

Fiscal History, Fiscal Policy

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Introduction

This paper is based on a presentation to a Symposium, *Well-being, budget responsibility rules and the Public Finance Act*, hosted on 15 April 2019 by the *Institute of Governance and Policy Studies* at Victoria University of Wellington, and on a follow-up presentation to the Fabian Society at Conolly Hall Wellington on April 23. It falls into two parts: an examination of trends in public revenue and spending in the post-war years and a suggested re-focusing of the Public Finance Act fiscal policy framework, that includes the possible use of fiat money creation in support of macroeconomic objectives, particularly full employment.

The historic analysis updates work undertaken earlier this decade, with the primary objective of deriving annual time series data summarizing trends in public revenue and spending, suitable for use in econometric analysis. Given the fragmented official statistical record this was not a simple task. The current update was stimulated by interactions with a group of colleagues, whose critiques of the current macroeconomic policy framework have also focused my attention on the fiscal policy framework within the Public Finance Act as discussed in the second part of this paper.

The commentary on recent history is limited to a reading of the trends evident in the reported series and does not examine the underlying drivers in any detail. Comments and corrections welcome.

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Post-War Fiscal History

Figure 1 records the changing levels of central government income, expenditure and savings over the years from 1948 to 2018, as recorded in official national accounting statistics. Figures are expressed as percentages of GDP, so they measure the relative scale of government activity within the total economy.

Figure 1 simplifies a complicated picture, presented as Appendix Table 1, which records succeeding generations of national accounting and Treasury data. The statistical record is tangled. In recent presentations I have shoehorned these multiple sources into summary time series, which I now feel create more problems than they solve. So, I revert to reporting individual series that can be related back to source.

Figure 1

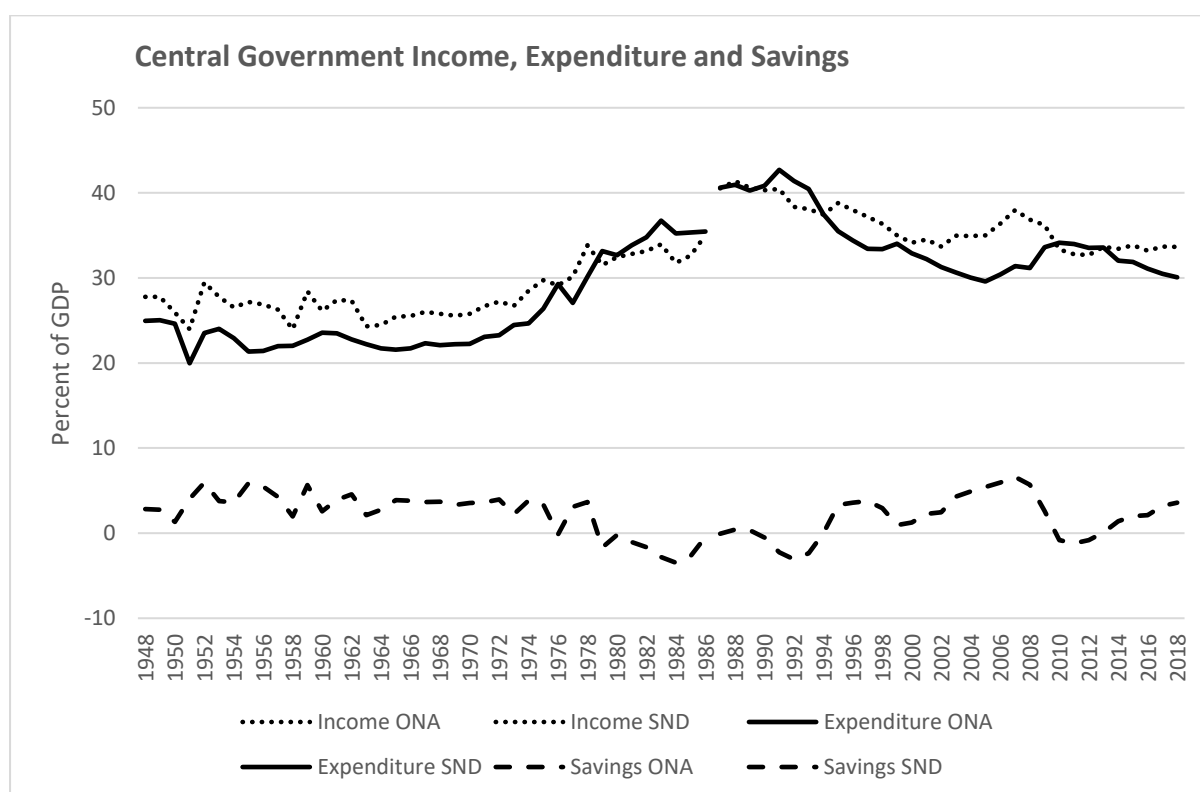


Figure 1 contains an unfortunate data break between 1986 and 1987. For years up to 1986 data are from the original national accounting series (ONA). Data from 1987 are those currently maintained by Statistics NZ, (SND). The break in 1986 is coincident with the introduction of GST but also probably reflects some change in coverage.

Long time series like these can usefully be broken into sub-periods. Changes in the trajectories of government revenues and expenditures flow from government decisions, from the evolving shape of the New Zealand economy and from international influences and events. The intermediate boundary points that I use for statistical trend analysis, 1972, 1992, and 2005, are no more than approximate markers of processes of change that occurred over several years.

The early 1970s saw the breakdown of the post-war consensus, marked internationally by accelerating inflation and the collapse of the international Bretton Woods fixed exchange rate system. New Zealand also saw inflation and increasing difficulty in maintaining its protected industrial structure. The period from the early 1970s through to 1992 embraced the Kirk and Muldoon years, the Rogernomic reforms and the early Bolger years. From 1992 there was a long period of consolidation until around 2005, at which point government spending started to rise as a proportion of GDP. More importantly the mid-late years of that decade saw increasing financial tensions in the major industrial powers leading to the global financial crisis and the long recovery from that.

The first period, 1948 to 1972, characterized at the time as stop/go, in retrospect looks very stable with government income averaging 26.4% of GDP, exceeding current expenditure, 22.7%, and contributing to an average public savings rate equal to 3.7% of GDP. This was a period of full employment, moderate GDP growth, inflation above 4 percent and repeated balance of payments crises.

Although the end of this phase is commonly linked to the oil crisis that crisis was itself in large part a response to escalating inflation in the developed industrial world associated with ongoing conflicts between increasingly concentrated capital and organized labour, both testing their strength within the limits set by governmental commitments to full employment. One outcome was the collapse of the fixed exchange rate system.

The years from 1972 to 1992 saw rapid increases in government income and expenditure leading to a long sequence of government deficits. The data break in 1986-87 obscures the trend but Treasury data for this period suggests that expenditure, expressed as a percentage of GDP, was increasing at an annual trend increment of 0.55. The trend increment for income was 0.50. Savings were negative from 1979 to 1987 on the national accounting measure. We'll explore the composition of these trends a bit later but note that the big rise in total expenditure occurred during the late 1970s whilst the rise in total income is sharpest in the late 1980s, reflecting the introduction of GST. These years saw the emergence of significant unemployment, averaging 3.8%, and annual inflation of more than 10%.

