



The Fiscal Responsibility Act 1994

The astonishing success of a weak non-binding policy

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Key points

The Fiscal Responsibility Act 1994 is an astonishing success story of a weak non-binding policy instrument

When the Fiscal Responsibility Act (FRA) was introduced, the FRA had limited opposition but only lukewarm support because it was expected to be ineffective due to its lack of legal enforceability. Today it provides the foundation for the Treasury's budgeting process, is embedded in the wider political discourse and is part of New Zealand's constitutional arrangements.

The FRA was a tripartite success – programmatic, process and political

Budgeting is simultaneously both an inherently political process and a technocratic exercise and the FRA has succeeded at both levels.

At the technical programme level, New Zealand's fiscal aggregates improved dramatically from 1994 when the FRA was enacted with net Government debt plummeting and Government net worth increasing markedly. This turnaround was underpinned the cross-party political commitment to fiscal responsibility, but the transparency required by the FRA had an important role to play as a commitment device cementing in prudent fiscal management.

In summary, the FRA was a commitment device that helped cement fiscal discipline into New Zealand's budgeting system and policy discourse rather than the catalyst that started it.

The FRA was innovative at the process level

The FRA was a success as the policy design process resulted in an innovative approach to the fiscal constitution based on principles of fiscal responsibility rather than legislatively fixed fiscal targets. New Zealand's pioneering approach based on fiscal transparency was followed by other countries including Australia with the Charter of Budget Responsibility Act (1998) and the United Kingdom with the Charter for Budget Responsibility (2011).

The FRA is a central part of the political discourse

The concept of fiscal responsibility has been adopted by political parties across the spectrum. This was epitomised during the 2017 election campaign when the opposition Labour and Green parties signed a Budget Responsibility electoral pact. This paper will explore how despite not being legally enforceable, the FRA has become a political force.

A top-down policy process isn't always doomed to fail

This success is striking given that the FRA was developed by the then National Government through a very top-down 'crash through' policy process, with almost no public or cross-party engagement before Select Committee consideration.

The lessons from the FRA are relevant to the proposal to establish an independent fiscal institution in New Zealand

This paper is drawn from the chapter of the same name in *Successful Public Policy: Lessons from Australia and New Zealand* (Luetjens, Mintrom and P 't Hart 2019 forthcoming). However, the findings are highly relevant today as New Zealand considers proposals to develop an Independent Budget Office.

This paper discusses how New Zealand already has a highly independent fiscal institution in the Treasury. A more limited case can be made for an institution to support the opposition in costing policy proposals as occurs in Australia with the Parliamentary Budget Office. The unexpected success of the FRA highlights how difficult it will be to create the conditions for another independent budget office to succeed in New Zealand.

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1. Was the FRA a policy success?

Sir Robert Muldoon, New Zealand's Prime Minister from 1975 to 1984 was recorded as observing that:

Most people wouldn't recognise a budget deficit if they fell over it in the street (Kerr 2008, p.3)

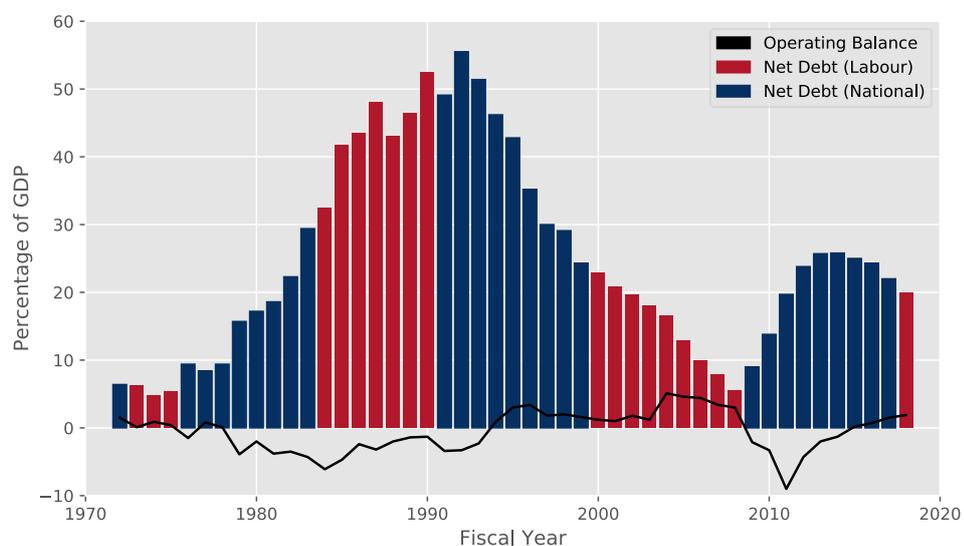
While that statement might have applied to New Zealand at that time, it would not be made in contemporary New Zealand where the major parties compete for the fiscal responsibility label.

The fiscal responsibility provisions in the New Zealand Public Finance Act 1989 (introduced as the Fiscal Responsibility Act (FRA)) have become an enduring part of New Zealand's public management regime since coming into force in 1994. Fiscal responsibility provides the foundation for the Treasury's budgeting process, is embedded in the wider political discourse and is now part of New Zealand's constitutional arrangements.

New Zealand track's record since the FRA is of sustained fiscal surpluses and reducing public debt

The FRA is one of the significant factors that help explain the success (see Figure 1) of successive administrations in running sustained structural fiscal surpluses and reducing Net Public Debt from a peak in 1992 at just under 50% of GDP to close to zero by 2006.

Figure 1 New Zealand Government Net Debt and Fiscal Balance



Source: data1850.nz

A cementing rather than a catalyst role

While the FRA was not the catalyst, as the improvement in New Zealand's fiscal position pre-dates the enactment of the FRA, the Act was an effective commitment device (Boston 2016) that helped cement fiscal discipline into New Zealand. In addition, the FRA was flexible enough to accommodate the global financial crisis (GFC) 2008-10 and the fiscal impact of the Canterbury earthquake sequence while ensuring New Zealand returned to a fiscally sustainable track (see Figure 2).

Arguably, the GFC, Canterbury earthquakes and Kaikoura earthquake have also helped cement the cross-party political commitment to fiscal discipline – as regular external shocks continue to remind policy-makers of New Zealand's economic vulnerability.

Part of the political discourse

In preparation for the 2017 General Election, the Opposition Labour and Green parties publicly committed themselves to Budget Responsibility Rules. These were subsequently largely included word-for-word in the 2018 Budget Policy Statement (BPS) and in the first Budget of the new Labour-Green-New Zealand First Coalition Government. These rules included a commitment to keeping spending below 30% of GDP, running an operating surplus over the cycle and reducing Net Debt to below 20% of GDP by 2022.

