

## **Spending Cap An Idea Whose Time Has Come**

Next month's budget is expected to include an announcement on some form of legislated cap on government spending. This could be one of the most important reforms the government has so far proposed.

The initiative was foreshadowed in last December's Budget Policy Statement, where the minister of finance Bill English noted that "Controlling the growth of, and getting better value from, government spending should be a permanent feature of the economic landscape."

The National-ACT Confidence and Supply Agreement also contained a commitment to refer "ACT's Taxpayer Rights Bill to the Finance and Expenditure Committee of Parliament as a government measure with the aim of passing into law a cap on the growth of core Crown expenses."

The Business Roundtable outlined the case for a formal spending constraint for central and local government (sometimes called a Tax and Expenditure Limit or TEL) in a 2004 report *Restraining Leviathan: A Review of the Fiscal Responsibility Act 2004*.

It argued that the Fiscal Responsibility Act (FRA) had brought greater transparency to the government's fiscal operations (thus avoiding post-election 'surprises', for example), and had created stronger disciplines around deficits and debt. However, it had been largely ineffective in curbing the upward trend in spending, and hence the overall tax burden.

This problem has been exacerbated with MMP. Economic research finds that countries with proportional representation systems have a propensity to bigger government as parties do deals at the expense of taxpayers. We saw that after the first MMP election in 1996 with the additional \$6 billion spending commitment engineered by New Zealand First.

Of course there is no 'right' general level of government spending. A country facing a serious security threat, for example, may need to devote

large resources to defence. Moreover, the quality of spending matters as well as the quantity.

But there is abundant evidence that the size of government in New Zealand has expanded well beyond optimal limits and that much spending does not represent value for money. Moreover, the high levels of taxation associated with big government discourage productive endeavour and reduce economic growth.

I know of only two examples of effective spending limits.

One is Hong Kong where its Basic Law (essentially its constitution) commits the government to keep its spending at or below 20% of GDP. Hong Kong's official policy of 'Big Market, Small Government' has served its citizens well: their average per capita income is now 75% higher than that of New Zealanders.

The other is the US state of Colorado where a TEL restricts the growth of government spending to the rate of population growth plus inflation, unless voters agree to increase the limit in a referendum. One such increase has been approved.

In its 2009 report on New Zealand the OECD advocated a spending rule for New Zealand and cited experience in Finland, Sweden and the Netherlands with such rules. They have typically taken the form of a real or nominal ceiling on spending over a term of government.

Such rules have been relatively ineffective, however. In all three countries government spending (on the OECD measure) is above 50% of GDP; in Finland it has leapt from 49% of GDP in 2008 to 58.4% in 2010.

New Zealand's experience with non-binding rules of this kind has also been unsatisfactory. The first Budget Policy Statement under the FRA (now part of the Public Finance Act) stated an intention to hold operating expenses stable in nominal terms for three years and to reduce expenses to below 30% of GDP. Neither target was met and the government was not effectively held to account for its non-achievement.

I would argue that any spending cap proposed by the government should be judged against three criteria: it should be binding (subject to referenda and with limited exceptions for valid reasons such as emergencies); it should be capable of being monitored on a year by year basis; and it should reduce the share of government spending in the economy over time unless voters choose otherwise.

A Colorado-type TEL would meet these criteria and was commended for consideration by the 2025 Taskforce. It would not be an unreasonable constraint. Core Crown expenses in real per capita terms were broadly stable and consistent with the rule in the 1990s until the advent of MMP.

The 2025 Taskforce rightly emphasised the importance of shrinking government spending as a proportion of GDP to facilitate private sector expansion and faster economic growth. A 2001 study for the Business Roundtable by Australian economist Winton Bates estimated that a reduction in total government spending from 40% of GDP (it is currently nearly 44%) to 30% would add 0.6% to the annual growth rate for 15 to 25 years.

This would be a large cumulative dividend. A hard cap would also force much greater scrutiny of low-value expenditures.

Credible moves in the May budget to implement spending constraints and advance a Taxpayer Rights Bill will be a litmus test of the government's commitment to faster growth and the goal of closing the income gap with Australia.

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