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**Working Paper**

## Returning to Surplus: New Zealand's Post-GFC Fiscal Consolidation Experience

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# Returning to Surplus: New Zealand's Post-GFC Fiscal Consolidation Experience

Dhritidyuti Bose, Renee Philip and  
Richard Sullivan

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New Zealand Treasury Working Paper 16/05

December 2016



THE TREASURY

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**NZ TREASURY WORKING  
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Returning to Surplus: New Zealand's Post-GFC Fiscal Consolidation  
Experience

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December 2016

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## Abstract

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New Zealand's fiscal outlook deteriorated following the Global Financial Crisis, and in late 2008 fiscal projections showed net government debt in New Zealand increasing from 5% of GDP to around 40% within 10 years, mostly reflecting permanently lower expectations for future tax revenue. These circumstances were compounded by the significant costs associated with the Canterbury earthquakes in 2010 and 2011. The structural deficit peaked at 4% of GDP in 2011. In 2011, the Government set a target to return the Budget to surplus by 2014/15, and stepped up its fiscal consolidation programme. A surplus was achieved in that year, and net debt has now peaked just above 25% of GDP. The surplus was achieved predominantly by slowing the growth rate of nominal spending so that expenses-to-GDP declined. The slowing in expense growth reflected a combination of factors including programme savings, efficiency savings, reprioritisation, and slower public sector wage growth. New Zealand's fiscal management approach – a combination of fixed nominal baselines for most expenditure alongside comprehensive top-down constraints on new spending through the Budget – provided effective tools for controlling expense growth. Nevertheless, the return to surplus is only the first step in fiscal consolidation and challenges remain to ensure these surpluses are sustained, and to rebuild the fiscal buffers that existed prior to 2009.

### **JEL CLASSIFICATION**

E62 – Fiscal Policy  
E65 – Studies of Particular Policy Episodes  
H62 – Budget Deficit; Surplus

### **KEYWORDS**

Balanced Budget; Fiscal policy; Fiscal institutions; Fiscal Management Approach; Fiscal Policy; Fiscal Target; National Budget; Public Finance Act; Surplus

## Executive Summary

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The New Zealand Government's announcement of an operating surplus in 2014/15 after six years of deficits was an important milestone on the path of fiscal consolidation. However, the consolidation is not complete, with net debt remaining above the Government's stated target range. Nevertheless, the achievement of surplus is an appropriate point to look back at how it was achieved and the prevailing conditions.

Prior to the Global Financial Crisis (GFC), New Zealand had experienced a sustained economic expansion and registered a succession of operating surpluses. These surpluses were considered structural at the time leading to increasing pressure to spend or disperse the surplus. There were increases in spending and reductions in tax over Budgets 2005-2008 including a significant package of tax reductions announced in Budget 2008. Despite this additional spending, surpluses were sufficiently large that the balance sheet was strengthened and net debt fell to around 5% of GDP by 2008.

Late 2008 saw the onset of the GFC and the election of a new government in New Zealand. The GFC placed considerable strain on government finances as was seen in many countries around the world. The New Zealand economy contracted by more than 3% from the beginning of 2008 to the middle of 2009. By December of 2008 the Treasury was no longer forecasting surpluses but instead projected persistent operating deficits and marked increases in net debt. The incoming Government announced measures to support the economy such as bringing forward capital spending, support for small-to-medium enterprises and implementing the already announced tax reductions.

Budget 2009 forecasts showed a reduction in New Zealand's potential output and higher structural operating deficits. This Budget began the process of consolidation by reducing future allowances for new spending, postponing future tax reductions and suspending contributions to the New Zealand Superannuation Fund.

The recovery from the GFC proved to be slower than initially expected, and tax revenues were revised down accordingly, increasing the degree of consolidation required to return to surplus. Further, the Canterbury earthquakes of 2010 and 2011 imposed additional significant costs on the Crown, estimated to be more than \$17 billion.

The operating deficit peaked at 8.9% of GDP in 2011 and later that year the Government introduced a target of achieving operating surplus by 2014/15 "subject to any significant shocks".

Fiscal policy became contractionary from 2011. 'Net zero' Budgets were presented in 2011 and 2012, indicating no net increases in government expenditure. Future operating allowances, or the amount of new discretionary spending, were reduced in all forecast Budgets.<sup>1</sup> Core Crown expenses declined by around 4% of GDP from 2011 to 2015, as the growth rate of nominal expenses was lower than GDP growth.

The slowing in expense growth reflects a combination of factors. Programme savings were estimated to total around 0.5% of GDP per year from Budget 2011, and measured efficiency savings were expected to deliver about the same amount. In addition, there were some significant one-off costs in 2011 such as those associated with the Canterbury rebuild. Slower public sector wage growth and other reprioritisation within departments are also likely to have contributed.

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<sup>1</sup> For a description of how operating allowances work see "Guide to New Zealand Budgeting Practices" at <http://www.budget.govt.nz/budget/guide/budgeting-practices/index.htm>

New Zealand's strong fiscal institutions have played a significant role in the achievement of the surplus. The interaction of the Public Finance Act 1989, the fiscal management approach and state sector reform were key to the ability to reduce expenses without major cuts to services.

The principles of responsible fiscal management are legislated in the Public Finance Act 1989. Governments set their own fiscal goals subject to the constraint that they must be consistent with the principles, which include maintaining debt at prudent levels, managing fiscal risks while having regard to the sustainability of fiscal policy and the interaction with monetary policy. These self-imposed goals have had strong political support and as such, the current Government's aims of returning to surplus by 2014/15 and reducing net debt to around 20% of GDP by 2020 had strong commitment.