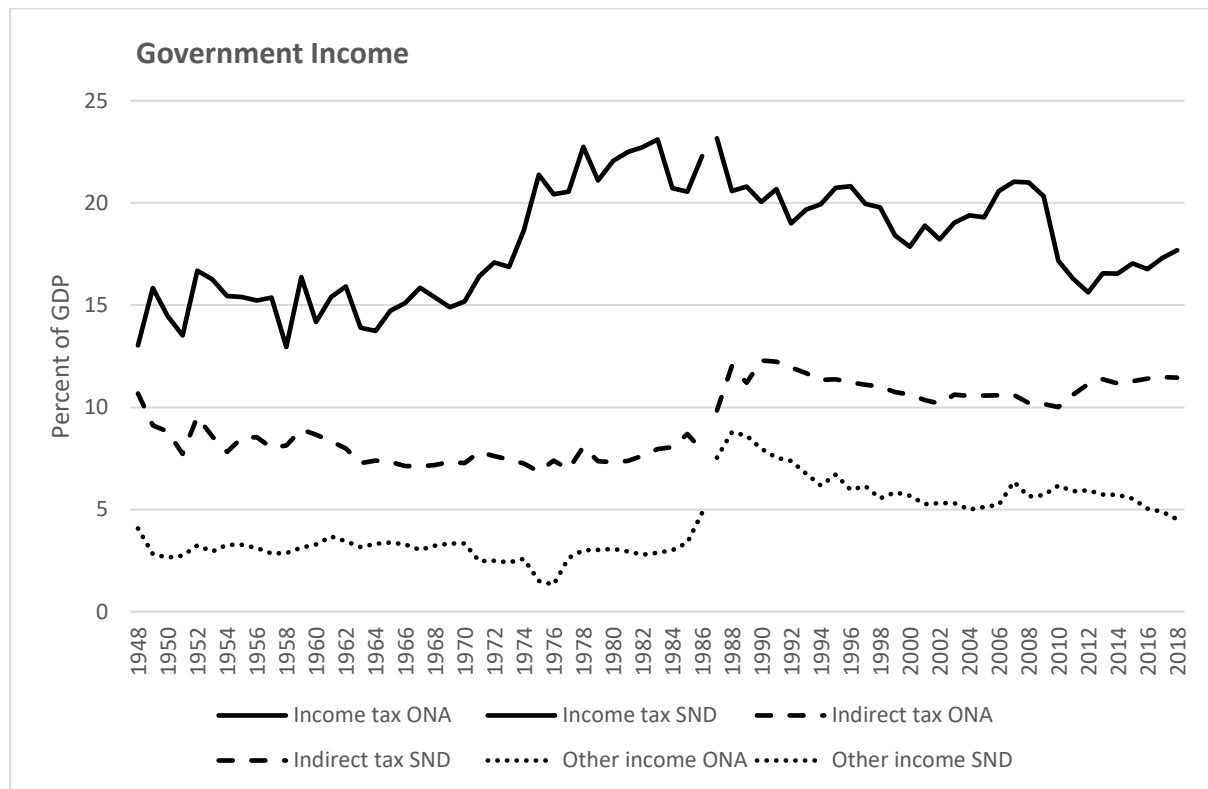
From 1992 to 2005 was a period of fiscal constraint and consolidation. Although total income was trending down by 0.4% per year the average for these years, on an SND basis, was equal to 36.2% of GDP. Total expenditure fell much more rapidly, with an annual trend decrement of 0.8% and the average value for the period was 34.1% of GDP. The outcome was a return to surplus with annual savings equaling 2.1% of GDP on average. Over this period inflation fell dramatically, to an annual 2% whilst the unemployment rate, which peaked at 10.9% in 1991, averaged 6.5%

The years from 2005 to 2018 cover the global financial crisis and its aftermath. Income rose briefly to a 2007 peak before falling back sharply in response to cuts in income tax. Over the period income trended down by 0.3% of GDP each year with an average value for the period of 34.5%. Expenditure, in contrast, was not significantly different at end than at the beginning, but this disguises a quite strong expansion from 2005 to a 2010 peak followed by

a prolonged period of retrenchment. Despite three small annual deficits (2010-12) savings averaged 2.6% of GDP over the period. Inflation continued at around the 2% policy mark, whilst unemployment declined slowly, averaging 5.3% during the period.

Figure 2 traces movements in three income categories (1) direct taxes such as taxes on income (2) indirect taxes such as sales tax, GST and customs' duties (3) other income (this last is particularly affected by classification and coverage problems).

Figure 2



The ratio of direct taxes to GDP is determined by the relative importance of the taxed income stream within GDP, the rate of taxation and, in the case of a progressive income tax, the thresholds at which higher tax rates become operative. With a fixed tax scale increases in real incomes and inflation, particularly important in the period under review, increase the proportions of taxpayers paying tax at higher rates so that, absent policy changes, direct taxes tend to rise as a ratio of GDP. In practice rates are adjusted downwards from time to time leading to the characteristic saw-tooth appearance, evident in our graph.

Over the longer haul, the chart shows significant shifts in the ratio of direct taxes to GDP. The period from 1948 to 1972 was relatively stable with direct taxes averaging 15.1% of GDP. During the 1970s the ratio rose sharply and averaged 20.8% of GDP over the twenty years to 1992. The upward shift stemmed largely from the action of inflation on a progressive tax scale. Yearbook data show that the average rate of income tax on persons rose from 19.6% in 1971-72 to 27.4% in 1981-82. Direct taxes trended downwards during the 1980s reflecting large drops in top tax rates and sharp reductions in the number of separate tax rates. The direct tax take rose during the Clark-Cullen years and then fell

sharply following the global financial crisis as a result of both cuts in rates and slowing income growth.

The ratio of indirect taxes to GDP is dominated by the introduction of GST in 1986, replacing the previous system of sales taxes. From 1948 to 1986 indirect taxes averaged 7.9% of GDP, from 1987 to 2018 10.6%, but this comparison is affected by the break in our data series.

The third category, other income, is the most difficult to read because of the data break between 1986 and 1987, which either coincides with a large lift in this variable or reflects a significant change in coverage or definition, or perhaps both. I have not been able to resolve this issue.

Figure 3

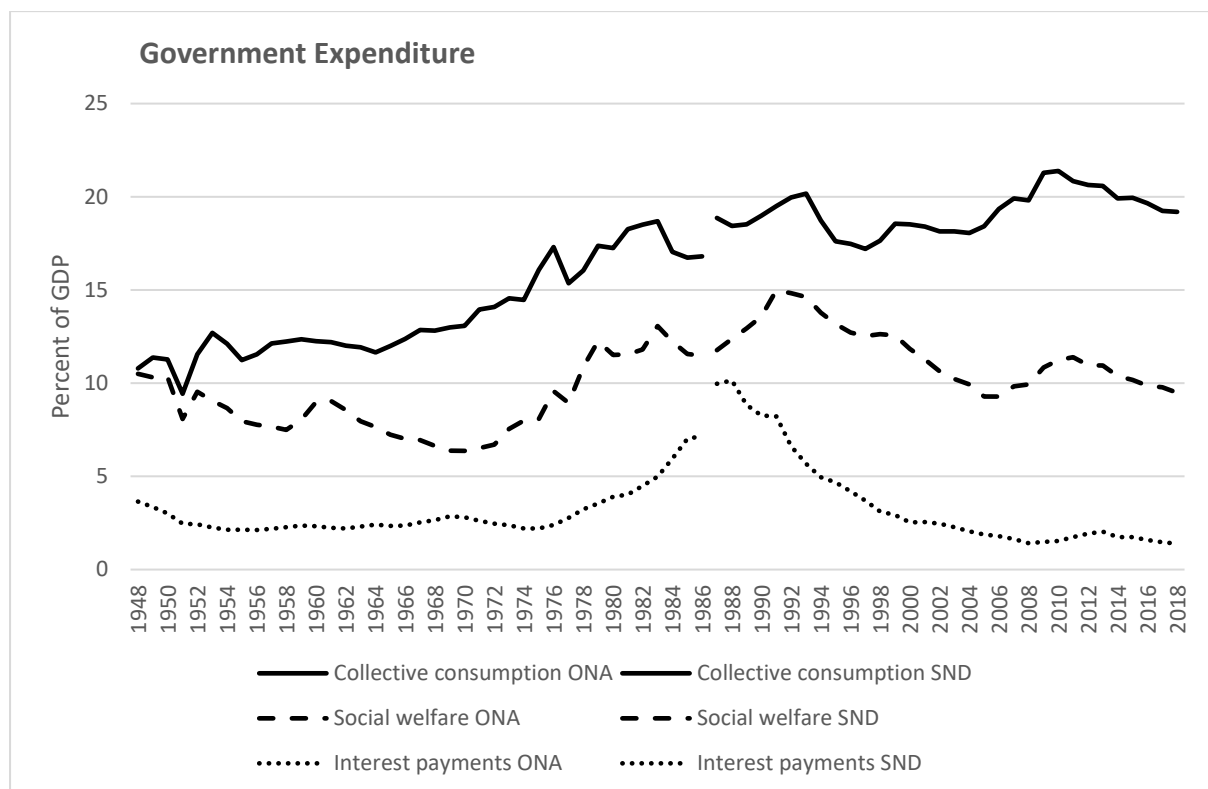


Figure 3 gives a threefold breakdown of government expenditure as recorded in the national accounts. The early post-war decades saw a rising trend in collective consumption as a share of GDP, offset by declining trends in social welfare and interest payments. In sharp contrast, the 1970s and 1980s were dominated by the upward track of all three categories. These were the Kirk and Muldoon years but more fundamentally they were the years following on from the breakdown, in the early 1970s, of the fixed exchange rate regimes that had characterized the early decades of the post-war world. New Zealand's own post-war model of a full employment economy operating behind quantitative import restrictions and high tariffs, effectively transferring economic rents from the pastoral to the urban sector, was under mounting pressure, not least from an expanding population and changing female (and male) work-force aspirations. In addition, external markets were under threat and further opportunities for import-substituting manufacture were limited.

These structural pressures were reflected in mounting domestic inflation and further fueled by increases in import and, on occasion, export prices. Finally, international inflation fed through to interest rates on New Zealand's external debt. International interest rates rose sharply in the early 1980s as policy makers in the major metropolitan economies adopted tight monetary policies.

Any reading of these trends for the years from 1972 to 1982 is bedeviled by the 1986-87 data break. What is clear is that each component was on a strong upward trend, peaking around the turn of the decade (1988 for interest rates, 1991 for social welfare, 1993 for consumption and 1991 for the combined total). We'll look at the detail of these changes below, but it is important to log the fact that these were large changes and that the aggregate shift in expenditure far outran the accompanying increase in revenue.

