

EMBARGOED UNTIL 2:00 PM TUESDAY 13 SEPTEMBER 2005

CONFERENCE 9TH ANNUAL PUBLIC SECTOR FINANCE FORUM

GETTING BETTER VALUE FOR MONEY IN PUBLIC
SPENDING

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WELLINGTON
13 SEPTEMBER 2005

GETTING BETTER VALUE FOR MONEY IN PUBLIC SPENDING

My views on government spending can be summarized by the following parable: If you spend your own money on yourself, you are very concerned about how much is spent and how it is spent. If you spend your own money on someone else, you are still very much concerned about how much is spent, but somewhat less concerned about how it is spent. If you spend someone else's money on yourself, you are not too concerned about how much is spent, but you are very concerned about how it is spent. However, if you spend someone else's money on someone else, you are not very concerned about how much is spent, or how it is spent.

Milton Friedman

1. Introduction

At this forum last year I presented a paper that summarised a Business Roundtable study, *Restraining Leviathan: A Review of the Fiscal Responsibility Act 1994*, by Bryce Wilkinson. It concluded that the FRA (which is now part of the Public Finance Act) had served New Zealanders well, particularly in constraining budget deficits and debt, and in making the state of the government's finances more transparent. However, the legislation has done little to constrain government spending. A conclusion of the study was that the fiscal responsibility rules should be strengthened by the addition of a tax and expenditure limit (TEL) provision, along the lines of the fiscal constitutions of a number of US states. This would be a 'top down' constraint that would limit the rate of growth of government spending to population growth plus inflation, unless voters decided otherwise in a referendum. Surplus revenue would be returned to taxpayers. There would be provisions to deal with exceptional circumstances.

Fundamental to a TEL rule (which is sometimes called a taxpayer bill rights) is the idea that taxpayers should have more control over what they are asked to pay in taxes. There was a very revealing exchange on this point earlier this year when we appeared before parliament's Finance and Expenditure Committee to present our submission on the 2005 Budget Policy Statement. The committee's chairman objected to the idea on the

grounds that if taxpayers were asked to authorise spending increases they would decline to do so. The episode illustrated how detached some in the political establishment have become from their fundamental role as agents of taxpayers to whom they are accountable.

A TEL would only be one device for improving spending disciplines. It would not, by itself, deal with the problem of existing spending that is wasteful or poorly targeted. This requires complementary constraints and processes. In this paper I focus on two important issues – the need for sound guidelines for assessing value for money in spending and the need for a comprehensive review of base spending. Before doing so I review the nature and scale of the wasteful spending problem and discuss some of its underlying causes.

2. The cost of wasteful spending

Total government spending currently comprises central government current spending of 30–33 percent of gross domestic product (GDP), local government current spending of 2–3 percent of GDP, gross capital formation (both sectors combined) of 2–3 percent of GDP, and other capital spending of perhaps 0.5–1.0 percent of GDP. At close to 40 percent of GDP, this level of central and local government spending is inconsistent with sustained rapid economic growth. Finance minister Michael Cullen has demurred and pointed out that four OECD countries with such ratios of government spending achieved real per capita GDP growth of 4 percent or more since 1985. However, these countries achieved that feat only for periods of around 5 years. At least a 10-year period is needed to avoid the bias introduced by cyclical factors and to be consistent with the government's goal of returning New Zealand to the top half of the OECD income rankings. No comparable OECD country with a government spending share around New Zealand's level has achieved per capita GDP growth of 4 percent or more for a decade. Those that have grown this fast, such as Ireland and South Korea, have lower spending ratios.

The deadweight costs of taxation alone make it highly unlikely that rapid growth could be achieved with high levels of government spending, even if it were uniformly of high quality. There is ample evidence, however, that

much government spending in New Zealand is wasteful or poorly targeted. Yet core Crown expenses (excluding contributions to the Government Superannuation Fund) are currently projected to rise by a further 28 percent, or an additional 2 percent of GDP, by 2009.

The endemic problem of wasteful spending is evident from routine media reporting. One recent example among many is the Auditor-General's report in 2004 on spending by New Zealand Trade and Enterprise and the Visiting Investor Programme. An editorial in *The Dominion Post* noted that:

Controls on spending were so loose that it was not always possible to find out who had received money, or how much had been paid out. Monitoring of outcomes was inadequate ... The scenario is becoming depressingly familiar. A government agency dishes out the money with the best of intent but the worst of control. Inevitably the money is wasted, the politicians overseeing the spending bluster and there are promises that it will not happen again ... [Cabinet minister X] also resorts to the standard approach adopted when an organisation is found wanting – of saying it is all in the past. He says he has received assurances that the problems identified by the Audit Office are being addressed.¹

Unless assistance to businesses is motivated by genuine problems of market failure, most of it is likely to be wasteful because of its resource misallocation effects.