The fiscal management approach relates to the 'rules' applied to decisions to help the government carry out its fiscal strategy. Key to the approach are the concepts of fixed nominal baselines for existing spending (ie, no automatic inflation adjustments) and contestable operating and capital allowances to fund new initiatives and cost increases. This provides a high level of scrutiny over new spending and central control over aggregate spending.

State sector reforms over the period focused on providing incentives for agencies to innovate and improve within existing resources. Prior to the GFC, departments had become used to an absence of funding pressure and thus had relatively little incentive to focus on value for money. The Government set a priority of delivering better public services within tight financial constraints. In addition, in 2012 the Prime Minister set the public service 10 challenging results to achieve over three to five years (titled Better Public Services Results). These targets and reduced operating allowances necessitated reprioritisation within existing spending while the introduction of four year plans and an investment approach to welfare increased departments' focus on results.

Looking back, one of the key lessons was that having fiscal buffers in place helped the Government manage the fiscal consequences of the GFC, the 2008/09 recession and the Canterbury earthquakes by allowing the automatic fiscal stabilisers to operate. The challenge now is to restore these fiscal buffers so the government has a similar capacity should another adverse shock occur. Returning to surplus is only the first step in the consolidation process, the next step is reducing the debt-to-GDP ratio which requires sustaining surpluses.

Another lesson was that a clear target with strong political support can provide a useful focal point for Budget decisions. The self-imposed surplus target had strong political support, which also gained acceptance in the public service and the public in general. It was not without risks. The target encouraged greater scrutiny over operating flows rather than capital expenditure, which does not directly affect the operating balance. The focus on a particular year encouraged a short-term focus as the target date approached. As a result, the Government has recently introduced some flexibility in its debt target to help balance stability and sustainability objectives, though this may prove challenging to achieve in practice given uncertainty around the cyclical position of the economy.

The final lesson was that the ability of departments to adapt to tighter fiscal conditions has been greater than expected. Departments' own internal savings and reprioritisation delivered much of the consolidation, assisted by slower public sector wage growth. However, the efficiency frontier is unknown and the ability for departments to continue to find further savings and reprioritisation options may be low.

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# Returning to Surplus: New Zealand's Post-GFC Fiscal Consolidation Experience

## 1 Introduction

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As it did for most countries, the Global Financial Crisis (GFC) caused significant negative effects on New Zealand's economy and its fiscal position. Fiscal projections in late 2008 showed net core Crown debt in New Zealand increasing from 5% of GDP to around 40% within 10 years<sup>2</sup>. This reflected falling revenue and higher spending as a result of a weaker economic outlook, and discretionary policy changes, most of which were made prior to the GFC. The fiscal position did indeed deteriorate rapidly – the estimated structural balance<sup>3</sup> declined from around 2% of GDP in 2008 to -4% of GDP in 2011. These circumstances were compounded by the significant fiscal impact of the Canterbury earthquakes in 2010 and 2011, which have been estimated to have caused damage (to buildings, loss in income, etc) of around 10% of GDP<sup>4</sup>.

This paper aims to review New Zealand's fiscal consolidation experience following the GFC to draw lessons for the future. It assesses the economic environment and factors inherent in New Zealand's fiscal institutions that made the achievement of surplus possible, and the lessons learnt. The paper is a description of the events and outcomes, using time-series data and various vintages of forecasts to show the evolution of economic activity and the fiscal response.

This paper is organised into four sections. The first section introduces. Section 2 shows that seven years after the GFC the operating balance<sup>5</sup> and structural balance returned to a small surplus. It outlines the environment in which the consolidation took place and the phases of New Zealand's recent fiscal experience: the pre-crisis backdrop, the deterioration over 2008 and 2009, and the fiscal adjustments pursued since 2011<sup>6</sup>. It also discusses the contribution of fiscal policy to aggregate demand over these phases as well as the wider macroeconomic motivations influencing the pace of fiscal consolidation.

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<sup>2</sup> Based on the current definition of net core Crown debt, which was introduced in Budget 2009 (see Appendix 1 for details).

<sup>3</sup> Key concepts such as 'structural balance' are defined in Appendix 1.

<sup>4</sup> Parker and Steenkamp 2012.

<sup>5</sup> Unless otherwise stated, operating surpluses or deficits in this paper refer to the operating balance before gains and losses (OBEGAL). New Zealand's operating balance and other fiscal indicators are not directly internationally comparable (see Appendix 1).

<sup>6</sup> This paper focuses on New Zealand's fiscal adjustment since the GFC in 2008. Other papers (See Janssen, 2001, 2015) have analysed New Zealand's fiscal adjustment experience of the 1990s. New Zealand had implemented fiscal consolidation and introduced the Fiscal Responsibility Act (FRA) in 1994 (subsequently incorporated into the Public Finance Act) in response to the deterioration of debt in the early 1990s. The fiscal adjustment was primarily expenditure based and contributed to achieving an operating surplus in 1994, the government previously having run deficits since 1979. Operating surpluses were maintained until 2008.



It also shows the fiscal outcome is significantly better than was expected at the end of 2008. Further, it demonstrates that the improvement has been achieved predominantly through adjustments on the expenditure side, without significant increases in tax rates or major cuts to government services or benefit levels. This is despite the fact that the economy, and to a lesser extent tax revenue, has grown more slowly than expected in late 2008.

