labour productivity growth rate from 1.5 percent per annum to 2 percent would be a major achievement and require significant change. The presumption that much faster economic growth can be generated in New Zealand by interventionist design rather than by focusing government on creating a legal, fiscal and regulatory environment that fosters enterprise should be reversed. Big, activist government based on the view that economic growth can be centrally planned is more likely to impair rather than enhance economic growth.

An important finding in the economic growth literature is that high levels of economic freedom are associated with high levels of prosperity, and increases in economic freedom with increases in the rate of economic growth. New Zealand's growth rate increased significantly after the economy was freed up. Economic freedom, however, is not the only thing that matters. New Zealand's progress has arguably been impeded by stop-go reform efforts and by retaining social incentives (for example, to stay on welfare) that are inconsistent with the new economic incentives. Moreover, New Zealand's ranking for economic freedom has slipped since 1995. It could do much to improve its score for economic freedom and sustain it in a consistent manner, and thereby improve the economy's growth prospects.

The size of government matters for prosperity. If government is too small it will not be able to fulfil its core public good functions. History and current spending patterns on core functions suggest that general government spending of 10–15 percent of GDP would generally suffice for these purposes. Allowing for goods and services tax (GST) and user charges, such a level would be consistent with a rate of tax on income of 10 percent – a rate that would have been regarded as recently as the nineteenth century as exorbitant for an income tax.

On this basis, and allowing for a modest welfare safety net, government spending in New Zealand appears to exceed the necessary level by some 20 percent of GDP. Bigger government reduces economic freedom by raising tax rates, undermining enterprise (through forced redistributions of wealth) and crowding out private activity – be it media, schools, hospitals, charities or electricity suppliers.

A more modest reduction is proposed by International Monetary Fund (IMF) researchers Vito Tanzi and Ludger Schuknecht. Their conclusion is that today's governments could achieve much of what they currently want to achieve with general government spending at around 30 percent of GDP.[I] In New Zealand's case this would imply a reduction in government spending of around 10 percent of GDP.

I Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century: A Global Perspective*, Cambridge University Press, Cambridge, United Kingdom, 2000.

A study for the Business Roundtable by Australian economist Winton Bates estimated that progressively reducing government spending (and taxes) by 10 percentage points of GDP (to around 30 percent) might add around 0.5 percent per annum to GDP growth over a 10 to 25 year period, if done by pruning the most ill-justified spending.[II] This is well worth having, but it would still leave projected economic growth below what governments obviously think the electorate aspires to achieve. Bates's estimates are similar to comparable estimates by the OECD and to estimates accepted by Arthur Grimes.[III]

Such findings will be challenged for obvious reasons. Numbers of public servants and other beneficiaries from government spending can be expected to resist vigorously attempts to question, let alone evaluate, its efficacy. However, this study considers some of the opposing arguments and casts doubt on them. In particular, the argument that New Zealand could be wealthier with bigger government because some countries, particularly in Europe, are wealthier with bigger government does not stand up to scrutiny. The rich countries of the world became rich when their governments were small. This is true for those that participated in the industrial revolution in the nineteenth century and for Japan and the 'Asian tigers' in the twentieth century. The ongoing economic decline of continental Europe relative to the United States, the United Kingdom and Australia should also alert New Zealanders to the problems of European-sized governments.

The empirical difficulties of establishing the adverse effects of excessive taxation and spending on economic growth by cross-country regressions are reminiscent of the problems in the 1980s and 1990s of demonstrating that state ownership of commercial enterprises impairs performance. Economic analysis insists that incentives matter in respect of government ownership, the quality of government spending and the response to taxes. However, it can take a considerable research effort to overcome the econometric problems of figuring out how much these incentives matter. A recent paper by Folster and Henrekson tackles a number of the statistical issues and finds a robust (negative) relationship between government size and growth amongst the rich countries.[IV] It is implausible to suggest that per capita GDP growth rates of 4 percent per annum or higher could be achieved with general government spending around its current level of 40 percent of GDP.

Some empirical cross-country research finds that spending on capital works and education tends to be associated with increased prosperity, whereas prosperity tends to be impaired by government current spending, particularly on transfer payments.

[II] Winton Bates, *How Much Government? The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, Wellington, 2001, pp 56–57.

[III] Arthur Grimes, 'Economic Growth and the Size and Structure of Government: Implications for New Zealand', *New Zealand Economic Papers*, June 2003, pp 151–174.

[IV] Stefan Folster and Magnus Henrekson, 'Growth Effects of Government Expenditure and Taxation in Rich Countries', *European Economic Review*, Vol 45, No 8, pp 1501–1520.

However, it does not follow that increased government spending of this nature will necessarily increase prosperity. This is a matter for case-by-case investigation, taking into account the possibility of crowding out higher value private spending and diminishing marginal returns. The need is to foster enterprise and to distinguish the effects of a favourable environment (higher rates of investment) from the causes.

A key point to make about such generalised findings is that they do not constitute a case for reducing or expanding spending in any particular country. The fact that a cross-country regression might find that spending on capital works tends to be associated with increased prosperity should not be used to justify additional capital spending. Spending should only be increased (or cut) if it is justified in a particular case.

The main value of the cross-country regressions is to test the general plausibility of the case that the cumulative effects of some factor on economic growth are material. However, specific tax and spending proposals should be evaluated on their particular merits rather than on the basis of a correlation with economic growth. The government should focus on the quality of spending and regulation regardless of any presumed effects on economic growth.

One example of this approach is the evaluation by Tanzi and Schuknecht of the effects of the growth of the welfare state in the richer countries since 1960. The authors found no evidence that it has improved economic or social outcomes. The review in this section of the study of the expansion of the welfare state in New Zealand points to alarming rises in welfare dependency. For example, the proportion of the population on sickness, disability or orphans benefits has risen from five per thousand in 1970 to 28 per thousand in 2000. Around one in six people of working age rely on a benefit. Problems of obesity, suicide, teenage births and hardship are manifest. The evidence seems to be consistent with the cross-country regressions that find that government spending on transfers impairs prosperity.

It is implausible to argue that the increase in scale and scope of government spending in the twentieth century in New Zealand was as a result of the general rise in national income. Rather, it is related to surges in spending during the two world wars, each of which permanently doubled per capita taxes, and to changed attitudes to the proper role of the state, particularly in providing welfare and superannuation. The marked difference between the expansion of central government and local government in New Zealand seems inconsistent with 'Wagner's law' – the proposition that the demand for government services rises appreciably faster than income.

There is much else that governments could do to lift the underlying economic growth rate. Privatisation, lower marginal tax rates, increased openness, freer labour markets, and a reduction in 'command and control' safety and environmental legislation would all help. For any given share of government spending in the economy, improvements in other policies may enhance economic performance. Similarly, a reduced government spending share does not guarantee improved performance if there are shortcomings in other policy settings. Nevertheless, a reduction in government spending from its present 40 percent level relative to GDP seems a necessary, if not sufficient, condition for raising annual per capita growth to 4 percent or more.

Summary of section 4

The OECD has favoured supplementing debt and deficit targets with an expenditure target on the grounds that the former can be met too readily with higher taxes that impede economic growth. Several countries have caps for government spending.

Tax and expenditure limitations (TELs) are one device for getting governments to focus more on reducing wasteful government spending. Voters know about spending caps from their personal lives. They understand the need to prioritise. Provision can be made for such rules to be set aside when necessary, but a super-majority requirement for voting to do so is likely to be desirable if the rule is to be effective.

The US states have provided a laboratory in recent decades for research into the effectiveness of TELs. Research for the Fraser Institute and the National Center for Policy Analysis finds that states that have higher levels of economic freedom tend to have higher per capita incomes. Because larger government reduces measured economic freedom, TEL and other rules that reduce the size of government tend to increase economic growth. Other researchers have found strong evidence that well-designed TEL rules do reduce government taxes and spending and that the reductions are greater if they are combined with other devices such as super-majority requirements for tax increases, balanced budget requirements, term limits and citizens' initiatives.

The research also finds that the most effective rules have:

(1) been constitutional rather than statutory;

(2) capped spending at inflation plus population growth;

(3) provided for immediate refunds of surplus revenues to taxpayers; and

(4) been linked to other budget rules, such as balanced budget requirements.

Colorado's Taxpayer Bill of Rights accords well with these criteria, even though Colorado has experienced major stress associated with the drop in revenue following the dotcom crash. The experience has led researchers to propose modifications to rules (3) and (4).

One implication of these lessons is that a New Zealand TEL would have a better chance of enduring success if it were well-designed and passed with clear public support, preferably by way of a referendum. This implies the need for broad public debate.

A rule holding spending growth to population growth and inflation (except where the electorate votes for higher spending) could see per capita economic growth reduce average spending and tax burdens substantially through time. The Annex to this report indicates one possible legislative model for a TEL rule in a New Zealand context.

Summary of section 5

Section 5 identifies a range of other possible devices for improving government spending disciplines. They fall under the following headings:

- tax apportionment rules, the flat tax and the benefit principle;
- improving the accountability of select committees to citizens;
- improving asset management;
- binding citizen strike-down referenda;
- principles for determining when government spending is justified;
- a spending review commission with special powers;
- improving the accountability of the executive to parliament;
- reducing the improper delegation of parliament's power to spend;
- reducing the ability of the Inland Revenue Department to oppress taxpayers and other creditors;
- other ideas for spending caps.

Few of these approaches are mutually exclusive. The major barrier to raising spending quality is political will in the executive. Welfare reform (US-style), asset sales and a review of the principled basis for government involvement in health and education stand out as obvious 'big ticket' items for improving the quality of spending.

The proposals in sections 4 and 5 for giving citizens a greater direct say in determining the level of taxes and spending are inherently democratic. The aim is to find institutions that will better induce politicians to act in the common interest rather than to reward factions or to impose on citizens the views of a political elite concerning the proper role of the state.

Summary of section 6

Section 6 concludes that New Zealand's experience under the Fiscal Responsibility Act 1994 is consistent with the findings in overseas research that rules that focus on limiting deficits do not discipline spending and taxes through time. They need to be supplemented by measures aimed at improving spending disciplines.

On the evidence of this research, TELs and super-majority rules for increased taxation may offer the greatest potential. However, other options, most of which are of a complementary nature, warrant further research and public debate.

1

INTRODUCTION

For the last decade, New Zealand's Fiscal Responsibility Act 1994 (FRA) has been a key element of New Zealand's framework for sustaining fiscal surpluses and reducing net indebtedness.[1] The Act has served as a model for several other countries.[2]

This paper reviews experience in New Zealand with the FRA in order to identify strengths and weaknesses within the Act and suggest improvements.

Section 2 reviews fiscal policy and performance under the FRA. The major concerns relate to inadequate spending disciplines.

Section 3 examines the inconsistency between the spending policies of governments and their targets for faster economic growth.

Section 4 reviews international practice and experience with tax and expenditure limitation rules.

Section 5 canvasses a number of other possible fiscal disciplines.

Section 6 presents conclusions.

The Annex indicates how a New Zealand Taxpayer Bill of Rights might be expressed in legislative form.

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1 The current government intends to integrate the FRA, essentially unchanged, into the Public Finance Act 1989 by way of the Public Finance (State Sector Management) Bill 2003.

2 See, for example, David Rae, 'Next Steps for Public Spending in New Zealand: The Pursuit of Effectiveness', Organisation for Economic Cooperation and Development, Economics Department Working Paper No 337 (ECO/WKP(2002)23), Paris, 2 August 2002, p 31.

2

REVIEW OF FISCAL POLICY AND FISCAL PERFORMANCE UNDER THE FRA

2.1 Introduction

Section 2.2 summarises trends in public debt, government spending and revenues. The focus is on a 'before and after' comparison. This subsection relies mostly on the statistics of spending and revenues that are produced by Statistics New Zealand as part of its System of National Accounts (SNA). Other official series (such as the Government Financial Statistics (GFS), the Crown Financial Statements (CFS), which is based on generally accepted accounting principles (GAAP) statistics) and the venerable budget 'table 2' series suffer from significant data discontinuities during the period in which the FRA has been in place. The last of these series is no longer produced.

Section 2.3 reviews the evolution of fiscal management approaches since 1991, using CFS data where available.

Section 2.4 assesses the strengths and weaknesses of the FRA in the light of sections 2.2 and 2.3.

Section 2.5 offers concluding comments.

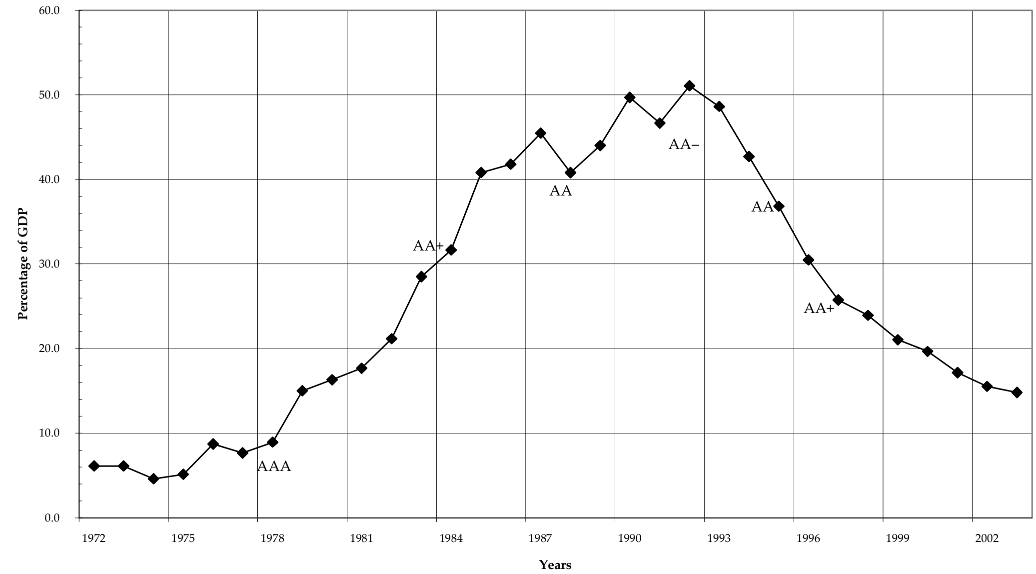
2.2 Review of fiscal outcomes

Figure 1 summarises the debt spiral that led to the 1984 fiscal and currency crisis and the subsequent period of fiscal consolidation that helped restore the debt situation and the New Zealand government's credit rating. Between 1973–74 and 1983–84, net public debt rose from 6.1 percent of gross domestic product (GDP) to 31.7 percent. Although the incoming government in 1984 took immediate, vigorous and successful steps to reduce the fiscal deficit, the 'bow-wave' effect of ongoing deficits after borrowing costs and large losses on assets saw net public debt rise further to peak at 51.1 percent of GDP in 1991/92.[3]

In 1983 and 1984 respectively, Standard and Poor's and Moody's Investor Services downgraded New Zealand's credit rating for sovereign foreign currency debt from the coveted 'triple A' rating of the late 1970s. Other downgradings followed. The first reversal occurred in March 1994 when Moody's upgraded New Zealand from Aa3 to Aa2. Standard

[3] For a detailed breakdown of the sources of the rise in public debt after 1983–84, see table 8B in the Economic Strategy Statement released with the 24 July 1990 Budget, p 137.

Figure 1: Net public debt (percentage of GDP) and Standard and Poor's rating history



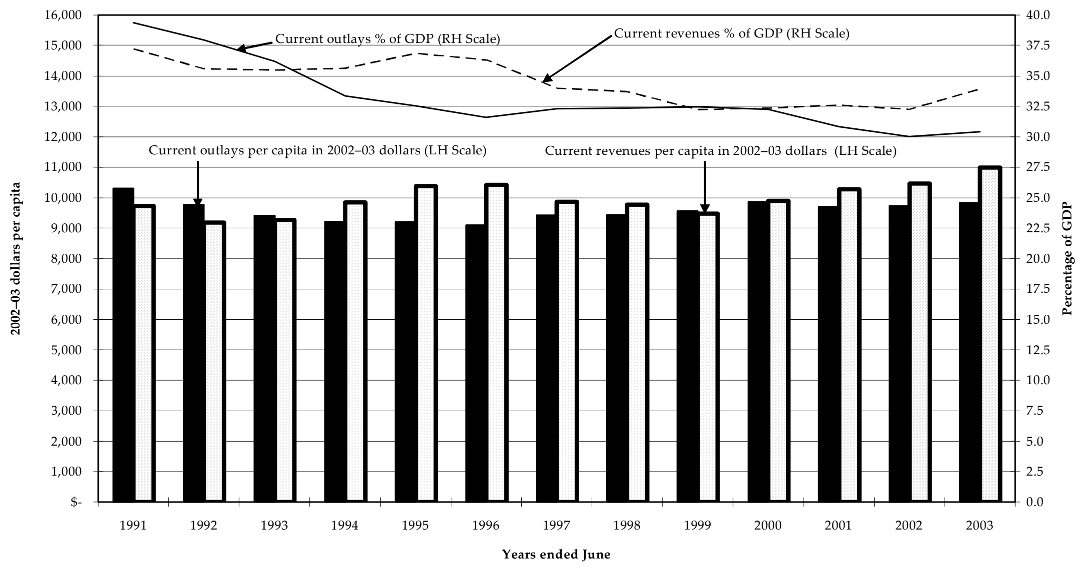
Source: New Zealand Debt Management Office.

and Poor's first did the same in December 1994 when it upgraded New Zealand from AA– to AA. Moody's restored the 'triple A' rating on 21 October 2002, but Standard and Poor's (and Fitch Ratings) still have New Zealand one notch lower at AA+.

Figure 2 summarises developments in central government current spending and revenue from 1991 to 2003. The chart uses the SNA statistics published by Statistics New Zealand.

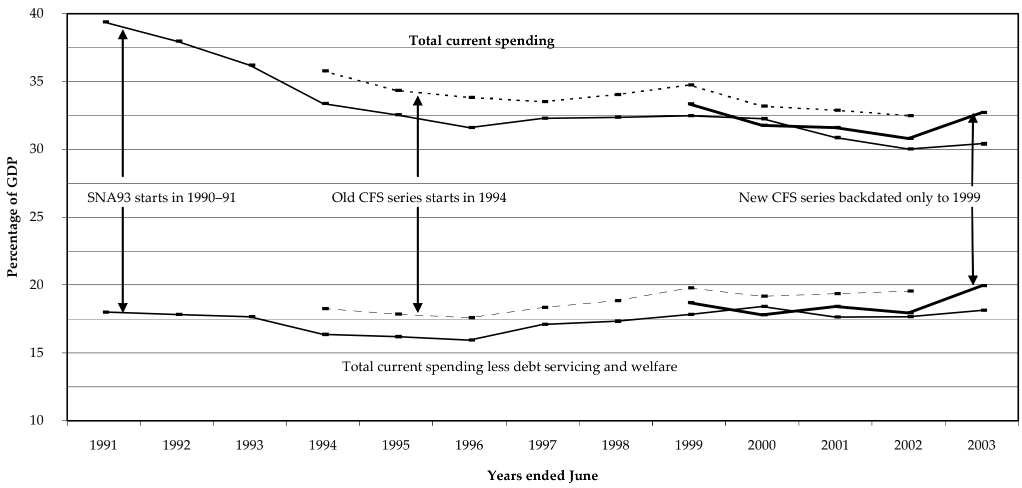
Figure 2 shows that real per capita spending declined to 1995–96, but has since risen. Central government current outlays fell from 39.4 percent of GDP in 1990–91 to 31.6

Figure 2: Current central government outlays and revenues (SNA basis)



Source: Statistics New Zealand.

Figure 3: Central government/core Crown current spending (SNA and GAAP (CFS)) percentage of GDP



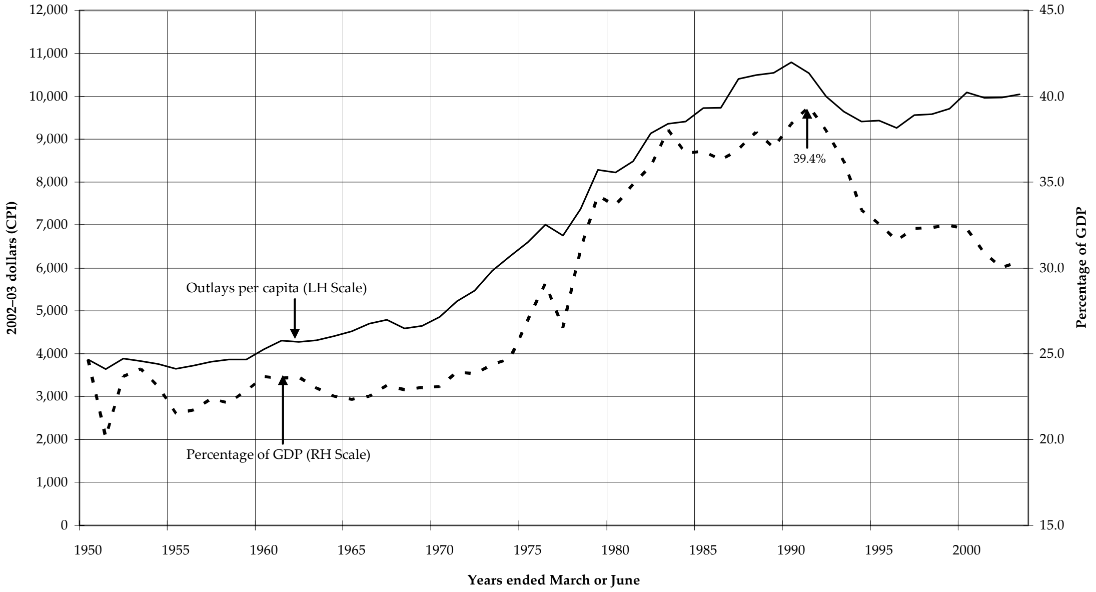
Source: Statistics New Zealand and The Treasury.

percent in 1995–96. Real spending per capita fell by 12 percent. Current revenue per capita in 2002–03 dollars was 7 percent higher in 1995–96 than in 1990–91 as the 1993–1996 government used the revenue from strong economic growth to reduce debt. The combined effect of reduced real spending per capita and increased real taxation per capita was to turn a current account deficit of 2.2 percent of GDP in 1990–91 into a surplus of 4.7 percent of GDP by 1995–96.

The 1996 Budget increased real per capita spending in 1996–97 markedly, and the subsequent Mixed Member Proportional (MMP) governments also opted to increase expenditures rather than to reduce taxes or net debt more quickly. Discretionary spending was increased faster than might appear from Figure 2 because surpluses and strong economic growth were reducing two elements of automatic spending – interest on public debt and welfare (see Figure 3). Between 1996 and 1999, slower economic growth was associated with a decline in real current revenue per capita and in the ratio of revenue to GDP. The higher spending and reduced revenues eliminated the fiscal surplus by 1998–99. Thereafter, revenue growth per capita rose absolutely and relative to GDP. It outstripped expenditure growth and a surplus of 3.5 percent of GDP in 2002–03 resulted. Real current spending per capita was marginally lower in 2002–03 than in 1999–00, but it was marginally higher when spending on public debt interest is excluded.