Another example is the observation by the OECD, in its 2005 survey of New Zealand, that New Zealand-resident enrolments in post-secondary education have grown by almost 35 percent since 1999, but that this reflected a proliferation of courses of low quality and/or remote career relevance. This has been common knowledge for many years, but dealing with it has obviously not been a priority. In the case of health, there has been a 26 percent rise in real spending per capita since 1999-00 but productivity appears to have fallen. For a range of operations that account for 44 percent of hospital costs, the Treasury has reported that a recent 7 percent rise in hospital funding produced only a 1.5 percent increase in outputs.²

A good deal of government social spending benefits middle and upper income households, the same groups that substantially fund it through taxation. A 2001 study found that in 1997/98, 27 percent of spending on

¹ *The Dominion Post*, 14 December 2004.

² Hansard, 8 June 2005.

health and education services, retirement incomes and other benefits went to households in the top 40 percent of taxpayers, which paid around 68 percent of all taxes.³ Such 'churning' of income, and the deadweight costs of taxation associated with it, does nothing for equity, is economically wasteful and damages economic growth.

The Working for Families package is another example of poor targeting. Around a third of its cost arises from assistance to families earning over \$35,000 a year after tax. It also increases average effective marginal tax rates and thereby harms growth.

Much wasteful spending occurs in the social welfare area. The United States has demonstrated that the combination of a freer labour market and stricter conditions of access to benefits can drastically reduce welfare rolls while leaving most beneficiaries better off. The 35 percent increase since 2000 in the number of adults on sickness and disability benefits in New Zealand defies logical explanations.

Another indicator of waste is an inability to stop programmes or reprioritise spending. A past secretary to the Treasury has observed that:

... it was interesting in the 2000 budget round that out of 500 budget proposals from spending ministers, only a handful offered up savings, particularly given that there was a new government in office, which may have wished to discontinue or reprioritise some existing programmes.⁴

Although the Labour-led government embarked on a value-for-money review, savings from baseline spending in the 2000 Budget amounted to only around \$65 million, 0.2 percent of spending. There has been no sign of ongoing reviews of value for money in subsequent budgets.

At various times the major government control agencies, the State Services Commission (SSC) and the Treasury, have commented on government spending programmes. A 1999 SSC Occasional Paper stated that departments were poor at explaining *ex ante* how outputs contribute to governments' desired outcomes. They were also poor at evaluating *ex post* how well their outputs contributed to these outcomes. It found that

³ James Cox (2001) *Middle Class Welfare*, New Zealand Business Roundtable.

⁴ OECD, *Economic Survey of New Zealand*, Volume 2002/8, p 70.

there were "few incentives for departments to provide robust information on the relationship of their outputs to the desired outcomes".⁵ In its 2002 briefing to the incoming government, the Treasury observed that government agencies could easily demonstrate efficiency gains in delivering services, but "cannot show to the same extent that services actually deliver the results that the government wants. This is a serious flaw."

The following statement by the OECD is a damning indictment of New Zealand's budgetary processes:

There was, and still is, no systematic framework for assessing value for money ... Although the budget process forces a detailed examination of new spending proposals, this represents only 5 percent of total expenditure. There is no centrally driven, systematic or regular review of the remaining 95 percent.⁶

This is a remarkable statement, especially given New Zealand's habit of regarding itself as a world leader in public sector financial management. No company operating in competitive markets could neglect to scrutinise its cost base regularly. Economic growth and living standards are sacrificed if government consumption spending and transfers do not represent value for money.

3. What explains excessive and poor quality government spending?

Waste in government can persist on a large scale for many reasons. For example:

- (1) vested interests may pressure governments for favours, such as subsidies or under-priced services, at the expense of taxpayers at large. Current election promises on student loans are a case in point;
- (2) the frequently short and uncertain tenure of politicians biases them in favour of policies that provide short-term political benefits at the expense of much greater future costs (eg national superannuation in 1975);

⁵ 'Improving Accountability: Setting the Scene', State Services Commission, Occasional Paper No 10, August 1999, p 24.