The decades from the 1990s have been difficult, with significant periods of austerity and the global financial crisis. Nevertheless, the economy has been on an expansion path with reductions in the level of unemployment in the lead up to the GFC and again in the recovery from that shock. Collective consumption fell during the 1990s, rose quite sharply from 2004 to 2010 and was then clawed back to something like the mean level of the last thirty years (19.2% of GDP).

In contrast social welfare and interest payments have been on unambiguous declining trends apart from brief rises following the GFC. It is these reductions that have driven the overall fall in government expenditure, relative to GDP, from a thirty-year (1989 - 2018) average value of 33.9%, to an annual 30.1% in 2018.

Figure 4

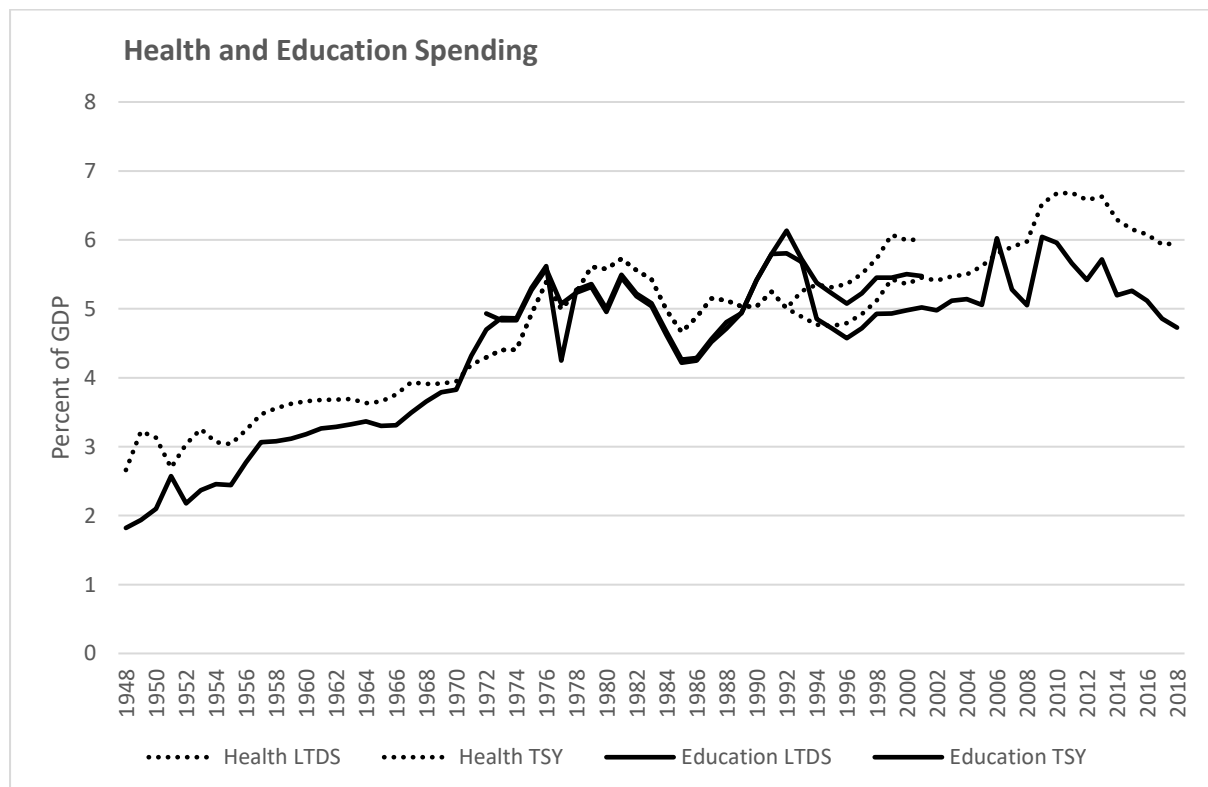


Figure 5 looks at health and education spending, the two largest items within collective consumption, as recorded in the old Treasury long-term data series (1948 to 2001) and the overlapping long-term fiscal series maintained on the Treasury website (1972 to 2018). The dominant first impression is the significant rise in both education and health spending, but a closer reading shows that the largest part of that increase occurred in the years to 1972. Since then education's share of GDP has fluctuated widely but in 2018 was slightly below that of 1972. Health spending also fluctuated, but less markedly and around a rising trend. The shares of GDP going to public health and education both declined during the past decade.

The long-term shifts are evident in Table 1.

Table 1 Health and Education spending as percent of GDP

	1948	1972	2018
Health	2.7	4.3	5.9
Education	1.8	4.9	4.7

These are large and important elements within the overall patterns of government and national spending. They inevitably invite questions about the adequacy and effectiveness of these services, but answers depend on much more detailed analysis. What are the underlying trends in population age composition, what changes have occurred in educational participation and in recourse to one or another element of the public health system, what are the relative cost trajectories of the various elements of health and education spending? All interesting questions but beyond my current scope.

The increase from a 4.5% share of GDP for combined health and education spending in 1948 to the current 10.6% is a large shift. As one who has benefitted from and am usually impressed by the services delivered, I am keen to see them adequately funded. At the same time, as with all areas of public activity, there is an ongoing need to test whether better ways of doing things can release funds for other uses in the system or beyond.