Figure 3 compares three measures of central government current spending. The measure in the System of National Accounts (SNA93) starts in 1991 and currently runs to 2003 on a consistent basis. The original GAAP statistics in the Crown Financial Statements start in 1994 and run through on a consistent basis to 2002. The new system of CFS (based on line-by-line consolidation) continues through to 2003, but has only been backdated to 1999. Figure 3 shows each series inclusive and exclusive of spending on

Figure 4: Central government current outlays (2002–03 dollars per capita and percentage of GDP)



Source: Sundry official yearbooks linked to SNA central government series 1990–91.

interest and welfare. Overall, spending has trended down relative to GDP. Whereas spending on interest and welfare has fallen relative to GDP, other spending has held up, or risen, depending on the series chosen and the time period considered. As Figure 3 shows, the recent move to line-by-line consolidation introduced a discontinuity into the CFS series. The effect has been to lower measured spending by around 1.3–1.5 percent of GDP.[4]

Figure 4 puts the recent trend in current spending into a longer-term context. It links the SNA93 data from 1991 into older national income account measures for central government current outlays back to 1950. (The series should be interpreted cautiously because it is largely taken from old yearbooks and may omit revisions and contain inconsistencies.) Even so, the central feature of Figure 4 – the dramatic lift in the size of government to 1991, whether measured relative to GDP or to the real spending burden in dollars per capita – is beyond doubt. The reduction in real government current spending per capita from 1991 as shown in figures 2 and 3 was from a record level on this measure.

Figure 4 shows that government current spending fell as a percentage of GDP from a peak of 39.4 percent in 1990–91 to 30.8 percent in 2002–03, a level not seen since the 1970s. This is still well above the ratio of around 23 percent on average that prevailed during the 1950s and 1960s. On a real (Consumers Price Index (CPI) deflated, 2002–03 dollars) per capita basis, spending peaked at $10,802 in 1989–90, and was $9,883 in 2002–03. During the 1950s it was always below $3,900. Its 2002–03 level is over twice its highest level during the 1960s ($4,793 in 1966–67).

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4 The actual figure for 2002–03 on the new basis is 32.4 percent of GDP. The forecast in the 2004 Budget for 2003–04 is 30.6 percent of GDP.

By 2002–03, total taxes per capita reached $10,223. This is the highest in 2002–03 dollar terms in New Zealand's history. At 32.0 percent of GDP, it is below its record high of almost 37 percent of GDP in the recessionary year of 1989–90.

In summary, these statistics establish beyond doubt that the fiscal stabilisation programme that commenced in 1984 achieved its goals of surpluses and debt reductions in the 1990s. They do not of course establish the extent to which the improvement is as a result of the FRA. One contributing factor was the strong economic growth after 1992 that lifted revenue sharply (Figure 2). During the two decades to 1993, real GDP grew at 1.5 percent per annum on average, or 0.7 percent per capita per annum. Between 1993 and 2003, real GDP grew at 3.6 percent per annum on average, or 2.5 percent per capita per annum.

While the improved fiscal constitution enshrined in the FRA might have contributed to the higher rate of economic growth, other factors may have made a comparable contribution. These include privatisation, greater openness from reduced import protection, a freer labour market, low inflation, lower top tax rates and market-determined prices and interest rates. It is worth noting that Australia markedly improved its economic performance during the 1990s. It consolidated its fiscal position from 1993 to 1999 without an equivalent to the FRA. (Its transparency-based Charter for Budget Honesty was not implemented until 1998.)

The next section considers in more detail the evolution of fiscal policy during the last decade.

2.3 Evolution of fiscal policy 1994–2003

The evolution of fiscal policy since 1994 has been summarised in two Treasury working papers and a more recent Treasury publication.[5] Themes include:

- The real constraint on increases in non-indexed government spending until the mid-1990s, in good part as a result of the Public Finance Act 1989.
- The breakdown in this constraint (referred to by the Treasury as a system of "fixed nominal baselines") in the mid-1990s.
- The (unplanned) move to a system of overall caps on new operating spending as a result of the first coalition agreement under MMP in 1996.
- The subsequent technical and 'gaming' difficulties with what Treasury refers to as this "fiscal provisions" approach, one result being the increased emphasis put on (arbitrary) targets for gross debt as a device for disciplining the growth in capital spending.

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[5] John Janssen, 'New Zealand's Fiscal Policy Framework: Experience and Evolution', Treasury Working Paper, 01/25, Wellington, 2001; Angela Barnes and Steve Leith, 'Budget Management that Counts: Recent Approaches to Budget and Fiscal Management in New Zealand', Treasury Working Paper 01/24, Wellington, 2001; and *The New Zealand Fiscal Management Approach: An Explanation of Recent Changes*, The Treasury, Wellington, January, 2003.

- The shift in attention in recent years away from issues of fiscal consolidation and debt reduction towards a longer-term focus on the fiscal implications of demographic trends 40 or 50 years into the future.[6]
- The resulting planned changes to the content of the FRA in the Public Finance (State Sector Management) Bill 2003. These changes replace the fiscal provisions approach with a "fiscal management" approach.

The remainder of this subsection elaborates on these evolving themes.

2.3.1 Fixed nominal baselines

The Public Finance Act 1989 saw a change from an input-focused system for controlling base spending to an output-focused system. The former system facilitated the indexation of all spending for cost increases. The latter system did the same for programmes linked directly to price levels (for example, welfare benefit rates), wage rates (for example, superannuation) and demographic factors (for example, health and education). These account for around 83 percent of spending. However, for the remaining spending, the change had the effect of imposing on government departments the burden of proving that nominal spending should be increased because cost increases outweighed productivity gains.

This burden of proof proved to be a real hurdle for departments. The fiscal pressures on them were increased by cuts to departmental baseline spending of between 1 and 5 percent between 1991 and 1993.[7] Cuts to welfare benefit rates during this period further explain the tight control on government spending during the Bolger/Richardson government.

After 1993, pressures to increase nominal baseline spending grew. By the mid-1990s, an Output Price Review mechanism was put in place to address concerns about under-funding. In its 1994–1996 budgets, the Bolger/Birch government failed to keep expenditure for 1996–97 within its 1994 budget night projections, the eventual discrepancy being over 2 percent of GDP.[8] The degree to which it increased discretionary spending is indicated by the limited decline in the non-interest spending ratio despite very fast economic growth by historical standards (see Table 1).

During this period the government used the extra revenue from economic growth to reduce debt. The submissions in March 1995 and 1996 made by the Business Roundtable on the government's Budget Policy Statements (BPSs) supported the use of fiscal surpluses to reduce debt, but questioned the prudence of the increases in discretionary spending

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6 For projections for New Zealand of the fiscal implications of age-related spending pressures out to 2050, see the OECD's *Economic Outlook*, Vol 2002/2, No 72, December 2002, Section IV 'Fiscal Sustainability: The Contribution of Fiscal Rules', particularly Table IV.3.

7 Barnes and Leith, above n 5, p 4.

8 An analysis by Janssen (above n 5, p 21) indicated that new spending decisions in the 1996 Budget accounted for at least $2.7 billion of a $5.1 billion shortfall between the operating surplus forecast for 1997–98 in the 1994 December Economic and Fiscal Update and the eventual outcome of a $2.5 billion surplus.

and the slowdown in structural reform and asset sales. They argued that planned tax cuts would widen rather than flatten the tax scale and that insufficient priority was being given to the goal of reducing government spending below 30 percent of GDP.

Table 1: CFS spending and revenue ratios 1993–1996 electoral term (percentage of GDP)

Year ending June	**1994**	**1995**	**1996**	**1997**
Total taxation	33.4	34.1	34.3	32.4
Total core Crown revenue	36.4	38.0	37.3	35.3
Total spending excluding finance	31.2	30.1	29.9	30.4
Total core Crown spending	35.8	34.3	33.8	33.5

Source: The Treasury <http://www.treasury.govt.nz/fiscaldata/> (last accessed 28 July 2004).

The tendency of the government to increase nominal baseline spending no doubt contributed to a concern in the Treasury that large operating surpluses were being projected as a result of the unrealistic fixed nominal baseline spending assumption (for example, a projected surplus approaching $8 billion for 1997–98 in the 1995 Budget). Such projections could independently reduce spending discipline. The option of removing projected surpluses by scheduling tax cuts was favoured.

2.3.2 Spending caps and fiscal provisions

In its 1997–1999 budgets, the first MMP coalition government (National/New Zealand First) lifted the planned rate of growth in spending markedly. The increase was driven by politics, not analysis. The government's formative Coalition Agreement set a $5 billion (cumulative) target for new spending during its term of office.[9]

The Treasury was left to sort out 'technical' details, such as what was new spending and therefore had to be included in the cap. The rules the Treasury developed for determining what spending fell within the cap proved to be troublesome and evolved into what it called the "fiscal provisions" mechanism.

Key aspects of the fiscal provisions approach comprise:

- a nominal limit on the sum of (non-formula-driven) increases in funding for an existing policy and funding for new policy;
- a set of principles and rules that determine what spending 'counts' against the limit;
- the three-year time horizon (November to November); and
- Treasury forecasts (subject to the agreement of ministers) for "fiscal provisions", "technical provisions" or "indicative provisions" beyond the current parliamentary term based on "an approximate average of the cost of new policy over the last few years".[10]

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9 If spent evenly during its term of office, 1999–00 spending would have been roughly $2.5 billion (2.4 percent of GDP) higher than 1996–97 spending as a result. The 1997 Budget projected that non-finance (CFS) operating spending would be $4.3 billion higher in 1999–00 than in 1996–97. This figure also allows for changes in inflation and demographic-related spending.

10 Barnes and Leith, above n 5, p 7.

The submissions by the Business Roundtable on the BPSs in 1997, 1998 and 1999 expressed the view that the budget strategy – of big spending increases, deferral of tax cuts, no privatisations and continuance of statutory monopolies – was inconsistent with the government's growth strategy and its professed goal of greater social cohesion. The additional spending was risky to the point of imprudence, and by 1999 the long-term target of reducing spending below 30 percent of GDP was no longer credible. There was no programme for aligning policy with that target. As a result, the Business Roundtable claimed that the 1999 BPS failed to conform to the requirements of the FRA.

In the event, the $5 billion target was not all spent. In 1998–99 (in reaction to the Asian economic crises and an economic slowdown), the government reduced this target to $4.25 billion. Partly as a result, non-finance spending for 1999–00 was about $150 million below the 1997 budget night forecast.

Table 2: CFS spending and revenue ratios 1996–1999 electoral term (percentage of GDP)

Year ending June	**1997**	**1998**	**1999**	**2000**
Total taxation	32.4	32.8	31.2	31.2
Total core Crown revenue	35.3	35.4	35.2	33.5
Total spending excluding finance	30.4	31.2	32.3	31.0
Total core Crown spending	33.5	34.0	34.7	33.2

Source: The Treasury <http://www.treasury.govt.nz/fiscaldata/> (last accessed 28 July 2004).

Even so, as Table 2 shows, non-finance operating spending (CFS basis) was 31.0 percent of GDP in 1999–00, up from 30.4 percent in 1996–97, despite fast GDP growth. Current non-finance Crown spending on a national income account basis was 29.9 percent of GDP in 1999–2000, up from 29.0 percent in 1996–97. Total core Crown operating spending (CFS basis) peaked at 34.7 percent of GDP in 1998–99, but, overall, it fell fractionally from 33.5 percent in 1996–97 to 33.2 percent in 1999–00.

In its 2000 budget, the new Labour/Alliance coalition government set a cap of $5.9 billion for new spending during its term of office.[11] This was later lifted to $6.1 billion. Again, the new spending was politically driven, being determined without any value-for-money assessment by the public service. Indeed, such an assessment would not be possible as long as the spending provision was unallocated.

The new government lifted the target for operating spending (CFS basis) from the previous government's 30 percent of GDP to 35 percent. It also adopted a policy of increasing rather than reducing tax rates and of opposition to privatisation.

According to the 2003 CFS, core Crown expenses for 2002–03 were almost $1.5 billion higher than the 2000 budget night target. The increase was in good part as a result of changes in the actuarial value of the unfunded liability in the Government Superannuation Fund. Non-finance operating spending rose from 29.6 percent of GDP to 30.6 percent between 1999–00 and 2002–03 (see Table 3).

11 The 2000 Budget projected that non-finance spending in 2002–03 would be $3.8 billion higher than in 1999–00.

Table 3: CFS spending and revenue ratios 1999–2002 electoral term (percentage of GDP)

Year ending June	2000	2001	2002	2003
Total taxation	29.6	30.1	29.4	31.2
Total core Crown revenue	32.1	32.7	32.2	33.9
Total spending excluding finance	29.7	29.6	28.9	30.6
Total core Crown spending	31.7	31.6	30.6	32.4

Source: The Treasury <http://www.treasury.govt.nz/financialstatements/year/jun03/> (last accessed 28 July 2004.) (The data in this table are on a somewhat different basis from the data in tables 1 and 2.)

The government's 2001 Budget introduced a new fiscal parameter OBERAC, the Operating Balance Excluding Revaluations and Accounting Changes. This removes revaluation movements and accounting policy changes to provide a smoother measure of underlying financial stewardship. Full line-by-line consolidation of the accounts was introduced by the 2002 Budget.

The submissions by the Business Roundtable on the BPSs of 2000, 2001 and 2002 pointed out the inconsistencies between the government's professed goals for economic growth and the growth projections underlying the fiscal and economic forecasts. Fiscal surpluses in good times are not a sufficient condition for sound fiscal stewardship. These submissions noted the absence of any corrective action to accelerate growth, the absence of a rational debate over privatisation and the failure of the government to respond to genuine concerns raised by those taking the trouble to make detailed submissions.

2.3.3 Increased emphasis on a target for gross debt

Recent budgets have put more emphasis on the target for gross Crown debt (and therefore less emphasis on the target for net debt). Indeed, the long-term gross Crown debt objective is now seen by some as a 'key anchor' for fiscal policy. The current government's target is to reduce gross debt below 20 percent of GDP by 2015. According to the 2004 Budget, this ratio was 28.0 percent of GDP at 30 June 2003. Net core Crown debt was 13.7 percent of GDP at 30 June 2003.

The rationale for this emphasis appears to be to limit gross capital spending independently of value-for-money considerations. In this sense, the target is a 'top-down' approach to controlling spending that is complementary to the cap for operating spending as a percentage of GDP. For a given level of capital spending, the target also has the potential to raise the required operating surplus.

2.3.4 Fiscal management approach

In its 2003 budget, the government did not set a fiscal provision spending cap for the next three years of the sort that had been set by the coalition governments after the 1996 and 1999 general elections. Instead, it budgeted for increases in core Crown operating spending that would see it falling from 32.1 percent of GDP in 2002–03 to 30.4 percent of GDP in 2005–06. (This is marginally less ambitious than the projection in the 2000 Budget that the spending ratio would fall from 33.4 percent in 1999–2000 to 31.4 percent in 2002–03 – a fall that did not materialise. In the 2004 Budget the government lifted planned spending for 2005–06 to 31.5 percent of GDP.)

The 2004 Budget also set a convoluted target for new operating spending of less than 35 percent of GDP “over the horizon used to calculate NZS Fund contributions” by the amount of contributions to the New Zealand Superannuation (NZS) Fund as a percentage of GDP. The construct made no statistical sense (in that it mixed operating and capital items) and was presumably a short-term contrivance introduced for political reasons. The fiscal strategy report accompanying the 2004 Budget did not include this formula in its discussion of long-term fiscal objectives. Instead, it talked in terms of combining the above debt target with a budget surplus target that would be large enough to fund NZS Fund contributions and meet the gross debt target. To achieve the surplus target and fund projected base spending and new spending commitments (see below), the government stated that core Crown operating expenses and taxation would be held at around 32 percent of GDP and 31 percent of GDP respectively.

The 2003 Budget decision not to adopt the fiscal provisions approach for the 2003–06 period was made by the minister of finance who had a number of concerns with it. The ad hoc fixed nominal limit blurred the distinction between fiscal strategy and budget management, creating confusion and debate. It also invited gaming. Because cost increases from non-indexed base spending had to be absorbed within the nominal limit, ministers soon found that the ‘pot’ was smaller in real terms than it appeared. Haggling over these issues was time-consuming, and concerns about the erosion of public sector capability would not go away.

This decision was contrary to the recommendation in a 2002 assessment by the OECD secretariat.[12] Its report considered that the top-down framework had contributed to the large reduction in public debt in New Zealand and helped produce appreciable efficiency gains.

The new “fiscal management approach” is intended to provide a government with increased flexibility in allocating spending between categories, in part through greater delegation of authority by parliament. For example, it will be easier for the executive to switch spending between operating and capital items. It is also intended to help shift the focus from stabilisation to longer-term intergenerational fiscal planning. The Treasury will be required to report on the risks and outlook over a 40-year period every four years.

These shifts in attention and priorities are not restricted to New Zealand. The 2002 OECD report noted that there is a general problem worldwide with population ageing and a need for structural reforms and more effective fiscal rules.[13] Some rules appear to have lost their ‘bite’ and in some countries problems of fiscal sustainability have re-emerged.

The virtues of flexibility may come at the price of reduced fiscal discipline. The pressures to increase base spending going into the 2004 Budget were strong given the higher than expected surpluses, resistance to reducing tax rates and the shortfall in spending relative

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12 Rae, above n 2

13 Organisation for Economic Cooperation and Development, above n 6..

to the 35 percent of GDP spending target. The OECD secretariat has warned that "excess revenue is more likely to be spent, thereby ratcheting up spending over time".[14]

In its 2004 budget, the government provided for new operating resources (spending or forgone revenue) of $2.4 billion in the year ended June 2005 (1.7 percent of GDP) rising to $3.8 million in the year ended June 2008 (2.3 percent of GDP). However, it also anticipated that additional spending in the 2005, 2006 and 2007 budgets would add a further $5 billion to spending in the year ended June 2008, lifting the total additional fiscal burden in that year to 5.3 percent of GDP. The Business Roundtable's submissions on BPSs in 2003 and 2004 pointed to the continuing gap between the government's growth targets and its growth projections. Too many policies were anti-growth, yet the government was refusing to acknowledge that the policies were failing to lift the underlying rate of economic growth. The submissions argued that the lift in the top tax rate to 39 percent in April 2000 had been a mistake and the government needed to pay greater attention to the recommendations of the McLeod Tax Review for a lower and flatter income tax structure. The submissions also argued that government expenditures needed to be reduced below 30 percent of GDP by focusing on value-for-money considerations and that regulatory impediments to growth should be reduced.

2.4 Assessments of the FRA – strengths and weaknesses

Both an OECD report and a Treasury working paper point to a number of relatively technical problems with the FRA. Specifically:

- the over-specification of revenue, spending, deficit and debt objectives gives the government too much flexibility to choose targets after the event;[15]
- the absence of a time limit for achieving long-term fiscal objectives weakens their meaningfulness;[16] and
- trade-offs between capital and current spending are difficult to make because controls on new capital spending are not well integrated with current spending budget allocation programmes.[17]

The biggest concern that outside observers, such as the OECD and the Business Roundtable, have about New Zealand's experience with the FRA is its failure to do more to impose value-for-money disciplines on new and existing government spending. If governments had held core Crown operating spending other than on interest and unemployment at its real per capita level in 1993–94, per capita taxes could have been lower in 2002–03 by $1,430 in 2002–03 dollars or 14 percent. Spending could have been 27.1 percent of GDP in 2002–03, not 31.5 percent. An OECD report also suggested that

14 Rae, above n 2, p 31.

15 Janssen, above n 5, p 18.

16 Janssen, above n 5, p 18; OECD, above n 6, p 31.

17 Organisation for Economic Cooperation and Development, above n 6, p 35.

the contribution of the FRA to expenditure constraint had been limited.[18] The report estimated that explicit policy decisions after 1992–93 lifted government spending to 2001–02 by around 3 percent of GDP.

It is noteworthy that the two devices that did appear to constrain spending at times during this period – the fixed nominal baselines and the fiscal provisions approaches – were both ad hoc, and neither endured.

As far as new spending is concerned, the focus of governments on setting government expenditure targets as a percentage of GDP makes economic growth a 'windfall' for additional government spending. The faster the rate of economic growth, the greater the flow of tax receipts and the more money the government has available to spend. This is not desirable. Governments have an incentive to spend in the pursuit of political objectives rather than in the interests of taxpayers at large. They should not be allowed to plan to spend taxpayers' money simply because they expect it to be available. The OECD found that of the $10 billion increase in nominal spending in the nine years to June 2002, more than half was as a result of explicit policy decisions.

Of even greater concern is the absence of meaningful value-for-money assessments of base spending. An assessment of the FRA by the OECD secretariat found little evidence of any willingness by spending ministries to change priorities.[19] Another concern was the excessive fragmentation of appropriations. New Zealand had around 800 separate appropriations for outputs spread across 78 Votes in 2000. Australia and Sweden have the equivalent of 27 Votes or broad categories of spending, according to the OECD.

The OECD report observed that budget allocations have a strong historical basis and there is "no centrally driven systematic or regular review" of the 95 percent of government spending that is not new spending, and no "systematic framework for assessing value for money". It commended the Canadian approach and summarised it in the following box.[20]

The OECD report suggested that an outcome-based review of social assistance would probably offer the greatest gains. It pointed to deficiencies in its administration, the problem of high benefit levels, and the advantages of competition, user charges, choice and diversity.

The Business Roundtable reviewed the role played by the FRA in its BPS submissions in 2003 and 2004. It considered that:

- The FRA has been useful in focusing attention on the need for fiscal prudence, transparency and longer-term fiscal targets.

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18 Rae, above n 2.

19 Rae, above n 2.

20 Rae, above n 2.

OECD tests for evaluating value for money

1. Does the programme still serve a clearly defined public purpose that matters?
2. Is this an appropriate role for government?
3. Would we establish the programme today if it did not already exist?
4. Is it desirable to maintain it at its current level?
5. Can it be delivered more effectively or efficiently? Have there been changes (in the service environment, infrastructure, technology, etc) since the programme's inception that would now permit an alternative means of achieving its objective with greater economy, efficiency, or effectiveness?

Sources: Canadian Office of the Auditor General and Finance Canada.

- It may thereby have helped achieve fiscal surpluses and reduce debt. The outstanding question is whether a future government will succumb to the temptation to resume prolonged deficit spending amidst political difficulties and recession.
- The focus on a longer-term target of reducing government spending below 30 percent of GDP has not been successful. To the contrary, a spending ratio target has allowed governments to treat the revenue from economic growth as available to be used for political purposes, while still claiming fiscal prudence.
- The point that fiscal surpluses in good years are a necessary but not sufficient criterion for sound fiscal stewardship has not been widely understood.
- Governments have been able to avoid having to justify fiscal and regulatory strategies that are incompatible with their targets for economic growth.
- The FRA has not led to any meaningful dialogue with governments about (1) the gap between their targets for economic growth and the growth forecasts of respected forecasters; (2) the contribution of lower tax rates, privatisation and deregulation to economic growth; and (3) the need for formal systematic reviews of the quality of existing spending.

The glaring omission from the longer-term expenditure goals of governments, particularly after 1993, has been the almost total unwillingness to assess, case-by-case, whether there is a principled basis for any particular item of government spending (along the lines recommended by the OECD above). By and large, governments have refused to take seriously the notion that they should not be spending taxpayers' money unless they are doing so for sound national interest reasons.

2.5 Concluding remarks

The demise of the system of fixed nominal baselines is understandable. Governments cannot credibly continue to tell the public that spending programmes are justified and then fail to fund them adequately. Such a system needs to be backed up with a willingness to eliminate spending programmes that do not provide value for money, rather than have governments continue to defend them.

In the mid-1990s, in an environment of increasing unwillingness to pursue privatisation and deregulation, politicians moved to defer tax cuts and increase spending. The 'fiscal provisions' approach from 1996 provided governments with an arbitrarily large, but capped, pot of money for discretionary spending driven by politics. Governments were free to spend it as they wished, as long as they could command a majority in the House, independently of value-for-money considerations and even without the benefit of public service advice on whether the spending was in the public interest. The major virtue of the approach was that it was politically embarrassing for a government to spend beyond its own 'cap'.