New Zealand was a pathfinder on fiscal responsibility and the success of the FRA in making fiscal responsibility an active part of everyday political discourse is striking given the mixed record of most countries' experiences with legislated targets for budget balances, spending and debt of various sorts. New Zealand General Government net debt to GDP ratio is now the fourth lowest in the OECD (after Norway, Luxembourg and Estonia). The NZ Treasury (2018) reports that according to the Open Budget Survey, 'New Zealand is a world-leader in fiscal transparency' ranking first (out of 115 countries) on fiscal transparency as well as on public participation while lagging slightly at 14th on Budget oversight. The latter is due to the lack of an independent fiscal institution discussed further at the end of this paper.

New Zealand's international positioning is particularly striking given the relatively arcane and technical nature of the FRA provisions (discussed in Box 1) and the lack of overt legal penalties for breaching the rules.

A political force even though it's not legally enforceable

The surprising success of a weak non-binding policy instrument is because it has political force even if it is not legally enforceable. The FRA:

- Makes the Government of the day responsible for articulating how it proposes to operationalise the principles of fiscal responsibility when developing its budget (the principles are detailed in Box 1 and include its targets for Net Debt levels and a balanced Budget over the business cycle)
- Requires the Treasury to provide twice-yearly an independent economic and fiscal update including specified ex ante information on the fiscal strategy, the current economic and fiscal outlook and risks to that outlook, a pre-election update, the outlook over 10 years and every four years over the 40-year term

- Gives the Secretary of the Treasury an independent statutory role in ex ante and ex post financial reporting based on generally accepted accounting principles (GAAP). These principles are set by an independent accounting standard body, as the accounting framework for all ex ante and ex post fiscal reporting minimises the scope for 'creative accounting'.

The emphasis on greater openness and transparency increases the focus on more strategic and long-term fiscal issues, relative to short-term and political factors. In addition, the FRA offers escape clauses ('safety valves') for cyclical fluctuations or systemic events such as natural disasters. This ensures that the government of the day has discretion about how they apply the principles in the face of changing circumstances.

1.1. Was the FRA a tripartite success – programmatic, process and political?

Budgeting is simultaneously an inherently political process and a technocratic exercise. The FRA has succeeded at both levels.

Programmatic success?

At the technocratic level, the FRA has been a *programmatic* success as New Zealand's fiscal aggregates have been turned around since the early 1990s with large structural operating fiscal surpluses as shown in Figure 1 up until the period of the GFC. Figure 1 also shows how until 2008 net Government debt as a percentage of GDP has plummeted. As a result, Government net worth has increased dramatically.

This fiscal consolidation was part of a package of economic reforms initiated since 1984, which along with an improvement in the external trading environment (including the rise of the Asian economies), caused the:

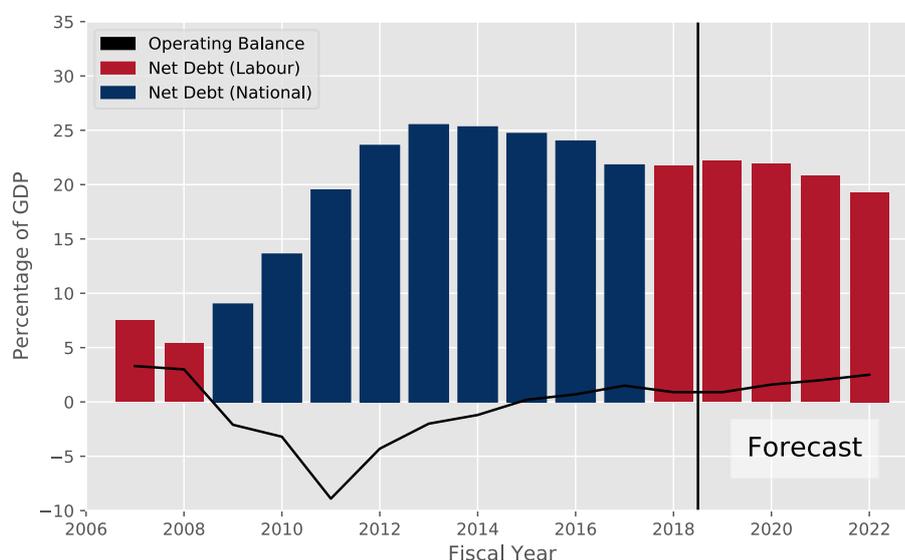
Faster growth (steeper upward trend) from the early 1990s to 2010 in New Zealand's GDP per capita (Lattimore and Eaquab 2011, p.7).

This renewed economic growth is in marked contrast with the period of poor economic performance and relative economic decline from the mid-1970s to the early 1990s.

The exception to the pattern of fiscal consolidation was the period after the GFC and the Christchurch earthquake sequence shown in Figure 2. Arguably this period was part of the success of the FRA.

At the technical level, the buffer created by low public debt meant the government had the fiscal space to achieve broader stabilisation objectives in more difficult times. At the political level, the Canterbury earthquakes along with the GFC and the 2016 Kaikoura earthquake have also helped cement the cross-party political commitment to fiscal discipline. A series of major 'external' shocks, along with more minor shocks, such as severe droughts and biosecurity scares helped to remind policy-makers of New Zealand's economic vulnerability.

Figure 2 The recent track and outlook for the operating balance and net public debt



Source: NZ Treasury

The sustained commitment since the early 1990s to prudent fiscal management by successive National Governments (shown in blue in Figures 1 & 2) and Labour-led administrations (shown in red) has meant that New Zealand now has one of the lowest public debt to GDP ratios in the OECD. While other factors, discussed in more detail below, underpinned the cross-party political commitment to fiscal responsibility, the transparency about fiscal forecasts required by the FRA had an important role to play in cementing in prudent fiscal management.

The FRA provided the foundations for the fiscal management regime. This helped keep fiscal strategy issues on the political agenda, buttressed the Treasury’s Fiscal Management Approach, and provided an independent scoring mechanism, which increased the credibility of political commitments to fiscal responsibility.

Process success?

At the *process* level, the FRA was a success as the policy design process resulted in an innovative approach to the fiscal constitution based on principles of fiscal responsibility rather than legislatively fixed fiscal targets. Buckle (2018 p. 17) describes how:

New Zealand was a pioneer in specifying principles and reporting provisions to improve fiscal transparency in order to strengthen fiscal accountability and support improved fiscal policy

and was followed by other countries including Australia with the Charter of Budget Responsibility Act (1998) and the United Kingdom with the Charter for Budget Responsibility (2011).

Two principles stand out for the attention they receive in New Zealand – Net Debt reduction and maintaining an operating surplus – while the other principles have not achieved the same traction. This approach generally proved easy to implement as the FRA was largely codifying the Treasury’s budgetary practice of the time and successive Ministers of Finance have found it a useful device for managing Cabinet through the budget process.

After 25 years the principles still provide the framework that the Treasury uses to guide the development of the fiscal strategy and the ‘rules of the game’ under the ‘Fiscal Management Approach’ (Lomax et al. 2016). By contrast, the 40-year fiscal and economic outlook introduced into the FRA in the 2004 legislative reforms have had little direct impact on the political discourse.

Political success?