Figure 5

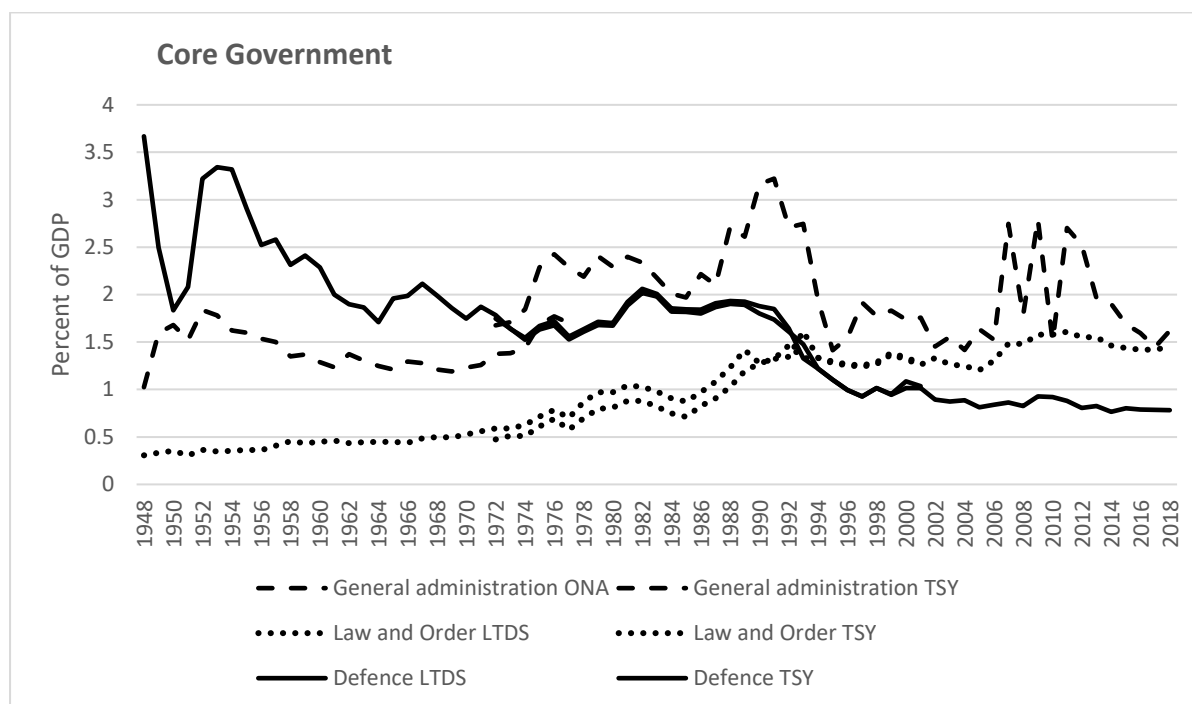


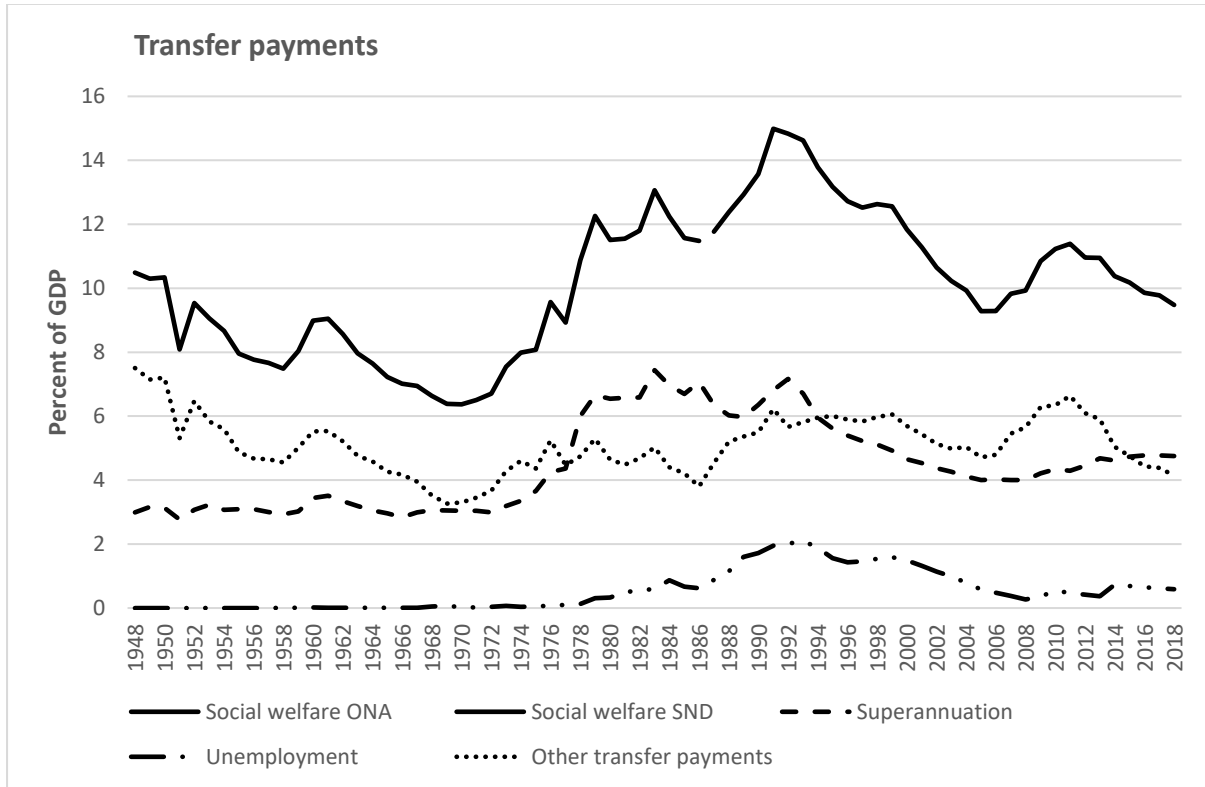
Figure 6 focuses on three elements of collective consumption, central administration, defence and law and order, something approximating the night-watchman core of the state. Data for Law and Order, and Defence are again from Treasury long-term data and long-term fiscal series. For General administration I use national accounting data for 1948 to 1977 and Treasury's long-term fiscal series for 1972 to 2018. The central administration series fluctuates erratically (reflecting in part statistical re-classifications) around a long-term average equal to 2.1% of GDP (Treasury series 1972 to 2018). In sharp contrast defence and law and order show substantial trend shifts over the post-war period. The post-war defence spending wind down was briefly reversed by the Korean War to 3.5% in 1953 but then fell steadily to as low as 1.5% at points in the 1970s, lifted to 2.0% in the early 1980s since when it has declined to 0.8% of GDP in 2018. Law and order (Police, Justice and Corrections) spending increased from 0.3% of GDP in 1948 to around 1.5% of GDP during the past decade.

Figure 6 replicates the earlier series for total social welfare transfers (as measured in the national accounts) and decomposes this into three categories, superannuation, unemployment and a residual item which I have labelled other transfer payments, but which might better be referred to as family assistance. It is a diverse grouping covering all types of family assistance other than that related to age and unemployment. Its composition changes significantly over the long period under review.

Total transfers ranged between a 1970 low of 6.4% and a 1991 peak of 15.0%. The 9.5% value for 2018, the last year in our series, was less than the 1948 value of 10.5%. The post-war mean value was 10.1%. Three phases are evident. From 1948 to 1972 falling levels of family assistance, resulting from progressive removal of consumer subsidies and the

inflationary erosion of a fixed rate child benefit, meant that by 1972 the GDP ratios of family assistance and total welfare payments had declined by 4.2 and 4.1%, respectively.

Figure 6

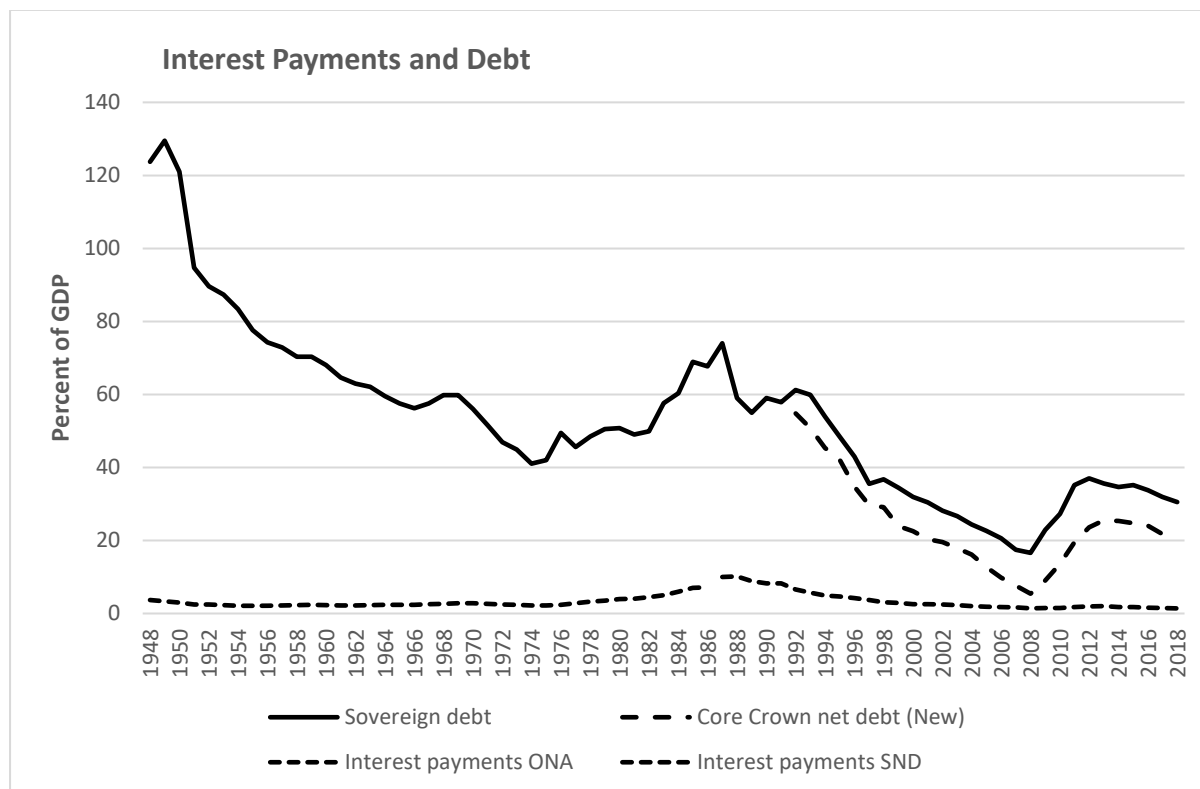


A sequence of policy changes drove transfer payments upwards between 1972 and 1992. The introduction of the domestic purposes benefit in the early 1970s was followed by the much more costly doubling in superannuation payments at the end of the decade. The 1980s saw increased levels of tax-based income support to families and significant growth in the level of unemployment. Total transfer payments rose from 6.7% to 14.8% of GDP between 1972 and 1992 (on our national accounting measure). The total shift of 8.1% was dominated by the 4.2% shift in the cost of superannuation complemented by a 2.0% shift in unemployment payments and a 2.0% shift in family assistance payments.

Figure 7 describes the evolution of total government debt and debt servicing costs over the last seventy years. Sovereign debt, which had reached a peak of 129.5% of GDP in 1949 followed a downward trend during most of the period (largely reflecting growth in nominal GDP), but with two significant periods of increased debt. The first, from a 1974 low of 41.0% to a 1987 peak of 74.0%, reflected the financing problems associated with increases in collective consumption and transfer payments in the post-Bretton-Woods years. Additionally, interest payments rose because of increases in debt and inflationary increases in interest rates. From 1987 debt ratios resumed their long-term falling trend, troughing at 16.6% in 2008, at which point the global financial crisis triggered a rise to 35.6% in 2013. By

2018 sovereign debt had fallen to 30.5% in 2018. The corresponding figure for net core crown debt, the measure currently used as a fiscal target, was 19.9%.

Figure 7



Interest payments on public debt, expressed as a percent of GDP, are recorded at the bottom of the chart. The cost of interest payments peaked at 10.1% of GDP in 1988 as compared with 3.6% in 1948 and only 1.4% in 2018. Expressed in relation to the quantum of sovereign debt the implicit average interest rate peaked at 17.2% in 1988.