Section 3 considers the role of the various institutional factors in New Zealand that have supported the fiscal consolidation and the relative importance of these. It shows that the recent fiscal experience has been supported by the Government's fiscal targets, and in particular, the high-profile goal to return to surplus by 2014/15. This self-imposed target provided political motivation to eliminate the deficit. New Zealand's fiscal management approach – the combination of fixed nominal baselines and top-down constraints on new spending through the Budget – provided an effective tool for controlling operating expense growth. Further, changes to the operation of the state sector shifted the focus of departments from increasing spending towards working together to achieve results within an assumption of limited new funding, which has also helped achieve significant savings and reprioritisation.

The fiscal consolidation is not complete and Section 4 concludes by outlining some of the remaining challenges. There remains uncertainty around the level of the structural surplus, and forecast surpluses for the next two years are small making them vulnerable to adverse shocks. Net debt remains above the Government's debt objective.

## 2 Phases of recent fiscal experience

---

### 2.1 Pre-crisis backdrop

In the lead up to the GFC New Zealand experienced a sustained period of economic expansion, with real GDP growth averaging nearly 4% per year from 1999 to 2007<sup>7</sup>. Spurred on in part by the rapidly improving terms of trade, strong migrant inflows and a strong global economy, the beginning of the century saw solid growth in employment, incomes, consumption and investment. Domestic demand was the main driver of growth and the cycle was associated with high credit growth and high house price inflation. Consumer price inflation had been near the top of, or above, the 1-3% target range for much of the 2000s and official interest rates rose from 4.5% in March 1999 to a high of 8.25% in July 2007.

In the early 2000s the Government's fiscal strategy aimed to increase operating surpluses to a level sufficient to repay debt and to accumulate financial assets in the New Zealand Superannuation Fund (NZS Fund).<sup>8</sup> Initially this strategy was achieved by managing expenditure growth. However, by the mid-2000s tax revenues were consistently higher than expected reflecting stronger-than-expected economic growth (Mears et al 2010), and the surplus rose quickly.

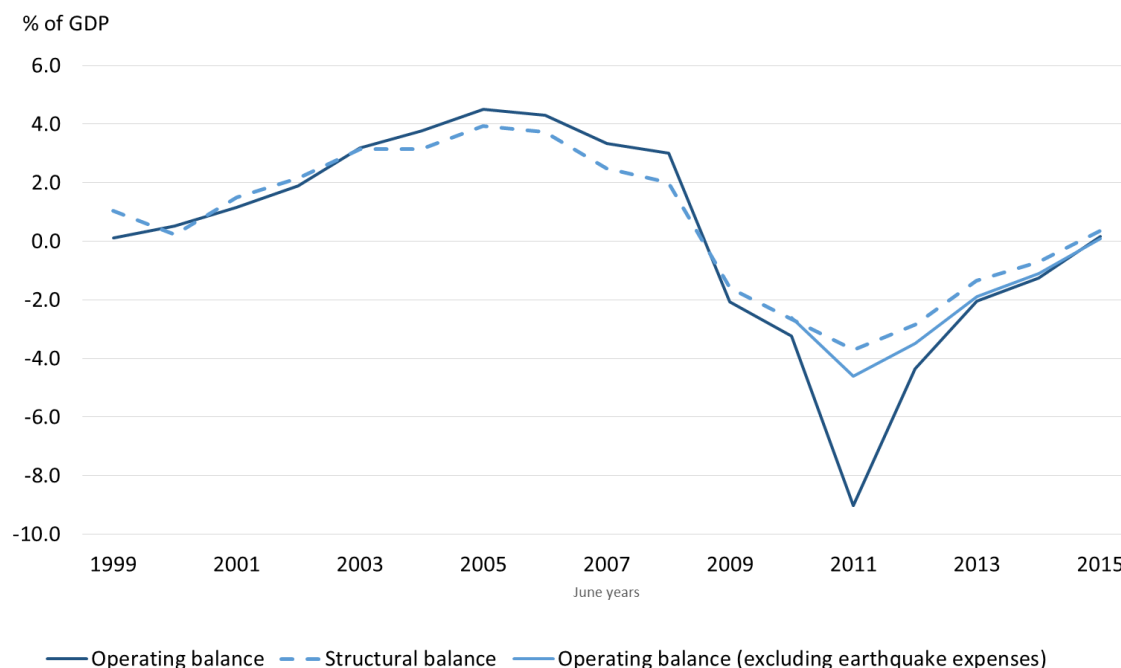
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<sup>7</sup> Unless otherwise stated, economic and fiscal data reported in this paper refer to fiscal years ending June.