At the political level, the concept of fiscal responsibility (the focus on net debt and operating surpluses in particular) has been adopted by the main political parties across the spectrum. This was epitomised during the 2017 Election campaign when the opposition Labour and Greens parties signed an electoral pact that included Budget Responsibility Rules that were aligned with the fiscal responsibility provisions of the FRA. Fiscal responsibility is now deeply embedded into the everyday political discourse. When the FRA was introduced, there was limited opposition but widespread scepticism about whether it would have much impact. Support for the FRA is much stronger and more widespread now than at the time of its introduction. Thus, it has proved to be an enduring policy success.

Box 1 Key features of the fiscal responsibility approach

The principles of responsible fiscal management, incorporated since 2004 in the Public Finance Act (PFA) of 1989, require Governments to:

- Ensure the achievement and subsequent maintenance of “prudent levels” of public debt, by running operating balances that, on average over time, are non-negative and consistent with the desired trajectory of the debt
- Achieve and maintain levels of the Crown’s net worth that provide an adequate buffer against potential future events adversely impacting the Crown’s balance sheet
- Manage prudently the fiscal risks facing the Government
- Pursue policies consistent with reasonable stability and predictability of tax rates.

In 2013, the principles were amended to incorporate considerations relating to:

- The interaction between fiscal and monetary policies
- The likely impact of any fiscal strategy on present and future generations
- Efficiency and fairness of the tax system
- Effectiveness and efficiency in management of the Crown’s resources.

This political success is striking given that the FRA was developed by the then National Government through a very top-down policy process within the Executive branch, with no public or cross-party engagement before consideration by the Select Committee. Just how fiscal responsibility has become an integral part of everyday political

discourse backed by a multiparty consensus will be explored in the next section of this paper.

Part of the constitutional fabric

New Zealand has no single codified constitution, so its constitutional arrangements can be found in a range of documents. While it has no prescriptive legal status, the Cabinet Manual itself is regarded as an authoritative description of New Zealand's constitutional conventions and statutes. In the Introduction to the Cabinet Office Manual, Sir Kenneth Keith, one of New Zealand's leading jurists, explicitly mentions the Public Finance Act as one of the statutory sources of the New Zealand constitution.

The then Minister of Finance (Sir William English), when introducing the 2013 FRA amendment said:

Given the constitutional significance of the fiscal responsibility provisions, it was important that we discussed the changes with other parliamentary parties before introducing them to Parliament (quoted in Lipski 2015, p.8).

As such the fiscal responsibility provisions in the PFA now form an integral part of New Zealand's constitution.

Sustained over 25 years

Box 2 and Figure 2 show how the FRA has endured through three long-running administrations, one major recession (2006-2009), and the major fiscal shock of the Christchurch earthquake sequence (9-10% of GDP). The imprimatur of fiscal responsibility is very important for all the major and minor parties on both the left and right, as evidenced by the 2017 Labour Green agreement on Budget Responsibility Rules. The absence of a large and strong populist party with no concern for long-term fiscal prudence has helped, as has the absence of a 'Tea-Party' type conservative party committed to low taxes but not necessarily lower expenditure.

In this paper, the story of the design, roll-out and increased acceptance of the FRA is explored by drawing on the available literature as well as through the words of its designers, and implementers. A qualitative methodology was adopted, based on a literature scan and semi-structured interviews with the key decision-makers, who were directly engaged in the development and operation of the FRA. The interviews included two former Secretaries to the Treasury, a former Minister of Finance, and a former Budget Director and the current Chief Accounting Advisor.

The remainder of the paper will explore how fiscal responsibility has become an integral part of New Zealand's constitutional arrangements and is now a part of everyday political discourse. It will discuss how the success reflects a combination of careful policy work by the Treasury for the initial political champion, sustained support from successive Ministers of Finance, and some fortuitous circumstances that helped cement the regime.

1.2. What was the context and the key challenges?

In early 1993, when the FRA first emerged as a fiscal policy initiative, New Zealand was into the eighth year of the most wrenching and wide-ranging reform programme undertaken by any OECD country. Only the countries of Eastern Europe, emerging from four decades of communist rule, had been through more extensive change.

Part of a wide-ranging reform programme

This reform programme was a reaction to the excesses of the National Government under Sir Robert Muldoon (1975-84) which had introduced an increasingly unorthodox style of economic management following a sustained period of poor economic performance and sustained economic stagnation. The policies of the Muldoon Government had culminated in an 18-month wage and price freeze underpinned by a reported fiscal deficit that grew to 9% of GDP (7% of GDP on a basis comparable with other statistics in this paper). Sustained structural fiscal deficits had resulted in Public Debt growing from around 5% of GDP in the early 1970s to around 45% of GDP by 1984 shown in Figure 1.

Reformist governments, first under Labour (1984-1990) and then National led (1990-1999), set about addressing the structural imbalances that had developed over the previous decades including turning around the fiscal balance and reducing public indebtedness.

Post-election fiscal surprises

The incoming National Government (in 1990) faced the unpleasant surprise of a deteriorating fiscal outlook which was accentuated by the need to bail out the failing Bank of New Zealand. In opposition they had based their election commitments on the Budget forecasts which were much more benign.

In response in the December 1990 statement and the 1991 Budget, the National Government had to abandon most of its pre-election manifesto and instead introduce 'the mother of all budgets.' This announced wide-ranging spending cuts and social policy reforms including reductions in social welfare benefit payments to beneficiaries.

Public disquiet with the reform programmes of both major parties was growing, and political polls showed people favoured a new Mixed Member Proportional system (MMP) over the traditional First Past the Post system (FFP). An indicative referendum in 1992 signalled a change to the electoral voting system which a binding referendum with the 1993 election was expected to confirm.

1.3. Political champion

The political champion for the FRA was the National Minister of Finance, Ruth Richardson, who tasked the Treasury to develop a fiscal analogue to the Reserve Bank Act (RBA). But whereas monetary policy is essentially technical, fiscal policy is inherently political as the Budget is an overt expression of the Government's priorities.

The immediate political driver for the Minister's request was the fiscal position National inherited on taking office in 1990 together with the threat of MMP in 1993, and the view that minority and coalition governments are prone to weak fiscal control

and deficit spending. The other driver was shaped by New Zealand's recent experience of fiscal deficits and the political costs of deficit reduction. The Minister wanted to leave a legacy so that no Minister of Finance would go through what she (and previous Labour Finance Ministers) had had to go through. In that she was supported by the Prime Minister who was concerned to ensure that future governments should not expect the unpleasant fiscal surprise that their administration had inherited.

Box 2 includes a chronology of events leading up to the enactment of the FRA and beyond. It shows while National were returned to office after the 1993 Election, it was with a significantly reduced majority. Ruth Richardson, when replaced as Minister of Finance, did not take up another Cabinet position but was appointed as Chair of the Select Committee on Finance and Expenditure (FEC). As the Chair of the Select Committee considering the FR Bill, she could drive it through the parliamentary process to enactment. Shortly thereafter Ruth Richardson resigned from Parliament and left politics.