Concluding comments on fiscal history

Looking back, four major points stand out:

1. It is useful to have long-term series descriptive of public revenues and expenditures that fit together within a balanced accounting framework. Deficiencies in the public record inhibit analysis and understanding of our post-war history. The system reported here (and the underlying workbooks) need to be linked to the IMF's *Government Finance Statistics Yearbook* series as now published by Statistics New Zealand. This should provide a steadily lengthening record in the years ahead.
2. Over the post-war period there has been a rise in the aggregate level of public consumption. We are asking government to do more, but alternating periods of

expansion and retrenchment remind us that getting this right (battling the conflicting pressures from left and right) is always politically fraught.

3. The post-war period has seen major swings in the relative importance of transfer payments. There have been significant compositional changes and major fluctuations in level, but it is striking that the total proportion of GDP being absorbed by social welfare payments at end is very similar to that at beginning.
4. The concurrent expansions in collective consumption expenditures, social welfare payments and finance costs in the twenty years following the breakdown of the fixed exchange rate system placed unsustainable pressures on the public finances and, more fundamentally, on New Zealand's post-war development model.

Fiscal Policy Objectives

Fiscal policy, complicated though it is, is but one element within wider macro-economic and development frameworks. Briefly stated, the macro-economic objectives, as I see them, are:

- High incomes, equitably distributed, and work, for an increasing population (the desirable size of New Zealand's population is debatable but taking that as given, gainful work, high incomes and equity remain as constants).
- A healthy public sector providing services and infrastructure. In looking at the role of the state we need to move beyond simple aggregation of individual utilities and recognize that the political process does define collective purposes.
- Stable prices, low inflation. Technical change and shifts in supply and demand generate ongoing changes in relative prices. Price stability is a relative term so that policy targets need to be selected carefully and policy makers need to be mindful of the inter-connections between inflation targets and other macro-economic outcomes.
- External sector. The well-being of New Zealanders depends upon a high level of interaction with the world economy. We are part of a global world and thus interested in the performance and governance of the international economy. For small high-income countries the external frontier provides great opportunities and severe constraints. Resource use is conditioned by external markets and the fortunes of our industries affected by competition from producers in other countries. These volatile forces must be married year by year through the balance of payments. For New Zealand the external balance of payments constraint is a fact of life.

Against these desiderata I juxtapose my understanding of the four main elements of official policy framework.

- A light-handed regulatory framework influences resource allocation (labour, capital and natural resources).
- Fiscal policy is anchored on Section 26G of the Public Finance Act, which required annual reductions in debt towards prudent levels, now achieved, and now requires that expenses shall be less than or equal to revenue, on average.
- Monetary policy administered by the Reserve Bank targets stable prices (and now employment) with the Official Cash Rate as the primary instrument.
- A freely floating exchange rate manages the external account, but New Zealand's net international indebtedness remains high.

This policy mix has certainly delivered on some important dimensions, inflation is low, the public accounts are in balance and public debt is low, the economy continues to grow. Against this we have three areas of ongoing stress, employment, social deprivation and an exposed international debt position. I don't discuss these in detail but two graphs from my presentations set up the dilemma.

Figure 8 compares New Zealand's inflation rate with the mean rate of three countries of special interest to us, Australia, the United Kingdom and the United States over the years from 1950 to 2018. Several features stand out. (1) There are two distinct inflationary periods, the brief Korean War inflation of the early 1950s and the prolonged inflation of the 1970s and 1980s, during the breakdown of the Keynesian consensus. (2) Although the New Zealand inflation rate generally follows the pattern set in the world at large (as mirrored in our three comparators) the New Zealand rate was significantly higher than the average for those three countries during the later 1970s and the 1980s. (3) The similarity between New Zealand and world inflation rates during the most recent decades places a caution against attributing our current low inflation rate solely to the workings of the Reserve Bank Act (influential though that has been).

Figure 9 charts the course of unemployment in New Zealand since 1955. There is a data break in 1986. From that point on figures are from the Household Labour Force Survey. Earlier figures are from Chapple's backward extrapolation, which has its critics, but the picture is broadly compatible with quinquennial census data. Characteristically, total unemployment was less than 2% up until the end of the 1970s, rising sharply to a 10.9% peak in 1991. It then trended downwards to around 4% before the global financial crisis lifted it to more than 6% for several years since when it has again fallen and was 4.4% in March 2019.

Figure 8

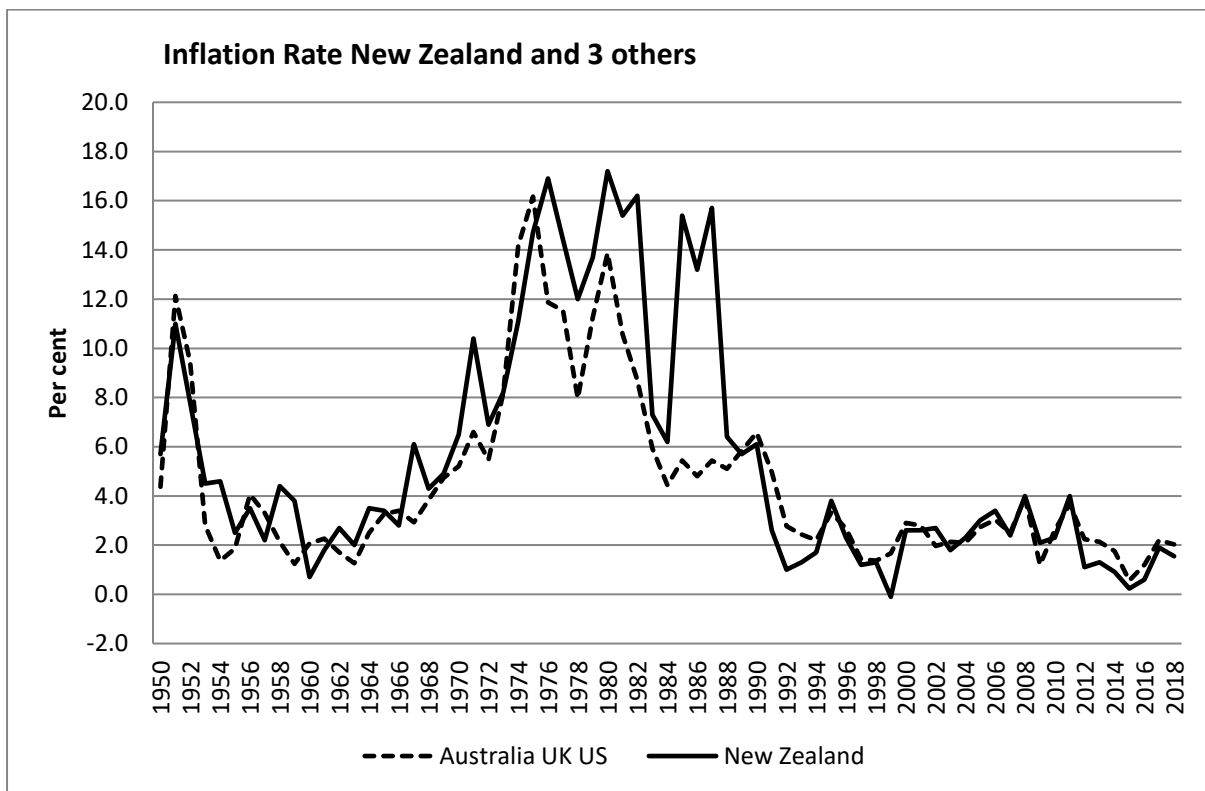
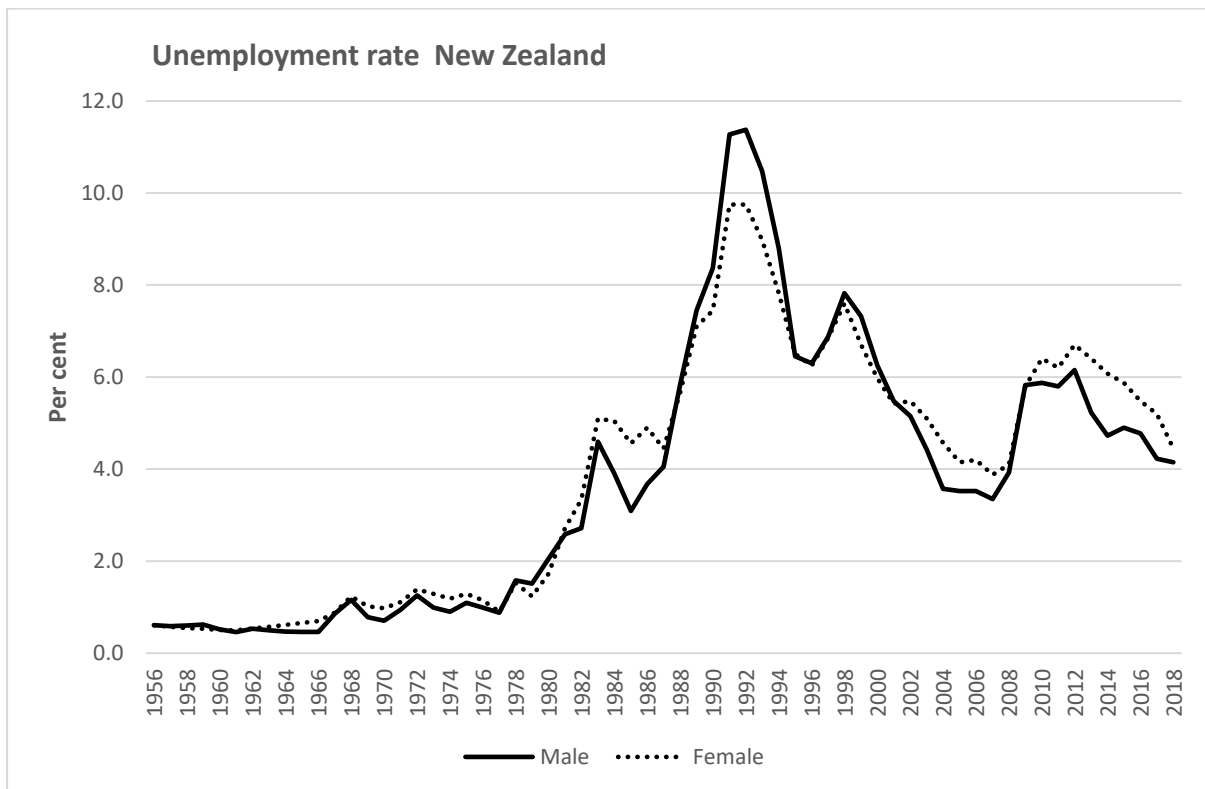