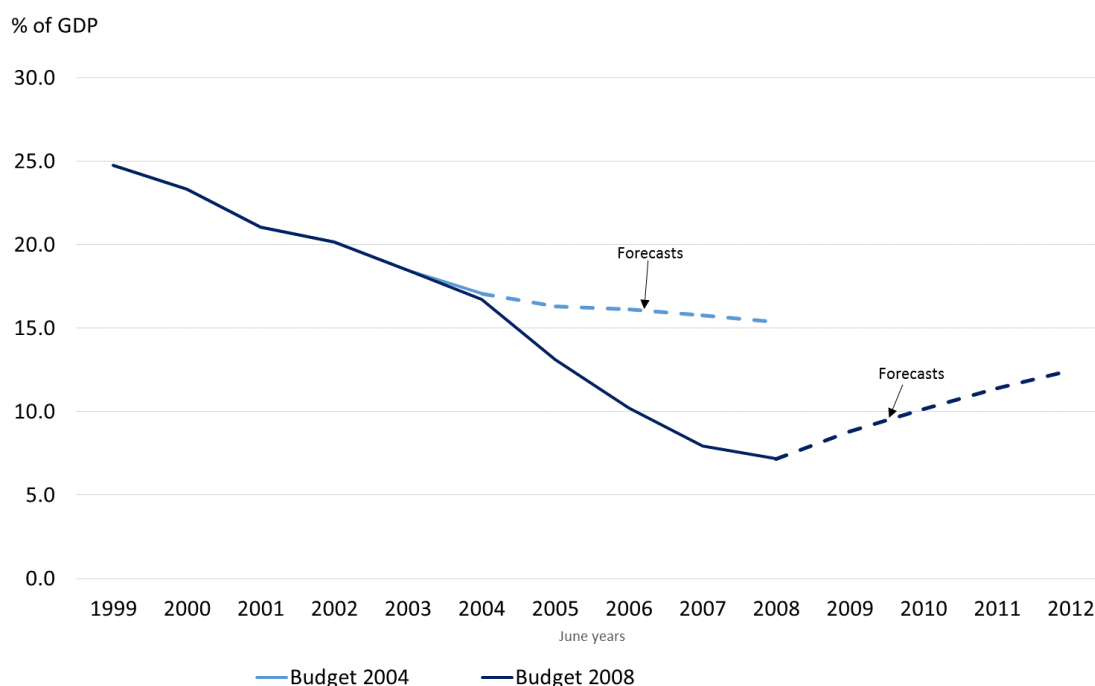
<sup>8</sup> The NZS Fund (a New Zealand Government savings vehicle) was established in 2001 to prefund, from current tax revenue, some of the projected increase in public pension costs (New Zealand Superannuation) associated with the ageing population (McCulloch and Frances, 2001). New Zealand Superannuation is a universal, flat-rate benefit paid by the Government to New Zealanders once they reach the qualifying age (currently 65), at the rate of 66% of average ordinary time wages after tax for a qualifying couple. The long-term fiscal challenges expected to result from population ageing have been well documented elsewhere (eg, The Treasury, 2013c).

The length of the economic expansion made it difficult to determine how much of the increase in economic activity, and therefore tax revenue, was structural and how much was cyclical (Mears et al 2010). Over the period 2005-2008, the Treasury increased its estimates of structural revenues by around 1 percentage point of GDP each year, and by 2008 the Treasury considered most of the operating surplus was “structural” (Figure 1). Much of the stronger-than-expected tax revenues were used to strengthen the balance sheet, and net debt fell faster than expected (Figure 2).

**Figure 1 – Operating balance and structural balance**



**Figure 2 – Net core Crown debt forecast revisions<sup>9</sup>**



<sup>9</sup> Net core Crown debt data in Figure 2 have been adjusted to the current definition, which differs from the definition published in Budgets prior to 2009. See Appendix 1 for further details.

With most of the surpluses in the mid-2000s thought to be structural, and debt reaching low levels, there was growing pressure to reduce the level of surpluses. The Government increased new spending in Budgets 2004-2008<sup>10</sup>. These Budgets expanded existing services (eg, health care, education, and justice), and increased transfers through a number of flagship projects – income subsidies for low and middle income working families (“Working for Families” in Budgets 2004 and 2006), interest-free student loans (Budget 2006), and a subsidised saving scheme (KiwiSaver<sup>11</sup>, in Budgets 2005 and 2007). Expenses also increased as the cost of existing programmes, such as early childhood education, turned out higher than expected (Mears et al 2010). Overall, structural expenses are estimated to have increased by around 8 percentage points of GDP between 2004 and 2009.

The Government also reduced the corporate tax rate in 2007 and announced a significant package of personal tax rate reductions in Budget 2008 (1.5% of GDP per forecast year to be implemented in three tranches from October 2008 to April 2011). The 2008 tax reductions were announced when the economy began slowing but before it was known that the economy was in recession, and before the worst of the GFC. When the tax reductions were announced in Budget 2008, the Treasury was still predicting the operating balance to remain in surplus through the forecast period, albeit at a lower level.

With the benefit of hindsight, the degree to which the surpluses were structural was overestimated. Although the tax reductions announced in 2008 turned out to be well-timed from the perspective of stabilising the economy following the GFC, their permanent nature added to the subsequent structural deficits. Nevertheless, the strengthening of the balance sheet through the mid-2000s meant that there were large fiscal buffers that would help manage the shocks that were to come.