The current 'fiscal management' approach eliminates even this impediment, exacerbating the underlying problem. By setting a relatively static target for government spending as a percentage of GDP, this approach allows economic growth and fixed tax rates to generate the equivalent of a company's 'free cash flow' for governments to spend at will. The underlying presumption is that such revenues should not be returned to taxpayers, except at the pleasure of politicians who might prefer to spend it massaging the interests of important constituencies. The conflicts of interest here are serious and obvious.

The advent of MMP may be a compounding factor in these developments. A growing empirical literature is finding that electoral institutions affect fiscal policy. The OECD summarised its recent findings in 2003.[21] Compared with majoritarian (first-past-the-post) systems, parliamentary regimes with proportional representation tend to be associated with heavier tax burdens, higher public spending, and a greater tendency to increase spending during downturns and to react more strongly to negative than to positive output shocks. Torsten Persson and Guido Tabellini report independently that a robust estimate is that proportional representation rather than plurality (majoritarian) rule raises total central government spending by 5 percent of GDP.[22] Although other factors may be operating, there is evidence that the effect may be due in good part to the higher incidence of political fragmentation and coalition governments under proportional systems, with inter-party deals being made at the expense of the taxpayer.

The OECD's list of questions for evaluating spending programmes invites an increased focus on value-for-money considerations in government spending. However, the OECD does not identify any principles that would help address the question of whether a programme is "an appropriate role for government". Nor does it suggest a process for applying its tests.

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21 Organisation for Economic Cooperation and Development, *Economic Outlook*, No 7, particularly Chapter IV, 'Fiscal Stance over the Cycle: The Role of Debt Institutions and Budget Constraints', p 136, Paris, 2003.

22 Torsten Persson and Guido Tabellini, 'Constitutions and Economic Policy', *Journal of Economic Perspectives*, Vol 18, No 1, Winter, 2004, pp 79–98.

During the period of the FRA, a major concern of the business community has been the inconsistency between governments' targets for economic growth and their spending, taxation, privatisation and regulatory policies. By and large, governments have refused to engage in constructive dialogue on these points. They have commonly failed to adhere to their initial spending targets and to achieve their professed targets for economic growth. Nor have they felt obliged to take corrective action or to hold themselves accountable for these failings.

Section 3 takes up the issues of the proper role of government and the relationship between economic growth and the size of government as it expands beyond the levels necessary to facilitate rapid rates of economic growth.

3

GOVERNMENT TARGETS FOR ECONOMIC GROWTH, TAXES AND SPENDING

3.1 Introduction

This section examines the inconsistency between governments' tax and spending policies and their own targets for much faster economic growth. One recurrent feature of New Zealand's experience under the FRA is that governments have simultaneously promised the electorate much faster rates of economic growth *and* big increases in discretionary government spending, particularly on current consumption and transfer payments.

Section 3.2 reviews the targets for economic growth during the period of the FRA by parties that were members of coalition governments.

Section 3.3 reviews expert opinion on the sources of economic growth. A key finding is that high levels of economic freedom are conducive to higher levels of prosperity. This tends to support the case for low or moderate taxation.

Section 3.4 identifies three distinct controversies in the New Zealand debate concerning the relationship between the size of government and economic growth. One is the controversy over whether overall government spending of around 40 percent of GDP is inconsistent with the government's growth targets. A second is the claimed lack of a consensus in the economic literature on the empirical importance of the size of government, and the observation that other countries with larger governments are more prosperous than New Zealand. The third controversy concerns the notion that the composition of government spending and taxes might be more important for prosperity than the level of taxes and spending. Section 3.4 deals with the first and third of these controversies. It also deals with some aspects of the second controversy, leaving others to section 3.5.

Section 3.5 provides a historical perspective on the rise in the size of government in New Zealand since the nineteenth century and among industrial nations. The purposes of this review are: (1) to ascertain in a New Zealand context what size of government suffices to enable it to perform its core functions; (2) to assess whether the rise in the size of government in the last century might have reflected popular demand (for example, as postulated in Wagner's law); and (3) to consider the issue raised by international research of whether the marked rise in the size of government in industrialised countries has been accompanied by improved outcomes.

Section 3.6 makes concluding observations.

3.2 Ambitious growth targets for the gullible

The senior member of the 1996–99 coalition government, the National Party, set a target for economic growth of 3.5–5.0 percent per annum. The junior member, New Zealand First, proclaimed a 6 percent growth target. The dominant member of the 1999–02 coalition government, the Labour Party, initially set a growth target of getting New Zealand's real GDP per capita back into the top half of the OECD by 2010 (but then disclaimed this intention). This implied sustaining a rate of growth in GDP per capita of at least 4.5 percent per annum. The current government has left the time period for the achievement of this goal open-ended but emphasised the desirability of achieving real GDP growth of 4 percent per annum on a sustained basis.

All parties were pledging to deliver these rates of growth without foreshadowing any need for major changes of policy. Even the privatisation of commercial state enterprises is beyond the scope of current government policies, in sharp contrast to international practice.

3.2.1 Historically implausible

Such growth rates are implausible in terms of New Zealand's historical performance. According to the long-term time series put together by a New Zealand Institute of Economic Research economist, Phil Briggs, New Zealand's rate of GDP growth per capita averaged 1.4 percent per annum between 1900 and 2000. Between 1900 and 1970 (that is, before the difficult years for New Zealand following Britain's entry to what is now known as the European Union and the first global oil shock) it averaged 1.5 percent per annum. According to Maddison's data, the average per capita growth rate among the western nations was 1.9 percent per annum during the twentieth century. New Zealand was bottom at 1.3 percent per annum on this exchange-rate adjusted basis, while Norway was top at 2.6 percent per annum.[23]

New Zealand probably outperformed its long-run average around half the time during the last century. But periods of sustained high outperformance for a decade or more have been rare, and were usually associated with the emergence from a serious slump rather than a permanent lift in the overall rate of growth. For example, the data by Briggs indicate that New Zealand only sustained per capita growth rates of around 3 percent or more for a decade during the 1860s, between 1896 and 1906, and during the recovery from the 1930s depression and the rapid expansion during World War II. Since 1950, a growth rate of 2.5 percent per annum has only been sustained for a decade twice – 1957–1967 and 1993–2003. In both cases, the growth rates probably overstate the trend because they incorporate cyclical effects. To achieve a trend rate of per capita growth even in the 1.5–2.0 percent range would represent a remarkable improvement for New Zealand.

3.2.2 Inconsistent with professional growth forecasts

The major official and private sector agencies are not forecasting that New Zealand will be able to sustain real GDP per capita growth of even 2 percent per annum on

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23 Angus Maddison, *The World Economy: A Millennial Perspective*, Development Centre of the Organisation for Economic Cooperation and Development, Paris, 2001.

current policies. A common assumption is that trend labour productivity growth in New Zealand will be of the order of 1.5 percent per annum. If employment growth were to average around 1.0 percent per annum during the next decade, this implies trend real GDP growth of around 2.5 percent per annum. Trend real GDP per capita growth would be less than 1.5 percent per annum if an ageing population sees population growth exceed labour force and employment growth.[24]

3.2.3 *Wildly optimistic compared with industrial country norms*

Harvard University economics professor Robert Barro, a major contributor to the modern economic growth literature, has suggested that wealthy countries are likely to have already the institutions and policies that facilitate prosperity. This would make it hard for them to lift further their growth rates markedly. For example, Barro found no evidence that increases in infrastructural spending, research subsidies or educational spending would help a lot. He concluded that:

> Basically, 2 percent per capita growth seems to be as good as it gets in the long run for a country that is already rich.[25]

The question to be asked of political parties in New Zealand that promise much higher rates of economic growth without major policy change is why such a scenario is remotely plausible. Visions need to be realistic if they are not to disappoint.

There is ample evidence that countries that achieved prosperity with sound policies and institutions, but then stifled enterprise and entered a long period of relative decline, can do better than the norm for a period by analysing their errors and correcting them. Protectionist policies (such as those New Zealand adhered to in the 1950s) are now near-universally acknowledged in the economic literature to be a mistake. New Zealand has done much better economically since it dropped protectionist policies. There is now similar agreement that the chronically high unemployment rates in Europe compared with the United States are as a result in good part of the differences in labour and product market regulation and welfare regimes. Rigid labour markets in New Zealand drove up the rate of unemployment; it dropped sharply under the Employment Contracts Act 1991. Similarly, it is now widely accepted among economists that the privatisation of commercial enterprises in an environment of open competition generally improves efficiency. Studies of rates of multi-factor productivity growth across industries in New Zealand have found particularly large increases in areas that were most comprehensively deregulated, such as transport and communications. There is also widespread agreement that, beyond some point, high tax rates discourage enterprise and impair economic performance.

Ireland, the Netherlands and three US states provide recent examples of economies that had been in long-term economic decline turning themselves around by radical changes

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24 These illustrative numbers are taken from the Treasury's economic projections to 2050.

25 Robert Barro, *Determinants of Economic Growth: A Cross-Country Empirical Study*, The MIT Press, Cambridge, MA and London, England, 1998, pp 46–47.

in the policies and institutions that were holding them back.[26] Features of their policies included tax and spending reductions and cooperation between unions, business and government in holding down wage growth. In the Netherlands, aggressive measures to moderate wages, reduce taxes and government spending, privatise and deregulate were initiated in 1993 and 1994. General government total outlays on the OECD's measure fell from 56 percent of GDP in 1993 to 48.2 percent in 1997. The rate of economic growth picked up quickly. The cuts in Ireland were more severe with spending on the same measure falling from 51.4 percent of GDP in 1987 to 42.5 percent in 1989. Another significant measure was a 10 percent tax rate on foreign investment in selected industries (since raised to 12.5 percent and applied generally). Ireland achieved 6 percent plus rates of per capita economic growth during the 1990s.

These experiences serve to demonstrate that countries that want to change their economic performance materially must make significant changes of policy. Rapid economic growth is a story of rapid change. Political parties that promise much faster rates of growth with mere tinkering of policies are not credible.

Barro suggested that governments in wealthy countries could improve their growth rates by deregulation, cutting non-productive spending and reducing tax rates. However, he doubted that they would be able to raise their longer-term growth rates from the 1.5–2.0 percent range to even 4 percent per annum by these means. Such a remark serves to emphasise the exceptional nature of Ireland's experience.

3.2.4 Inconsistent with policy directions

Seen in this light, targets to achieve 4 percent per annum GDP growth (with no change in immigration policies to increase population) essentially propose to double projected labour productivity growth to 3 percent per annum. Such an increase is wildly implausible with current policy settings. Labour market policies, including legislation to introduce an extra week's annual leave (cutting the working year by around 2 percent), are adding to costs and reducing productivity growth. The MMP governments have been increasing tax, spending and regulatory burdens. The following section documents why such policies can be expected to reduce rather than enhance economic growth.

3.3 Expert opinion on the sources of economic growth

Adam Smith stated his conclusions on the prerequisites for achieving economic prosperity over two hundred years ago as follows:

> Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things.[27]

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[26] Fred McMahon, *Road to Growth: How Lagging Economies Become Prosperous*, Atlantic Institute for Market Studies, Halifax, NJ, 2000, discusses the cases of Ireland, Holland, Georgia, Massachusetts and Michigan in some detail.

[27] Adam Smith, lecture in 1755, quoted from an account published in 1793 by Dugald Stewart and cited on p xl of the 1976 edition of the Cannan version of *An Inquiry into the Nature and Causes of the Wealth of Nations* that was published by the University of Chicago in 1976.

He saw the natural course of things as emanating from human nature:

> The uniform, constant and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things toward improvement, in spite both of the extravagance of government, and of the greatest errors of administration. Like the unknown principle of animal life, it frequently restores health and vigour to the constitution, in spite, not only of the disease, but of the absurd prescriptions of the doctor.[28]

It does not follow that small government and the rule of law will inevitably lead to material prosperity. Some people may prefer leisure or the contemplative life. However, the countries that became wealthy during the industrial revolution demonstrated the interest of the majority of their peoples in overcoming poverty, and the main source of their increases in living standards was the institutions and policies shaped by the thinkers of the Enlightenment. In a modern version of the same ideas, the president of the Atlantic Institute for Market Studies, Brian Lee Crowley, has written:

> Economic growth is not a mysterious force that strikes unpredictably or whose absence is inexplicable.
>
> On the contrary, growth is the fruit of two forces: the ability of people to recognize opportunities, on the one hand, and the creation by government of a legal, fiscal and regulatory framework in which it is worthwhile for people to exploit those opportunities.[29]

It would be difficult to exaggerate the gap between such viewpoints and the view in government policy circles in New Zealand today that faster growth can be engineered by large, active government. Attempts by governments or organisations like the World Bank to engineer prosperity in poor countries by direct measures have largely failed in the last 50 years, according to an assessment by former World Bank economist William Easterly. The attempts he reviewed included the provision of external aid, investments in machinery, efforts at raising levels of education, measures to control population growth and initiatives to make (and subsequently forgive) loans on condition of institutional reforms.[30]

Unfortunately, while it is hard for governments to engineer prosperity, it is easy for them to engineer economic stagnation. All they have to do is hobble enterprise by harming the environment in which it flourishes. High tax rates, protectionism, corporate welfare, state spending on uneconomic major projects, regulations that impair common law freedoms of contract, rights to sue and security in private property, and spending policies that reward rent seeking and state dependency all tend to have this effect.

The biographer of Lord Keynes, Robert Skidelsky, considered the effects of Keynesian policies when the enthusiasm for big, activist government was at its height and drew

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28 Smith, above Book II, Chapter III, p 364.

29 McMahon, above n 26, p 10.

30 William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, The MIT Press, Cambridge, MA, London, England, 2001.

the conclusion that "[t]he only safe rule is to create an environment in which enterprise can flourish".[31]

Recent research by Richard Roll and John Talbott sheds further light on the sources of economic growth and concludes that natural factors such as resource endowments are not a dominant explanation. They found that over 80 percent of the differences in prosperity between the poorest and richest countries can be explained by differences in institutions and policies, most notably the protection of private property, civil liberties, political and press freedom.[32]

Work by OECD researchers examining the divergence between the United States and the European Union seems broadly consistent with these conclusions. It finds that the following "macro policies" have "a significant impact on long-term growth": stable and low inflation, lower taxes and openness to trade. At the industry level, a "light" regulatory touch in product markets and the labour market is important. Product market deregulation can lift productivity by 10 percent. Labour market regulation can lower incentives to invest in new technologies and research and development (R&D). The welfare and tax systems can combine to raise structural unemployment.[33]

William Beach and Garth Davis glean six key rules from the modern economic growth literature.[34] They are to: accumulate capital, keep government small, open the economy to foreign trade and investment, respect property rights and the rule of law, do not burden the productive sector with excessive government controls and regulation, and invest in human capital.

Policies and institutions that are conducive to enterprise are consistent with policies that confer a high level of economic freedom on citizens as individuals. Recent research using newly constructed indexes of economic freedom has found a strong relationship between economic freedom and prosperity as well as better 'socio-economic' outcomes – lower rates of unemployment, higher levels of human development, longer life expectancy, greater adult literacy and less poverty.[35] In addition, *increases* in economic freedom are associated with *increases* in economic growth (as the above examples of the Netherlands and Ireland indicate). A Granger causation analysis indicates that while

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31 Cited by Ken Farr, Richard A Lord and J Larry Wolfenbarger, 'Economic Freedom, Political Freedom, and Economic Well-Being: A Causality Analysis', *Cato Journal*, Vol 18, Fall, 1998, p 261.

32 Richard Roll and John Talbott, 'Why Many Developing Countries Just Aren't', CIPE Electronic Roundtable, 6 June 2002.

33 Jean-Phillippe Cotis, chief economist, Organisation for Economic Cooperation and Development, 'A Question of Structure: Explaining the divergence of growth in the OECD area', *OECD Observer*, Organisation for Economic Cooperation and Development, 26 November 2003. See also Alain De Serres, 'Structural Policies and Economic Growth: A Non-Technical Overview', Organisation for Economic Cooperation and Development, Economics Department Working Paper No 355, Paris, 2003.

34 William Beach and Gareth Davis, 'The Institutional Setting of Economic Growth', *1999 Index of Economic Freedom*, Heritage Foundation and *Wall Street Journal*, p 8.

35 See, for example, Herbert Grubel, 'Economic Freedom and Human Welfare', *Cato Journal*, Vol 18, No 2, Fall, 1998, pp 287–304, Steve Hanke and Stephen Walters, 'Economic Freedom, Prosperity, and Equality: A Survey', *Cato Journal*, Vol 17, No 2, Fall, 1997, pp 117–146, and James Gwartney and Robert Lawson, *Economic Freedom of the World: 2004 Annual Report*, The Fraser Institute, Vancouver, 2004.

a high level of economic freedom is an important source of prosperity, there is a (virtuous) feedback effect with high levels of economic well-being leading to greater economic freedom.[36]

A recent review by the Treasury of the empirical literature on the sources of economic growth does not refer to the research utilising the new indexes of economic freedom (or even acknowledge that they exist). Nor does it address the issue of the proper role for government in promoting prosperity. However, it did "highlight the importance of institutions and economic policies to New Zealand's relative economic growth performance" and commended the importance for sustaining per capita GDP growth of "the maintenance of institutions that embody first order economic principles, such as the protection of property rights".[37] This clearly has implications for the role of government. The more emphasis governments put on redistributive policies, the less they put on the protection of private property.

One point made in the Treasury paper is that the historical rate of GDP growth in New Zealand tends to be lower than would be expected on the basis of cross-country regressions 'explaining' differences between growth rates on the basis of assumptions about the importance of different explanatory variables. New Zealand ranks highly for economic freedom, for example, but its growth rate (and GDP per capita) is well below what its ranking might suggest.

Several points need to be made here. One is that any index of economic freedom is necessarily imprecise and the divergence between New Zealand's performance and its freedom ranking may be at least partly explained by measurement error. For example, the Resource Management Act 1991 essentially nationalises changes in land use. However, the degree to which this reduces economic freedom depends on how liberally diverse local authorities grant resource consents for changes in land use, a factor that is not captured in the index. A second point is that even if there is no measurement error, a change that increases economic freedom in New Zealand is still likely to increase the rate of economic growth, even if it stays below the regression line. New Zealand's economic growth picked up sharply once the labour market was freed up and government expenditure reduced from 1991–92.[38] Australian economist Winton Bates reports that some regression studies indicate that the rate of economic growth in New Zealand would probably have been negative in the absence of the 1984–1993 reforms.[39] A third point, made by Wolfgang Kasper, is that policy has been much more erratic in New

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36 Farr *et al*, above n 31, p 260.

37 The Treasury, *New Zealand Economic Growth: An Analysis of Performance and Policy*, Wellington, April, 2004, <http//www.treasury.govt.nz/release/economicgrowth> (last accessed 28 July 2004). The citations are from paragraph 150.

38 In 2004, New Zealand's economic freedom score for labour markets was only 5.9. This was down from 7.5 in 1995 and gave New Zealand a world ranking of only thirty-third in 2004. (See Gwartney and Lawson above n 35, p 14.)

39 Winton Bates, private correspondence, May, 2004.

Zealand than other countries such as Ireland and Australia.[40] The Treasury's finding that the rate of investment in New Zealand tends to be lower than in Australia and some other countries may reflect the time consistency problem created by erratic swings in economic policies in this country. James Gwartney and Robert Lawson make the point that it is the historical consistency of the value for economic freedom, not the current value, that best explains the level of prosperity.[41]

3.4 Does the size of government in New Zealand impede economic growth?

3.4.1 Three controversial issues

At least three controversies have arisen in New Zealand over the relationship between the size of government (as indicated by central and local government spending) and the rate of economic growth. They are:

- whether it is plausible to target annual rates of economic growth of 4 percent per capita with overall general government spending (OECD basis) around 40 percent of GDP;
- the impact of reductions in the current size of government on economic growth; and
- the claim that the composition of government spending and taxes is more important for economic welfare and growth than the overall size of government.

The first controversy followed a comment from a US expert on economic growth, James Gwartney:

> New Zealand is still a big government welfare state. Government spending continues at nearly 40 percent of GDP, a figure much too large for maximum growth. I do not know of any country that has sustained per capita income growth of 4 percent or more with that level of government spending.[42]

The minister of finance asserted in July 2002 that Gwartney's statement was "simply wrong". The next subsection summarises the exchanges on this controversy.

The second controversy follows research commissioned by the Business Roundtable from Bates who estimated that reducing government spending as a ratio of GDP by 10 percentage points (for example, from 40 to 30 percent) over a decade could effectively add 0.5 percent per annum to economic growth for a period of 10 to 25 years. The controversy arises in part from the formidable empirical difficulties involved in estimating this relationship accurately. For example, a review article in 1999 by Jonathon Temple observes that:

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40 Wolfgang Kasper, *Losing Sight of the Lodestar of Economic Freedom: A Report Card on New Zealand's Economic Reforms*, New Zealand Business Roundtable, Wellington, 2002. New Zealand's rating for economic freedom on the Fraser Institute's measure rose from 5.6 to 8.6 out of 10 between 1975 and 1995, but has since slid back to 8.2.

41 Gwartney and Lawson, above n 35, p 34.

42 Cited in Bates, above n II, p 26.

> Big government and high taxation may have a negative effect, but the evidence is still somewhat ambiguous.[43]

As a local example of contradictory findings, an analysis conducted for the Ministry of Economic Development by economist Arthur Grimes "suggest[ed] that size of government per se has at most only a minor effect on long-term growth outcomes".[44]

Critics have also made the point that, at almost 40 percent of GDP, New Zealand's government spending ratio is the seventh smallest in the 28-country OECD. (Korea's ratio of 29 percent is the smallest.) Grimes observes that on this basis the size factor should be favourable for New Zealand's relative rate of economic growth. (Indeed, it arguably has been: New Zealand's rate of GDP growth has been the seventh fastest in the OECD in the decade to 2003 and was associated with a reduction in the size of government.)[45] However, this is irrelevant to the issue of the size of government in New Zealand that is conducive to an acceleration of growth.

Such findings or opinions obviously resonate with those pushing for higher government spending and those who believe that incentives do not matter. Other arguments that are made include:

- Many OECD countries have higher incomes per capita than New Zealand and larger shares of government spending in GDP. This suggests that New Zealand could be wealthier if governments were smarter.
- The twentieth century saw big gains in prosperity and in the size of government in most member countries of the OECD. This suggests to some that the two are compatible.
- The real issue is the quality of spending; if governments get that right, the level of spending will be right, even if it is high. Currently, some low-quality spending may be at the expense of higher-quality spending. If so, it is not clear that the optimal level of spending would be less than the current level.
- The growth in the relative size of government since the nineteenth century is welfare-enhancing because public demand for government spending rises faster than incomes – as Wagner's 'law' postulates.

We return to this second controversy and related matters below.

The third controversy arises from Grimes's suggestion that the composition of spending and taxes is likely to be of greater importance.[46] The Ministry of Economic Development

43 Jonathon Temple, 'The New Growth Evidence', *Journal of Economic Literature*, Vol XXXVII, March, 1999, p 152.

44 Grimes, above n III, p 172.

45 New Zealand scores relatively poorly for the size of government in world economic freedom rankings. For example, it scored 6.7 out of 10 for a ranking of 39 in 2004 for this component compared with its overall score of 8.2 for its third equal ranking according to Gwartney and Lawson, above n 35, p 14.