Figure 9



Unemployment on this scale not only damages those directly affected but reflects a failure to manage the economy to its full potential, with associated losses in output, income, consumption, public revenues and collective provision of goods and services.

The policy question is “Can we do better than that?”. And if so, what policies do we need? In what follows I focus on two issues (1) a re-framing of Section 26G of the Public Finance Act and (2) the circumstances under which fiscal stimulus might be sensibly provided by direct money creation by government.

These issues will remain live long after I have gone, and both need to be integrated within the wider framework of a comprehensive employment strategy.

What is a feasible target unemployment rate in today’s world? New Zealand was a very different place in the 1950s and 1960s. The population was less than half its present size, much more reliant on its rich pastoral base with a pre-ponderance of male single-earner families working within an economy protected by quantitative restrictions and tariffs. Today’s much more diverse labour force works in an open economy exposed to competition from all comers.

Still, as Simon Chapple recently pointed out, the OECD’s best performers have much lower unemployment rates than New Zealand (Czech Republic 2.1%, Japan 2.4% and Iceland 2.7%). These rates are not far removed from the 2% “frictional” unemployment figure adopted in my 1990 NZ Planning Council paper, *“The Fully Employed High Income Society”*, which noted that this corresponded approximately to levels then prevailing in Sweden and Japan

As I see it, a 2% unemployment rate is still a sensible target. In qualitative terms we should be aiming to have the lowest or one of the lowest unemployment rates in the OECD.

Re-framing Section 26G of the Public Finance Act

The current Act’s primary focus is on securing and maintaining a prudent level of debt. Levels of public debt are important but by themselves provide an inadequate guide to the formation of fiscal policy. Indeed, the single-minded pursuit of an overriding debt target can impose unnecessary austerity and deflect attention from other important considerations that should inform and guide fiscal policy.

There needs to be an argument about the elements of a more appropriate and comprehensive framework. Figure 10 contains a suggested redraft of the principal sections of 26G.

The suggested reformulation opens with six proposed guidelines, (a) to (f), which are discussed below. The final three guidelines replicate existing sub-sections of 26G.

Operating surpluses in times of growth.

The ongoing need for government capital formation and the desirability of funding some part of this from revenue rather than from borrowing indicates a need for operating surpluses on average over the longer haul. The scale of these surpluses

needs to be determined with reference to planned capital spending and to funding preferences.

Figure 10

Suggested reformulation of Section 26G Public Finance Act

Guidelines for fiscal management

- (1) The Government shall pursue its policy objectives in accordance with the following guidelines:
 - (a) Recognising the need for capital formation and other investments by Government and the desirability of funding some part of these from revenue, Government shall aim to achieve operating surpluses on average over the longer haul. The scale of such surpluses needs to be determined with reference to the planned scale of capital formation and other investments and to funding preferences.
 - (b) In times of recession or in the face of major external shocks government may judge it sensible to run deficits for a period. Any such decision needs to be justified with reference to the reasons for incurring a deficit and the approach the Government intends to take in returning to surplus and the planned time period for such a return.
 - (c) Judgements about appropriate future levels of debt shall be made within a framework that summarizes recent trends, acknowledges the interdependence of public and private sector debt within a balance of payments constraint, sketches the scale of planned developments and analyses the trade-offs that exist at the margins between operating revenue, operating expenditure, capital formation, other investments and borrowing.
 - (d) Judgements about appropriate levels of provision of public goods and services and of transfer payments shall be assessed with reference to the drivers of current programmes, assessment of their effectiveness, consideration of the cost of funding them and of their underlying democratic mandate.
 - (e) Fiscal settings shall be assessed with reference to their implications for broader economic objectives, including well-being, economic growth, full employment, price stability, external balance and the net international investment position, having regard to likely fiscal feedback and the interaction between fiscal policy and monetary policy.
 - (f) Fiscal setting shall be assessed with respect to their distributional implications.
 - (g) Revenue strategy shall be formulated having regard to efficiency and fairness, including the predictability and stability of tax rates.
 - (h) Fiscal strategy shall be formulated having regard to its likely impact on present and future generations.
 - (i) The Crown's resources are to be managed effectively and efficiently.

Licence to run deficits in times of recession

The Government needs explicit licence to run deficits in times of recession, if that is sensible in the circumstances, as in the wake of the global financial crisis. This is arguably the hallmark of a fiscal framework attuned to the fluctuating needs of the macro economy and is particularly relevant at times when official interest rates are near their lower bounds.

Debt guidelines that balance funding options for planned investments

Debt guidelines are pivotal in determining fiscal stance. Judgements about the appropriate level of debt over the next several years need to be taken within a framework that

- (1) Summarizes recent trends in operating revenue, operating expenses, government capital formation, other investments by government and government borrowing.
- (2) Acknowledges the interdependence of public and private sector debt within a balance of payments constraint.
- (3) Sketches the scale of planned future developments and analyses the trade-offs likely to exist at the margins between each of these potential funding avenues.

Establishing appropriate levels of public spending

A central function of government is the provision of collective goods and services and of transfer payments. Determining appropriate levels of these requires ongoing monitoring of current programmes, assessment of their effectiveness, consideration of the cost of funding them and of their underlying democratic mandate. Recent decades have arguably seen under provision in these areas reflecting unrealistically low spending to GDP targets.

Assessing fiscal settings within a macro-economic framework

Fiscal settings carry implications for broader economic objectives, including well-being, economic growth, employment, price stability and external balance. Section 26P(1) of the Public Finance Act requires three-year forecasts of GDP, consumer prices, unemployment, employment and the balance of payments current account, but does not require these to be taken into account in determining fiscal stance. Section 26G should make such a linkage.

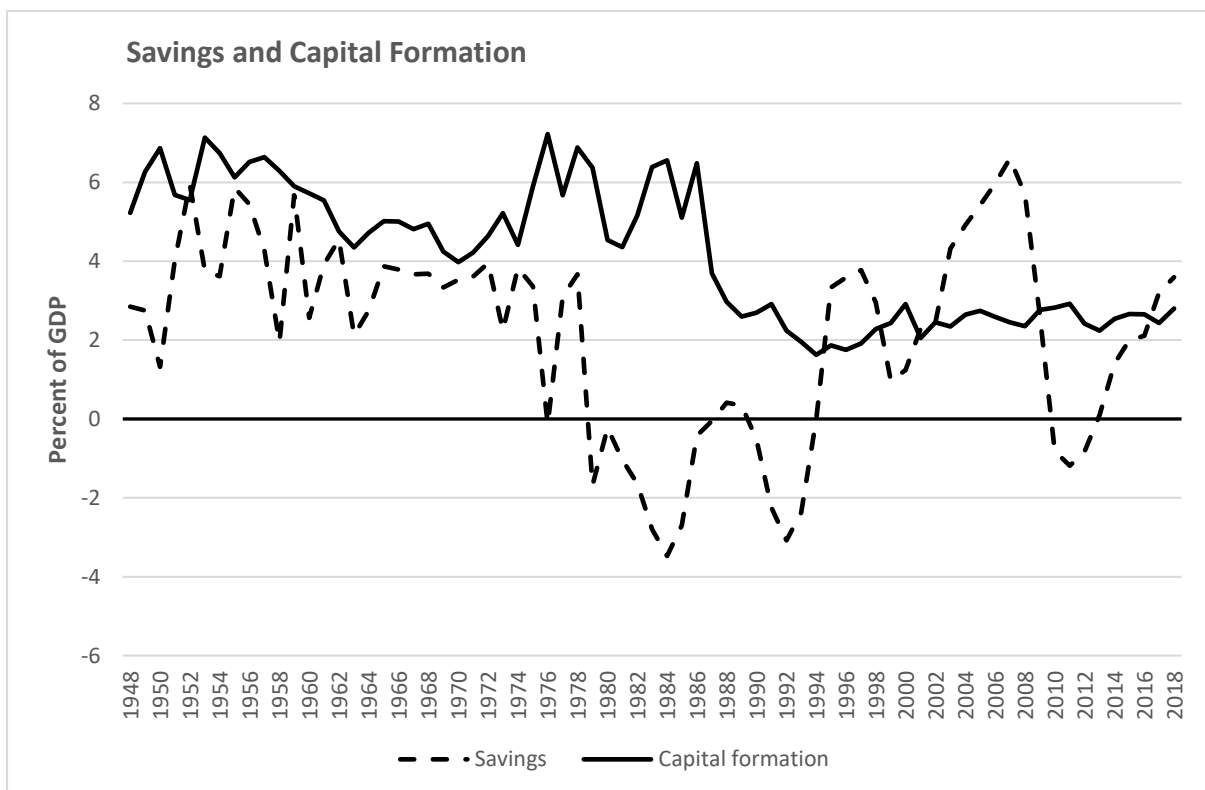
Assessing distributional implications of fiscal policy settings