## 2.2 Post crisis deterioration and Budget 2009 response

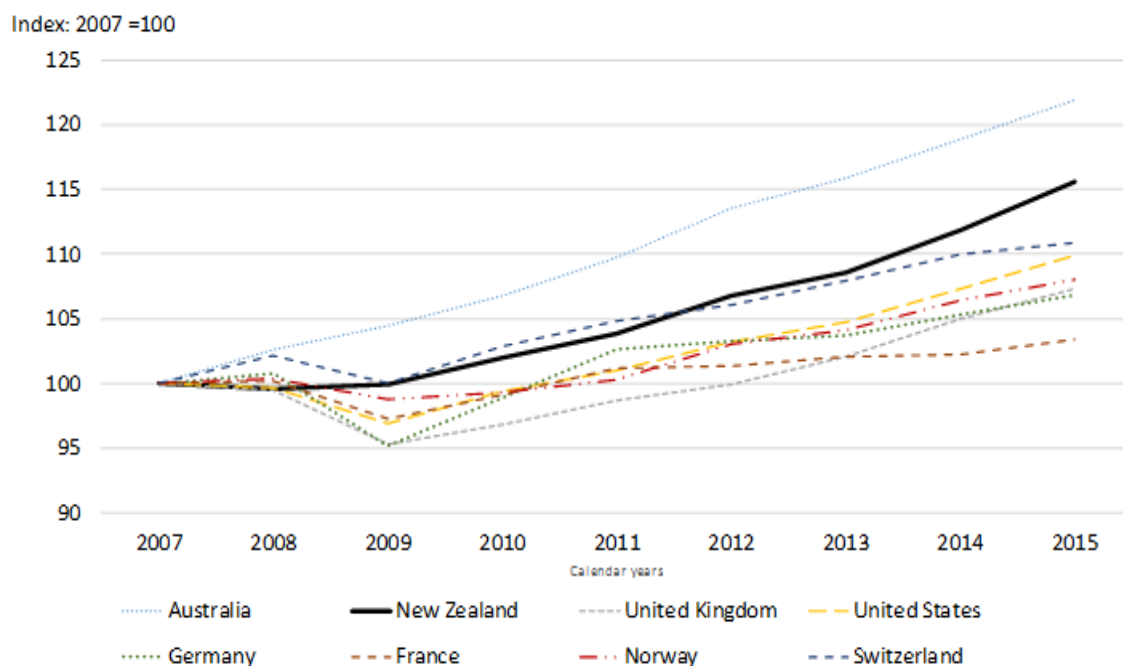
The New Zealand economy entered recession in early 2008, before most other countries, partly reflecting a drought in 2007/08. Macroeconomic conditions deteriorated significantly between the 2008 Budget in May and the end of 2008 as the impact of the GFC became apparent, amplifying the impact of domestic recession. The New Zealand economy contracted by over 3% in real terms from the beginning of 2008 to the middle of 2009, and official interest rates were reduced from 8.25% to 2.5% over this time. Although the New Zealand economy entered a recession prior to many other countries, the decline in real GDP following the GFC was less sharp relative to many European economies and the recovery has also been faster (Figure 3).

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<sup>10</sup> New Zealand Budgets are usually released in May or June, and apply to the following fiscal year (1 July – 30 June).

<sup>11</sup> KiwiSaver is a voluntary work-based savings scheme (with automatic enrolment and opt-out provisions). Employees who contribute are entitled to employer and government contributions, up to a cap. The changes in 2009 involved reducing minimum contribution rates, removing the employer tax credit, and removing the member fee subsidy.

**Figure 3 – Real GDP<sup>12</sup>**



Source: IMF World Economic Outlook, April 2016

Despite low levels of net debt in 2008 (around 5% of GDP), New Zealand's fiscal position was forecast to deteriorate sharply as the outlook for nominal GDP growth, and therefore tax revenue growth, deteriorated. The first tranche of tax reductions took effect (on 1 October 2008), and spending on unemployment benefits began to rise (a key automatic stabiliser).

A new National-led government took office in late 2008. The incoming Government recognised that it was appropriate for the fiscal position to deteriorate as tax revenue fell and benefit expenses increased. The strong starting point for the fiscal position meant there was no immediate pressure to reduce spending, and the Government was clear that doing so could exacerbate the recession. The Government announced a fiscally neutral package to implement its pre-election commitments (an additional round of personal tax reductions to take effect on 1 April 2009, broadly offset by a reduction in KiwiSaver subsidies and the removal of R&D tax credits). It also brought forward some capital expenditure (infrastructure spending on school property, roads and housing projects) and increased the planned level of capital expenditure to be announced over the next few Budgets. In December 2008, the Treasury was forecasting persistent operating deficits. Net debt was projected to rise to around 40% of GDP in June 2018 and to around 50% by 2022/23, and was not projected to decline in the absence of any policy change.

In early 2009, transitional assistance was announced to support firms, households and redundant workers (including a small-business relief package and the ReStart assistance package for redundant workers).

By Budget 2009 it was becoming clearer that part of the slowing in tax revenues was structural – previous forecasts had been optimistic and most forecasters were now revising down their estimates of potential output going forward. The Treasury's forecast of potential GDP for the 2013 fiscal year was revised down by 5% between December 2008 and Budget 2009. This contributed to increasing estimates of the forecast structural deficit.

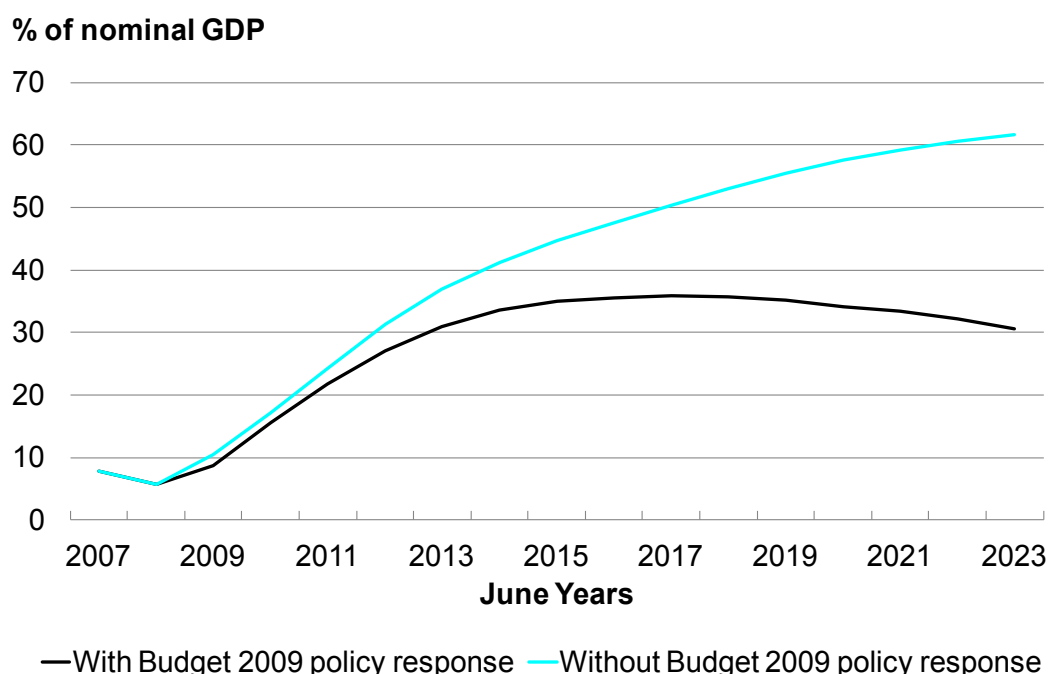
<sup>12</sup> GDP data from the IMF for New Zealand differs slightly from the data elsewhere in this paper, which is sourced from Statistics New Zealand. As the IMF data is based on calendar years, the decline in real GDP in New Zealand appears less pronounced due to the timing of the contraction.