46 Grimes, above n III.

endorsed this view in its *Growth and Innovation: Benchmark Indicators Report 2003*.[47] In early 2004, the Secretary to the Treasury, John Whitehead, asserted in a speech that "[r]ecent international work on the question indicates that it is the quality of Government spending, rather than the level that is more important in terms of growth".[48]

This proposition raises two issues: is it true and is it relevant? The first issue is empirical. There are two common measures of the size of government – the ratio of government expenditure to GDP and the ratio of taxes to GDP. The two measures are related. The paper by Grimes appears to dispute that the effect of size is material on the first measure, but to accept that it is material on the second measure. This seems to be inconsistent. None of the research cited by Grimes makes the case that cutting the size of government by cutting wasteful spending and taxes would produce smaller gains than changing the mix of spending and improving the structure of taxes. The government has stated that higher economic growth is its most important economic goal. It follows that the relative order of magnitude of the effects of size and composition is irrelevant. They are not mutually exclusive options. In reality, any government wishing to improve economic growth would determine the optimal size of government in conjunction with assessing the optimal mix of spending and taxes.[49] A recent OECD report provides a much better summary of the economic literature:

> The main conclusion from the literature is that there may be both a "size" effect of government intervention as well as specific effects stemming from the financing and composition of public expenditure. At a low level, the productive effects of public spending are likely to exceed the social costs of raising funds. However, government expenditure and the required taxes may reach levels where the negative effects on efficiency and hence growth start dominating.[50]

3.4.2 High growth rates and government spending at 40 percent of GDP

Critics of the proposition that the size of government in New Zealand is an impediment to much faster rates of economic growth have typically raised issues related to: (1) the cross-country comparability of measures of the size of government; (2) the time period for which the high growth rate is to be sustained; and (3) whether Finland, Luxembourg, Korea and Ireland constitute relevant counter-examples.

On the first issue, it is reasonable to start with the measures of the size of government that are published by the OECD in its regular *Economic Outlook* series. It has to be accepted that no measure will be uncontroversial given definitional problems and the degree to which regulation can substitute for government spending (for example, in relation to

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47 Ministry of Economic Development, p 16. It cited Fabling and Grimes (as MED Internal Working Paper, 2002).

48 John Whitehead, Secretary to The Treasury, speech to the Auckland Regional Chamber of Commerce and Industry, 'The Growth Challenge', Auckland, 19 March 2004.

49 Norman Gemmell and Richard Kneller, *Fiscal Policy, Growth and Convergence in Europe*, Treasury Working Paper 03/14, Wellington, June, 2003, make a similar point on p 14.

50 Andrea Bassanini and Stefano Scarpetta, *The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries*, Organisation for Economic Cooperation and Development, Economic Studies, No 33, 2001/11, Paris, p 14.

health, education and pensions). Grimes compared recent International Monetary Fund (IMF) statistics on the size of general government with the OECD measures for 21 countries. He found that the size of government is higher using the IMF measure for every country except New Zealand, where the difference is 2.2 percent of GDP.[51]

On the second issue, the government's initial goal was to lift New Zealand back into the top half of the OECD within a decade. It seems reasonable, therefore, to examine which countries, if any, had sustained growth rates of 4 percent per capita or more for a decade with government spending equal to or greater than 40 percent of GDP.

A paper by Roger Kerr assessed the historical record of OECD countries in recent decades.[52] He found that Finland had not sustained 4 percent per capita growth for a decade and Korea could be ruled out as a counter-example because its government spending ratio peaked at 23.3 percent of GDP between 1985 and 2000. Government spending in Ireland was almost 51 percent of GDP in 1985 but was brought down to below 40 percent of GDP in 1989 (the beginning of Ireland's period of fast economic growth). Although the ratio rose above 40 percent from 1991 to 1994, it was sharply reduced after 1994 and was 29 percent in 2000. That left Luxembourg as a borderline case. However, Luxembourg's small size, location and role in Europe in relation to financial services beg the question of its relevance to the New Zealand situation.

The fact is that very few countries have sustained per capita growth rates of 4 percent per annum for a decade or more in recent history. Prosperity has typically been achieved with small government by today's OECD standards.

Europe (and British Commonwealth countries like New Zealand) became wealthy through the industrial revolution, peace, low tax rates, the rule of law and free trade and immigration. Government was small by today's standards. In their major study of global public spending trends, Tanzi and Schuknecht reported that around 1870 the unweighted average of general government public spending in a number of industrialised countries was about 11 percent of GDP (the range was from just below 6 percent to 18 percent). Conversely, the communist nations – with very large government – under-performed the West.

After World War II, Japan, and more recently the Asian 'tigers', also achieved prosperity with small government, recording the fastest rates of growth in real GDP in the world between 1980 and 1995. Total government expenditures in these countries averaged 20.1 percent of GDP in 1995. The next five fastest growing countries during this period had government shares that were larger but below the OECD average. Moreover, contrary to Wagner's law, the average of the ratios of government spending to GDP for these 10 fastest growing countries fell slightly from 25.2 percent in 1975 to 24.7 percent in 1995.[53]

51 Grimes's paper is silent on whether sustained per capita growth rates of 4 percent per annum could be achieved with an overall share of government at around 40 percent of GDP.

52 Roger Kerr, 'Memo to Dr Cullen: Big Government Harms Growth', New Zealand Business Roundtable, Wellington, 25 September 2002.

53 James Gwartney, Robert Lawson and Randall Holcombe, 'The Size and Functions of Government and Economic Growth', paper prepared for the Joint Economic Committee, US Congress, April, 1998.

Communist regimes, such as China and Vietnam, are achieving rapid economic development by expanding the role of voluntary exchange and allowing the share of government to fall. The low marginal tax rates in China (in agriculture and the free economic zones) illustrate the point. Russia has also adopted a low, flat rate of income tax of 13 percent, and similar moves have been made by some Baltic and East European countries.

A recent paper by the Treasury refers to sustaining real GDP growth per capita of at least 3 percent per annum with a view to lifting New Zealand back to the top half of the OECD rankings in the next 20 years.[54] This is a more modest goal, but is still not credible under current policies – including maintaining the high share of government spending in the economy.

3.4.3 Why the size of government matters and how much it matters

Lessons of history

A review by Charles Adams of the history of taxation over 5,000 years concluded that:

> Taxes are the fuel that makes civilization run, but how we tax and spend determines to a large extent whether we are prosperous or poor, free or enslaved, and most importantly, good or evil.[55]

Adams found that regimes that sustain moderate rates of tax collections can be successful whereas regimes that impose draconian and rapacious tax regimes have resulted in decline, tyranny, civil war and serfdom. He suggests that an adequate tax rate to collect on income would be 10 percent – "the tax in the ancient world that operated for thousands of years".[56]

Adams's review warns about the dangers of the intrusive tax regimes that now exist in many countries, including the United States. Intrusive tax regimes are an inevitable consequence of big government spending. The complexities of such regimes make it impossible for many taxpayers to know what they must do in order to comply with the law. Professor Geoffrey Walker summed up recently the corrosive effect in Australia (where overall tax burdens are lower than in New Zealand) as follows:

> In the federal tax field … the rule of law has all but collapsed under pressure of the sheer volume of often unintelligible legislation and the grant of wide discretions to the Australian Taxation Office and the courts … The separation of powers has also virtually broken down: the executive government exercises legislative and quasi-judicial powers, the judiciary exercises policy-making powers, rights effectively turn on opinions about a citizen's purposes and in a variety of ways the law is changed at the point of application.[57]

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[54] The Treasury, above n 37, p 27.

[55] Charles Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilisation*, Madison Books, Lanham, Maryland, 1993. The citation is from the front cover.

[56] Adams, above, p 469. He also observes that the tax base matters as well as the rate.

[57] Geoffrey de Q Walker, *The Tax Wilderness How to Restore the Rule of Law*, Centre for Independent Studies, CIS Policy Monograph 60, 2004, p ix.

Of course, small government is not *sufficient* for high levels of economic prosperity. Small government may be corrupt or inefficient. It may fail to establish and protect individual autonomy and a system of private property rights. It may not achieve peace or establish a tolerable administration of justice and the rule of law. It may not protect public health services or ensure an efficient transport system. It may serve the interests of privilege and oppressive tribalism rather than openness and equality before the law.

High levels of economic freedom require taxes to be at least the level necessary to secure personal autonomy and private property. As indicated above, government spending of the order of 11 percent of GDP on average sufficed to provide these protection services during the industrial revolution.

In New Zealand in 1874 central government tax revenues were about $390 per capita in 2002–03 dollars – 4.7 percent of GDP. Central government spending out of current revenue was $958 per capita in 2002–03 dollars, 10.7 percent of GDP. Interest payments alone on the public debt were probably around 4 percent of GDP, reflecting the major expenditures on public works.

This level of spending was not regarded as minimal in its day. Historian Keith Sinclair reported that "Anthony Trollope [who visited New Zealand in 1872 when prime minister Julius Vogel's debt-funded spending schemes were in their early stages] thought the colony 'over-governed, over-legislated for, over-provided with officials, and over-burdened with national debt', an opinion which has had innumerable supporters ever since".[58]

3.4.4 The minimum size necessary to provide core functions

The core functions of government are to provide for national and individual security and other essential public goods. There is room for debate as to what to include in the latter category. Gwartney *et al* report that the OECD countries spend currently between 9 and 15 percent of GDP on protecting persons and property, national defence, education, monetary stability and physical infrastructure.[59] Contrary to Wagner's law, they did not find evidence that core spending tended to increase more than proportionately through time with higher incomes.[60]

In the case of New Zealand, between 1971–72 and 1996–97 total central government spending on public administration, defence and foreign relations, education, transport and communication, and the development of industry averaged 15.0 percent of GDP. Such spending peaked in 1975–76 at 19.6 percent of GDP and followed a declining trend thereafter to 11.5 percent of GDP in 1996–97. In 1996–97, spending on public administration was 3.0 percent of GDP, defence and foreign relations 1.6 percent, education 5.0 percent, transport and communications 0.8 percent, and development of

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58 Keith Sinclair, *A History of New Zealand*, Pelican edition, Penguin Books, London, Fakenham and Reading, 1959, p 157.

59 Gwartney *et al,* above n 53, p 26.

60 Michael James, *How Much Government?*, Centre for Independent Studies, Policy Monographs 11, 1987, argues that government growth is likely to be the unintended outcome of established political commitments and processes, rather than a reflection of common preferences.

industry 1.0 percent. The only category to absorb a larger percentage of GDP in 1996–97 than in 1971–72 was public administration.

Given the undoubted scope for governments to make far greater use of the private sector to provide education and infrastructure, there can be little doubt that the core functions of general government in New Zealand could be adequately supplied with funding of 10–15 percent of GDP (including about 3 percent of GDP for local government).[61]

Of course, governments in New Zealand are also involved in the provision of a welfare safety net, including for people in retirement. A generous allowance for such spending would put it at no more than 10–15 percent of GDP. Spending on core public goods and welfare might therefore total around 20–30 percent of GDP (including local government). Thus, it would be quite feasible to consider the benefits for economic growth from reducing the size of general government by 10 percentage points of GDP, to around 30 percent. Indeed, Tanzi and Schuknecht conclude that much of what governments want to achieve currently could be realised with general government spending at around 30 percent of GDP. (The data they use are broadly consistent with those in the OECD's *Economic Outlook* on general government total outlays.)

In contrast, MMP governments in New Zealand have set goals for core Crown operating spending (GAAP basis) that have varied between 30 and 35 percent of GDP (not including local government). Moreover, general government spending is larger than core Crown operating spending because it includes all central and local government spending and some capital spending. The OECD provides a measure of general government spending as a ratio of GDP amongst its member countries. Until recently, this measure included net capital outlays; now it includes gross capital outlays. According to the OECD's measure, general government spending in New Zealand in 2001 was 37 percent of GDP on the old basis and 39 percent on the new. For 2003–2005, the OECD is currently forecasting that general government spending in New Zealand will be almost 40 percent of GDP on the new basis.

These calculations suggest that governments in New Zealand are spending in total at least 10–20 percent of GDP more every year than would be necessary to provide for the core functions of government including a welfare safety net. Such taxes and spending reduce economic freedom and, other things being equal, economic growth and prosperity.

3.4.5 Excessive taxes and spending matter because incentives matter

The size of government matters because incentives and freedom matter. Taxes alter incentives.[62] Taxation without consent is a confiscation of private property that undermines economic freedom.

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61 A 1997 paper for the Treasury by Ted Sieper concluded that spending on core public goods plus as much as a third of health, education and welfare spending would require total central government spending to be no more than 14–15 percent of GDP. See E Sieper, 'Review of Gerald W Scully: Taxation and Economic Growth in New Zealand', The Treasury, Wellington, 1999 (released under the Official Information Act 1982).

62 Easterly, above n 30, p xii states (quoting Steven Landsburg) that "[p]eople respond to incentives; all the rest is commentary".

The history of any tax system is a history of problems of avoidance and evasion. It is fundamental to the design of a sound tax system that these incentive issues are addressed. Accepted economic reasoning establishes that the costs of raising taxes tend to rise with the square of the marginal tax rate.

Early estimates of the magnitude of these costs (notably by Arnold Harberger) suggested that they were quite small. As a result, many economists may have attached little importance to their effect on growth. However, more recent estimates point to a much larger effect (see pp 37–38 of this report). The higher estimates today reflect changes in tax rates, the tax structure and estimated response elasticities.[63]

Economic theorising on incentives also establishes that the size of government matters because incentives to spend matter. Governments lack the incentive and knowledge to spend money as carefully as taxpayers themselves. As the material in section 2.4 demonstrates, New Zealand governments have not been seriously interested in evaluations of the efficacy of base spending.

Government spending is likely to be wasteful because of voter, political and bureaucratic failure. Politicians give weight to party political considerations in evaluating spending programmes. Their interests will commonly be short term and factional. The time horizon for evaluating the politics of a major long-term spending decision may be as short as the date of the next general election. What might count, for example, is not whether it was credible that the 'Think Big' spending programme debated before the 1981 general election would generate 410,000 jobs by 1990, but whether the claim could sway voter opinion in 1981. Newspaper reports, almost on a daily basis, attest to the fact that wasteful spending is endemic in government.[64]

The potential for excessive spending and taxation to cost the community a great deal is indicated by the following illustrative calculation. Suppose the government is spending around 20 percent of GDP unnecessarily and that it is spending it 80 percent as well as taxpayers would spend it for themselves. In this case, such spending reduces effective national income by around 4 percent of GDP year in and year out. The overall cost is greater than this because of the deadweight cost of taxes. If this average deadweight cost is between 25 and 50 cents in the dollar, that would cut another 5 to 10 percent of GDP a year off effective national income, making it 9 to 14 percent lower in total.

3.4.6 Econometric tests of the importance of size

Many econometric problems arise in attempting to estimate the importance of excessive taxes and spending for prosperity, hence Temple's cautious conclusion cited earlier. One issue is that size is far from being the only relevant consideration. Another is that theory tells us that it is effective marginal tax rates that distort behaviour, but empirical work may only use average tax rates because of data problems. There are many other empirical difficulties. Bates listed four major reasons why econometric studies that tested the

63 See Bates, above n II, pp 52–55.

64 For a historical perspective see, for example, Michael Bassett, 'Spend our Money Wisely', *Dominion Post*, 20 March 2004.

relationship between the size of government and economic growth may be inconclusive.[65] Negative results have to be assessed for their robustness; it is not a matter of 'counting heads' among studies with different findings.

Temple's caution is reminiscent of the earlier debate in the economic literature on whether privatisation (a phenomenon that dates from around 1980) produced net benefits. This was also essentially a debate about whether people can invest and manage their own money better than governments. Initially, the empirical literature produced a range of conflicting answers because of estimation problems and the limited number of privatisation events that could be evaluated. Further research was required to correct for flaws in earlier estimates before researchers generally came to agree that, on average and over time, privatisation produced net benefits.

Such an evolution of the empirical research may establish more conclusively the adverse effect of large government on economic performance. For example, a paper by Stefan Folster and Magnus Henrekson published after Temple's review addressed the finding that a number of cross-country comparisons do not identify a robust negative relationship between government size and economic growth. They focused their study on rich countries in 1970–1995 and developed a model that tackles a number of the troublesome econometric issues. They reported that:

> … the more econometric problems are addressed, the more robust the relationship between government size and economic growth appears. Our most complete specifications are robust even according to the stringent extreme bounds criterion.[66]

An even more recent review of the sources of economic growth by the OECD assessed the accumulated evidence on the effects of the size of government. It concluded that a reasonable estimate to use as a 'stylised fact' was that a rise in the share of taxation in GDP of 1 percentage point would reduce GDP per capita by 0.6–0.7 percent.[67] This is also the estimate of Bassanini, Scarpetto and Hemmings.[68] Graeme Leach has provided a useful summary of studies finding a negative impact of taxation on economic growth.[69]

In a New Zealand context, Bates assessed that a 1 percent increase in government spending as a percentage of GDP would effectively reduce GDP per capita by 0.5 percent. Expressed differently, each additional dollar of tax-funded current spending could impose a

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65 Bates, above n II, pp 56–57.

66 Folster and Henrekson, above n IV.

67 Organisation for Economic Cooperation and Development, 'The Policy Agenda for Growth: An Overview of the Sources of Economic Growth in OECD Countries', Paris, 2003, Table 1, p 8.

68 Andrea Bassanini, Stefano Scarpetta and Philip Hemmings 'Economic Growth: The Role of Policies and Institutions, Panel Data Evidence from OECD Countries', Organisation for Economic Cooperation and Development, Economics Department Working Paper (ECO/WKP(2002)9), Paris, 2001, p 26 and p 37.

69 Graeme Leach, *The Negative Impact of Taxation on Economic Growth*, Reform, September, 2003, Table 2. <http://www.reformbritain.com/filedata/negative%20impact%20of%20taxation%20on%20economic%20growth.pdf> (last accessed 28 July 2004.)

deadweight cost on the community of 50 cents.[70] Applied to spending of 20 percent of GDP, that is equivalent to a 10 percent reduction in national income, year in and year out.

Bates considered that a reduction of spending of 'only' 10 percent of GDP spread over a decade would increase the growth rate by 0.5 percent per annum for a decade. Given that labour productivity is forecast to be growing at a trend rate of around 1.5 percent per annum, such a gain is equivalent to lifting the rate of labour productivity growth by a third. That would be a major achievement. Such a reduction would still leave general government total outlays in New Zealand at just below 30 percent of GDP, according to the OECD's latest numbers. This would be above the 1960s ratio.

Bates's estimates seem modest in relation to other estimates, particularly if the reduction in the size of government is achieved by reducing current transfer spending (around 20 percent of GDP) and high marginal tax rates. For example, David Smith has estimated that GDP in the United Kingdom would have been 54 percent higher in 1998 if government spending had not been lifted by 8 percent of GDP between 1960 and 1998.[71]

Grimes's assessment that the size of government per se has at most only a minor effect on long-term growth outcomes is difficult to follow, particularly because his article does not question the estimate by Bassanini *et al* referred to above. This is a larger estimate than that of Bates for a reduction in distorting taxes and spending.[72]

Grimes's finding that the effect may be smaller than the estimate by Gwartney, Holcombe and Lawson is unexceptional. Bates explains why the Gwartney *et al* estimate is likely to be too high in coming to his own estimate that is 50 percent lower.[73] Grimes cited Bates's paper but did not acknowledge that Bates had already made a similar argument.

The introduction to Grimes's paper associates Business New Zealand and the Business Roundtable with the estimate by Gwartney, Holcombe and Lawson that Bates had criticised. Here, Grimes was clearly under a misapprehension. The only substantial piece of research the business community has commissioned on the topic is by Bates, whose estimates are not out of line with the tax-based estimates that Grimes endorses in his paper.

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70 Bates, above n II, p ix.

71 David Smith, 'Public Rags or Private Riches?', as cited by Lord Skidelsky, *Financial Times*, 29 December 2000.

72 The major technical contribution of Grimes's paper is to modify a single, reduced form, pooled cross-country time series regression of the effect of size of government on economic growth in the paper by Gwartney, Holcombe and Lawson referred to earlier. Grimes's assessment that the effect of the size of government is minimal appears to be based on the presumption that adding up to six dummy variables to the basic regression, perhaps in conjunction with specification changes, represents a definitive test of the effect of the size of government on economic growth. However, the power of such a test is not apparent given the possibility that the dummy variables are simply 'throwing out the baby with the bath water'. It is curious, for example, to find that dummy variables inserted to represent the effects of the oil price shocks of 1973–74 and in the early 1980s have their biggest negative effect on economic growth in the 1990s when government expenditure shares were greatest. Moreover, the author cites no authorities in support of his appeal to Wagner's law in order to respecify the basic equation.

73 Bates, above n II, Appendix 3 and pp 58–59.

3.4.7 Compositional effects

Naturally, the benefits from reducing the size of government depend on how it is done. Spending should only be cut where its costs to citizens' welfare exceed the benefits. Conversely, spending should be increased where the benefits from extra spending exceed the costs. Roading projects, where the cut-off benefit to cost ratio has been 4:1 or higher, are an obvious candidate.

On the tax side, theory and empirical evidence (see below) suggest that the priority is to cut high effective marginal tax rates. Marginal tax rates can be reduced until they are equal to the average rate of tax.

Any evaluation of whether the costs to citizens in general of existing spending exceed the benefits needs to take into account the evolution of private arrangements that are currently crowded out by state action. This is particularly so where state spending is on private goods. For example, increasing government operation of schools and hospitals has led to less private provision in many countries. Government services tend to be relatively unresponsive to users' needs. They are also likely to be under-priced, leading to wasteful supply and demand and costly forms of non-price rationing.[74]

Transfer spending is likely to be particularly costly. The government, in taking money from middle class income earners through taxes to give it back to them as benefits, distorts their behaviour on both the tax and expenditure sides, for no obvious overall gain. For example, universal state superannuation is likely to change people's work effort, savings and retirement decisions in undesired ways.

Public spending is more likely to be justifiable in national interest cost-benefit terms when it relates to public goods.

Investigations into the value for money of spending programmes must be done on a case-by-case basis. It would be absurd, for example, to conclude that because cross-country regressions indicate that countries with higher rates of capital formation or spending on research and development tend to have higher rates of economic growth than New Zealand, governments should actively promote either.

The same criticisms and conclusions apply to the inference that there are normative implications in a regression analysis that finds some categories of spending contribute positively to GDP and others contribute negatively, if at all. There is a tendency to call the former categories productive spending and the latter unproductive or non-productive. This may lead to the unwarranted inference that if governments want to increase GDP they should increase spending in the productive category and reduce it in the unproductive category. However, government spending (for example, on security) can be worthwhile (and vital to a country's economic prosperity) even if it is classified as 'unproductive'. Similarly, government spending on 'productive' investment can be

[74] For a far-reaching study of the failures of state involvement in education, see EG West, *Education and the State: A Study in Political Economy*, Liberty Fund, 3rd edition, Indianapolis, IN, 1994.

damaging to growth (New Zealand's experience with many former government trading enterprises and the 'Think Big' projects illustrates the point). Moreover, there is a need to focus on underlying causes and forces rather than proximate causes or correlations. For example, endogenous growth models might find that factor accumulation, with an emphasis on human capital, is important for growth. However, what is likely to be important for factor accumulation is an environment in which enterprise can flourish, as Skidelsky has suggested. State spending on education could crowd out higher-quality private spending, or could exhibit diminishing returns: more is not necessarily better.

With these critical qualifications, it may be of interest to review the empirical cross-country research into which sorts of taxes and spending seem to be positively or negatively related to economic growth.