Much public advocacy and commentary on fiscal matters focuses on the distributional implications of tax and spending policies. The progressivity in income tax, the regressive impact of flat rate expenditure taxes, such as GST, the impacts of income support to families, old people and socially disadvantaged individuals and groups, as well as entitlements to public education and health care, all carry distributional implications. Re-distributional measures have a fiscal dimension that should be evaluated in Budget documents.

The first three guidelines, surpluses in normal times, deficits on occasion and ongoing monitoring and balancing of the expected costs of debt against the expected benefits from investment of borrowed funds, revolve around the issues of public saving, public investment and debt.

Figure 11 records national accounting estimates of government savings and capital formation over the post-war period. The scale of public capital formation is lower now than in the early post-war decades, but for the seventy years to 2018 public capital formation averaged 4.2% of GDP and on average half of this was funded from the surplus on government's current account, 2.1% of GDP. There was a sharp downward shift in government capital formation between 1984 and 1994, probably attributable to the switch in policy preferences to a "small state" model and a reduction in Crown debt. For the two decades to 2018 central government capital formation was fully funded from government savings, both series averaging 2.6% of GDP. It seems likely that government will see a need to increase its level of capital formation in future. Any such decision needs to be made in parallel with a decision on the appropriate funding balance between government saving from current income and government borrowing.

Figure 11



Macro-economic objectives

The proposed subsection 26G(1)(d) reintroduces the idea of judging fiscal settings with reference to their implications for macroeconomic objectives such as economic growth, employment, price stability, external balance and the net international investment position. The 1989 Act deliberately eschewed such connections, reflecting a belief that active,

Keynesian, fiscal policy had been comprehensively discredited by the experience of the 1970s and early 1980s. Whilst fiscal policies during that period certainly evidenced the difficulty of identifying the direction of current economic developments and devising and implementing appropriate fiscal responses in a timely manner, they did not establish that governments should not consider the potential impact of fiscal settings and measures on the economy. The Global Financial Crisis demonstrated that such connections must be considered by any government interested in the welfare of its citizens.

The central point is that responsible fiscal policy must acknowledge that we live in a world of multiple (often conflicting) objectives. At a minimum the fiscal objective function needs to include output, employment and external balance in addition to inflation (currently assigned to the Reserve Bank) and public sector debt as governed by the Public Finance Act. The Budget documents should review trends in these multiple objectives and report what we know of their relationship to fiscal variables. To what extent do key fiscal variables influence macro-economic outcomes and to what extent is there feedback from those macro-economic outcomes to the fiscal variables themselves?

The pursuit of multiple objectives is not simple and involves unavoidable trade-offs. The early post-war decades showed that failure to resolve such trade-offs could lead to unsatisfactory outcomes. The policy re-design of the late 1980s and early 1990s showed that by focusing monetary and fiscal policy instruments on just two objectives, price stability and fiscal balance, both could be achieved but, as is evident from the record, in association with damaging levels of unemployment, continuing external imbalance and worrying levels of poverty and deprivation.

The re-formulated fiscal policy core outlined above attempts to sketch a more successful marrying of multiple objectives. Criticisms and suggestions will be welcomed.

“Unconventional” policy instruments

Internationally, responses to the GFC included extensive use of “unconventional” policy instruments including central bank purchases of government securities. Unconventional in the two decades before the crisis, but conventions change. In the early post-war decades money creation by central bank purchases of government securities was part of the norm, as evidenced by the New Zealand Monetary and Economic Council’s 1966 report on *The New Zealand Financial System*.

Following a discussion of the funding constraints faced by private sector actors, the Council argued:

“Government expenditure, (...), is not constrained by similar considerations, that is, by the possibility of raising sufficient taxation or borrowing from the public to match its expenditure decisions. Money creation, for example, by borrowing from the Central Bank, is an additional possible means of financing expenditure available in appropriate circumstances to Government but not to ordinary spenders. Strictly speaking, the level of Government expenditure is determined by decisions as to the type and volume of public services that the Government considers should be provided

in the general welfare. The extent to which Government should cover its expenditure by taxation, borrowing, or by money creation depends primarily upon an assessment of the extent to which the Government wishes to influence the general level of activity in the economy. In times when there is widespread unemployment of resources, it may be appropriate to finance expenditure by money creation, rather than by taxation or by borrowing. In times of full employment, however, such action would almost certainly increase inflationary pressures.

Similar arguments are advanced by many present-day economists, see, for example Adair Turner's *Between Debt and the Devil*, and by proponents of "modern monetary theory" who usually, like the Monetary and Economic Council, note the constraints arising from the approach to full employment and from external factors, including the fact (crucial for small open economies such as New Zealand) that governments cannot simply print foreign exchange.

It is important to acknowledge that the Monetary and Economic Council's focus was on the possible use, in appropriate circumstances, of money creation as a supplement to government's mainstream financing options through taxation and borrowing. The discussion in the following section focuses on some issues relating to money creation. The wider issues surrounding taxation and borrowing are not developed in detail in this paper but are outlined in the earlier discussion on reformulation of Section 26G of the Public Finance Act.

Some issues relating to money creation

The technical ability of governments to create domestic credit by instructing their central bank to purchase government securities is not in doubt. The substantive questions are

- (1) Under what circumstances is such credit creation appropriate?
- (2) Does such issuance inevitably lead to excessive government spending?
- (3) Does the exercise of this power compromise the central bank's ability to pursue its statutory objectives?

Proponents of money creation usually concede that the process is constrained by the approach of full employment, however defined, and by external constraints, inasmuch as any stimulus to domestic activity can be expected to spill over into demand for imports of goods and services, with an associated demand for foreign currencies.

Which takes us to the second question. The short answer is that, whilst there is no inevitable link between money or credit creation and excess there are plenty of historical examples where credit creation helped create unsustainable debt burdens. The decades preceding New Zealand's policy reforms of the 1980s and 1990s provides a contentious example.

Table. Central Government income expenditure, savings and debt as percent of GDP

(Decade means year ending)

	1958	1968	1978	1988
Central government income	27.3	26.5	28.4	33.3
Central government expenditure	21.7	22.4	27.2	37.1
Central government savings	5.6	4.1	1.3	-3.8
Sovereign debt	90.1	61.9	48.6	58.8

(National accounting series: I have over-ridden the 1986-87 data break so that the means for the decade ending 1988 may be slightly inflated. Savings and debt figures are not affected.)

Like many other countries New Zealand emerged from the Second World War with very high sovereign debt, equal to 124% of GDP in 1948. This ratio declined steadily during the 1950s and 1960s reaching a low of 41% in 1974. From that point on the head-winds of a severe terms of trade shock coupled with on-going stresses, both internationally and domestically, in the post-war Keynesian policy framework, placed the New Zealand economy under increasing pressure. In addition, central government spending increased strongly during the 1970s and 1980s with significant rises in final consumption expenditures, increases in welfare spending, including superannuation and family support, and significant rises in finance costs associated with rising interest rates and debt.

By 1987 the sovereign debt ratio had increased to 74% of GDP, as compared with 41% only thirteen years previous. Although the reforms of the 1980s were contentious there is little doubt that the policy makers were struggling with a difficult problem that demanded a response. But it would be wrong to characterize developments from 1974 to 1987 as the inevitable consequence of money creation or of Keynesian management. Better management of the policy mix over those years could have led to better outcomes.

Any exploration of money creation needs to consider current institutional arrangements, particularly the position and powers of the Reserve Bank. Ideally, the fiscal and monetary authorities would work in tandem, but differences of opinion are likely. Mechanisms to resolve such differences would potentially constrain either or both the Minister and the Governor and affect public perceptions on the independence of the Bank. These questions are explored in the following paragraphs, but they are large issues and need further development.