Budget 2009 was the first post-GFC Budget. While the December 2008 announcements had focused on supporting the economy through the downturn, Budget 2009 announced measures to consolidate the fiscal position. These were mostly “back-loaded”, intended to take effect once the economy was recovering.

The measures included postponing the second and third tranches of personal tax reductions (due to take effect in April 2010 and April 2011), reducing forecast new operating allowances<sup>13</sup> from Budget 2009 onwards<sup>14</sup> and a line-by-line review of expenditure by departments, enabling savings through spending reprioritisation, dropping unfunded commitments, and halting employment growth in public service administration<sup>15</sup>. Contributions to the NZS Fund were suspended until sufficient surpluses had been achieved.

The policy response was expected to reduce the debt-to-GDP ratio from 2017 onwards. Nevertheless, Budget 2009 was still projecting a decade of operating deficits with a return to surplus from 2019 (Figures 4 and 5).

**Figure 4 – Net core Crown debt, Budget 2009 forecasts**

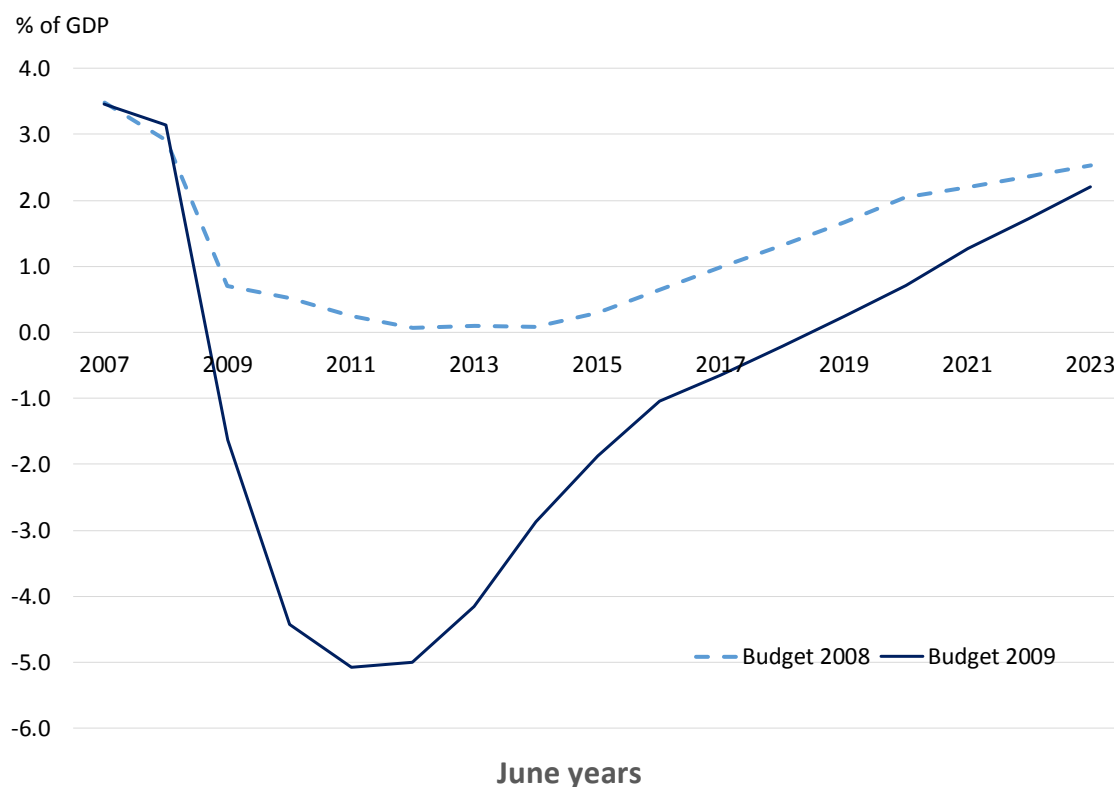


<sup>13</sup> The operating allowance is an allocation for all new operating spending and revenue decisions in a Budget. For a description of operating allowances see “Guide to New Zealand Budgeting Practices” at <http://www.budget.govt.nz/budget/guide/budgeting-practices/index.htm>.

<sup>14</sup> Although net new spending in Budget 2009 was lower on average than previously signalled, the Budget 2009 initiatives were front-loaded into the 2009/2010 financial year to help take the worst edges off the effects of the recession. The allowance for net new spending in Budget 2009 was revised down by less than in future Budgets.

<sup>15</sup> After rising by more than 30% from 2000 to 2007, fulltime equivalent numbers were flat from the end of 2007 to mid-2012.