First, in respect of the structure of taxes, Bassanini *et al* found that direct taxes are more harmful for prosperity than indirect taxes – increasing the share of direct taxes in total taxes from 50 to 60 percent would reduce per capita income by 3.3 percent. In a New Zealand context, Erwin Diewert and Denis Lawrence estimated the marginal deadweight costs of taxes on labour to be about 18 cents in the dollar compared with around 14 cents in the dollar for indirect taxes.[75] Other studies have found significant effects.[76] In a path-breaking 1996 study, Harvard University economist Martin Feldstein calculated that government in the United States had reached a size where raising an additional dollar of income tax cost US$2.56, representing a deadweight cost of US$1.56.[77] It would be very difficult to justify much non-core current spending at that level. The US Office of Management and Budget guidelines for cost-benefit analyses of federal programmes state that costs in the form of public expenditures may need to be multiplied by 1.25 to account for the excess burden of taxes. Other research finds that the structure of taxes matters, as well as the overall level of the tax take.[78]

In a recently published book disputing claimed relationships between big government and inferior economic performance, Lindert objects to the estimates of Feldstein and others arguing, for example, that they imply that the rise in social spending in Sweden should have reduced its GDP by up to a totally implausible 50 percent.[79] However,

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75 W Erwin Diewert and Denis A Lawrence, *The Marginal Costs of Taxation in New Zealand*, New Zealand Business Roundtable, Wellington, 1994.

76 Jim Saxton, 'Hidden Costs of Government Spending', Joint Economic Committee, US Congress, December 2001, summarises many estimates for the United States in Table 1 and suggests that a conservative estimate of the cost is 40 cents for each additional dollar of tax collected. Leach, above n 69, also summarises in Table 4 estimates for the United Kingdom and Australia.

77 Martin Feldstein, *How Big Should Government Be?*, National Bureau of Economic Research Working Paper 5868, December, 1996.

78 Some research finds that indirect taxes do not have a statistically significant negative effect on growth. Such taxes are sometimes referred to as non-distorting. This terminology is confusing because deadweight cost estimates support the intuition that they distort work–leisure decisions.

79 Peter H Lindert, *Growing Public: Volume 1, The Story: Social Spending and Economic Growth since the Eighteenth Century*, Cambridge University Press, Cambridge, UK, 2004.

Feldstein's estimates (1) apply to the United States not to Sweden; (2) calculate the effect of a marginal change, not a major change; (3) are a welfare measure rather than a GDP measure; in particular, they are based on compensated demand elasticities rather than uncompensated elasticities;[80] and (4) do not lend themselves to a 'before and after' GDP comparison.

Secondly, in respect of the composition of government spending, Bassanini *et al* find that an increase in government consumption expenditure (for example, on state sector employment) reduces national income, perhaps by 0.6–0.7 percent for each half a percentage point increase in the ratio of such expenditure to GDP. In 2002–03, New Zealand central government consumption expenditure was 7.7 percent of GDP at $2,463 per capita. Bassanini *et al* find that higher transfer payments have a more negative effect on national income than higher consumption expenditures. Increases in taxes relative to GDP to fund increases in transfer payments are particularly costly on this measure.

On this basis, reducing income taxes and welfare spending by, say, 5 percent of GDP over a decade would have a larger effect on GDP per capita than that estimated by Bates.

3.5 Documenting the rise of government in the twentieth century

By 1913, that is, immediately prior to World War I, Tanzi and Schuknecht estimate that government spending in the industrialised countries had crept up from the 11 percent of GDP average in 1870 to 13 percent of GDP. This rise was associated with the growing influence of socialist thinking favouring state redistribution.

Views at that time about the optimal level of taxes (and therefore size of government) would shock many people today. Tanzi and Schuknecht report that French economist Paul Leroy-Beaulieu suggested in 1888 that taxes of 5–6 percent of income were moderate. Taxes would be 'exorbitant' and reduce economic growth if above 12 percent of income.[81] A classic study of income taxation by Seligman in 1911 was able to observe that *after a hundred years* the rate of income tax had never exceeded 6 percent and that the "early complaints against the inquisitorial character of the tax have long since well-nigh completely disappeared".[82]

One of the most striking trends of the twentieth century was the rise of big government and the redistributionist state. Tanzi and Schuknecht report that World War I boosted the average share of government in their sample of industrialised nations to 19 percent by 1920.

The continued growth in socialist thinking after World War I was evident in the title of John Maynard Keynes's book, *The End of Laissez-Faire*, published in 1926. The Great

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80 Breadwinners (who still tend to be males) with more mouths to feed tend to reduce their work effort less than other people when tax rates go up. Feldstein's measure captures their welfare loss, whereas the use of GDP as a measure does not.

81 Tanzi and Schuknecht, above n 1, p 5.

82 Adams, above n 55, p 352.

Depression further boosted government spending, lifting the average share of government to 23 percent of GDP by 1937, twice the average 1870 ratio for industrial countries.

During the 1940s, John Maynard Keynes agreed with fellow economist Colin Clark that the upper limit for the size of government was 25 percent of GDP.

Yet World War II saw a further lift in the size of government internationally. This was partly because many European countries enshrined welfare policies as constitutional rights after the war. By the 1960s and 1970s enthusiasm for an expansionary, activist redistributionist role for the state was at its height. Tanzi and Schuknecht report that the average share of government spending was 28 percent in 1960, 43 percent in 1980, and 45 percent in 1990. They consider the 1960–1980 period to be "the golden age of [romantic] public sector intervention".[83]

The increase in the size of government in the twentieth century in the industrialised nations appears, at first blush, to be associated with strong economic growth. For example, Maddison's index of real GDP per capita in 12 Western European countries rose at 1 percent per annum in 1900–1950 and at 2.8 percent per annum in 1950–2000. However, the first half of the century was marked by two world wars and a major depression. The second half was marked to a greater degree by one of Adam Smith's prerequisites for prosperity – peace.

If we look more closely at per capita GDP growth rates in the second half of the twentieth century, a more nuanced picture emerges. The overall per capita growth rate for these 12 Western European countries was 4.2 percent per annum in 1950–1960 but only 1.6 percent in 1990–2000. Moreover, the average growth rate for each decade during this period was lower than in the previous decade. One of the largest declines during this period was in Germany's rate of economic growth – from 7.1 percent per annum per capita in 1950–1960 to 1.6 per cent per annum in 1990–2000. The German 'economic miracle' after World War II has vanished under the burden of heavy taxation and regulation. The United Kingdom's best decade in this period was 1980–1990 when real GDP per capita grew at 2.4 percent per annum under the policies introduced by the government of Margaret Thatcher.

The history of the growth of government in New Zealand during the twentieth century reveals a similar pattern.

In 1900, New Zealand's GDP per capita was second in the world to the United Kingdom, according to Maddison. Revenue from taxation was $500 per capita in 2002–03 dollars, about 7.5 percent of GDP. Spending on core activities – defence, judicial and legal services, and government administration – was almost $200 per capita and spending on interest on the public debt was just short of $300 per capita (all in 2002–03 dollars). Consolidated fund spending was 13.3 percent of GDP. The state's redistributional spending in 1900 was so small that revenue from taxation needed to exceed spending on core activities and debt servicing by only $14 per capita in 2002–03 dollars.

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83 Tanzi and Schuknecht, above n I, p 16.

Governments used the exigency of World War I to double the ongoing per capita tax burden – to almost $1,000 in 1920. It stayed around this level until the 1930s when spending by the first Labour government was instrumental in lifting it to roughly $1,500 in 2002–03 dollars by 1938–39. This was triple its level in 1900. Meanwhile, GDP per capita had risen by $4,458 in 2002–03 dollars. The $1,000 increase in government spending per capita was 22 percent of the lift in GDP per capita.

National income accounts were first compiled in New Zealand for the year ended March 1938–39. These accounts showed general government current spending to be 19.6 percent of GDP. Excluding debt servicing, it was 17 percent. Current spending on goods and services was 13 percent of GDP. Spending on social assistance and pensions was only 3 percent of GDP.

World War II led to a further doubling in the per capita tax burden to $3,000 in 1950 (in 2002–03 dollars). The rise as a percentage of GDP was from 12.8 percent in 1938–39 to 18.8 percent. General government current spending rose to 26.4 percent of GDP in 1950, largely because of increased benefits, pensions and subsidies.

By 1960, central government taxation per capita in New Zealand had reached almost $4,000 in 2002–03 dollars (taxation was 22.4 percent of GDP). By 1971, it was almost $5,500 (25.7 percent of GDP) and by 1980 it was $7,300 (30.5 percent of GDP). It peaked on this basis in 1990 at $9,900, with taxation at 36.8 percent of GDP. It was then reduced by 1992, to almost $8,000 per capita. Such reductions are unusual, and this one proved to be temporary. In 2000, New Zealand's GDP per capita was 3.7 times larger than in 1900 on Maddison's reckoning, but its global ranking had dropped to twenty-fourth. Central government taxation per capita was $9,300 (in 2002–03 dollars), 31 percent of GDP. Central government current spending was $10,000 per capita (rounded and in 2002–03 dollars), 33 percent of GDP. Social assistance benefits in cash accounted for 11.5 percent of GDP. Spending on justice, defence and public administration had risen to 4.6 percent of GDP. Spending on interest on the public debt was 2.4 percent of GDP.

Figure 5 illustrates these developments using central government consolidated account spending. The series is indicative and contains some discontinuities.[84]

Between 1900 and 2003, real revenue from taxation rose twenty-fold from roughly $500 per capita to $10,000 while GDP per capita rose fractionally over four-fold from $7,500 to $32,000 (in 2002–03 dollars). Central government current spending in 2002–03 was $9,800 per capita.

At 15 percent of GDP, central government current spending of $5,000 per capita would suffice to fund the core functions of central government when per capita income is $32,000. On this basis, tax rates in 2002–03 could have been half their actual levels and still have sufficed (in conjunction with other sources of revenue) to fund a modest

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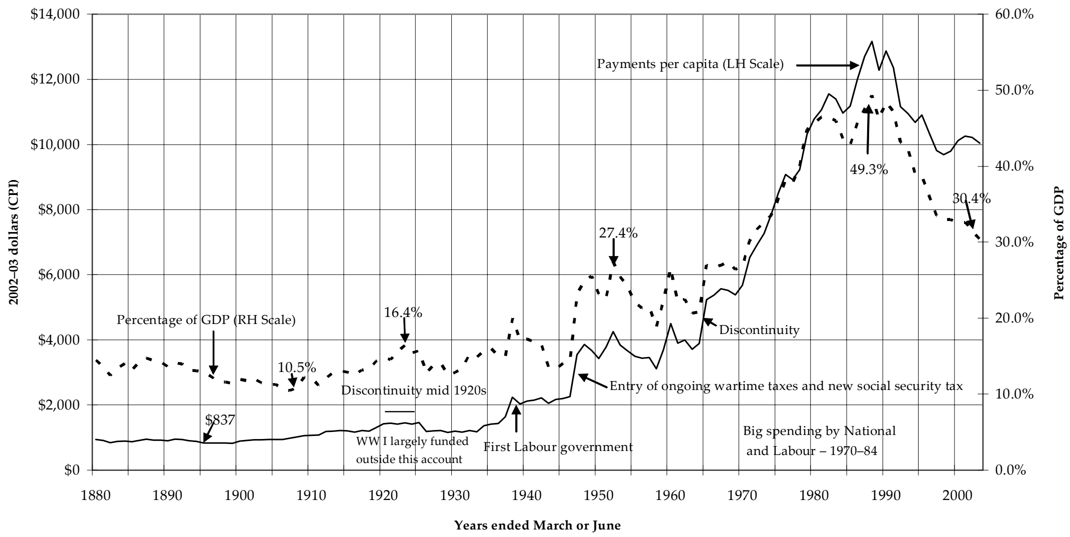
84 There were changes in the classification of road spending and revenues in the 1920s and early 1960s. For the purposes of the chart, the historical series was linked to the newer 'net financial expenditure' classification in 1981 and this series was in turn linked to the SNA series for central government current outlays in 1998.

Figure 5: Central government (mainly current) payments (2002–03 dollars per capita)



Source: Sundry official yearbooks, Statistics New Zealand.

welfare state. In reality, the comparison is understated because GDP per capita could have been much higher if marginal tax rates had been held at more modest levels.

In raising average tax rates so sharply since 1938–39, governments have largely sought to expand spending on central government transfer payments in the form of cash benefits ($3,300 per capita in 2002–03) and benefits in kind, such as health and education benefits (close to another $3,000 per capita), totalling $6,250 per capita. Together, these two categories now account for government spending (and taxes) of around 20 percent of GDP.

It is implausible that the growth in the welfare state reflects the operation of Wagner's law. It is more likely that it reflects changing ideas about the role of the state and the increasing power of vested spending interests. It is noteworthy, for example, that the timing of the increases in the state's share looks opportunistic, being related to world wars, the Great Depression and (in the 1970s) inflation and progressive tax rates. Another fact that seems inconsistent with Wagner's law is that local government did not expand comparably as a percentage of GDP. Local government spending appears to have expanded more or less in line with GDP.

At a more academic level, Wagner's law lacks a satisfactory economic rationale or convincing empirical support.[85]

Other factors can explain the relative constancy of the share of local government spending in GDP. These include Baumol's hypothesis that productivity gains are less in the case of at least some public sector activities, and the hypothesis that the demand

85 See, for example, the entry in the MIT *Dictionary of Economics*, p 459, and the brief review of the empirical work in Searna Dutt and Dipak Gosh, 'An Empirical Examination of the Public Expenditure-Economic Growth Correlation', *Southwest Oklahoma Economic Review*, 1997, pp 13–17.

for other public sector activities roughly corresponds to the demand for a normal good – that is, it expands at the same rate as real incomes.

Adams's observation that 10 percent was the normal rate of tax for successful civilisations is also consistent with the notion that the costs of meeting demand for the core functions of government roughly expand with the growth in national income.

With the growth of government to modern levels, the notion that taxes should be paid in the interests of taxpayers and therefore with their general consent has been lost. Adams has made the point that the heavier the tax burden, the less the tax system can rely on consent (a willingness to comply) and the more it must rely on heavy-handed compulsion (with the tax office obtaining draconian powers to invade privacy and override common law rights). Whereas in the 1940s US Supreme Court judge Jackson could comment that Americans were largely law-abiding and tax assessments were essentially an honour system, by 1982 Chief Justice Neely commented that cheating on tax was pervasive in the United States.[86] Oppressive tax systems lead to evasion, avoidance and flight.

3.5.1 Assessing the costs and benefits of the rise in government in the twentieth century

The question to be asked is whether the benefits New Zealanders have derived from this big expansion in the size of government last century have exceeded the costs. Governments are refusing to ask this when base spending is not evaluated to see whether it is meeting its objectives or providing value for money.

Economist Arthur Okun made the point several decades ago that policies to redistribute income are like transferring water using a 'leaky bucket'. Some value is lost in the transfer.[87] For welfare programmes and other social policies, the issue is whether such losses are compensated by the benefits accruing to those receiving the transfers. Tanzi and Schuknecht addressed this issue in an international context. Their methodology

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86 Adams, above n 55, pp 378–379.

87 See Arthur Okun, *Equality and Efficiency: The Big Tradeoff*, Brookings Institution Press, Washington, DC, 1975. Lindert's book *Growing Public* suggests in effect that there has been no leaky bucket (at a macroeconomic level anyway) with the rise of the welfare state in the industrialised nations in the twentieth century. He suggests five reasons why he could not find such an effect:

1) countries with larger welfare states tended to offset the negative effects on GDP by adopting more pro-growth tax structures than countries with smaller welfare states;
2) countries with larger welfare states tended to have universal benefits rather than targeted benefits; this reduced job disincentives;
3) much social spending (for example, on education and public health) was conducive to growth;
4) much welfare spending is on pensions, and the reduction in the work effort of the elderly might be too small to pick up in overall GDP trends; and
5) government support for childcare, maternity services and the like could induce increased workforce participation by women, and therefore raise GDP per capita.

Point 1 is not a rejection of Okun's leaky bucket proposition. It simply illustrates that if governments want to increase GDP growth they should look at both welfare spending and the structure of taxes.

was generous to big government in that it attributed any improvements in social or economic indicators to the rise in government spending, ignoring the possibility that greater gains might have been achieved otherwise.[88]

Tanzi and Schuknecht found that social indicators (for example, literacy, infant mortality and life expectancy) in the industrialised countries improved up to 1960. On the basis of their methodology, they concluded that "a reasonable claim" could be made that increased government spending since the early 1900s contributed to these improvements.

Beyond 1960 Tanzi and Schuknecht found that the further large increase in the share of government spending in the industrialised nations was associated with a slowing, or even reversal, of the improvement in these social indicators. They also found that economic performance since 1960, as measured by GDP growth and rates of unemployment, has been on a par or better on average in countries with small governments than in countries with big governments.[89] Larger government was not associated with less variability in economic activity or better performance in other economic dimensions. In addition, they found that social indicators in the newly industrialising countries were closing the gap very rapidly with the industrialised countries, despite their much lower shares of government spending than even the small-government industrialised countries.

Redistributive spending is usually defended on the basis that it is to assist the poor. However, the incentive of a political majority may be to benefit themselves. Because the people who make up the middle class are a numerical majority, a plausible hypothesis is that state redistribution largely benefits the middle class at the expense of the rich and the poor. Empirical research has lent support to this hypothesis.

One unintended and undesired consequence of middle-class activism could be that the state regulates to make it harder for the poor to obtain paid employment and therefore makes the poor welfare-dependent. If the state were to make welfare benefits more generous and accessible it would have the same effect. The increase in state dependency in New Zealand since 1960 is illustrated by the twelve-fold increase in the proportion of the population drawing unemployment, sickness and invalids benefits – from five per thousand in 1960 to 59 in 2001–02. The domestic purposes benefit did not exist in

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87 Continued ...

Point 2 is too bald as stated. A universal system is more expensive and so raises the tax burden averaged over all taxpayers. For a given level of benefits, a targeted system can have a lower average tax burden at the cost of higher effective marginal tax rates on taxpayers whose income falls in the abatement range. Which arrangement has the greater disincentive effect depends on the relative magnitudes of the parameters. Point 3 does not appear to be in conflict with the empirical work cited above on the adverse effects of transfer payments. This commonly finds positive effects for education spending and a positive finding for public health. Point 4 is correct in principle, but is an empirical matter. Point 5 could have a one-off effect on the level of GDP per capita. However, the higher taxes necessary to fund the subsidies seem likely to deter enterprise and thereby longer-run growth in GDP per capita.

88 Tanzi and Schuknecht, above n 1, p 75.

89 Tanzi and Schuknecht, above n 1, p 248.

1960, but in 2001–02 28 per thousand of population were drawing it. These increases are on top of dramatic growth in per capita payments on accident compensation.

In 2002–03 dollars per capita, spending on the unemployment, sickness and invalids benefits was $721 in 2001–02, a fourteen-fold increase from $57 in 1960. In 2001–02, $417 per capita in 2002–03 dollars was spent on the domestic purposes benefit. One hundred years earlier, this combined sum of $1,138 per capita would have sufficed to fund all central government consolidated account spending.

Is this a case of helping the poor or is it an example of the perverse effects of labour market regulation and a welfare system that has grown far beyond a safety net of last resort?

The amount of welfare money going to the poor will be a misleading measure of assistance to the extent that welfare benefits displace private earnings from productive work. Tanzi and Schuknecht found that the share of national income of the bottom 40 percent of households is only 2.8 percentage points higher in countries where government spending is high (for example, 55 percent of GDP) than in countries where it is much lower (for example, 35 percent of GDP). In the case of New Zealand, James Cox has calculated that around 46 percent of government social spending in New Zealand in 1997–98 went to households in the top three quintiles (60 percent) of taxpayers who paid 84 percent of all taxes.[90]

The 'churning' that occurs when citizens pay taxes with one hand and receive the money back in cash or kind with the other is common amongst the industrialised nations. Because of the deadweight costs of taxation, it is costly to tax middle-income earners just to give the money back to them as welfare, or even to try to spend it better on their behalf than they could spend it themselves. Tanzi and Schuknecht present a table covering 11 industrialised nations that shows churning accounted for government spending of, on average, 20 percent of GDP in the early 1990s.[91]

The 2002 post-election briefing of the Ministry of Social Development identifies many concerns with social outcomes in New Zealand:

- Around 16.5 percent of working-age people and 26 percent of all children are reliant on a benefit. In 2000–01 the social assistance system – including tax credits but excluding New Zealand Superannuation – cost around $7.1 billion or 6.7 percent of GDP.
- About 9 percent of the working-age population has been on a benefit for more than a year.
- The proportion of core benefit recipients who received their benefit for over four years was 29 percent in 2002 (up from 23 percent in 1998).

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90 James Cox, *Middle Class Welfare*, New Zealand Business Roundtable, Wellington, 2001. 'Social spending' includes welfare, health and education spending.

91 Tanzi and Schuknecht, above n 1, p 141.

- The proportion of the population on sickness, disability or orphans benefits is growing fast, for example, from five per 1,000 of population in 1970 to 15 in 1990 and 28 in 2000.
- Around 9 percent of 18–24 year olds at 30 June 2002 were receiving the unemployment benefit.
- Since 1998, between 26 percent and 29 percent of all children aged under 18 years have been dependent on core benefit recipients.
- Many people migrate between benefits rather than leave the system. Over half of the people who came off the sickness benefit between 1997–98 and 2001–02 went on to another core benefit.
- Between 1990 and 1994, New Zealand's child poverty rate rose sharply on most measures. There was some decline in the number of children in poverty between 1994 and 1998 but little change since. In 2000–01, depending on the measure used, between 6 percent and 29 percent of children were in poverty (approximately 63,000 to 285,000 children).
- Child mortality rates are moderately high by OECD standards. Rates for Maori and Pacific Islands children are much higher.
- Suicide rates have risen over the last 25 years, with New Zealand rates at the high end of the OECD range. Men aged between 20 and 39 years have the highest suicide rates. Women have their highest suicide rates between 15 and 24 years.
- Teenage birth rates in New Zealand are the third highest in the OECD.
- Over the eight year period between 1989 and 1997, obesity rates rose sharply from 10 percent to 15 percent for males and from 13 percent to 19 percent for females. The issue is more acute for Maori and Pacific peoples. More than one in four are obese.
- More people are relying on discretionary hardship assistance. For example, the number of Special Needs Grants increased 16 percent in the two years to December 2001, while main benefit numbers were decreasing.
- The current system provides only limited incentives for some people to move into and remain in work. For many people work does not pay because of the financial disincentives in the system.[92]

Since 1960, real spending per capita on the sickness benefit has risen five-fold and spending on the unemployment benefit per capita has risen by a factor of 140. Real spending per capita on the unemployment, sickness, invalids and domestic purposes benefits combined has risen twenty-fold. A social researcher could be expected to ask in which direction cause and effect has been working. Have these massive increases in

92 Ministry of Social Development, Briefing to the Incoming Minister, 'Improving Wellbeing for all New Zealanders', Wellington, 2002, p 52.

expenditure been alleviating misery or fuelling it? Are the real beneficiaries of this spending the recipients or the providers and the bureaucracy?

The briefing by the Ministry of Social Development does not raise such obvious questions. The Ministry's attitude to the potential self-competence of beneficiaries and the scope for effective supportive voluntary actions independent of government is indicated by the unqualified and undocumented assertion that: "People need an adequate income before they can improve their situation".[93] How then did poor countries become rich? The notion of self-help is apparently inconceivable.