Money creation by ministerial fiat entails the sale of government securities to the central bank in exchange for cash. The government incurs a liability, equal to the value of securities sold and accesses a corresponding cash asset, available for spending. The central bank's balance sheet records matching entries, comprising the government securities as an asset and the cash issued as a liability.

By these means government acquires cash that can be spent in ways that will increase total demand, so stimulating aggregate production and moving the economy towards its “sustainable full-employment” objective, however that might be defined.

Two practical questions arise. At what interest rate are the government securities issued and is the central bank free to dispose of them on the open market at its sole discretion?

The obvious reference point is the “Official Cash Rate” (OCR), the central policy instrument of the Reserve Bank, which underpins the rate paid by the Bank on settlement account balances, held with it by trading banks, and the interest rate charged on overnight borrowing by such banks. The current OCR is 1.00% and, as usual, corresponds closely to rates earned on bank bills and to secondary market government bond yields. Some may argue that because the interest payment is from one arm of the government to another the rate is immaterial and could even be zero. The point is open for discussion, but my immediate concern is to articulate linkages that can be introduced with minimum disturbance to the current policy framework. So, I would opt for the OCR rate.

On the second question, allowing the central bank to dispose of government securities acquired through official money creation at times of its own choosing would potentially negate the policy and risk serious policy conflict. The monetary base can be expected to increase through time, but cyclical circumstances and the pressures arising from movement towards full employment may suggest a need to reduce the central bank’s holdings of government securities in some circumstances. The minimum pre-condition for such sales should be consultation between the Bank, the Minister and their advisors within a framework that determines who holds final authority (the Minister, the Governor or a Policy Committee). Clearly this is part of a wider control issue and demands detailed attention to the architecture and design of the control framework.

But, returning to the wider context, two points need to be made. First, the control framework for money creation needs to be integrated within the wider framework governing macro-policy instruments, including both fiscal policy (decisions on taxation, spending and borrowing) and monetary policy (influencing investment decisions and credit creation by banks). Secondly, macro-economic interventions have multiple effects. The sought for improvement in employment outcomes through money creation, as with any other stimulus, will be associated with the likelihood of some increase in inflationary pressure and in pressure on the balance of payments and thereby on the net international debt/investment position. And obviously, if money can be created through fiscal means it can also, if necessary, be removed from circulation through taxes or charges for government services.

And so we come back to the central feature of macro-economic policy making, namely the need to satisfactorily marry the attainment of full employment and price stability with internal and external balance. Give one or two of the four objectives primacy and they can be achieved, if need be, at the cost of under-performance on the others. New Zealand’s

experience demonstrates that. Aim for satisfactory outcomes over the four as a set and trade-offs between objectives may force acceptance of less satisfactory outcomes with respect to one or more of the objectives. Persistent failure may suggest revision of objectives.

The macro policy frame

The central features of the policy frame with respect to the four macro objectives are:

Well-being, economic growth and employment: In addition to a new preparedness to use macro policy instruments to stimulate demand, the full range of labour-market, industry, education, training and assistance policies remain in force and, as ever, should be under continuing review with the aim of improving performance. The case for demand stimulation itself needs to be moderated by ongoing assessment of possible impacts on the other three macro objectives.

Inflation: Under present arrangements the Reserve Bank is responsible for maintaining stability in the general level of prices and, since December 2018, supporting maximum sustainable employment and uses the OCR as its principle instrument to these ends. Our proposal to target employment directly through fiscal policy establishes a need for coordinating mechanisms as discussed above.

Internal balance: Our proposed section 26G (1) (c) establishes a framework for monitoring all public revenue and expenditure categories in terms of their contributions to aggregate well-being (or some alternative measure) and relating these to the marginal cost of government borrowing, so positioning the Minister of Finance to make periodic judgements about the desirable public debt to GDP ratio. This provides the basis for a more secure assessment of desirable and sustainable levels of public borrowing.

External balance: More frequent use of expansive fiscal policies can be expected to flow into demand for external resources, including imports of goods and services and external debt servicing costs. The floating exchange rate will moderate these pressures, but the continuing high level of New Zealand's net international liabilities evidences the continuing difficulties of shaping a productive structure that enables this country to pay its way in the world. The search for an optimal, sustainable New Zealand productive structure is an ongoing necessity.

As noted, these objectives are interconnected. They may conflict, in which case trade-offs are inescapable. The key requirement is for ongoing monitoring and analysis of such trade-offs as the basis for short- and medium-term policy judgements. In turn, such analysis requires us to identify, or to develop and calibrate, appropriate models that articulate the linkages between relevant variables in the system and enables exploration of their interactions through time.

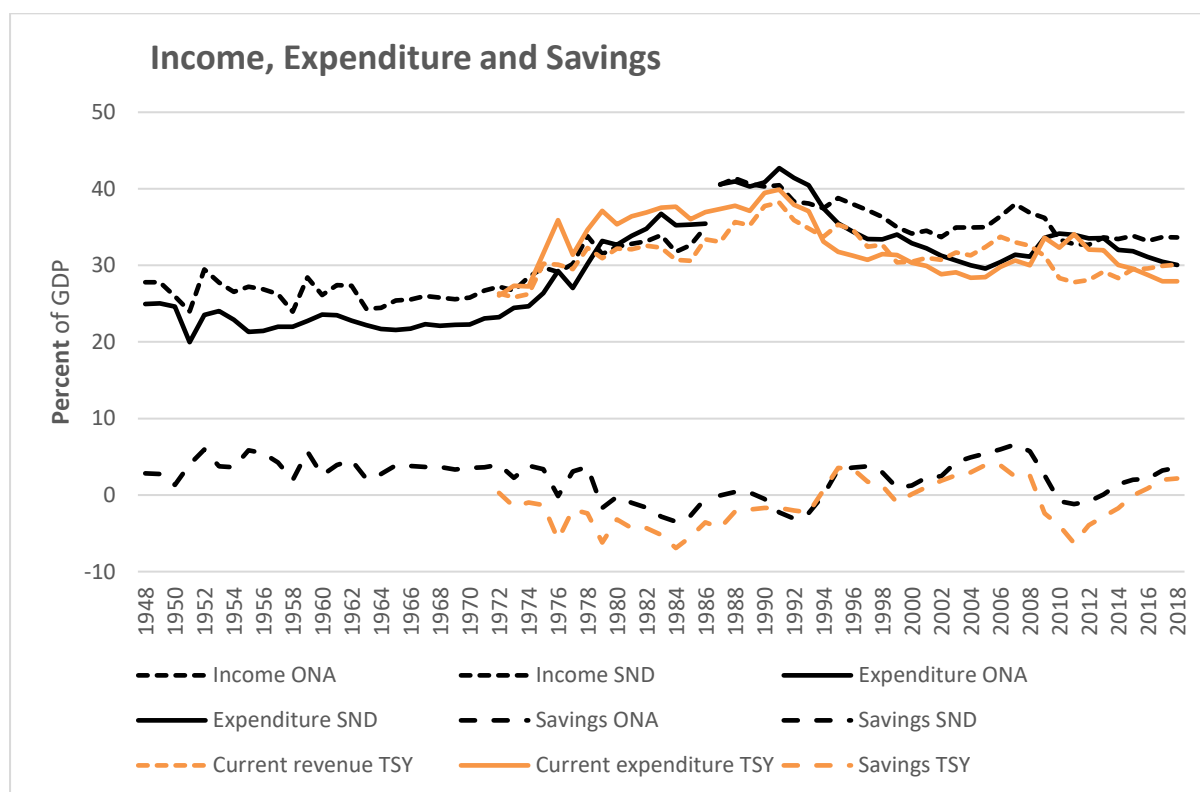
Suggestions, comments and criticisms welcome.

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Appendix Table 1

As noted above, the statistical record on government income and expenditure is tangled. National accounting standards have developed within a stable theoretical frame but there have been changes in practice and coverage and there is an unfortunate break between 1986 and 1987. Treasury data come from two main sources, the Long-Term Data Series, which end in 2002, and available on the Statistics NZ website, and Treasury's long-term fiscal series, which begin in 1972 (available on the Treasury website).

The following graph records the national accounting series, as in Figure 1 in our main text alongside long-term fiscal series currently maintained by the Treasury.



All national accounting data are printed in black with the original national accounts (ONA) spanning from 1948 to 1977 linked with data from supplements to the Monthly Abstract of Statistics, spanning from 1976 to 1986, and the contemporary national accounts (SND), as available on the Statistics NZ website and reaching from 1987 to 2018. The Treasury long-

term fiscal series, which refer to Core Crown, are printed in orange and span from 1972 to 2018. The differences in level between these two sources deserves further exploration

The Treasury long-term data series, stored on the Statistics NZ website, are drawn from multiple sources and I have not been able to derive a satisfactory LTDS based measure of the operating balance. The LTDS data provides a lot of information on trends in public spending and income, which has been used in discussing trends in education, health and other spending in the main text above. Matthew Gibbons' article, *Government Expenditure in New Zealand since 1935: a preliminary reassessment*, Policy Quarterly – Volume 13, Issue 2 – May 2017, provides an interesting comprehensive review.