**Figure 5 – Operating balance, Budget 2008 and Budget 2009 forecasts**

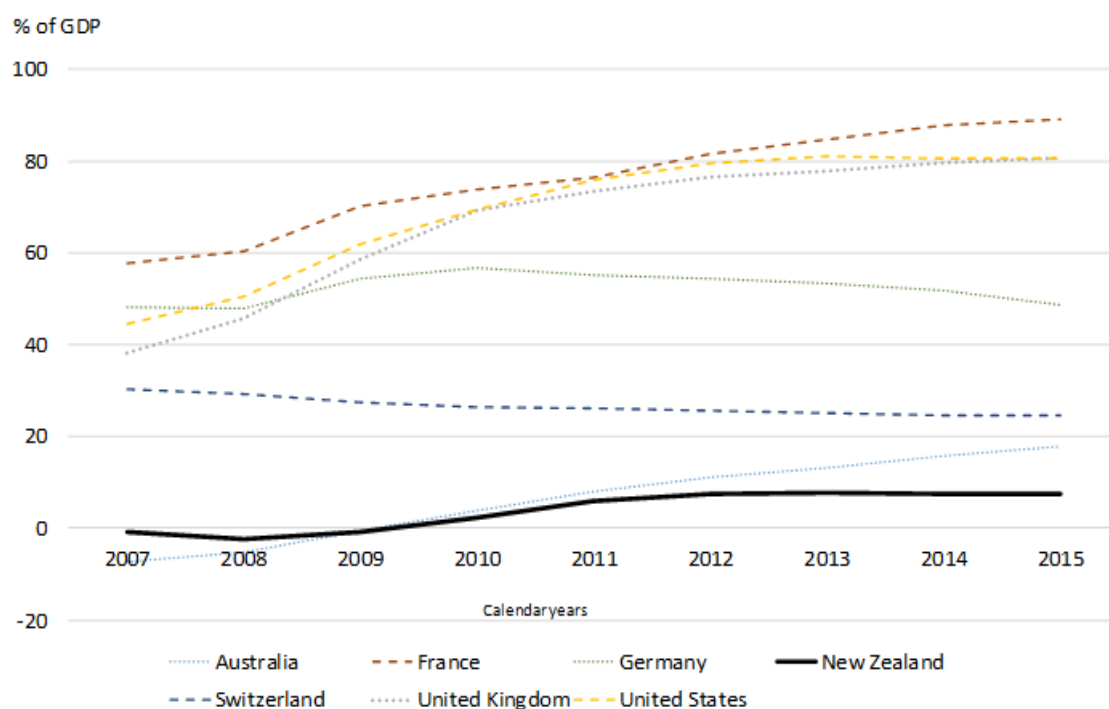


The scale of revisions to the economic and fiscal outlook meant that it was difficult to disentangle structural shifts in the economy from discretionary policy changes. As such, the Treasury considered the fiscal impulse indicator was not a reliable guide to the stance of fiscal policy at the time. Current estimates suggest that fiscal policy was stimulating aggregate demand during 2009 and 2010, which helped support the economy through the recession (Figure 12).

Following widespread implementations of fiscal stimulus in the immediate post-GFC period advanced economies, in general, undertook sharp fiscal adjustments during 2010-14, and while significant headway was made in reducing deficits, controlling government spending proved more difficult (IMF 2012). New Zealand's net debt levels prior to the GFC were low by international standards (Figure 6), which allowed the government to support the economy through the recession and delay consolidation until the economy had recovered. New Zealand is one of the first advanced economies to have returned to fiscal surplus according to the IMF (Figure 7)<sup>16</sup>. New Zealand had its own currency, a floating exchange rate and little or no foreign currency debt which assisted its macroeconomic adjustment to the crisis, especially when compared to eurozone countries.

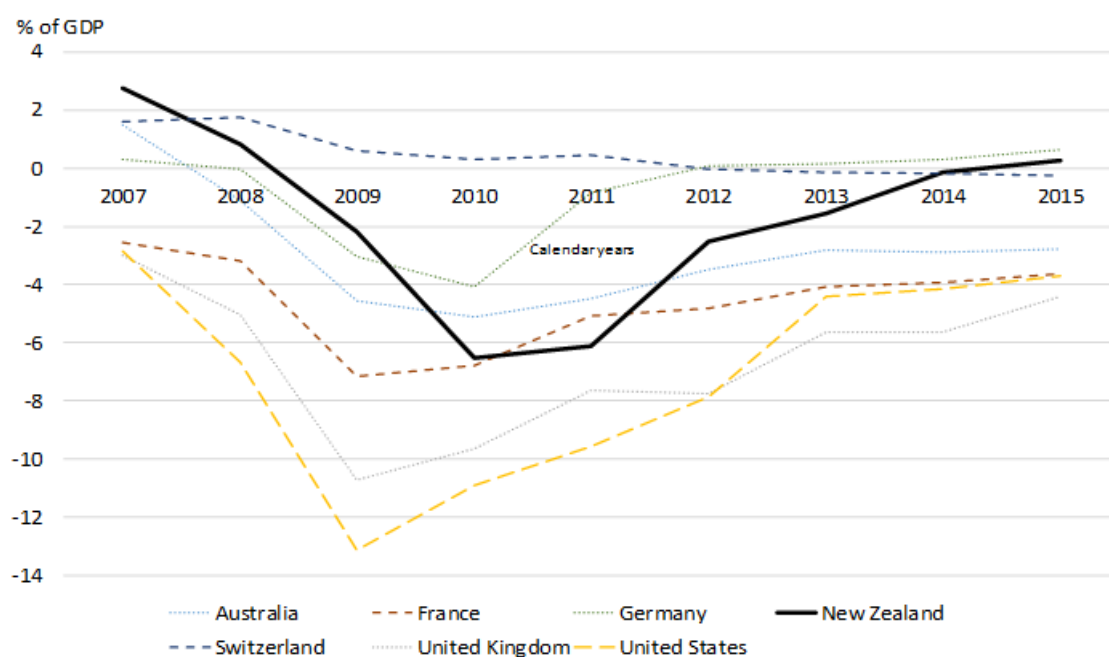
<sup>16</sup> The international fiscal experience over this time is discussed in IMF's Fiscal Monitor of October 2012  
<http://www.imf.org/external/pubs/ft/fm/2012/02/fmindex.htm>