⁶ OECD, *op cit*, p 71.

- (3) politicians and state agencies have an interest in protecting state providers from competition, leading to high costs of production, reduced consumer choice and other inefficiencies in the supply of services (the ACC and Pharmac monopolies illustrate these points);
- (4) the excessive size of parliament and cabinet. Governments have ignored the view of voters in a 1999 referendum that parliament should be reduced to 100 MPs. A large cabinet means more ministers with spending roles;
- (5) cabinet ministers commonly lack expertise in contracting with state agencies and in managing large enterprises. State agencies may lack expertise in reducing waste;⁷
- (6) state ownership of commercial enterprises is typically less efficient than private ownership, and government provision may crowd out the private sector;
- (7) the bureaucratic, rule-bound nature of state welfare programmes make them ill-suited relative to private welfare for handling the highly personalised nature of many welfare cases;
- (8) mistaken policy ideas (such as the drive for self-sufficiency in energy that motivated the 'Think Big' programme);
- (9) bureaucratic incentives and agendas. State agencies have an incentive to expand their budgets rather than to offer up savings; and
- (10) the sheer size of governments, which exacerbates the problems of bureaucracy and militates against the kind of scrutiny of costs that occurs in the private sector.

At root these problems are the result of a failure by governments to establish a limited set of priorities and to execute them with a high degree of competence. The logical end of this road is the loss of any principled

⁷ Treasury states in its 2002 briefing to the incoming government that agencies are generally poor at evaluating, reporting and monitoring what they are doing. It suggests that this is in part due to lack of expertise, resistance from interest groups, cost and time.

concept of the fundamental purpose of government. This was vividly illustrated when the prime minister was asked why the government was putting taxpayers' dollars into the America's Cup challenge. She replied: "the Government's role was whatever the government defined it to be."⁸

What is needed is more public debate about what role for government will best contribute to the well-being of the community at large. The OECD and the Treasury in its 2002 briefing to the incoming government took a small step in this direction by suggesting, *inter alia*, that governments should not spend taxpayers' money before establishing that the programme would serve a clearly defined public purpose and was an appropriate role for government.

Unfortunately, these documents left open the question of what is a public purpose or an appropriate role. Standard economic analysis provides some guidance. It indicates that the first role of government is to protect individual rights, including security in property and freedom of contract. Other core duties include ensuring the provision, by state action if necessary, of public goods and a limited social safety net. Where the boundaries around the state are properly drawn can change through time due to things like changing technologies. There can also be legitimate political debate over matters such as income redistribution. Nevertheless, limited – not open-ended – government is an essential underpinning of any society that values freedom and prosperity.

4. What can be done?

In its 2002 survey, the OECD recommended that New Zealand:

- continue to improve the machinery of government (better evaluation, greater focus on outcomes, less fragmentation, multi-year appropriations);
- raise the effectiveness of social spending (more pro-active administration, greater focus on work incentives);

⁸ 'Clark promises tax money for new cup bid', *The Dominion Post*, 4 March 2003.

- make greater use of market mechanisms (contracting-out, competition in education, health and accident insurance);
- strengthen top-down spending control (set timeframes for objectives, fund capital spending in part from privatisations, maintain fixed departmental baselines); and
- reconsider local government reforms (legislate principles for appropriate activities, establish a top-down control framework, consider spending caps, encourage efficient user charges, and review the power of general competence).

This is a sensible list although it is not comprehensive. It does not cover issues such as the MMP electoral system,⁹ the number of MPs in parliament, options for making the executive more accountable to parliament, greater use of direct democracy (strike-down referenda), better spending guidelines, or a spending review commission. Some of these options were canvassed in section 5 of *Restraining Leviathan*. More recently, Richard Prebble has put forward some interesting ideas for making the executive more accountable to parliament.¹⁰

One of the OECD's most important suggestions is to look for opportunities to make greater use of competition and choice. Competition is the most powerful mechanism available for improving value for money in respect of private goods. Public provision of private goods is particularly undesirable because of the conflict of interest it creates when governments are both regulators of markets and owners of organisations operating in them. This is a problem in energy, water, transport, accident compensation, education and health.

Time and space do not permit canvassing all the options for obtaining better value for money in public spending. In the remainder of this paper I explore just two of them, government spending guidelines and the issue of a zero base review of government spending.

