

Submission

Public Finance (Fiscal Responsibility) Amendment Bill 2012

18 February 2013

Committee Secretariat
Finance and Expenditure
Parliament Buildings
Wellington

To whom it may concern,

Please find attached the McGuinness Institute's submission on the Public Finance (Fiscal Responsibility) Amendment Bill 2012 to the Finance and Expenditure Committee.

We would welcome the opportunity to provide further comment on the Public Finance (Fiscal Responsibility) Amendment Bill 2012 and would like to register our interest in speaking to the Select Committee about our submission. Our contact details are provided below.

Kind regards,



Wendy McGuinness
Chief Executive

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About the McGuinness Institute

The McGuinness Institute is a non-partisan, not-for-profit research organisation specialising in issues that affect New Zealand's long term future. Founded in 2004, the Institute contributes to the ongoing debate about how to progress this nation through the production of timely, comprehensive and well-researched information. This information can take a number of forms including books, reports, working papers, think pieces, workshops and videos.

Experience

Wendy McGuinness, the Chief Executive of the Institute, was part of the team that worked on the development of the Public Finance Act 1989. Her particular contribution was the report on the *Implementation of Accrual Accounting in Government Departments* (1988)¹. She then ran a consultancy firm, McGuinness & Associates, providing services to the public sector during the transition from cash to accrual accounting. She is a former Councillor of the New Zealand Institute of Chartered Accountants and has been awarded a fellowship, entitling her to use the term Fellow Chartered Accountant.

1 See W L McGuinness (1988). *Implementation of Accrual Accounting for Government Departments*. Retrieved 18 February, 2013 from <http://mcguinnessinstituteblog.org/wp-content/uploads/Implementation-of-Accrual-Accounting-for-Government-Departments-by-W-L-McGuinness.pdf>

Submission

We agree with the intent of this Bill and support the three new principles of responsible fiscal management proposed in the Public Finance (Fiscal Responsibility) Amendment Bill 2012, the new requirement to assess past fiscal strategy and the codification of existing practices.

Reasons supporting these changes

We believe one of the key outputs of governments should be informed citizens. The counterfactual, an uninformed society, is likely over time to create poor public policy, and therefore poor outcomes for society. Hence the heart of this Bill relates back to the concept of *responsible government* established in New Zealand in 1856. Responsible government embodies the principle of parliamentary accountability; governments are responsible to Parliament and therefore Ministers must account to Parliament for their decisions and for the performance of their departments. This requirement fits well within this Bill, enabling all Members of Parliament to be informed about New Zealand's fiscal management and to put forward questions in the House. Hence the relationship between governments, Members of Parliament, and the people (that they represent) is strengthened, and as a consequence policy changes will become more transparent and lead to more informed debate both inside and outside the House.

Finance Ministers have often been placed under significant pressure when economic surpluses exist, making it difficult for surpluses to be used to pay off long-term debt or invest in long-term projects. We believe governments must work harder to show the links between:

- a. Budgets and plans (promises) and actual results (practices);
- b. Cash surplus (cash accounting) and net profit and fixed assets (accrual accounting);
- c. Fiscal strategy and monetary policy, and
- d. Short-termism and long-term thinking.

A recent example is Hon Michael Cullen's Budget surplus in 2007. Many people accused him of political squirrelling rather than sound economic management. The general public at the time were keen to explore how surpluses should be utilised. For example, an opinion piece in the Herald on 22 October 2007, written by Peter Lyons, an economics teacher at St Peter's College in Epsom noted:

Dr Cullen has dismissed calls for tax cuts in recent years. He believes tax cuts would result in increased consumer spending causing greater inflationary pressures. This would require the Reserve Bank to continue raising interest rates. While this argument may be valid, it is patronising and paternalistic...

A cynical observer might suggest that the "borrow and spend" election strategies of Governments in the 1970s and 1980s have been replaced by an "over-tax and bribe" approach in recent years.

This has been forced on politicians by the Fiscal Responsibility Act and the greater transparency of public finances.

The borrow and spend policies were known as pump-priming the economy and were highly inflationary. This new approach could be termed hollow gift electioneering...

Dr Cullen need not be proud of his huge Budget surplus. It does not indicate prudent economic management. It represents economic distortion in the form of over-taxation.