In terms of the discussion in section 2.4, the whole briefing illustrates the failure to ask if the benefits of existing spending exceed the costs. The tendency is simply to assume that disadvantage is evidence that more money needs to be spent. State welfare in New Zealand was introduced when average living standards were much lower than they are today. With general increases in prosperity, fewer people, not more, ought to be dependent on welfare. It is hard to escape the conclusion that many welfare interventions have exacerbated rather than alleviated problems of disadvantage, for example, by increasing marriage break-up and hence sole parenthood.

Economist Wolfgang Kasper summed up recently the problems with big government as follows:

> Long-term historic experience and international comparisons show that big government does not enhance the relative distribution of income and wealth, lead to greater happiness nor contribute to a dynamic, enterprising economy. On the contrary, the politicisation of economic life has fomented widespread discontent, public apathy, envy, structural rigidity, and social disharmony. Big government means high taxes and/or growing public debt burdens, hence disincentives to work, learn, risk and innovate – in short to economic growth. Moreover, high taxes tend to reduce private saving, creating another handicap for economic growth.[94]

3.6 Conclusions

It is highly implausible that New Zealand will be able to sustain even the 2.5 percent per annum growth rate in real GDP per capita of the last decade on current policies. A far more realistic indicator of the underlying growth rate is the general consensus that trend labour productivity growth is around 1.5 percent per annum.

The claims of successive MMP governments that their policies will generate sustained per capita growth rates of 3 percent or more are a fraud on the electorate.

There needs to be a far better understanding that even to raise the underlying labour productivity growth rate from 1.5 percent per annum to 2 percent would be a major challenge and would require more than marginal changes in policy settings.

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93 Ministry of Social Development, above, p 7.

94 Wolfgang Kasper, *Economic Freedom Watch*, Centre for Independent Studies, Report No 6, Sydney, 13 November 2003.

The presumption that much faster economic growth can be generated by interventionist design rather than by focusing government on creating a legal, fiscal and regulatory environment that fosters enterprise should be reversed. Big activist government based on the view that economic growth can be centrally planned is more likely to impair rather than enhance growth.

The notion that the expansion of the role and size of government in the rich countries has not been bad for economic growth is essentially an argument that tax and spending incentives do not matter. In fact, they matter a great deal. Europe's high rates of unemployment and overall economic decline relative to the United States is widely attributed to its bigger governments, including the scale of state welfare and intrusive regulations.

It is a more difficult matter to ascertain the extent to which excessive government is harmful to prosperity. However, the assessment by Bates that progressively reducing government expenditure (and taxes) in New Zealand by 10 percent of GDP (to around 30 percent) by pruning the most ill-justified spending might add around 0.5 percent per annum to GDP over a 10 to 25 year period is not out of line with findings endorsed by the OECD and Grimes.

Such findings will be disputed for obvious reasons. Large numbers of public servants and other beneficiaries from government spending can be expected to resist vigorously attempts to question, let alone evaluate, its efficacy. Moreover, politicians will tend to evaluate current spending programmes according to political rather than national interest criteria.

The question is what might be done to motivate politicians to pay greater attention to value-for-money considerations in government spending. That is the subject of the next two sections.

4

TAX AND EXPENDITURE LIMITATION RULES

4.1 International experience

4.1.1 Support for spending targets from the OECD

Fiscal balance requirements (for example, the requirement that operating deficits and surpluses balance out over an economic cycle) are common around the world. There seems to be little dispute that on their own they do not impose much constraint on the level or average quality of government spending. During periods of high nominal income growth, real government revenues can increase sharply under the tax structures that have prevailed in the industrial countries during the last 50 years. Governments are able to increase spending commensurately. Much of this expenditure may be difficult to cut in a recession. (For example, much spending may be on state sector salaries and transfer programmes the costs of which may increase during recessions.) In a recession, a fiscal balance requirement could therefore induce governments to rely heavily on raising tax rates or imposing new forms of taxes or user charges. The higher tax rates and broader tax base could see revenue and spending rise even more sharply in the next economic expansion. (In time, of course, the higher tax rates may reduce future expansions and future tax revenue.)

The OECD has favoured consideration of supplementing debt and deficit targets with an expenditure target on the grounds that the former can be met too readily with higher taxes that impede economic growth.[95] An expenditure target might or might not be accompanied by a revenue target, or a balanced budget target.

Voters know about spending caps from their personal lives. Most families cannot buy everything they want and must limit spending in order to keep within what they can afford. They have to prioritise. Governments need to do the same. In effect, tax or expenditure limits that are imposed on governments, or are self-imposed, give politicians a level of protection against vested special interests and encourage fiscal decisions that are more closely aligned with the public interest.

4.1.2 Where are expenditure rules found?

Tax and expenditure limitations (TELs) are not as common as budget balance or debt targets. They can found at the national or federal level of government, and at lower levels of government:

95 Organisation for Economic Cooperation and Development, above n 6, p 126. An appendix summarises the rules OECD countries have in place.

- *Hong Kong* (a non-OECD country) has a "general principle" that over time expenditure growth should not exceed the growth rate of the economy, taking into account both real and nominal measures. The current government aims to reduce public expenditure from 22.5 percent of GDP in 2004–05 to 16.9 percent in 2008–09.
- The OECD reports that *Japan* had a rule in 2002 that caps government spending as a percentage of GDP at its current level until the end of the fiscal year 2006.
- *The Netherlands* has ceilings on central government social security and health-care spending.
- In *Spain*, rules provide for a cap on spending.
- *Sweden* has nominal expenditure limits, three years ahead, for 27 areas of spending.
- *Switzerland* has a rule that caps expenditure at cyclically adjusted revenues. This rule can only be avoided with an absolute majority in both houses.
- The *United States* has medium-term nominal caps for discretionary spending at the federal level.
- Within the *United States*, 27 states have TEL rules on their books. These rules focus on containing the growth in spending and revenue. Their dates of adoption vary from 1978 (Delaware) to 1994 (Florida).
- Within *Australia*, the New South Wales government is required by that state's General Government Debt Elimination Act 1995 to keep the annual growth in general government spending and cost of services below the growth in gross state product. The requirement applies to the four years ending in the current budget year and to the four years starting with the current budget year. The state government's budget for 2003–04 provides for nominal spending growth of 3.5 percent per annum to 2006–07 against projected gross state product growth of 5.8 percent per annum.
- Within *Canada*, two provinces (Ontario and Manitoba) have comparable legislation. The Ontario legislation prohibits increases in a wide range of existing tax rates, or the creation of a new tax, unless approved by popular referendum. In the event of a budget deficit, the premier and cabinet members may be obliged to take a 25 percent pay cut, rising to 50 percent for a third year of deficits.

4.1.3 How do TELs relate to other rules?

At the state level within the United States there has been a proliferation of approaches in recent decades to improving fiscal disciplines. These have made the United States a laboratory for testing the efficacy of various fiscal rules in isolation and in combinations. In a recent study, Dale Bails and Margie Tieslau grouped the rules into three categories:

- those that directly constrain spending or tax levels (TELs, line-by-line vetoes, balanced budget requirements and super-majority voting requirements);
- administrative constraints on budgetary processes (term limits, limits on the introduction of bills and the budget cycle); and

- mechanisms for direct democracy (citizen initiatives and state referendums).[96]

They tested for the effect of these mechanisms on the fiscal performance of 49 states between 1969 and 1994. They found that states tended to have lower spending per capita if they maintained TELs, super-majority voting requirements, balanced budget requirements, term limits and citizen-initiated referenda. However, the coupling was important. Balanced budget rules, to be effective, also required TELs to be in place. In addition, super-majority rules required complementary balanced budget rules to achieve the desired goals.

Bails and Tieslau estimated real per capita state and local spending in states with TELs to be US$42 lower than in states without TELs. In states with both TELs and balanced budget requirements, spending is reduced by nearly US$135. In states with the comprehensive budgetary institutions tested, they find that real per capita expenditures are reduced by nearly US$473.

The study concluded that the choice of rules affects spending decisions. Such findings are more consistent with public choice theories about government spending than with theories that postulate that politicians resist factional pressures successfully.

Research by the National Center for Policy Analysis (NCPA) and the Fraser Institute at the state/province level in North America finds that the states with the highest level of economic freedom tend to have incomes per capita that are over US$7,000 higher than those in the state (West Virginia) with the lowest level of economic freedom.[97] Tax and expenditure limitations and other rules that are effective in lowering the share of government spending and taxes in these states are likely therefore to increase economic freedom and thereby the rate of economic growth.

Grant Gulibon and Thomas Armstrong report independently that in recent years the group of 14 states within the United States that had a super-majority requirement alone or with a TEL rule had achieved faster overall employment and output growth than 36 other states.[98] In similar vein, Timothy Besley and Anne Case found that super-majority rules have large and significant negative effects on taxes per capita.[99]

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[96] Dale Bails and Margie Tieslau, 'The Impact of Fiscal Constitutions on State and Local Expenditures', *Cato Journal*, Vol 20, 2000, pp 255–277.

[97] Amela Karabegovic, Fred McMahon and Dexter Samida with Glenn Mitchell, *Economic Freedom of North America 2004 Annual Report*, Fraser Institute and National Center for Policy Analysis, 2004.

[98] Grant Gulibon and Thomas Armstrong, 'The Case for a Pennsylvania "Tax and Expenditure Limitation"', *Commonwealth Policy Brief*, The Commonwealth Foundation for Public Policy Alternatives, Vol 03, No 7, June, 2003.

[99] Timothy Besley and Anne Case, 'Political Institutions and Policy Choices: Evidence from the United States', *Journal of Economic Literature*, Vol XLI, March 2003, pp 7–73.

4.1.4 Which TELs are most effective?

Tax and expenditure limitations vary considerably across the states within the United States. These variations have enabled researchers to draw conclusions about the characteristics of an effective rule.

This research finds that some TELs appear to reduce expenditure growth, some may be ineffective and some may *increase* it. As an example of the first point, TELs that ratchet down the spending or tax base in recessions make it harder for governments to increase spending during the next economic expansion. In short, the nature of the rules matters a great deal. As a result, research that treats all rules as the same may miss the fact that the group of states with TEL rules shows greater expenditure constraint than groups without TEL rules.

A recent review of the research by University of Colorado economics professor Barry Poulson concludes that effective rules tend to:

- be constitutional rather than statutory;
- limit the growth of government spending to inflation and population growth rather than other aggregate measures of economic activity;
- provide for immediate refunds of surplus revenue above the TEL limit; and
- be linked to other budget rules, most importantly to balanced budget requirements.[100]

States with TELs that have these characteristics appear to have been more successful in constraining expenditure growth.

California provides an instructive lesson in how to make the worst of a promising start. In Michael New's view, Proposition 13 did an excellent job of providing short-term tax relief, but it failed to restrain spending.[101] Governments subsequently raised the income tax, sales tax and taxes on beer, wine and cigarettes. Per capita general fund tax revenues rose 33 percent between 1990 and 2001. The *Wall Street Journal* commented that under Governor Davis, the state "spent like drunken sailors if that is not unfair to shoreleave".[102] A Cato Institute report in early 2003 stated that California was probably in the poorest fiscal shape of any state.[103]

4.1.5 Why are other TELs less effective?

Constitutional rules have to be approved by voters en masse. In contrast, legislative rules may be designed to appease voter anger about wasteful spending, and to head

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100 Barry Poulson, *Tax and Spending Limits: Theory, Analysis and Policy*, Independence Institute, Colorado, January 2004.

101 Michael New, 'Fiscal Trail Blazer: Colorado's Taxpayer Bill of Rights is leading the way', Cato Institute, 6 November 2002, <http://www.cato.org> (last accessed 28 July 2004).

102 The *Wall Street Journal*, 'States of Prosperity (or Not)', 16 July 2002.

103 Chris Edwards, Stephen Moore and Phil Kerpen, 'States Face Fiscal Crunch after 1990s Spending Surge', *Cato Briefing Papers*, No 80, 12 February 2003 (see Table 1, Figure 3 and pp 7–8).

off citizen initiatives, rather than actually do something about the problem. Dean Stansel found that TELs written by politicians tended to be more vague, less restrictive and more easily circumvented.[104]

Michael New found that TELs enacted by citizen initiatives cause per capita spending to fall, whereas TELs enacted by the legislature tend to increase per capita spending.[105] John Matsusaka found that government spending in states that provided for citizen initiatives was of the order of 4 percent lower than in pure representative states.[106]

New found that TELs passed by citizen initiatives tended to have four features that constituted stronger disciplines than those initiated by legislatures:

(1) more restrictive limits on the growth in spending;

(2) greater limits on the ability of state governments to shift spending pressures to the local government level;

(3) greater constitutional protections; and

(4) less discretion for politicians in the refunding of surplus revenues.

On point 1, New found that 29 percent of citizen-initiated TEL rules limited government spending growth to inflation plus population growth, as against none for legislatively initiated TEL rules. The most common approach amongst TEL rules is to limit the growth in revenue and expenditure to the growth in state income (except where voters approve otherwise). This approach obviously allows more latitude for governments to increase spending in an economic expansion. It could, however, be a more severe discipline in the rarer event that real GDP falls while the population increases. On the other hand, some TELs that are based on inflation and population growth caps are designed to ratchet down the base during recessions – if real revenue per capita falls during the recession, then the new level provides the base for capping expenditure growth thereafter. In an independent study, Stansel found that the income-related cap was much less effective in constraining spending growth than the inflation and population growth cap.

On point 2, Stansel found that only five out of 18 TELs stopped state governments from evading the limits by shifting spending responsibilities to local government via unfunded spending mandates. Such TELs could be expected to control the sum of state and local government spending more effectively.

On point 3, the problem with legislative arrangements is that a future legislature may simply be able to overturn them when it is politically convenient to do so. Provisions that have been sanctioned by a voter referendum are likely to be more constitutionally robust. Stansel found that constitutional TELs lowered real per capita spending growth

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[104] Dean Stansel, 'Taming Leviathan: Are State Tax and Spending Limits the Answer?', *Policy Analysis*, No 213, Cato Institute, July, 1994.

[105] Michael New, 'Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations', *Policy Analysis*, Cato Institute, 13 December 2001.

[106] John Matsusaka, 'Fiscal Effects of the Voter Initiative: Evidence from the Last 30 Years', *Journal of Political Economy*, Vol 103, No 31, 1995, p 587.

rates by 4.8 percentage points compared with a 2.3 percentage point reduction by legislative TELs.

On point 4, some TELs give governments considerable discretion in determining when excess revenues will be returned and who will receive them. This creates opportunities for welfare-reducing rent seeking activities. In Colorado, the legislature found that it could spend the current year's surplus and fund the actual return of the excess revenue out of the next year's (projected) surplus. In the latest recession, the projected surplus did not eventuate and the legislature was required to fund the revenue rebate by cutting current spending. That exacerbated Colorado's fiscal crisis.

4.1.6 How have the states with the best arrangements fared?

The researchers cited above generally regard Colorado as having one of the best arrangements amongst those currently in place. The Colorado Taxpayer Bill of Rights was passed by citizen initiative with over 53 percent of the vote in 1992. It:

- limits increases in per capita state spending to the rate of inflation, except where voters explicitly approve otherwise;
- ratchets down the amount of revenue the state can keep and spend as revenue falls during recessions;
- requires voter approval for state and local governments to retain and spend revenue in excess of the limit;
- requires voter approval for any new taxes, tax rate increases, extensions of an expiring tax, or tax policy change that directly increases net revenue;
- mandates the immediate return of all surplus revenues to taxpayers;
- requires the state government to 'backfill' local governments whenever state legislation has a negative impact on local government; and
- locks in independent earlier rules (particularly the 1992 Arveschoug-Bird Amendment that placed a cap on general fund appropriations equal to the lesser of 5 percent of Colorado personal income in an earlier year or 6 percent above the previous year's appropriation, with exceptions for federal mandates and court orders).

Some salient features of Colorado's early experience with this legislation are as follows:

- Per capita state spending between 1992 and 2002 grew just under 1 percent per annum faster than inflation.
- Colorado had the second lowest rate of growth in per capita spending compared with 10 peer states.
- Tax rebates between 1997 and 2002 exceeded US$3.2 billion (around $8,000 per resident).
- Colorado's tax take as a percentage of personal income dropped from twenty-eighth highest amongst the states in 1989 to forty-third by 2000.

- Voters defeated measures to raise taxes or increase spending every year from 1993 to 1999. However, in 2000 voters did approve an amendment that increased state aid to public education and reduced the surplus for both 2000 and 2001.

In recent years, following the dotcom crash, Colorado experienced its worst fiscal crisis in decades. Revenue in 2001–02 was down by 15 percent. Colorado had the third largest state budget deficit in the United States at 9.2 percent of GDP, according to an official November 2002 assessment.

Because of its constitutional requirement to balance the budget, year in and year out, Colorado cannot use debt to smooth revenue fluctuations. Nor did it have assets in the form of a 'rainy day' fund that it could use for this purpose.

The legislature was in an untenable position. While the TEL rule ratcheted down the revenue base, an unrelated constitutional provision required the state to ratchet up spending on K-12 (kindergarten through to twelfth grade) education (at inflation plus 1 percent). This spending constitutes more than 41 percent of the general fund budget. Medicaid constitutes another 20 percent. In effect, the legislature was required to get voter approval for a relaxation of the TEL rule or to cut heavily into the portion of state spending that was discretionary – only around one-third of total spending.[107]

In contrast, in New Zealand central government can readily cut wasteful base spending if it wishes to do so. Although much spending is formula driven, a government with a parliamentary majority has the power to alter the relevant parameters (for example, the eligibility criteria for benefits and benefit indexation formulae) without the constraints of a bicameral structure and an independent president or governor.

In recent years the Colorado legislature has raided cash and trust funds and cut spending on higher education, health care and state jobs. According to a recent report, lawmakers are looking at about a dozen amendments that would weaken its TEL rule. Their difficulty may be to get voters to endorse any of these changes.[108]

The analysis by Poulson concluded that in order to reduce the likelihood of future similar crises, Colorado should:

(1) reduce its reliance on income tax (at a flat rate of 5 percent) for revenue in favour of more stable sources (for example, sales taxes);

(2) eliminate mandated spending;

(3) eliminate recourse to stop-gap 'smoke and mirror devices' to balance the budget;

(4) create a 'rainy day' fund; and

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[107] See Barry Poulson, *Fiscal Crisis in Colorado: Analysis of the Worst Fiscal Crisis in Colorado History*, Independence Institute, Colorado, Issues Paper No 2-2003, March, 2003.

[108] See Colleen Slevin, 'Colorado May Tinker with Tax Restrictions', Associated Press, 8 April 2004.

(5) close loopholes in the existing TEL rule that relate to deferring refunds to the following fiscal year, targeting refunds to special interest groups, and 'fiddling' with measures of the rate of population increase for TEL purposes.

4.1.7 How might a TEL be integrated with a budget stabilisation fund?

Poulson argues that the current Colorado rule can be interpreted as aiming to constrain the growth of government in the long run without attempting to stabilise the state budget over the business cycle. His 'new generation' rules for a TEL would combine an inflation and population growth limitation rule with a budget stabilisation fund. The operation of this fund would require two sets of rules. One set would determine when and how surpluses during economic expansions would get paid into the fund. The second set would determine when money in that fund could be used to stabilise the budget during recessions.

In essence, his proposal caps the amount that can be built up in the budget stabilisation fund at 10 percent of total TEL-capped revenues. The fund can be drawn on in any fiscal year to the extent of any deficiency between the current year's revenue and the previous year's revenue. This is in addition to an amount of 3 percent of total TEL-capped revenues held in an emergency fund.[109]

Poulson's proposed new TEL rules would also tighten up the provisions determining which taxpayers would receive refunds of surpluses. The specific prescription is that excess amounts be refunded:

> … to the taxpayers who paid the state *ad valorem* property taxes or state income, sales or other excise taxes for or during the preceding state fiscal year in a manner that is proportional, on a pro rata basis, to the manner in which such taxes were collected from such taxpayers.[110]

New Zealand governments are not required to balance their budgets year in and year out, regardless of the economic cycle. No recourse to a budget stabilisation fund is needed to fund deficits during economic recessions. Such deficits can be funded from debt and asset sales. This flexibility does, of course, reduce immediate pressures to raise taxes or cut spending. However, governments are required to establish a programme for returning to surplus during the forecast expansion phase. Such a system is less likely to see the sort of fiscal crisis that Colorado is experiencing, but it may be at the cost of reduced pressures to reassess the merits of spending programmes.

4.1.8 Pros and cons of an inflation and population growth limit

Colorado's TEL ratchets the spending base down when revenue falls in recessions. This may reduce the power of spending interests through time. To maintain the size of government relative to GDP with a growing population would require voter support through referenda.

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[109] Monies in this fund can only be withdrawn for emergencies declared by law. This would require a majority of two-thirds of elected members in each house. 'Emergency' does not mean a revenue or budget shortfall.

[110] Poulson, above n 100, p 29.

Colorado only adopted its current TEL after intensive debate. It enacted its first (unsatisfactory) TEL in 1977. Citizen initiatives that intended to put greater disciplines in place were defeated in 1986, 1988 and 1990. The successful 1992 initiative was vigorously opposed by some politicians. For example, the incumbent governor campaigned strongly against it, declaring that it would make Colorado "an economic Armageddon".

A TEL rule that ratchets the base down during recessions would make it harder for a government to project a surplus during the forecast recovery phase without spending cuts (on the assumption that it would not be confident of getting approval to tax and spending increases in a referendum). Spending interests will see this as a negative feature. Yet, if a TEL rule is to be successful in pressuring governments to review base spending, it has to bite at some stage in the economic cycle. It may well be that it is easiest to focus a government's mind on reassessing value for money in spending during a recession. Undoubtedly, this would generate fears, of a Keynesian nature, that cutting spending might worsen the recession. However, expenditure cuts are not necessarily recessionary – for example, such fears in New Zealand in 1991 proved to be unfounded, and the expenditure cuts could be timed to occur during the forecast recovery phase.

Another likely concern with an inflation plus population growth rule is that the demand per capita for some public goods provided by government may grow more or less in line with the growth in income per capita. For prolonged periods, such an underlying trend might be obscured by other factors. For example, spending on defence, border protection or communicable diseases can be expected to be strongly threat-related, rather than related to trend growth in per capita income.

Another factor that could obscure the effect of income growth on the demand for public spending is the presence of changing supply constraints. In New Zealand, government spending may be much more constrained by supply than by demand. For example, a major portion of base government spending is on transfer payments, including funding for the provision of education and health services of a private good nature. The incipient demand for these transfers at near-zero prices is so great that supply has to be rationed by direct spending constraints rather than by demand – for example, by eligibility criteria for benefits, limiting staff–pupil ratios in education, and queues in public hospitals. (In the case of public roads the extent of budget rationing is indicated by the cut-off benefit to cost ratio of 4:1.) Because governments exercise the greatest control over the rationing devices, the levels of individual items of such spending, and the total, are politically determined. As such they can be expected to respond to changes in demographics, the strength of interest groups, and differing views on the efficacy of state-provided welfare, schools and hospitals relative to private alternatives.

Economist William Baumol put forward a different reason why some government spending might need to grow faster than inflation plus population growth, namely that there may be intrinsically low productivity growth in some public services. For example, if police and crime are constant per thousand of population and wage inflation is greater than consumer price inflation, spending on police and the courts could be expected to rise faster than price inflation plus population growth, unless there are offsetting productivity gains. Against this there is the possibility of economies of scale and productivity gains in the provision of many government services. (New technologies, for example, are very important in police work.)