⁹ Overseas research suggests that proportional voting systems tend to increase government spending by about 5 percent of GDP. See Torsten Persson and Guido Tabellini, 'Constitutions and Economic Policy', *Journal of Economic Perspectives*, Vol 18, No 1, Winter, 2004, pp 79-98.

¹⁰ See Richard Prebble, '150 Years of Parliament', 24 May 2004, at www.act.org.nz/mews-article.aspx?id=25694.

5. Government spending guidelines

Despite Treasury's comment that government agencies lack expertise in evaluating their spending programmes, it is astonishing that no Treasury guidelines on government spending exist. This contrasts unfavourably with the effort the Ministry of Economic Development has made to improve the quality of regulatory policy through the requirement in the Cabinet Office Manual for a Regulatory Impact and Business Compliance Cost Statement to accompany regulatory proposals. Treasury should encourage a more principled approach to government spending by producing a set of government spending guidelines and providing training in their use.

What might a good set of guidelines look like? One possibility would be to adopt a framework similar to that adopted in the guidelines for evaluating government regulations. These require, *inter alia*, that (1) the problem be defined and its causes established; (2) a public policy objective be determined that is not so narrow as to prejustify the recommended policy; (3) all practicable alternatives be identified, including market alternatives, and (4) the benefits from the recommended course of action should exceed the costs when compared to the best alternative course of action. Such a set of guidelines for government spending would, if adhered to and applied professionally, make it harder for wasteful spending to persist.

Nevertheless, experience with regulatory policy making should be heeded. Many poor quality regulatory proposals continue to be adopted, and many regulatory impact analyses have been weak. In part, this reflects a lack of will and competence on the part of ministers and departments. It also reflects the limitations of cost benefit analysis. A study commissioned by the Business Roundtable and other business organisations concluded that additional disciplines of a constitutional nature should be applied to regulatory policy making.¹¹

A similar approach should apply to the evaluation of government spending. Governments should not spend taxpayers' money unless:

¹¹ See Bryce Wilkinson (2001) *Constraining Government Regulation*, New Zealand Business Roundtable, Federated Farmers of New Zealand, Auckland Regional Chamber of Commerce and Industry, Wellington Regional Chamber of Commerce.

- for a sound public policy reason (relating to public goods or a social safety net, including underwriting access to services such as health and education);
- the benefits for citizens are rigorously demonstrated rather than perceived or assumed;
- all realistic alternatives, including voluntary arrangements and non-spending alternatives, have been examined and found inferior;
- the spending programme conforms with sound constitutional principles, in particular principles governing parliament's delegation of the power to tax and spend;¹²
- a careful assessment has been made of the possible unintended and undesired consequences of the programme (particularly the likely crowding out of voluntary provision, eg private schools or hospitals);
- consideration has been given to whether it will be possible to assess whether the programme is producing the intended results, and to terminate it if not;
- there is compelling evidence of willingness to pay – ideally evidence of support by a super-majority of taxpayers. Referenda, as used in Switzerland and other countries, could be used to assess taxpayer willingness to pay for major programmes; and
- a competent analysis shows that the benefits of spending exceed the costs when compared with the best alternative course of action.

In considering this checklist it should be noted that unsatisfied wants in the community do not constitute a sound public policy reason for government spending. Individuals always have unsatisfied wants because they are always budget-constrained. The government document *Opportunities for*

¹² "A long-standing principle under the Westminster style of government is that no expenditure of public money can take place without the prior approval of government", *Putting it Together*, Treasury, 1996, Wellington.

All New Zealanders that was released in December 2004 illustrates the importance of this point. It reported on programmes amounting to 78 percent of core Crown expenses but did not explain problems with private arrangements that might justify those spending programmes or raise any value-for-money considerations. The implicit assumption was that whenever there was an unsatisfied need, more government spending was desirable regardless of its efficacy.

Where government programmes are tax-financed, the spending guidelines should explicitly take into account the deadweight or economic costs of taxation. The current tax system in New Zealand probably imposes economic costs of at least 50 percent for the last dollar of revenue raised.¹³ To produce a net gain in welfare, therefore, \$1 of marginal government expenditure has to deliver a benefit of at least \$1.50. Many current government programmes would not pass that test.

6. Review of base spending

If a government were determined to undertake a zero base review of government spending, how should it go about the task? Past experience suggests approaches that would be unlikely to be fruitful. Across-the-board spending cuts and 'sinking lid' policies are arbitrary in their effects in that they may eliminate desirable spending while leaving unjustified programmes in place.