It is also a contributing factor to the huge debt mountain the New Zealand public has accumulated over recent years.²

² See NZ Herald (22 October 2007). Peter Lyons: Cullen's Budget surplus miserly rather than wise management. Retrieved 18 February, 2013 from http://www.nzherald.co.nz/opinion/news/article.cfm?c_id=466&objectid=10471235

Then, in 2008, Cullen did cut taxes,³ arguably in response to political pressure and/or as a softener for the upcoming election later that year. Cullen is noted as stating in a 6 February 2008 article:

*Dr Cullen has set four tests for delivering tax cuts: that they would not make inflation worse; would not require extra borrowing; would not lead to cuts in services; and would not increase inequalities in society.*⁴

This example shows how difficult it is to manage fiscal pressures in a transparent manner, particularly as we have such a short electoral cycle in New Zealand. Fiscal management will always be a political football, and that is the way it should be if we want to optimise outcomes for the public good. However, in order for the debate to be based on fact and on past experience, everyone needs to be able to get a handle on the ball.

To this end, the Institute ran a workshop in the middle of December 2012, called *LongTermNZ: Taking a long-term position on our future*.⁵ This workshop was an opportunity to bring together youth with an interest in macroeconomics and a desire to explore our long-term fiscal position. The participants attended the *Affording our Future* conference, hosted by the Treasury and Victoria University of Wellington, and then spent three days discussing what they had learned and drafting the *2012 Youth Statement on New Zealand's long-term fiscal position*. We believe the resulting statement (attached in hard copy) shows that young people want to not only understand and discuss fiscal management, but they also want to have their voice heard. Their statement included the following five key messages:

1. Youth need to participate in the debate.

We will inherit the consequences of today's decisions and we cannot afford not to care. Online voting and online platforms can engage young people at a time when traditional media cannot be relied upon to host important debates concerning the future for young people.

2. We have the opportunity to act early.

Unlike some countries struggling under heavy debt burdens, we have a window of opportunity in which to respond pre-emptively to demographic changes and rising health costs.

3. Building consensus around hard decisions is important.

Young people are willing to make trade-offs which recognise that the system must develop with changing demographics and rising health costs. Generations need to work together on this issue.

4. Other areas of spending remain important.

Although spending may be fiscally constrained, the future we want requires active investment in smart long-term options – like a low-carbon economy, lower imprisonment rates, and decreased child poverty. These options are often cost-effective in the big picture and over the long term.

5. There is no silver bullet, but we do have solutions and choices.

We should not rule anything out. As the examples in this statement have shown, trade-offs are inherent in all policy options, but everything should be on the table in looking forward to the next forty years.⁶

This transparency and agreement over general principles and the government's resulting fiscal strategy enables the Minister to withstand pressure to make changes just before elections, an issue raised by Peter Lyons earlier. Ideally, with Parliament and the public having more transparency over the government's long-term fiscal strategy, both current and future Ministers of Finance will be able to withstand pressure from their caucus, their political party, opposing parties and from lobbyists; allowing the debate to be focused on an overarching long-term fiscal strategy. We believe a steady-as-we-go fiscal strategy is far more desirable than an adhoc strategy that responds to self-interest.

3 See Budget 2008, and NZ Herald (7 February 2008). Cullen: Tax cuts but strict conditions. Retrieved 18 February, 2013 from http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=10491112

4 See Stuff.co.nz (6 February 2008). Three years of tax cuts, then more. Retrieved 18 February, 2013 from <http://www.stuff.co.nz/256244/Three-years-of-tax-cuts-then-more>

5 For more information about this workshop visit <http://longtermnz.org>

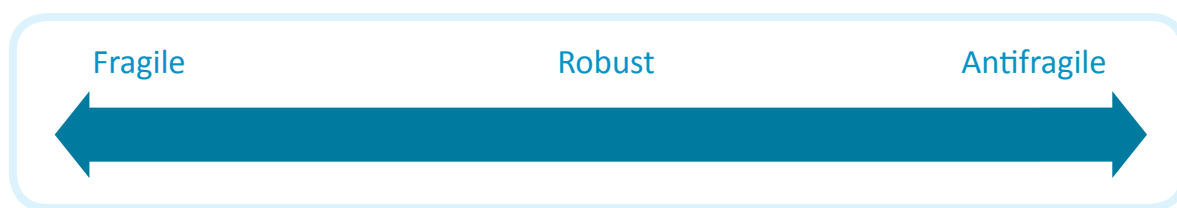
6 See 2012 Youth Statement, available for download from <http://longtermnz.org/wp-content/uploads/20130131-Youth-Statement2.pdf>

Good fiscal management delivers New Zealand a secure future

There are many opportunities that are derived from good fiscal management. A key opportunity (and often a lost opportunity) with fiscal strategy is understanding what went wrong or right – what are the lessons we can learn. We need to put more effort into understanding why a fiscal strategy worked or did not work. This should not be an opportunity to score political points but to gain a deep understanding of the components in the country's fiscal system. Often the country's surplus/deficit is a mix of prudent management and random 'Black Swan' events.⁷ Understanding what went wrong (or right) is not enough, we need to understand the strategy in terms of what was expected to happen, against what did happen. This way we can improve the quality of our fiscal strategy rather than lower the quality of the debate to political point scoring.