What, if anything, might be inferred about these matters from spending trends in New Zealand over a long period of time? In section 3 we noted that central government taxes per capita rose twenty-fold between 1900 and 2003 (from $500 to $10,000 in 2002–03 prices using the Consumers Price Index) while real GDP per capita rose only four-fold. In contrast, real per capita revenue from local authority rates, levies and licences rose roughly five-fold from $125 to $650 between 1900 and 2000.[111] As a percentage of GDP, central government spending and taxes skyrocketed. In contrast, local authority revenues from rates and other sources lifted fractionally from 1.8 percent of GDP in 1900 to 2.1 percent in 2000. Moreover, the ratio for local authorities appears to have peaked in the late 1930s at over 4 percent of GDP. The dramatic contrast with central government spending is suggestive of the importance of the growth of the welfare state and the effects of a progressive income tax structure in raising revenue for central government, particularly during the inflation of the 1970s.

However, the differential is not purely as a result of the rise in central government welfare benefits. For example, the first national income accounts (for 1938–39) put central government current spending on goods and services at 10.1 percent of GDP while local government consumption spending was 3.7 percent of GDP. Central government spending peaked on this measure at 17.0 percent of GDP in 1992–93 and has since dropped back (unevenly) to 15.9 percent in 2002–03. Local government spending on the same measure has fallen (erratically) to 2.1 percent of GDP in 2002–03. The differential movement in the relative size of central and local government spending on current goods and services as a percentage of GDP since 1938–39 also suggests that funding differences might be more important than the growth in demand in influencing the growth in government spending. Much central government spending on goods and services (for example, in health and education) substitutes for private spending, with the government under-pricing its services and discriminating in favour of state-owned providers in a myriad of ways.

It is clear from the historical data that the relationship between government spending growth and real income growth has been complex. War, inflation and fiscal drag, demographics (the ageing population and earlier retirement relative to life expectancy) and changes in ideas concerning the role of government (particularly in relation to welfare) have obscured the relationship. In respect of changing ideas about the proper role of government, New Zealand has tended to follow overseas developments. The timing of the worldwide move from the early 1980s to privatise state enterprises, and of the big expansion in welfare spending in industrial countries from 1960 (and the recent halving in welfare rolls in the United States) all point to the importance of factors other than economic growth in determining the size of government.

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111 Classification changes may reduce the accuracy of this comparison.

What does this imply for the longer-term sustainability of a TEL that requires governments to go to taxpayers every time they wish to increase government spending in line with income growth rather than population growth? Superficially, the evidence suggests that once the size of government has been reduced to a level that voters are happy with, their willingness to approve increases will grow with their growth in incomes, but not necessarily smoothly. For example, the fact that local government spending and rates revenues were around 2 percent of GDP in 1900 and in 2002–03 suggests that the demand for real government spending might be more related to real income growth than to population growth. The statistics cited in section 3.4 about trends in core government spending from 1971–72 are similarly suggestive.

However, at a deeper level the jury is still out. Much government spending may simply substitute for private spending. Income growth should be associated with total spending on similar items, rather than the government component. Clearly, governments can use emergencies to ratchet up tax rates permanently. This is not an income-related feature. It is also possible that the size of government spending is materially influenced by whether its tax structures generate extra revenue automatically – through inflation or income growth – without governments having to ask ratepayers or taxpayers specifically to approve higher rates of tax. In this sense, the differential movement between the size of central and local government may owe something to the differences between rates and a progressive income tax structure in generating passive revenue growth.

Ultimately, this is an empirical issue.[112] A TEL that limits spending to inflation and population growth gives voters greater voice. If voters repeatedly vote in successive referenda to approve proposals to increase spending and taxation at rates faster than inflation and population growth, we can be sure that spending interests would take the opportunity to propose that the TEL be modified to make it an income-related limit.

4.1.9 Is a citizen-initiated referendum critical in establishing a TEL?

Parliamentarians face many conflicts of interest. One is between their duty to taxpayers and their interest in spending taxpayers' money for their own benefit (for example, on perks). Another is between their duty to taxpayers and their interest in getting votes from non-taxpayers who benefit from government spending.[113] Parliamentarians' conflict between their responsibility to taxpayers to spend money wisely and their interest in lubricating constituencies looms larger in respect of spending than in respect of fiscal balance.

The constraint of a citizen referendum is one answer to this conflict of interest. New Zealand's arrangements do not currently permit citizen initiatives that bind

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112 Surveys of voter opinion on these matters can be difficult to interpret. For example, a press release by the New Zealand Employers' Federation of 7 October 1999 commented on conflicting findings in two polls, one of which found that 81 percent of respondents believed governments would waste the money from increased taxes.

113 Adams, above n 55, pp 458–459 comments on the conflicts of interests that arise when the power to tax and the power to spend reside in the same political entity. Under British rule, Hong Kong was an exception. Under the US Constitution, the separation of the executive (the presidential branch) from the legislature (the houses of Congress) is a partial safeguard.

governments. Therefore any TEL in New Zealand would be enacted by the legislature, like the Fiscal Responsibility Act 1994 (although ratification by a binding government-initiated referendum could be sought). The FRA has attracted cross-party support. It has not been explicitly breached.

Clemens *et al* have discussed some possible constraints in a Canadian context.[114] One option they raised is a "manner and form" constraint. They suggest that if a TEL rule were passed into legislation in conjunction with a referendum, any Act repealing the rule would also need to be approved by a referendum. They caution that whether a court would determine that such an amending Act needed a supporting referendum might depend on whether it was satisfied that the manner and form provision in the original legislation could not be interpreted as an attempt to restrict the substance of future legislation. In New Zealand such an approach would seem likely to make repeal more difficult politically rather than legislatively.

Another option would be to protect a TEL by requiring a super-majority in parliament for new taxes, increases in existing tax rates, or measures broadening the tax base. The case for a super-majority arises from the risk of a simple political majority acting in a predatory fashion on either a minority of the population or on a relatively unorganised majority of taxpayers. As an example of the minority situation, 24 percent of the tax collected from individuals in New Zealand is collected from just 71,000 taxpayers, comprising 2 percent of all taxpayers, and 45 percent is collected from just 274,000 taxpayers (9 percent of all taxpayers), according to statistics on the Treasury's website.

Since the early 1990s, six states in the United States have enacted laws that require a super-majority for tax increases in both chambers of the state legislature. These states are Arizona, Oklahoma, South Dakota, Nevada, Louisiana and Oregon. New reports that such measures appear to have a marked effect. For example, in the 2002 fiscal year (a recessionary year), these states cut spending by $36 for each $1 they increased their tax revenues. The national average was $1 for $1 in the same year.[115]

According to Peter Ferrara, 14 states, covering one-third of the US population, now require a super-majority for tax increases. Six states require a two-thirds super-majority vote of the legislature.[116] Three require a three-quarters vote. Two more require the approval by two-thirds of voters in a referendum. The last three require approval by three-fifths of the legislature. A further three states are close to adopting a super-majority requirement.

Ferrara reports that super-majority proposals are quite popular. In the four states where the requirements were enacted by referendum – Nevada, Oregon, South Dakota and

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114 Jason Clemens, Todd Fox, Amela Karabegovic, Sylvia LeRoy and Niels Veldhuis, 'Tax and Expenditure Limitations: The Next Step in Fiscal Discipline', The Fraser Institute, 1 October 2003.

115 Michael New, 'Key ratio: spending cuts to tax hikes', *The Orange County Chronicle*, 16 January 2003.

116 Peter Ferrara, *Supermajority Taxpayer Protection*, Policy Brief, Americans for Tax Reform, <http://www.atr.org/policybriefs/031700pb.html> (last accessed 28 July 2004).

Florida – the super-majority proposal received over 70 percent of the vote. A nationwide poll conducted by the Polling Company in 1997 found that 70 percent of voters would support such a provision at the federal level.

At the federal level, the proposed Taxpayer Bill of Rights and Tax Limitation Act would require a two-thirds majority for Congress to raise taxes. (The former would also limit domestic spending growth to the rate of inflation, allow the president to have a line-by-line veto and provide for a review of the performance of government agencies every five years.)

The anti-predation logic underlying the super-majority requirement is self-evident, and the evidence from the United States that it makes a difference is encouraging.[117]

Of course, a super-majority voting requirement is less effective if it can be rescinded by a simple parliamentary majority, as would be the case in New Zealand. Ultimately, a legislature-initiated TEL can only endure if it commands general support in the community.

There are other (non-exclusive) options for making a TEL rule more secure. Section 5 discusses, *inter alia*, tax apportionment rules (for example, a single rate of tax), a restoration of the principle that parliament should not delegate the power to spend, and formal entrenching of principles for evaluating the worth of government spending programmes and proposals. These options can also stand independently of a TEL rule.

4.2 Options for New Zealand

4.2.1 Implementing a TEL rule

What would be the most desirable TEL rule for New Zealand and how would it best be put in place? There are many options and the choice between them may not be obvious. This section (summarised in the form of a draft Bill in the Annex) suggests one set of answers to these questions.

Should the rule limit spending or taxes, or both? The US experience indicates that government spending is not reduced by constraints on taxes alone, or even by tax cuts.[118] The proposal in the Annex is to limit both spending and taxes. This obviously transfers greater power to voters, heightening the constraints on politicians and spending groups. To constrain taxes only would permit unwise spending to be funded from debt or asset sales. Constraining spending as well curbs incentives to switch to "non-tax" substitutes, such as user charges, for taxes. Under the proposed TEL rule, surplus taxes must be returned to taxpayers.

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117 Daniel Mitchell, *Why a Supermajority would Protect Taxpayers*, Heritage Foundation, 29 March 1996, <http://www.heritage.org/Research/Taxes/paper93.cfm> (last accessed 28 July 2004).

118 William Niskanen, 'Starve the Beast Does not Work', Cato Policy Report, Vol XXVI, No 2, March/April, 2004.

How might spending and taxes be defined? The most straightforward option would be to preserve the existing GAAP-based Crown Financial Statements structure. Government tax revenue would be defined to be fiscal year total revenue levied through the Crown's sovereign power. Government spending would be defined as core Crown operating expenses net of finance costs and of accounting changes and revaluations. (Finance costs are non-discretionary expenditures. Accounting changes and revaluations could alter the base in ways that are unpredictable and subject to reversal from one year to the next, without generating a case for changing operating spending.) It is important that the GAAP rules defining spending and tax measures be outside the control of the executive.

What about constraining capital spending? Explicit voter approval would be required for increasing Crown debt in conjunction with an increase in capital spending. The requirement would apply to underwriting of capital projects, where the underwriting is not backed by cash reserves and so would require borrowing if called. This provision would mean that the major project spending of the early 1980s would have required specific voter approval. It would allow debt to be increased in order to continue funding current operating spending in a year in which revenue falls below forecast. Consideration could be given to tightening this constraint to preclude using the proceeds from asset sales to fund capital projects. One problem with this provision could be the use of non-Crown debt to fund capital spending.

Would voters get a say? The proposal would follow the Colorado rule in requiring a referendum for increases in debt, revenue or spending that would otherwise violate the TEL.

Should there be a super-majority requirement for tax increases? The proposal is for a super-majority requirement of a least 75 percent.

Parliaments have already accepted the principle that elected representatives should not be able to make major decisions by a simple majority. For example, section 129(2) of the Companies Act 1993 requires a major transaction for a company to be approved by (at least) a 75 percent majority of the votes of shareholders. In the absence of such a vote, any shareholder can apply for an injunction to stop a major transaction and can hold directors personally liable for any economic loss. Shareholders who vote unsuccessfully against such a resolution can require the company to purchase their shares at a fair price.[119]

The argument for a super-majority voting requirement (not to mention injunctive relief and personal liability of elected representatives) is surely much stronger when outvoted dissenters have no ability to opt out. What is good for the (shareholder democracy) goose should also be good for the (parliamentary democracy) gander.

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119 Mark Kelly, Simpson Grierson, 'Unwanted Transaction: Where do you Turn', *Weekend Herald*, 3–4 April 2004.

The conflicts of interest in voting for tax increases provide an independently compelling reason for requiring a very substantial super-majority in the case of a parliamentary democracy. Currently, at any point in time there are around 1.1 million adults drawing a core benefit (including the accommodation supplement). In 2002 there were 2.7 million registered on the electoral roll. Clearly, those on benefits have a conflict of interest when voting on a proposal to raise taxes.

What if voters do not get a say? A super-majority of parliamentarians should be required for tax rate increases, increases in an existing tax base, or new taxes in the event that voters do not get a say. The case for this rule reflects the above arithmetic It may apply to some attempts to reduce tax avoidance.

What about emergency situations? It is essential that parliament be able to act promptly and decisively in the national interest in an emergency. Section 13 of the Public Finance Act 1989 provides for a minister to approve spending where the government has declared an emergency. The Act does not define an emergency. It may be desirable to tighten this provision. A two-thirds majority in parliament would be permitted to increase taxes and spending in a genuine emergency. However, they would not be able to increase income taxes for this purpose and they would be obliged to return any excess emergency tax revenues after the emergency is over.

Should the limit be set by income growth or by population growth and inflation? It is clear from experience in New Zealand and United States that an income-related limit allows governments to spend freely and unwisely during economic booms, and that such spending is difficult and painful to reverse during recessions. A population growth and inflation rule implies a falling share of government spending in a growing economy. Sections 2 and 3 have explained why this would be desirable in New Zealand until the government's share is much reduced. This limit also gives greater voice to voters, who can always subsequently vote to change it.

Should the rule ratchet down the base in recessions? The proposal in the Annex provides for the limit for revenue in one year to fall with a fall in revenue for the previous year. This rule would increase the pressure on a government to review the quality and effectiveness of base spending during recessions. The government would not be able to rely on the next expansion to avoid such a review. Again, this choice reflects the view that there is great scope in New Zealand to reduce government spending and thereby improve community welfare.

How would population and inflation be measured? The government statistician would provide the inflation and population statistics. It is important that the measures be independent of politicians. It is also desirable that they be independent of subjective forecasts. The proposal in the Annex is to use the rate of inflation in the calendar year that ended during the previous fiscal year. The rate of population increase would be for calendar year on year. For example, for the fiscal year ended June 2007, the inflation rate to be used would be that from December 2004 to December 2005. The rate of population increase would be the percentage change in the calendar year average population between 2004 and 2005. These increases would be applied to the estimated actual spending and revenue measures for the year ended June 2006 in order to calculate the spending and revenue limits for the fiscal year ending June 2007.

How would the referendum be worded? The wording on the ballot would be standardised in prescribed neutral language. Ballot notices would be accompanied by two 500-word summaries, one for and one against the proposal. The chief electoral officer would ensure that these summaries complied with the rules.

How would amounts to be refunded to taxpayers be calculated? If tax revenue in a given year exceeds the limit for that year, the excess would be refunded to taxpayers in the next fiscal year, unless voters approved a ballot to the contrary.

To whom would such a refund be paid? In principle, refunds should be paid to the taxpayers who paid the excess taxes. Otherwise politicians may target refunds at favoured constituencies. The proposed rule requires politicians to return the excess revenues on a basis that is proportional, or pro rata, to collections. How this is implemented in practice depends on balancing cost and convenience. For example, if the Inland Revenue Department has good electronic records of income tax paid by taxpayers, a pro-rata distribution of excess income tax on that basis should be feasible. This would not be possible with excess payments of goods and services tax (GST). A reduction in the rate of GST for a period is a possibility, but could disrupt the timing of consumer spending. An alternative would be to pay a refund to all taxpayers and beneficiaries based on beneficiary income for beneficiaries and assessable income for non-beneficiaries.

4.2.2 Is a TEL rule the best option for New Zealand?

A tax or spending limit is a 'top down' method of controlling spending. A TEL rule is inferior in principle to a 'bottom up' rule that spending be cut where the costs to the nation exceed the benefits. Generally, this would be where the spending could not be justified on public good or welfare safety-net grounds. This could mean cutting middle class and corporate welfare, for example.

However, no one appears to have been able to design a 'bottom up' spending constraint that has proven effective. Governments refuse to require base spending to be rigorously evaluated in national interest terms. This makes it easier for governments to evaluate it purely in political terms. In such circumstances a TEL rule may be more successful.

One thing that a TEL rule has going for it is that it accords with a deeply rooted notion that taxes should be levied only with the general consent of those who pay them. In the absence of general consent, the tax system has to be more intrusive and oppressive. This is likely to distort investment and induce dissent, avoidance, evasion, flight, marches on parliament and various forms of civil disobedience or unrest.

The notion that governments should seek the general consent of those they are seeking to tax, or their representatives, receives scant attention today. Yet its vitality was evident in the actions of the farmers who opposed the government's proposed levy on methane emissions. Similarly, very few parliamentarians could claim to be representing the interests of the top 5 percent of income earners when they voted to lift their marginal tax rate from 33 to 39 percent. Wealthy taxpayers are likely to vote with their feet in the face of oppressive taxation.

A simple TEL would fit readily into New Zealand's Fiscal Responsibility Act 1994 or its successor. It would mean that future Budget Policy Statements and Fiscal Strategy Reports would state future spending intentions in terms of spending per capita rather than relative to GDP. This would represent a different philosophy towards spending the 'growth dividend'. It might also provide voters with spending and revenue statistics that they can more easily scale in relation to their personal circumstances.

A rule that held spending growth to population growth and inflation would allow economic growth to reduce spending (and thereby average tax rates) as a percentage of GDP. For example, if GDP per capita were to grow at 2 percent per annum for a decade, such a rule applied successfully to overall (general) government spending of around 40 percent of GDP could reduce this ratio to below 34 percent in that period.

4.2.3 Putting TELs into perspective

A key virtue of a TEL is that it shifts the power to increase government taxes and spending from politicians to voters. It would be difficult to exaggerate the desirability of asserting the principle that politicians should not be spending taxpayers' money without their general agreement. It is not just the endless reports of waste and corruption in government spending of relatively small amounts that is offensive to good government. It is also unconscionable that politicians are spending around 40 percent of GDP year in and year out and without establishing that even major spending programmes are providing value for money for taxpayers at large.

It is important to put the benefits of a TEL into perspective. A TEL does not focus attention explicitly on the issue of whether base government spending is justified in national interest terms. It sanctions the continuation of existing spending in real terms even if it is of low quality. Indeed, there is a risk that governments will make it a habit to spend up to the TEL limit, if only so as to maximise base spending for future years. Nor does a TEL rule stop governments from spending new money wastefully and funding it by cutting back on existing spending that actually offers better value for money for taxpayers at large. This is a problem with all top-down spending rules. It arises because it is impossible to align the incentives of politicians or bureaucrats with the national interest. Nevertheless, relative to existing disciplines, a TEL would create greater pressure to review spending over time.

A TEL should not be the sole initiative in the pursuit of value for money in government spending. Indeed, from a longer-term perspective it may not be the most important initiative. This section has also considered the idea of a super-majority requirement for new taxes or extensions of existing taxes. Such a provision should apply independently of an 'inflation plus population growth' limitation. Section 5 considers other possibilities.

5

OTHER APPROACHES

The problem of putting governments under increased pressure to improve the quality of government spending is multifaceted. This section considers approaches that could complement or substitute for a TEL under the following headings:

- tax apportionment rules, the flat tax and the benefit principle;
- improving the accountability of select committees to citizens;
- improving asset management;
- binding citizen strike-down referenda;
- principles for determining when government spending is justified;
- a spending review commission with special powers;
- improving the accountability of the executive to parliament;
- reducing the improper delegation of parliament's power to spend;
- reducing the ability of the Inland Revenue Department to oppress taxpayers and other creditors;
- other ideas for spending caps.

The discussion below under each of these headings aims to identify the issue and to point in the direction of possible remedies. Some of the remedies are tentative and are put forward primarily as a basis for further discussion. The headings discussed first are those in which the case for applying the proposed remedy seems strongest.

5.1 Tax apportionment rules, the flat tax and the benefit principle

If taxes are not allocated within the community in accordance with some recognisable formula then the allocation is unprincipled – that is, arbitrary. Arbitrary taxes are akin to extortion. They are analogous to government takings of private property without fair compensation.

Tax apportionment rules require taxes to be allocated according to some principle. According to Charles Adams, by the nineteenth century in England the preferred principle was not a matter of public dispute. It was axiomatic that "every man is bound to contribute to the public revenue in proportion to the benefits he receives from the public protection".[120]

[120] Adams, above n 55, p 284.

One concept here was that insofar as the prime expense of the state was the protection of national wealth, citizens benefited from this expense in proportion to their share of the national wealth. Landowners paid land taxes, but the principle of consent applied in that they paid according to their own (ridiculously low) valuations, and the authorities applied the convention that a gentleman's word was not questioned.[121] Merchants paid customs taxes and some excise duties, but smuggling and evasion lightened their burdens. Homeowners paid a house and window tax that exempted the poor. None of this was ideal, but no group was oppressed and the overall system was moderate.[122] Adams commented that when the 10 percent income tax was introduced at the end of the eighteenth century it was considered to be an outrage. It was abolished in 1816 and not re-introduced until 1842.

A flat or proportional tax would be consistent with the benefit principle if the benefits from government spending are distributed in proportion to income. Such an apportionment rule would prevent 95 percent of taxpayers from voting to increase the marginal rate of tax paid by 5 percent of taxpayers.

The steps in a progressive tax structure are inevitably arbitrary. Indeed, the principle of taxation according to ability to pay is not an apportionment rule because it provides no basis for determining how much more those with greater resources should pay.

However, a flat tax is not necessarily as consistent with the benefit principle as a variant that would provide an exemption for the genuinely poor (through a mechanism such as New Zealand's low income rebate)[123] and a cap on the tax paid by any individual. Both the level of the exemption and the level of the cap would be a matter of judgment. For example, economist Steven Landsburg has suggested on fairness grounds that no individual should pay more than five times the average taxpayer's burden.[124] An official review of tax policy issues in 2001 (the McLeod report) recommended capping the amount of tax paid by an individual in any year at $1 million, a higher level than suggested by Landsburg.

The McLeod report also drew attention to the efficiency benefits of a single income tax rate structure. The Treasury acknowledged recently that these benefits could be significant for economic growth and canvassed the option of a flat 18 percent income

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121 Adams, above n 55, p 382 comments that the tax system in the United States was an honour system until around the 1950s.

122 Adams, above n 55, pp 262, 280–284.

123 Adams, above n 55, p 287 notes that Lord Kames in 1769 proposed that the poor should be relieved of any significant tax burdens in order to remedy the inequity of riches.

124 Steven Landsburg, *Fair Play: What Your Child Can Teach You about Economics, Values and the Meaning of Life*, The Free Press, New York, 1997.

tax rate.[125] The OECD also indirectly recommended dropping the top personal income tax rate in a report in 2002.[126]

A flat tax structure is likely to be opposed by those who wish to see higher-income earners pay a disproportionate amount of tax (rather than a proportionate amount) relative to their income. However, this argument commonly confuses the tax rate with the amount of tax paid. Those who want to increase the amount of tax actually paid by the rich should consider the effect of higher marginal tax rates in reducing the assessable income they report. Higher tax rates may drive the rich into unproductive assets, the hands of tax lawyers, or overseas tax jurisdictions. There is evidence from many episodes of reductions to high marginal rates that the amount of taxation paid by high-income earners increased, because of less avoidance and faster economic growth.

Faster rates of economic growth are likely to provide the best route to reduced poverty and greater wealth for all. If a less progressive tax rate structure is a route to increased prosperity, it is arguably more equitable than a more progressive tax rate. Expressed differently, if greater poverty is inequitable, progressive tax rates are inequitable to the extent that they do less to reduce poverty in the future.