1.4. Bureaucratic steward

If Ruth Richardson was the political champion for the introduction of the FRA, then the Treasury was the bureaucratic steward. While the Minister of Finance was initially attracted by the US style of legislated fiscal rules setting targets for spending, deficits, and debt, Treasury officials were very sceptical about legislated targets in fiscal constitutions.

This scepticism was based on an understanding of a range of countries' experiences and the US experience particularly with Gramm-Rudman-Hollings Balanced Budget Act. (The Maastricht treaty, which introduced statutory deficit and debt limits, and came into force in 1993 as the FRA was being developed, did not significantly influence officials thinking as there was no experience to draw on.)

Treasury officials however had positive experiences with increased fiscal transparency over the period of the reforms, which suggested that transparency could be a very effective fiscal tool. In 1992, the Treasury had been able to release a set of unqualified consolidated Crown accrual accounts that covered the wider state sector using GAAP. The resulting information had been influential in avoiding a double downgrade by the international credit rating agencies.

Box 2 The FRA: key events immediately before and after the enactment

January 1993: Ruth Richardson the then National Minister of Finance summons outgoing Treasury Secretary and Treasury officials to a retreat.

Early 1993: The Treasury provides a stream of advice to the Minister of Finance, which developed a regime based on fiscal responsibility principles rather legislated fiscal targets, leading to a Cabinet Paper.

Mid 1993: Cabinet approves the policy and subsequently the draft legislation.

September 1993: Fiscal Responsibility Bill introduced to House.

October 1993: First Pre-Election Economic and Fiscal Update published.

November 1993: General Election with National returned with significantly reduced majority, the majority in the referendum favour a new Mixed Member Proportional system (MMP) over the traditional First Past the Post system. Ruth Richardson is replaced as Minister of Finance, does not take up another Cabinet position but is appointed as Chair of Select Committee on Finance and Expenditure (FEC).

Early 1994: The Select Committee (FEC) considers the FR Bill. Limited opposition but only lukewarm support as there was widespread scepticism about whether it would have much impact (Scott 1995).

April 1994: Select Committee report reflects bipartisan support for the general thrust of the Bill but a split over whether fiscal responsibility principles should be legislated (favoured by the Government majority) or left to the Government of the day (favoured by Labour).

May 1994: The Budget includes a dry run of the operation of the FRA including a Fiscal Strategy Report.

June 1994: FRA assent to come into force from 1 July 1994.

May 1995: First Budget under the FRA.

October 1999: Election of 5th Labour-led Administration headed by Helen Clark.

2004: An omnibus public management reform Bill is introduced which makes three major amendments to the FRA as well some minor technical changes:

- The FRA is folded into Public Finance Act
- The Treasury is required, every four years, to provide Economic and Fiscal projections with a 40-year horizon
- Clarification that the focus of the Budget Policy Statement is the broad fiscal parameters and priorities to more clearly differentiate the contents of the BPS from the more detailed discussion in the Fiscal Strategy Report.

November 2008: Fifth National-led Administration elected under the leadership of John Key.

2013: Amendments to the PFA fiscal responsibility provisions amended the tax policy principle and included three additional principles:

- The interaction between fiscal and monetary policies
- The likely impact of any fiscal strategy on present and future generations
- Effectiveness and efficiency in management of the Crown's resources.

February 2017: The Opposition Labour and Greens parties commit to Budget Responsibility Rules.

September 2017: Election leading to 6th Labour-led Administration headed by Jacinda Ardern.

May 2018: Budget includes Labour and Greens parties Budget Responsibility Rules.

A FRA based on transparency about fiscal responsibility principles and a medium-term focus offered a number of technical opportunities to:

- Lock in good budgetary practices moving from one-year budgets to disclosure of three-year fiscal forecasts, practices that had emerged over the reform era but were not always observed
- Clarify roles to ensure the independence of the Treasury in preparing economic and fiscal forecasts
- Enable the Budget to be driven off GAAP based on independently set accounting standards and move away from the previous cash accounts (so-called Table 2), which were riddled with inconsistencies in treatment and had lost a lot of credibility
- Strengthen the public sector management reform agenda through reinforcing the use of GAAP
- Provide a commitment device to redress the time inconsistency problem by highlighting the future consequences of current policy settings
- Increase the credibility of fiscal policy, using transparency to help shape expectations and hence reduce the risk premiums on public debt
- Introduce a stronger top-down discipline on fiscal policy 'giving up control of the little numbers to get control of the big numbers' (to paraphrase the words in an interview with the Secretary of the Treasury at the time of the reforms).

A powerful politician championing the FRA, first as Minister of Finance then as Chair of the FEC, with active backing from the Prime Minister, got the FRA onto the political agenda and kept the Bill moving through the legislative process with the Treasury's support.

1.5. Crash through reform

There was no overt programme to build support for the FRA. When it was introduced, the FRA had limited opposition but only lukewarm support. Early on, opposition politicians thought the legislation would be ineffectual because of its unenforceability. Lipski (2015, p.8) quotes Winston Peters speech to the House as saying:

legislation of this type in this country is meaningless unless this Parliament means to keep faith with the public.

In a similar vein the Hon. Michael Cullen, later Minister of Finance in the Clark Administration, called the FRA "constitutional nonsense" and suggested the "notion that this Parliament will somehow bind future Governments on fiscal policy by stating such matters as it must 'maintain a fiscal surplus in any year', is constitutional stupidity".

Paul Swain, later a senior Minister in the same government, suggested "it is neither possible nor desirable for this Government to try legislatively to 'strait-jacket in' policy directions in the area of fiscal policy for future Governments".

However, leaving aside point scoring in Parliamentary debate, and quibbles over the legislature binding subsequent Parliaments, the FRA could build on a bipartisan political consensus that supported fiscal prudence. With a strong political champion, the Bill became law.

The new regime initially attracted favourable international attention. As Lipski observed (2015, p.7):

When introduced in 1994, the provisions were seen as world-leading and influential institutional reform. They have been cited as best practice by international agencies such as the Organisation for Economic Cooperation and Development and the International Monetary Fund” (see for example IMF (2007) Manual on Fiscal Transparency).

The continued external support is reflected in the 2013 National Integrity System Assessment by Transparency International as well as the Open Budget survey discussed earlier.

2. How was the policy designed?

The policy design process was remarkably quick by contemporary policy standards – from conception to enactment in under 18 months. Consistent with the *modus operandi* at the time, it was a very top-down process driven by the Minister of Finance, with the full backing of the Prime Minister, and supported by the Treasury

The policy design encountered little challenge within the government and limited interest and little sustained opposition when introduced into the House. The roll-out was similarly uncontroversial as the approach was technically easy to implement. The FRA was essentially codifying the approach already adopted in the 1994 Budget.

The chain of events, from conception in January 1993 through to application in the May 2018 Budget are shown in Box 2.