At the Institute we have embraced the thinking of Nassim Nicholas Taleb. In his latest book titled *Antifragile* (a term he has created), we believe he has identified a strategy worth exploring. His thesis is that people, companies and countries all sit along a continuum; for any given situation they can position themselves towards the fragile end, in the middle (robust) or towards the antifragile end. He argues that we often aim to be robust and resilient (the middle position on the continuum), when actually we should be aiming to be antifragile. To this end we hope to run a workshop later this year or early next year to explore how New Zealand could make itself antifragile – *AntifragileNZ: Securing New Zealand's long-term future*.

Figure 1: Nassim Nicholas Taleb's continuum



Taleb's latest book assumes that (a) Black Swans dominate society and history, and as a consequence (b) we don't quite know what going on.⁸ A recent Black Swan event in New Zealand was a significant earthquake in *Christchurch*. As noted in the book, antifragility is about optionality and the ability to not only be responsive to significant events, but be able to respond quickly and in such a way as to optimise them. Hence, the key to New Zealand being antifragile is optionality, and key to optionality is having money in the bank. This is why having a fiscal strategy is so important; managed well it will secure our long-term future. As evidence of this Taleb refers to the example of British Prime Minister William Gladstone who 'was insistent upon a balanced fiscal budget: fiscal deficits have proved to be a prime source of fragility in social and economic systems'.⁹ The ongoing Global Financial Crisis is a glaring example of such an event and highlights the need to position New Zealand as antifragile.

Implications for the Bill

As noted above, the Institute agrees with the intent of this Bill and supports (A) the three new principles of responsible fiscal management, (B) the new requirement to assess past fiscal strategy and (C) the codification of existing practices. We discuss each of these briefly in turn:

7 Taleb coined the term 'Black Swans'. In his earlier book to denote 'large-scale unpredictable and irregular events of massive consequence – unpredicted by a certain observer, and such unpredictor is generally called the "turkey" when he is both surprised and harmed by these events.' and 'The rarer the event, the less tractable, and the less we know about how frequent its occurrence'. N. N. Taleb (2012) pp 6-7. *Antifragile: Things that gain from disorder*. New York: Random House.

8 N. N. Taleb (2012) p 14. *Antifragile: Things that gain from disorder*. New York: Random House.

9 N. N. Taleb (2012) p 36. *Antifragile: Things that gain from disorder*. New York: Random House.

(A) the three new principles of responsible fiscal management

- i. that governments should formulate fiscal strategy with regard to its interaction with monetary policy;
- ii. that governments should ensure that resources are managed effectively and efficiently, and
- iii. that governments should formulate fiscal policy with regard to its likely impact on present and future generations.

Comment: As noted in the discussion in the House, one would hope that previous governments have applied such principles naturally as part of good process. However having them codified in law makes the process more transparent and accordingly invites accountability questions within the House and with the wider public. We wholeheartedly support this initiative. The addition of these three principles suggests that other principles exist that may naturally be part of the process but are not currently apparent in law. We will undertake some further thinking about what could also be included as a principle/s for the public good, and ideally present them in person at the Select Committee.

(B) the new requirement to assess past fiscal strategy

Comment: We believe this is an important addition to public policy, the ability to require the Minister to learn from the past, and share his observations in a report for future Ministers of Finance, public servants and the public. This provides a mechanism for the Minister of Finance to comment on the lessons that he/she has learnt in an open and transparent way; ideally by highlighting the relationship between cause and effect of his party's strategy while on 'his watch' as Minister of Finance. This could be a very useful tool for recording a long-term public policy archive for New Zealanders in the future. This initiative however raises two further questions which we are still thinking about: (1) how might New Zealand ensure this assessment is used as a tool for the betterment of New Zealand (rather than the betterment of the political party in question), and (2) to this end, how can we ensure it provides an opportunity for wider debate and discussion. For example, the first might be resolved by setting out some form of criteria that the Minister must report against while the second might involve requiring Treasury to also prepare such a report. These are simply ideas we are thinking about.

(C) the codification of existing practices including (i) the fiscal strategy report to include a revenue strategy that includes the Government's objectives for the tax system and tax policy and (ii) the Treasury to prepare an investment strategy every 4 years, providing information about the assets and liabilities on the Crown's Balance Sheet.

Comment: We support both of these initiatives, as mentioned earlier; we are thinking about whether any other existing practices should be codified. With all the changes currently occurring in the public service and the reduced role of libraries that document public policy in government departments, we believe there is a real need to codify practices that have proven to be successful in the past to be codified to preserve them for the future.

Thank you for the opportunity to present this submission in writing. We would appreciate the opportunity to provide more thoughts though an oral presentation.