5.2 Improving the accountability of select committees to citizens

Currently, select committees can pay lip service to complaints by citizens about proposed imposts. The Business Roundtable proposed recently that the Finance and Expenditure Committee should be required to respond in writing to submissions on Budget Policy Statements in the interests of promoting a more substantive dialogue about forthcoming budgets, as was envisaged when the Fiscal Responsibility Act 1994 was being debated. In the absence of a general requirement on these lines, specific requirements could apply to submissions opposing government taxes or charges that submitters believe are unjustified, or to submissions opposing spending programmes that submitters believe unfairly and unnecessarily appropriate their money for the benefit of other groups in the community. Similar provisions could apply in respect of regulatory takings. Select committees could be required to respond in writing to a complaint that the case for compensation had not been given due consideration.

5.3 Improving asset management

Governments commonly lack the flexibility and will to divest unused, underused, or unwanted assets. Several states in the United States have introduced legislation designed to allow state sector managers of assets to use management techniques that are common in the private sector, such as divestiture and leasing.

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125 The Treasury, above n 37, paragraph 175.

126 Organisation for Economic Cooperation and Development, *Economic Surveys: New Zealand,* Vol 2002/8-June, Paris, 2002, p 143.

The issue is also under active consideration at the federal level. The US General Accounting Office released a report on asset management problems, such as high repair bills on properties that may not be used or needed, and called for action. The US General Services Administration (GSA) has acknowledged the problems and called for agencies to be given greater freedom to manage their assets. There appears to be a strong consensus between these agencies that current arrangements are leading to great waste. The US Reason Foundation has also undertaken a study of these issues.[127] The failed Federal Asset Management Improvement Act 2001 would have required performance measures to be established for federal property management, with the GSA administrator reporting to Congress on property management effectiveness. Specific provisions allow for private–public partnerships to make better use of federal properties.

The current government's approach to asset management in New Zealand is essentially ideological. Asset sales are ruled out regardless of where the national interest lies. The contrast with widespread privatisation programmes in other countries is stark. There is no inherent reason for collective ownership of enterprises providing private goods and services. Research has clearly established that the private sector is generally a more efficient supplier. There is also scope for making greater use of contracting-out, although public–private partnerships need to be carefully structured so as to protect the interests of both parties.

5.4 Binding citizen strike-down referenda

Consideration could be given, independently of the TEL rule, to permitting citizens to pass binding strike-down legislation in respect of current and proposed spending programmes, taxes and statutory laws and regulations. The case for allowing citizens to strike down legislation was explained in a report for the New Zealand Business Roundtable in 1992.[128] A protest referendum allows citizens to constrain government and play a direct role without creating a large risk for minorities or a danger of catastrophic policy mistakes.

5.5 Principles for determining when government spending is justified

Former member of the US Council of Economic Advisers William Niskanen has argued that controlling government spending must include a sustained commitment to principle. "Members of the administration and Congress must increasingly ask why, rather than only how or how much?"[129] There should be a presumption against government spending on private goods and services. Governments should be focused

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[127] Steve A Steckler, John E Joyner and Brian F Wolf, *Tapping Public Assets: Frequently Asked Questions about Selling or Leasing Infrastructure Assets*, Reason Foundation, March 2003, <http://www.rppi.org/ps303.pdf> (last accessed 28 July 2004).

[128] Penelope Brook Cowen, Tyler Cowen and Alexander Tabarrok, *An Analysis of Proposals for Constitutional Change in New Zealand*, New Zealand Business Roundtable, Wellington, 1992, pp 523–524.

[129] Niskanen, above n 118.

on ensuring the provision of core public goods and services that cannot be better provided through voluntary arrangements, whether for-profit or not-for-profit, as well as a welfare safety net.

Any statement on the objective of a particular spending programme should identify the problem with private arrangements that the programme is directed at overcoming. General statements of spending objectives – for example, raising education levels or promoting better health services – provide no reason for government action. They simply open up the risk of government spending displacing more productive private spending.

One anomaly here is the absence of any Treasury guidelines for evaluating government spending proposals that would be the counterpart of the Ministry of Economic Development's guidelines for evaluating regulatory proposals. The OECD's material would assist the Treasury to prepare such guidelines. Expansion of the Legislation Advisory Committee Guidelines is a further option for increasing disciplines by providing greater guidance on spending.

There should be a ban on subsidies to businesses, or at the very least a strong presumption against such spending and lending. Governments should not be permitted to favour some businesses relative to others. Any such spending should require clear evidence of market failure and the likelihood that government intervention would produce a superior result.

Parliamentary rules could also be changed to improve the ability of a minority in parliament to vote to determine that the stated objectives of a spending programme were too broad and ill-defined to ascertain whether the spending would be in the public interest.

5.6 A spending review commission with special powers

The Grace Commission under President Reagan identified $424 billion in waste and fraud in federal spending, around $1,800 per capita. Such commissions put a spotlight on government spending and are an inexpensive way of raising awareness of waste in government. However, their specific recommendations are seldom put into effect.[130] (New Zealand's experience with reviews of business compliance costs and tax simplification is similar.)

In the late 1980s, Congress, under the leadership of Dick Armey, found a solution to its inability to handle the closure of unneeded defence bases in congressional districts. It took the form of setting up a review commission (the Base Realignment and Closure Commission), the recommendations of which Congress could only accept or reject outright.

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130 See, for example, Chris Kinnan and Derek Lyons, *Can Spending Commissions Succeed where Politicians Fail*?, Citizens for a Sound Economy, 9 July 2003, with reference to George Nesterczuk, 'Reviewing the National Performance', *Regulation*, Cato Institute, Vol 19, No 3, 1996 <http://www.cse.org/informed/issues_template.php?issue_id=1478> (last accessed 28 July 2004).

Senator Brownback has borrowed this idea in proposing that Congress set up a Commission on the Accountability and Review of Federal Agencies (CARFA). The purpose of CARFA would be to conduct a comprehensive review of federal agencies and programmes in order to recommend the elimination or realignment of duplicative, wasteful, or outdated functions. Congress would only have an 'up or down' vote on the commission's recommendations in their entirety.

If a spending review commission were set up, it should be instructed to pay particular attention to scrutinising the objectives of government spending programmes.

5.7 Improving the accountability of the executive to parliament

There is a case for providing better information to parliament and the public on the future fiscal implications of spending programmes, such as those affected by demographic trends. A document of this kind, the Intergenerational Report 2002–03, was published by the Australian Treasury in 2002. Member of Parliament Rodney Hide has suggested amending the fiscal management principles to include a requirement that the government inform parliament what percentage of GDP it proposes to commit each year, for 50 years ahead, to superannuation benefits, along with funding details. The proposals in the Public Finance (State Sector Management) Bill 2003 go some distance in this direction.

The media has given considerable publicity in recent years to the failure of ministers to give meaningful answers to parliamentary questions. Evasive or irrelevant answers reduce the accountability of the executive, and government agencies, to parliament.

The situation reflects poorly on the independence of the Speaker. This is a sensitive and constitutionally important matter that should be properly researched. While it might be possible to allow a minority to vote to overrule the Speaker on the issue of whether a question has been answered rather than evaded, the ramifications of this for parliamentary debate should be carefully considered.

5.8 Reducing the improper delegation of parliament's power to spend

The Treasury document, *Putting it Together*, that was released as supporting material for the Public Finance (State Sector Management) Bill 2003, states that "[a] long-standing principle under the Westminster style of government is that no expenditure of public money can take place without the prior approval of parliament".[131] The question is what might be done to bring current practice into better accord with this principle.

It seems beyond dispute that parliamentarians today often have little idea as to what the money they are voting to allocate under generalised headings will really be spent on. Even the prime minister was reported in April 2004 as saying that she would never have imagined that money allocated for promoting 'social entrepreneurship' would be

[131] The Treasury, *Putting it Together*, Wellington, 1996, p 29.

spent on promoting a regional television station (not to mention a hip hop excursion).[132] The Clerk of the House made a submission on the Public Finance (State Sector Management) Bill 2003 opposing a section in it that he considered would undermine the Estimates process and reduce the accountability of the executive and its agencies to parliament.

The Legislation Advisory Committee Guidelines state clearly that only parliament can authorise the expenditure of taxes and only parliament can pass laws enabling taxes to be raised. The checklist contained in these guidelines acknowledges the need to ask whether a particular piece of legislation delegates improperly parliament's powers to tax or regulate. It is not clear why the checklist omits any mention of the need to ask if legislation is inappropriately delegating the authority to spend.

One possible answer is that governments have set up so many ambitious spending programmes that it is impossible for them to make detailed spending decisions. There are not enough hours in the day. However, the principled solution to this problem is for parliament to reject many spending programmes on exactly these grounds – that they represent an inappropriate delegation of parliament's authority. At the very least, if the principle cited in *Putting it Together* means anything at all, it means that there should be a presumption against such delegations.

When parliaments allocate money for generalised purposes they delegate to the executive or its agencies the power to spend it. Usually the allocation of the spending will be formally arbitrary because the programme will involve weighing up multiple attributes using arbitrary weights. This means that parliament cannot formally hold the executive or its agencies to account for the detailed allocation of the money spent. As long as it was spent in a manner that was consistent with at least one attribute, parliament may only be able to conclude that the spending might have been unsound but not improper.

A related problem is the failure of parliament to require the executive to provide information that establishes that base spending contributes efficiently to achieving the goals of programmes compared with feasible alternatives. Parliamentarians do not have the benefit of impartial professional assessments of the quality of most spending when they vote on parliamentary appropriations. One option here would be for a minority of parliament to be able to require an independent spending review commission (see above) to provide impartial professional assessments of the efficacy of major items of government spending. This would raise issues of what constituted an impartial assessment and whether anything would be done if the assessment were unfavourable.

5.9 Reducing the ability of the Inland Revenue Department to oppress taxpayers and other creditors

When governments become large, they typically hand oppressive powers to the tax authorities. Taxation is no longer by the consent of those being taxed. Instead, the

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132 *Dominion Post*, 8 April 2004.

presumption is that taxpayers will cheat in the absence of intrusive rights to investigate their affairs. A parliamentary inquiry a few years ago reported harrowing tales of decent and productive citizens having their lives and businesses destroyed by the oppressive actions of the Inland Revenue Department.

The privacy of taxpayers should be preserved. The tax authorities should not be able to invade a taxpayer's property or bank accounts at will. Instead, they should be required to apply for a warrant in a similar manner to the police.

Adams has suggested a number of reforms to protect citizens better from oppression. The following may be relevant in the New Zealand setting:

- Establish a crime for tax extortion, as well as grounds for civil action for damages.
- Establish a civil action for damages for tortious tax administration, including malicious tax investigations, extortions and leaked information.
- Decriminalise the tax law. The tax laws are now so complex, vague and fuzzy that no one whose business affairs are at all complex can be certain that they are complying with the law. Tax fraud should remain a crime. The burden of proof in all cases should fall on the tax authorities.
- Restore the income tax to its original status of an indirect tax – for example, as a source (PAYE) tax – so that it is not a tax on the individual. Adams suggests a flat tax at source of 10 percent. Only those paying the source deductions and those in business would have to file a tax return. He notes that most Japanese did not file tax returns at the time of writing (1993).

The last of these proposals represents a fundamentally different philosophy from the 'benevolent despot' view of government that motivates the call for a flat income tax applied to a broad definition of income. The 'benevolent despot' view assumes that all government spending is necessary and asks only how to fund it at least cost. The assumption is utopian in that no one knows how to restrict government spending to non-factional welfare-enhancing spending. John Stuart Mill, among others, considered that the interests of government were not aligned with those of the community at large:

> The interest, for example, of the government is to tax heavily: that of the community is to be as little taxed as the necessary expenses of good government permit.[133]

A book by Geoffrey Brennan and James Buchanan models the implications for a fiscal constitution of the assumption that government is a revenue-maximising Leviathan.[134] They suggest that the goal of minimising the excess burden of taxes is akin to the goal of maximising net tax revenues. On their analysis, the goal of adopting a broad base for taxing incomes would not adequately contain government spending. They suggest

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133 John Stuart Mill, *Considerations on Representative Government*, Prometheus Books, New York, 1991, Chapter VI, p 131.

134 Geoffrey Brennan and James Buchanan, 'The Power to Tax: Analytical Foundations of a Fiscal Constitution', *The Collected Works of James Buchanan*, Vol 9, Liberty Fund, Cambridge University Press, New York, 2000.

that the optimal constitution might incorporate tax loopholes and tax exemptions. However, once in place, such features should not be 'up for grabs' amongst political factions. Instability in tax bases and tax rates through time is likely to impair wealth creation.

5.10 Other ideas for spending caps

Nobel laureate Gary Becker has suggested that the US Congress could establish an upper limit for the ratio of spending to GDP that would be breachable only during wartime and other emergencies. Another option would be to cap federal taxes at their present ratio to GDP, except when a super-majority, perhaps 60 percent or more, of congressional members support a higher ratio.

Brennan and Buchanan comment that aggregate spending caps tend to be arbitrary in the light of historical swings in spending, and lack resonance with the public. They suggest that the public is likely to understand and respond better to limits on tax rates and the tax base.

Rodney Hide has suggested capping increases in revenue from local authority rates in any one year to the rate of consumer price inflation plus 2 percent, with a maximum in any three-year period of inflation plus 4 percent. This may be more generous for many local authorities than an inflation plus population growth limit. The inflation plus population rule might have greater intuitive appeal to the public because it allows for faster growth when population pressures are increasing.

As with the inflation plus population growth rule, there is a risk that such proposals, in isolation, will become a floor rather than a ceiling. There is also a need to control other forms of local authority revenue.

5.11 Concluding comment

A growing body of empirical research is finding that the rules in a political constitution affect fiscal policy.[135] Besley and Case highlight the finding that restrictions on taxes and expenditures in the United States are strongly associated with differences in fiscal behaviour.[136]

The proposals for a flatter tax scale are well-researched and widely supported. They deserve serious consideration.

There is an undoubted need for better asset management, including privatisation of government-owned commercial enterprises.

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[135] Torsten Persson and Guido Tabellini, 'Constitutional Rules and Fiscal Outcomes', *American Economic Review*, Vol 94, No 1, March 2004, pp 25–45.

[136] Besley and Case, above n 99, p 68.

There needs to be extensive public debate on what principles should guide government spending. The view that the role of government is whatever the government wants it to be highlights the triumph of expediency over principle that currently prevails.[137] It also epitomises the view that it is a matter for the government, not voters, to determine.

From a democratic perspective, the challenge here is to find arrangements that will better constrain political processes to generate outcomes that are more consistent with the preferences of citizens generally. It would be desirable to improve the incentives for politicians to act in the common good rather than to favour a majority at the expense of a minority, on the one hand, or well-organised minorities at the expense of the majority on the other hand. When politicians have become as rudderless as they are today about what principles should guide the state in the roles it performs in the community, giving voters a greater ability to strike down government legislation, particularly in relation to taxes, would seem to be democratically and consistutionally desirable.

An implication of this approach is that the issue of the appropriate size of government would be determined by the expressed views of voters at large rather than by a politically powerful elite.

In all these cirumstances, a thorough review of base spending programmes is essential if the quality of spending is to be improved. This review should be informed by the OECD's list of evaluative questions and a set of Treasury spending guidelines. Mechanisms to ensure follow-up action is taken need to be considered.

137 See Roger Kerr, 'The Government's Role is Whatever the Government Defines it to Be: Discuss', New Zealand Business Roundtable, Wellington, 2003.

6

CONCLUSIONS

The provisions in the Fiscal Responsibility Act 1994 have served New Zealanders well to date, except for the lack of real government spending disciplines. New Zealand's experience is in line with the findings of international research that deficit limitation rules do not restrain growth in spending and taxation through time.

Current arrangements allow the government to treat the additional revenue from economic growth as being available to spend as a windfall. There is no burden on governments to prove that the spending is justified and no presumption that the money should be returned to taxpayers unless the government can show that additional spending is in the national interest.

Based on the experience of the United States, tax and expenditure limitation rules backed by citizen referenda and super-majority rules have the best chance of improving spending disciplines. This is the main conclusion of this paper.

Regardless of whether a TEL is put in place in New Zealand, there is much that can and should be done to improve the quality of government spending. Super-majority requirements for new taxes, increases in existing tax rates, or increases in the tax base would assist. So would allowing citizens to strike down such legislation by referenda.

The discussion in section 5 indicates that there are many other options that should also be considered. Priorities include meaningful reviews of base spending, flatter tax rates and a resumption of asset sales.

ANNEX

DRAFT NEW ZEALAND TAXPAYER BILL OF RIGHTS

(1) **General provisions.** This section takes effect on 30 June 2006 or as stated. Its preferred interpretation shall reasonably restrain most the growth of government. All provisions are self-executing and severable and supersede conflicting statutory provisions. Other limits on Crown revenue, spending, and debt may be changed only by future voter approval. Individual or class action enforcement suits may be filed and shall have the highest civil priority of resolution. Successful plaintiffs are allowed costs and reasonable attorney fees, but the Crown is not unless a suit against it be ruled frivolous. Revenue collected, kept, or spent illegally since four full fiscal years before a suit is filed shall be refunded with 10 percent annual simple interest from the initial conduct. Subject to judicial review, parliament may use any reasonable method for refunds under this section, including temporary tax credits or rate reductions. Refunds need not be proportional when prior payments are impractical to identify or return. When annual Crown revenue is less than annual payments on the public debt, pensions, and final court judgments, (5)(a) and (7) shall be suspended to provide for the deficiency.

(2) **Interpretation.** Within this section:

(a) 'Ballot issue' means a non-recall petition or referred measure in an election.

(b) 'Emergency' excludes economic conditions, revenue shortfalls, or state salary or welfare benefit increases.

(c) 'Enterprise' means a state enterprise as defined in the State-Owned Enterprises Act 1989.

(d) 'Government tax revenue' means fiscal year total revenue levied through the Crown's sovereign power.

(e) 'Government spending' means fiscal year core Crown GAAP operating expenses net of finance costs and adjusted for accounting changes and revaluations.

(f) 'Inflation' means the percentage change in the official all groups Consumers Price Index for New Zealand, or its successor index, as published regularly by the Government Statistician.

(g) 'Population' is the national resident population, as estimated and published regularly by the Government Statistician.

(3) This Act shall bind the Crown.

(4) Election provisions.

(a) Ballot issues shall be decided in a national general election, or on the first Tuesday in November of odd-numbered years. Except for petitions, the Crown may consolidate ballot issues and voters may approve a delay of up to four years in voting on ballot issues. Crown actions taken during such a delay shall not extend beyond that period.

(b) At least 30 days before a ballot issue election, the Chief Electoral Officer shall mail at the least cost, and as a package where ballot issues overlap, a titled notice or set of notices addressed to 'All Registered Voters' at each address of one or more active registered electors. Titles shall have this order of preference: 'NOTICE OF ELECTION TO INCREASE TAXES/TO INCREASE DEBT/ON A CITIZEN PETITION/ON A REFERRED MEASURE'. Except for voter-approved additions, notices shall include only:

(i) The election date, hours, ballot title, text, and local election office address and telephone number.

(ii) For proposed tax or Crown debt increases, the Treasury's estimated or actual total of Crown fiscal year spending for the current year and each of the past four years, and the overall percentage and dollar change.

(iii) For the first full fiscal year of each proposed Crown tax increase, the Treasury's estimates of the maximum dollar amount of each increase and of Crown fiscal year spending without the increase.

(iv) For the proposed Crown debt, its principal amount and maximum annual and total repayment cost, and the principal balance of total current Crown debt and its maximum annual and remaining total repayment cost.

(v) Two summaries, up to 500 words each, one for and one against the proposal, of written comments filed with the Electoral Officer 45 days before the election. No summary shall mention names of persons or private groups, nor any endorsements of or resolutions against the proposal. Petition representatives following these rules shall write this summary for their petition. The Chief Electoral Officer shall maintain and accurately summarise all other relevant written comments.

(c) Except by later voter approval, if a tax increase or fiscal year spending exceeds any estimate in (b)(iii) for the same fiscal year, the tax increase is thereafter reduced up to 100 percent in proportion to the combined dollar excess and the combined excess revenue refunded in the next fiscal year. Crown debt shall not be issued on terms that could exceed its share of its maximum repayment costs in (b)(iv). Ballot titles for tax or Crown debt increases shall begin, 'SHALL GOVERNMENT TAXES BE INCREASED (first, or if phased in, final, full fiscal year dollar increase)

ANNUALLY ...?' or 'SHALL CROWN DEBT BE INCREASED (principal amount), WITH A REPAYMENT COST OF (maximum total Crown cost) ...?'.

(5) **Required elections.** Starting 1 July 2006, parliament must have voter approval by a three-quarters majority in advance for:

(a) Unless (1) or (6) applies, any new tax, tax rate increase, or levy above that for the prior year, or extension of an expiring tax, or a tax policy change directly causing a net tax revenue gain to the Crown.

(b) Except for refinancing Crown debt at a lower interest rate or adding new employees to existing Crown pension plans, or in order to cover a deficit in pre-approved spending that results from an unforecast fall in revenue from the previous year, the creation of any multiple-fiscal year direct or indirect Crown debt or other financial obligation whatsoever without adequate present cash reserves pledged irrevocably and held for payments in all future fiscal years.

(6) **Emergency taxes.** This subsection grants no new taxing power. Emergency income taxes are prohibited. Emergency tax revenue is excluded for purposes of (4)(c) and (7), even if later ratified by voters. Emergency taxes shall also meet all of the following conditions:

(a) A two-thirds majority of the members of parliament declares the emergency and imposes the tax by separate recorded roll call votes.

(b) Emergency tax revenue shall be refunded within 180 days after the emergency ends if not spent on the emergency.

(c) A tax not approved on the next election date 60 days or more after the declaration shall end with that election month.

(7) **Spending and revenue limits.**

(a) The maximum annual percentage change in government spending equals inflation for the calendar year falling in the preceding fiscal year, plus the percentage change in the national population during the same calendar year, adjusted for spending tied to revenue changes approved by voters after 2004.

(b) The maximum annual percentage change in government tax revenue equals inflation for the calendar year falling in the preceding fiscal year, plus the percentage change in the national population during the same calendar year, adjusted for revenue changes approved by voters after 2004 and (8)(b) reductions.

(c) If revenue from sources not excluded from fiscal year spending exceeds these limits in dollars for that fiscal year, the excess shall be refunded in the next fiscal year unless voters approve a revenue change as an offset. Initial bases are operating fiscal year spending and tax collected in 2004–05. Qualification or disqualification as an enterprise shall change the bases and future year limits. Future creation of

Crown debt shall increase, and retiring or refinancing Crown debt shall lower, fiscal year spending and tax revenue by the annual debt service so funded. Debt service changes, reductions, (1) and (4)(c) refunds, and voter-approved revenue changes are dollar amounts that are exceptions to, and not part of, any Crown base. Voter-approved revenue changes do not require a tax rate change.

(d) Excesses under section (7)(c) shall be paid to the taxpayers who paid the taxes in the preceding year in a manner that is proportional or on a pro rata basis to the manner in which such taxes were collected from such taxpayers.

(8) Tax limits.

(a) New or increased transfer tax rates are prohibited. No new Crown tax shall be imposed. Neither an income tax rate increase nor a new definition of taxable income shall apply before the next tax year. Any income tax law change after 1 July 2005 shall also require all taxable net income to be taxed at one rate, excluding refund tax credits or voter-approved tax credits, with no added tax or surcharge.

(b) The Crown may enact cumulative uniform exemptions and credits to reduce or end business or personal taxes.

[An equivalent New Zealand Ratepayer Bill of Rights should be enacted.]

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