Looking at the sequence of events between conception of the idea in 1993 and enactment of the Bill in June 1994 a number of things deserve comment:

- *Speed of design:* New Zealand has a reputation for being the “the fastest legislators in the west” (Palmer 1979). In this case, the elapsed time from conception to enactment was under 18 months, and that included a General Election after introduction but before Select Committee consideration of the FR Bill. While rapid, the elapsed time required was not unprecedented as the style of the government of the day was to execute priorities quickly
- *Top-down and Executive driven:* The initiative for the FRA came from the Minister of Finance, who requested the Treasury in January 1993 to design the fiscal policy equivalent to the Reserve Bank Act for monetary policy independence. A small Treasury team, working closely with the Minister of Finance, then put up a stream of advice that culminated in the Fiscal Responsibility Bill introduced to House in September 1993
- *The lack of challenge:* While within the Executive there were critical voices (the Ministry of Justice had concerns about Parliament legislating the Executive’s Budget process), there were no significant challenges. Similarly, once in the House there was little sustained comment or opposition (unlike say the challenge raised to the proposals for a Regulatory Responsibility Bill in 2010).
- *Bipartisan consensus on fiscal responsibility as a concept:* The Opposition supported the broad thrust of the FRA on introduction but thought it would be ineffective in practice.

2.1. The rules of the game

In New Zealand’s political rules of the time, political power was extremely centralised. With a single House, a first past the post electoral system, the Westminster system of Cabinet Collective Responsibility, two well-established dominant parties with strong discipline, New Zealand’s system was described not unfairly as “an elected dictatorship” (Palmer 1979, p.10). With a forceful Minister of Finance, backed by the most powerful Government department, and with the Prime Minister’s active support, legislative change was reasonably easy to achieve.

The institutional feature that constrained that ‘unbridled power’ was that the New Zealand’s Treasury had a strong tradition of having a view independent of its Minister. The initiative for the FRA came from the Minister of Finance, who had in mind a regime of legislated fiscal targets and rules similar to those used at the state and federal level in the United States. The Treasury assembled a small focused team to respond to the Minister’s request.

2.2. Legislated transparency not fiscal targets

The advice they provided concluded that legislated fiscal targets and rules had proved singularly ineffective in a wide range of jurisdictions. To quote from recent work from the Cato Institute, “targets will be missed or abandoned, creative accounting and overoptimistic forecasts will be used to hit targets, exceptional needs for spending will be declared, and transition periods to hit targets will be lengthened” (Bourne 2018, p.6).

Instead, the Treasury proposed an innovative approach based on transparency about the principles of fiscal responsibility and independent forecasts and accounts. As one official observed, “Essentially debt and surplus targets are required to be committed to by the government of the day, and that’s a harder target to miss or abandon, than one that has been set for you by others”. This approach was accepted by the then Government and continues to set the framework for fiscal policy in New Zealand today.

By fiscal rules, what is meant is that there are set numerical targets or limits on the Budget balance, debt, spending, and tax revenue. These specific rules operate within a framework of more general fiscal constitution set out in the Public Finance Act, Standing Orders, and the Cabinet Manual and related documents. Examples of such rules include:

- Those that make the decisions of the Executive government are subservient to those of Parliament in a unicameral system, and/or of a second chamber in the case of a bicameral government
- The principle that Parliament will not delegate the power to tax
- The rule that government money cannot be spent except in accordance with parliamentary appropriations
- Rules relating to voting arrangements on fiscal matters.” (Wilkinson et al. 2014, p.53-54).

These general Budget rules also form an important constitutional context for the operation of the FRA.

3. How was the FRA implemented?

The FRA, once enacted, generally proved relatively easy to implement as it was largely codifying the Treasury's budgetary and accounting practices of the time. The accounting infrastructure that had been introduced by the 1989 Public Finance Act, was able to be applied to fiscal decision-making and accountability.

The 1994 Budget was used a 'dry run' so when the FRA came into force for the 1995 Budget, it was business as usual. Piloting was not essential to the success of the policy, but it did reinforce the case for enacting the FRA. The Treasury did however have to introduce a new IT system as the old Budget Management System lacked the required functionality to support the monthly fiscal reporting of progress against budgets and forecasts required by the FRA.

3.1. Strengthening the Minister of Finance

Budgeting is a technical process that serves a political purpose. Successive Ministers of Finance under Labour and National-led administrations found the transparency and disclosure requirements of the FRA a useful discipline to tame the spending aspirations of their Cabinet and Caucus colleagues.

It is instructive to compare the traction that the principles for the Operating Balance and Net Debt have achieved with the lack of any direct impact of the Long Term Fiscal Statement. The latter was introduced in the 2004 amendments to the FRA and required the Treasury to produce 40-year economic and fiscal outlooks every four years.

There was no 'dry run' prior to the introduction of the Long Term Fiscal Statement, no requirement for the government to formally respond, and limited direct political use for the projections. Unlike the four-year fiscal strategy where the government sets formal targets, and the Treasury reports against those goals, the 40-year fiscal projections stand in splendid isolation. As one former Treasury official observed "we legislated before we knew what it was' and 'we still don't know what a good 40-Year Fiscal Forecast looks like".

The Controller and Auditor General were similarly polite but scathing in their recent performance audit of the 2016 Statement of Long Term Fiscal Position (C&AG 2017).

3.2. Integral to the Budget process

There are three parts to New Zealand's Budget system:

1. The FRA principles which provide the foundation
2. The annual Budget Policy Statement (BPS) and Fiscal Strategy of the Government of the day along with supporting material prepared by the Treasury on the fiscal and economic outlook which provides the structure
3. The fiscal management approach of the Treasury which operationalises these fiscal principles and strategies.

The FRA principles have been discussed above and are outlined in Box 1. While providing a foundation, it is up to the Government of the day to articulate how they propose to operationalise the principles. Box 3 compares the budget responsibility rules used by the Labour led administration in the 2018 Budget Policy Statement with the corresponding statement of the previous National-led administration's BPS in 2017.

Box 3 Labour-led Government 2018 Budget Responsibility Rules (*compared with National's 2017 BPS*)

Reducing Net Debt to 20% of GDP within five years of taking office and maintain at prudent levels thereafter (*later than in the 2017 BPS*)

Running sustainable operating surpluses across the economic cycle (*no change from 2017*)

Maintain expenditure within the recent historical range of spending to GDP ratio (*2017 overtime, core Crown expenses are reduced to below 30% of GDP*)

Ensure a progressive taxation system that is fair, balance and promotes the long-term sustainability and productivity of the economy (*2017 pursue policies consistent with reasonable stability and predictability of tax rates*)

The Government will strengthen net worth consistent with the debt and operating balance objectives (*2017 ensure net worth remains at a level sufficient to act as a buffer to economic shocks*)

Prioritise investments to address the long-term financial and sustainability challenges facing New Zealand (*No direct counterpart in the 2017 BPS. The 2017 BPS did include 'manage prudently' the fiscal risks facing the Government*)

One of the key features of the 2018 BPS is that only two of the fiscal aggregates are expressed as measurable targets – Operating Balance and Net Debt. Successive administrations have committed themselves to running fiscal surpluses (operating surpluses across the economic cycle). There is a long-standing cross-party consensus on the need to reduce public debt. Both major parties are currently committed to reducing Net Debt to below 20% of GDP – the only point of difference is the timing.