A more fundamental approach is required. The first step would be a screening aimed at determining which programmes serve a public purpose and represent an appropriate role for government.

This filter should identify a large number of activities as candidates for opening up to competition or withdrawing government from entirely.

Leading candidates would be government commercial enterprises. Exiting from these activities both contributes directly to economic growth and allows governments to focus on performing their core roles better.

¹³ For an explanation of this figure, see Roger Kerr, 'Some Issues in the Current Tax Debate', 8 September 2005.

The role of governments in providing other private goods should be critically assessed. Greater use of user pays policies, reduced middle class 'churning' and targeted assistance, in combination with private sector competition, would reveal whether such services represented value for money in the eyes of users.

The remaining programmes would be concentrated in the core public good functions of government that are less amenable to the disciplines of competition and choice. This necessitates greater emphasis on clarifying objectives, allocating decision rights and monitoring and rewarding performance. An important task here would be to revitalise public sector management. The impetus to better performance dating from the second half of the 1980s appears to have waned.¹⁴

An approach that has been adopted by a number of governments is to set up an independent spending review commission or task force. Such an exercise has not been undertaken in New Zealand for many years and could have merit. It would allow the government to tap expertise from outside the public service and get well-informed and independent advice. A review would desirably be headed by a person with experience in monitoring and control issues in the private and state sectors.

Such a review group should operate on the basis of the spending guidelines discussed in the previous section. It should assess whether major spending programmes conformed with them and, if not, recommend whether they should be modified or axed. Because of the scale of the task, the review group should be supported by resources able to make more detailed investigations where specific expertise is required, for example defence. The Treasury should be fully involved with the work of such a group. Besides its value to an incumbent government, a high quality report would contribute to well-informed public debate on public spending, in the same way that past taxation reviews have raised the quality of debate on tax issues.

¹⁴ For a review of public sector management and suggestions for improvements, see Graham Scott (2001) *Public Management in New Zealand: Issues and Challenges*, New Zealand Business Roundtable.

A spending review group could also make recommendations on how base spending should be reviewed each year. There seems no reason why government agencies should not follow best practice in the private sector.

There are many examples of spending commissions and task forces that have produced meagre results. Critical success factors in such exercises include a focus on core principles for government operations, political determination, and public understanding of the benefits of more limited government.

It should also be noted that many policy actions that governments can take have indirect impacts on public spending. Reforms to labour market regulation, for example, can boost job creation and reduce welfare rolls. Tax reductions can facilitate greater use of charges for government services, at least in the case of better-off groups. Greater use of the private sector in the provision of infrastructure can reduce government capital expenditure. Regulatory reform can reduce the need for spending on regulatory agencies.

In general, the adoption of more vigorous pro-growth policies can raise private incomes and reduce demands on governments for services or assistance.

Reducing the share of government spending in the economy by a combination of keeping spending growth below the growth rate of the economy and cutting wasteful spending is feasible, as the experience of many countries demonstrates. In its recent budget the Hong Kong government projects a fall in public spending as a percentage of GDP from 20.2 percent in 2005-06 to 16.0 percent in 2009-10, and a cut in actual spending in that period.

7. Concluding comments

Wasteful spending in government is a worldwide problem that worsened in the industrialised world with the growth in government from the 1960s.

There is evidence that the expansion of government has harmed economic performance without improving social outcomes.¹⁵

The will to provide value for money in government spending is weak because accountability to taxpayers and the public more generally is weak.

Effective responses to this problem require action across a broad front. Fundamental to all of them is the need for much greater public awareness of the need to focus government on its core activities and to allow competition and choice to discipline spending wherever possible.

The executive needs to be more accountable to parliament and parliament more responsive to the interests of taxpayers and less responsive to the lobbying of vested interests that wish to benefit at the expense of the community at large. A tax and expenditure limitation rule could play an important role in empowering taxpayers.

This paper has focused on two other pieces in the jigsaw, the need for spending guidelines that incorporate a principled approach to determining a proper role for the state, and the task of reviewing base spending using these guidelines. Both activities are necessary and desirable; neither will be effective without political determination and progress on many other fronts.

¹⁵ See Vito Tanzi and Ludger Schuknecht (2000) *Public Spending in the 20th Century: A Global Perspective*, Cambridge University Press, Cambridge, United Kingdom.