There has been much less traction with the principles relating to Tax, Risk, and Net Worth. Although there are fewer surprise announcements of tax changes, there is no evidence that the FRA tax principles have had any practical effect, and the lack of commentary on the changes to the tax principles (shown in Box 3) reinforce this. Ministers of Finance are answerable for the operating balance of taxes and spending (before accounting gains and losses) but there has been much less focus on change in Net Worth.

The Government's Investment Statement, introduced by the 2013 amendments to the Public Finance Act, has attempted to increase the focus on the Crown's management of its Balance Sheet but so far with limited success. The risk principle is operationalised in the Budget Economic and Fiscal Update with a detailed discussion of the key risks facing the economy (including two alternative scenarios) as well as disclosure of specific fiscal risks (both quantified and unquantified).

As the Treasury Secretary has statutory independence on the preparation of this material, the effect is to reinforce the credibility of the integrity of the fiscal forecasts. Arguably the increased transparency also encourages Governments to address the risks that may hit them in the near future by taking action earlier.

The fiscal management approach

To give effect to the Government's fiscal strategy, the Treasury has developed a fiscal management approach. The key features of this approach were developed in the 1990s, it was fully formed in the early 2000s and are still applicable today. They include:

- Fixed Nominal Baselines with no allowance for inflation
- Operating Allowance for new initiatives (on a net basis) with limited exclusions such as debt servicing and major accounting gains or losses
- Capital Allowances for new financial or major physical investments
- Technical Forecasting Changes including the operation of automatic stabilisers through welfare benefits, and tax revenue changes, as well as New Zealand Superannuation
- Fiscally Neutral Changes which can be agreed within the financial year
- Contingencies for between budget baselines changes.

As one of FRA's architects commented 'the act codified and embedded an emergent culture'. This culture in turn reflected a wider cross-party consensus on the imperative for greater transparency and fiscal responsibility. Arguably the FRA also represented a return to the culture of fiscal conservatism in New Zealand that existed up to the 1970s.

The Treasury commented in a Regulatory Impact Statement in support of the 2013 PFA amendments, "There is no legal sanction for breaching the provisions, and it would also be possible for a government to comply with the form of the provisions but not their substance. The success or otherwise of the fiscal responsibility provisions therefore *depends on the level of acceptance and support they receive across government*" (Treasury 2012, p.1 emphasis added). Put another way the FRA has political force even if it is not legally enforceable.

3.3. Parliament largely absent

The discussion to date has focused on how the Executive has implemented the FRA. We turn now to the legislature, as a key part of the design was increased scrutiny by Parliament. The FRA provides for a Budget Policy Statement for Parliament to scrutinise how the Government proposes to operationalise the fiscal responsibility principles. The BPS is generally provided in February, well in advance of the Budget (May).

In practice, the Select Committee's reviews of the BPS have rarely been very enlightening or insightful. The size of the New Zealand Parliament, unlike its British parent, is too small for politicians to make a career leading the work of Select Committees. As one interviewee observed "the role of a unicameral parliament in our version of the Westminster system is to focus on law making not scrutiny. To the extent it is involved in scrutiny it has been down in the weeds (the standard Estimates

questionnaire of inputs and individuals' expenses) rather than in the sky focusing on the big picture of fiscal strategy".

This is consistent with Mark Prebble's Iron Rule of Political Contest which can be paraphrased as "the opposition in Parliament does not criticise the government in order to improve it, they criticise it in order to lawfully overthrow it" (Prebble 2010, p.35-38). Unless the BPS was to provide an opportunity for the opposition to attack the Government, the standard and level of scrutiny would not be high.

The transparency, quality, and multi-year focus of the fiscal information has been useful to the Auditor General in providing the context for Parliamentary briefings and for the Opposition in helping them shape their policy platform. The FRA has been successful in ensuring that no incoming government has experienced the unpleasant fiscal surprise that faced the 1990 National administration.

3.4. Monitoring by commentators and capital markets

Parliamentary monitoring, by analogy with policing was based less on regular patrols and more on waiting for alarms to go off. The Treasury's role as the independent and credible score keeper was an important source of information to trigger the alarms. Economic commentators and financial market analysts are both active users of that financial information who could then sound the alarm.

As one of the architects of the FRA stated:

One clear consequence of financial market reforms was the speed at which markets would respond to poor policy and in particular to poor fiscal policy. The aggregate fiscal policies of governments were closely assessed by financial analysts and could be quickly reflected in interest rates. The discipline being imposed by financial markets has played quite a significant role in supporting much better fiscal policy and transparency.

Political commentators and economic analysts (such as Bank Economists) were also actively scrutinising the fiscal information for inconsistencies with the 'Wellington consensus' on the importance of prudent fiscal management.

3.5. Gaining broad acceptance

Fiscal policy has become part of the wider political discourse as parties compete for the 'Fiscal Responsibility' mandate. Parties across the political spectrum place considerable effort into costing their pre-election policies.

As discussed above, the electoral agreement between the Opposition Labour and Greens parties on Budget Responsibility Rules has flowed directly into the 2018 BPS and Budget documents. Following the release of the 2018 Budget, the National Business Review, New Zealand's leading business journal, featured a lead article whose headline is that 'the 2019 Well Being Budget will put pressure on the budget responsibility rules.'¹

While there are dissenting voices suggesting that the FRA provisions are a ‘false idol’ⁱⁱ or a ‘straight jacket’.ⁱⁱⁱ The more widespread view is that it is a useful addition to the public management system and indeed provides a framework that can be used to assess other target setting regimes such as the Child Poverty Reduction Bill (Easton 2018).^{iv}

4. Why has the FRA been durable?

One of the key dimensions of policy success is how well the policy regime endures over time in following political changes in administrations and in the face of economic expansions and contractions.

Figure 1 shows how under successive National and Labour-led administrations before the GFC have run sustained structural surpluses driving down the net public debt to GDP ratio accordingly. For example, New Zealand ran sustained structural surpluses in the range of 1.5-6% of GDP from 1994 to 2006. Net Public Debt over the same period fell from just over 60% of GDP to just under 5%. Indeed, the ratio would fall below zero if the New Zealand Superannuation fund is also included.

While it is tempting to attribute that reduction in public indebtedness to the FRA, in fact the start in the improvement in New Zealand's fiscal position pre-dates its enactment. While the transparency required by the FRA had an important role to play, other factors were more important:

- The legacy of the Muldoon years with a bipartisan political commitment to fiscal responsibility
- The establishment of the New Zealand Superannuation Fund (the so-called Cullen Fund) to partially pre-fund the increased future cost of the New Zealand Superannuation pension, due to population ageing
- The increasing recognition of the importance for a small trading nation of fiscal resilience and sustainability.

FRA, while not the catalyst, helped cement fiscal discipline into the political discourse and Budgeting practice in New Zealand. As one interviewee observed 'it is less about whether the FRA helped achieve a better fiscal performance, and more about whether it helped sustain it'.

4.1. Safety valves for cyclical fluctuations

Fiscal strategy needs to focus on short term macroeconomic stability as well as medium term fiscal sustainability. One of the criticisms of the Fiscal Responsibility Bill in the Select Committee was that the medium-term focus would constrain the government from undertaking an anti-cyclical fiscal policy, beyond the operation of automatic stabilisers. These fears have not proved justified. If anything, the opposite has occurred as New Zealand has experienced some of the biggest swings in the structural fiscal balance in the OECD.

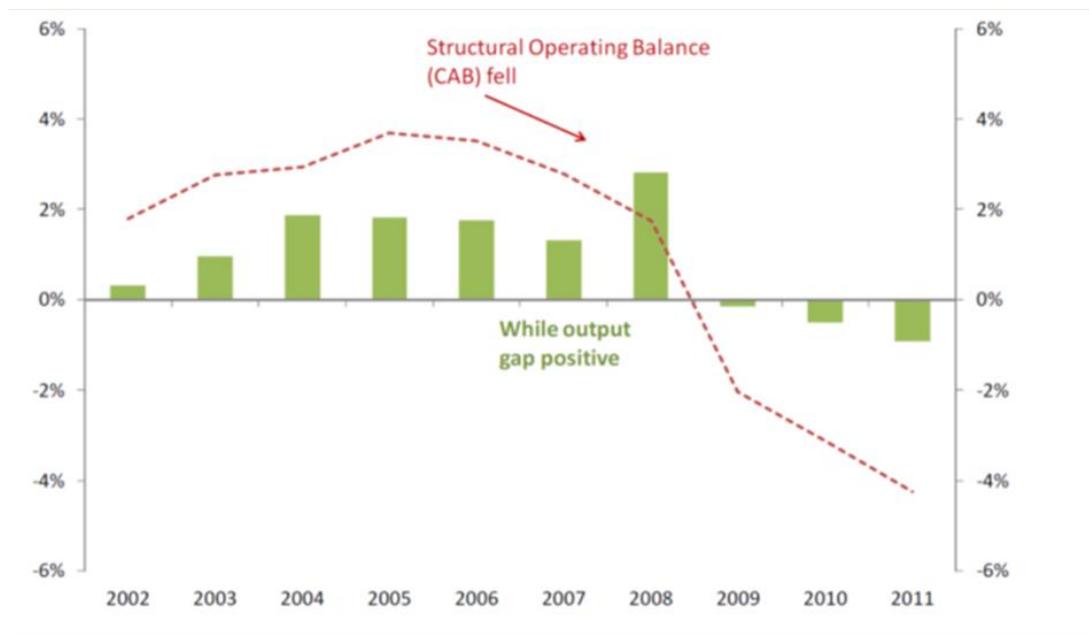
The Treasury's analysis suggests that the FRA framework, while focusing on medium term fiscal sustainability, places little attention to the shorter term macroeconomic stability such as the impact of pro-cyclical increases in government spending.

Brook (2013, p.71):

Suggests that New Zealand's current fiscal policy framework – with its emphasis on a debt target – gives insufficient emphasis to macro stabilisation during upturns in the business cycle, especially once the debt target has been met. In a small open economy such as New Zealand, with a floating exchange rate, pro-cyclical fiscal stimulus is unlikely to have much impact on aggregate demand (because of leakage into imports and the offsetting impact of tighter monetary policy), but it does have a significant impact on the mix of macroeconomic conditions. Higher real interest rates, and associated exchange rate appreciation, is unhelpful to an economy already experiencing macroeconomic imbalances.

Figure 3 compares the cyclically adjusted (or structural) fiscal balance with the output gap. It covers the second and third terms of the Clark Labour led Government and the first term of the Key National Led Government. (For an independent account of New Zealand fiscal policy before the GFC see Norman and Gill (2010), for an official summary of fiscal policy since the GFC, see Bose et al (2016) and for a detailed account of the history and evolution of the FRA including a more technical assessment using the sustainability, stability and structural roles of fiscal policy (see Buckle 2018).

Figure 3 Destabilising fiscal stance – operating balance and the output gap



Source: NZ Treasury 2012 Page 6

Pro-cyclical destabilisation

In 2008, an election year in New Zealand, there was a marked easing in the stance of fiscal policy despite the output gap still being significantly positive. This reflected windfall gains in taxation revenue which were used to fund permanent increases in operating spending such as enhancements to Working for Families.

The tax revenue increases proved temporary and their reversal coincided with the onset of the GFC and subsequently the impact of the Christchurch Earthquake sequence (around 10% of GDP over 3 years). As a result, New Zealand faced a record fiscal deficit of around 9% of GDP in 2011.

The framework provided by the FRA meant that when the subsequent National-led administration committed itself to return to fiscal surplus, this was credible and the impact on financial markets was minimised. The Government successfully delivered a small fiscal surplus in 2014 (shown in Figure 2).

The experience of fiscal management in the face of sustained economic growth led the Treasury to recommend an additional fiscal anchor based on medium term expenditure or revenue constraints to augment the anchor provided by debt (Treasury 2008 Post Election Briefing), and subsequently developed the case for additional fiscal responsibility principles introduced in 2013 that were included in Box 1 above.

Figure 3 is drawn from the Treasury Regulatory Impact Statements for the 2013 amendments to the fiscal responsibility provisions in the PFA. It is difficult to discern any impact of the 2013 amendments. For example, it is not clear if the three new principles have informed the 2018 BPS and the Fiscal Strategy Report and the lack of explicit mention has not attracted unfavourable comment.

5. Lessons learnt from the FRA

5.1. The endurance of fiscal transparency and responsibility

New Zealand's generally positive experience with the FRA contributing to sustained surpluses and debt reduction is consistent with the old saying about 'good things take time.' When the FRA was introduced, there was limited opposition but widespread scepticism about whether it would have much impact. Support for the FRA is much stronger now than at the time of its introduction.

Since its enactment in 1994, the FRA has set the framework within which fiscal policy has been conducted in New Zealand. Its emphasis on transparency of forecasts has been key to ensuring fiscal responsibility and resilience. The durability of the regime is because the FRA does not specify, for example, what constitutes a 'prudent level of public debt'. It is left to the government of the day to operationalise what is meant and to disclose this in the annual fiscal strategy report. Similarly, with the notable exceptions of the operating balance rule, net worth and net debt, the other fiscal aggregate principles are qualitative and not readily measurable leaving the interpretation to the government of the time.

5.2. Flexibility within a framework

The flexibility of this approach allows the framework to adapt to changing circumstances (the Christchurch earthquake, cyclical fluctuations such as the GFC provide examples from recent history). Arguably recent shocks have also help 'cement' the cross-party political commitment to fiscal discipline. This suggests the FRA can remain a success in the future so long as the cross-party commitment to fiscal responsibility is sustained.

5.3. Fiscal targets and constitutions

New Zealand's experience with a regime based on transparency also speaks to the ongoing debate about fiscal targets and fiscal constitutions. Looking at a range of countries' experiences with entrenching fiscal targets the Cato Institute concluded:

The academic evidence and historical record show that formal fiscal rules are neither necessary nor sufficient to obtain sound public finances...The key is to design rules that are simple enough to be well understood and monitored, but flexible enough to be durable against unforeseen economic shocks that temporarily derail that goal. Doing so requires well thought-through procedural details and means of enforcement (Bourne 2018, p.6).

5.4. The success of the FRA is due to subtle effects

The enduring and increasing success of the FRA has several unexpected features:

- An apparently weak instrument proved politically powerful when backed by an independent and credible scorekeeper and monitoring by financial markets and commentators
- Policy success is very path dependent: that the FRA has been increasingly influential and adopted by political parties across the spectrum is a result of both careful design and good luck
- Budgeting is inherently a political statement (as well as a technocratic process) which means that technocratic Budget rules can influence details of how the game is played but does not change the fundamental nature of the political game
- Ownership of goals matters: the FRA required the government of the day to articulate the fiscal goals. This reduces the amount of cheating and gaming as the government owns the goals rather than having targets set in legislation
- Widespread consultation and buy in to the design of a policy regime is not a precondition for success: the FRA was developed by the then National Government through a short very top down policy process, with almost no public or cross-party engagement before Select Committee consideration
- The unexpected and indeed astonishing success of the FRA arose from a technical policy solution providing a valuable political management tool for Ministers of Finance.
- Transparency about fiscal responsibility is not enough on its own.

5.5. Transparency is not enough on its own

The success of the approach, as Teresa Ter-Minassian (2014, p.14), former Director of the IMF's Fiscal Affairs Department observed, is down to the:

Quality, comprehensiveness, reliability and timeliness of the budget documentation, to facilitate adequate scrutiny by the Parliament, and by society at large, of the consistency of the Government's fiscal strategy with the above-listed principles. Accordingly, New Zealand has pioneered, and refined over the years, comprehensive fiscal reporting requirements, intended to ensure transparency, and to promote time consistency and a broad debate of the fiscal policy choices of successive Governments.

Equally important is that the ex-post financial information is of the same quality as the ex-ante budget information. The FRA is underpinned by a consolidated set of Government Financial Statements that are consistent with generally accepted accounting principles set by an independent accounting standards body. The accounts are prepared by the Treasury. Treasury, as the most powerful department, is an influential institution in New Zealand in its own right. In the case of the FRA, it has been given statutory independence in the preparation of the fiscal forecasts and Financial Statements.

This means as one interviewee observed “that New Zealand has the cleanest set of financial accounts in the west” which are not subject to the accounting fiddles and off-balance sheet shenanigans seen in other jurisdictions and in New Zealand in the past.

Merely supplying of information does not mean that it will be used. While the intended demand for financial information from Parliament did not eventuate, economic commentators and financial market analysts have both been active users of that information. This active monitoring acted to reinforce the Minister of Finance position within Cabinet on the importance of fiscal responsibility.

5.6. Unfinished business

Nonetheless the framework provided by the FRA is not without potential risks and problems.

The first, is that the durability of the FRA into the future is dependent on popular support for the importance of fiscal responsibility and that the cross-party commitment to fiscal responsibility is sustained. To date New Zealand politics has been notable for the absence of a large and strong populist party with no concern for long-term fiscal prudence and of a 'Tea-Party' type conservative party committed to low taxes but not necessarily lower expenditure.

Second, the ongoing integrity of the FRA framework is heavily reliant on the Treasury continuing to actively pursue its stewardship role including as an independent score keeper.

Third, while the FRA provides a useful framework for Executive government, the fiscal regime is largely silent on where the other political parties fit. New Zealand is one of few OECD countries without an independent budget office. While New Zealand's size may well mean building an independent economic and fiscal forecasting capability is not realistic, there remains the role of assisting other political parties with costing policy proposals (Wilson 2017).

The Government has released a Consultation document on the establishment of an Independent Fiscal Institution (IFI) which appears to assume that such an institution is required. In addition to costing opposition policies, the functions proposed include:

1. Commenting and assessing compliance with the Government's fiscal strategy and fiscal targets
2. Commenting on the Treasury's economic and fiscal forecasts
3. Commenting on long-term fiscal sustainability and fiscal risks, and
4. Producing relevant and related research and commentary on fiscal and budgetary issues.

Just where the sustained demand for these additional functions is to come from and why that can't be met from existing independent institutions such as the Office of Auditor General, The Treasury and potentially the Productivity Commission is rather unclear.

Fourth, the framework has had limited effectiveness in taking into account the effect of the business cycle. Graph 3 shows the changes in the structural fiscal balance. New Zealand has experienced some of the biggest swings of the structural fiscal balance in the OECD. While Net Debt provides a powerful fiscal anchor for medium term sustainability, it is less robust for dealing with macroeconomic stability.

6. Conclusions

These caveats aside, there are unique factors that may limit how broadly the lessons from this case can be applied. There were both political and technical pre-conditions that were required to underpin the operation of the FRA. The FRA principles need to be supported at the political level by the commitment of the government of the day to a fiscal strategy based on fiscal prudence and at a technical level by a Fiscal Management Approach to operationalise the government fiscal strategy.

The power of the Treasury's fiscal tools

At the technical level, the FRA was backed by a powerful Treasury with a suite of tools and techniques to make the fiscal strategy stick. The FRA gave fiscal policy a top-down discipline for sustaining a long-term regime fixed nominal baselines while the financial management reforms delivered the required bottom-up flexibility. As one source commented "introducing the FRA in 1984 simply wouldn't have worked".

...backed political will

Without political will, however, the techniques of fiscal management won't deliver fiscal discipline. As the FRA is not legally enforceable, it needs to have political force. Political will is not something that exists in isolation. The ongoing legacy of the Muldoon years is an enduring consensus across the major political parties on the importance of prudent fiscal policy.

and financial market monitoring

Financial market and other non-political monitoring processes have helped sustain that political will. The FRA helped to codify and embed into political discourse and budgeting practices a commitment to fiscal prudence and lent credibility to the Budget process. But without that political commitment, fiscal responsibility principles would have remained just principles, with government statements complying with the form of the provisions but not their substance.

...means the FRA is a powerful commitment device

In summary, the FRA was a commitment device that helped cement fiscal discipline into New Zealand's Budgeting system and policy discourse rather than the catalyst that started it. In the process, the FRA provides the foundations for the Treasury's Budgeting process, is embedded in the wider everyday political discourse, and is now part of New Zealand's constitutional framework.

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