**Figure 6 – General Government net debt**



Source: IMF World Economic Outlook, April 2016

**Figure 7 – General Government fiscal balance<sup>17</sup>**



Source: IMF World Economic Outlook, April 2016

By Budget 2010, stimulatory monetary conditions, a global recovery and increased export volumes were expected to support an economic recovery in New Zealand. The terms-of-trade rebounded to historical highs on the back of booming dairy prices. There was a sense that the worst of the crisis had passed. The Treasury was forecasting real GDP growth to recover to about 3% in each of the four years following 2009/10. The deficit was forecast to gradually decline, returning to surplus in 2015/16 (beyond the forecast horizon at the time).

<sup>17</sup> IMF definition of fiscal balance. New Zealand's operating balance and other fiscal indicators are not directly internationally comparable (see Appendix 1)



Budget 2010 announced a modest increase in net spending along with a broadly fiscally neutral tax package – reducing personal income tax rates and increasing indirect tax rates – with the aim of raising the supply of labour and rebalancing the economy from private consumption and government spending towards investment and exports.

## 2.3 Fiscal adjustment since 2011, and another shock

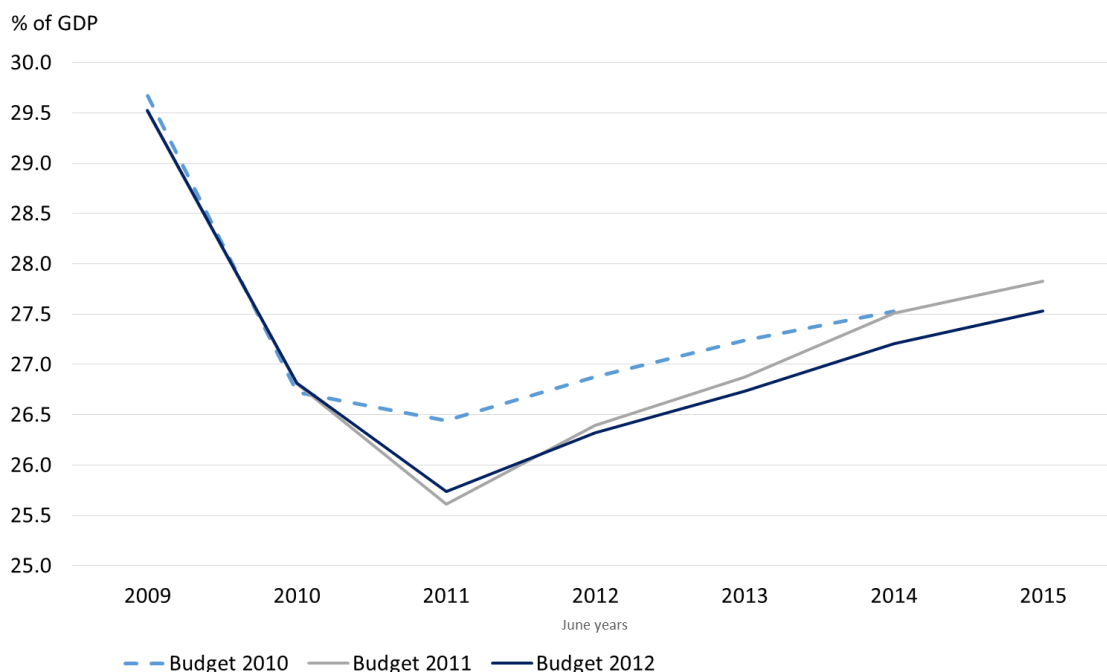
The economic recovery proved to be slower and more drawn out than anticipated through 2010 to 2012. In addition, two large earthquakes in Canterbury in late 2010 and early 2011 had a significant impact on the Crown accounts and further slowed the recovery.

The earthquakes in Canterbury were very destructive, resulting in significant loss of life and turmoil for those involved. Economic activity in Canterbury fell significantly in the immediate aftermath and reconstruction continues today. Early estimates suggested the damage (to buildings and loss of income etc) was likely to represent around 10% of GDP, which compared with around 3 to 4% of GDP in the case of the 2011 Japanese earthquake and tsunami, for example (Parker and Steenkamp 2012). At the time, the Government estimated its reconstruction expenses would be \$15 billion and it also provided a \$5 billion assistance package. Earthquake-related operating expenses are excluded from our assessment of structural operating balances (most of which were recognised in the 2011 fiscal year), although any impact of additional expenditure on net debt is included.

In Budget 2011, the Government set out a goal to return to surplus no later than 2015/16, which was subsequently brought forward to 2014/15. The target was set for the actual balance rather than the structural balance, which is not widely understood, although was “subject to any significant shocks”.

Nevertheless, as the global economy recovered more slowly than expected, forecasts for tax revenue were revised down in Budget 2011 and again in Budget 2012 (Figure 8). In addition, the slow recovery led the Treasury to lower potential output estimates by approximately 2% in late 2012, reflecting low productivity growth (which was in addition to the 5% reduction in the immediate aftermath of the crisis). These economic developments meant that the magnitude of expenditure adjustments required to return to surplus in 2014/15 was larger than originally expected.

**Figure 8 – Core Crown tax revenue**

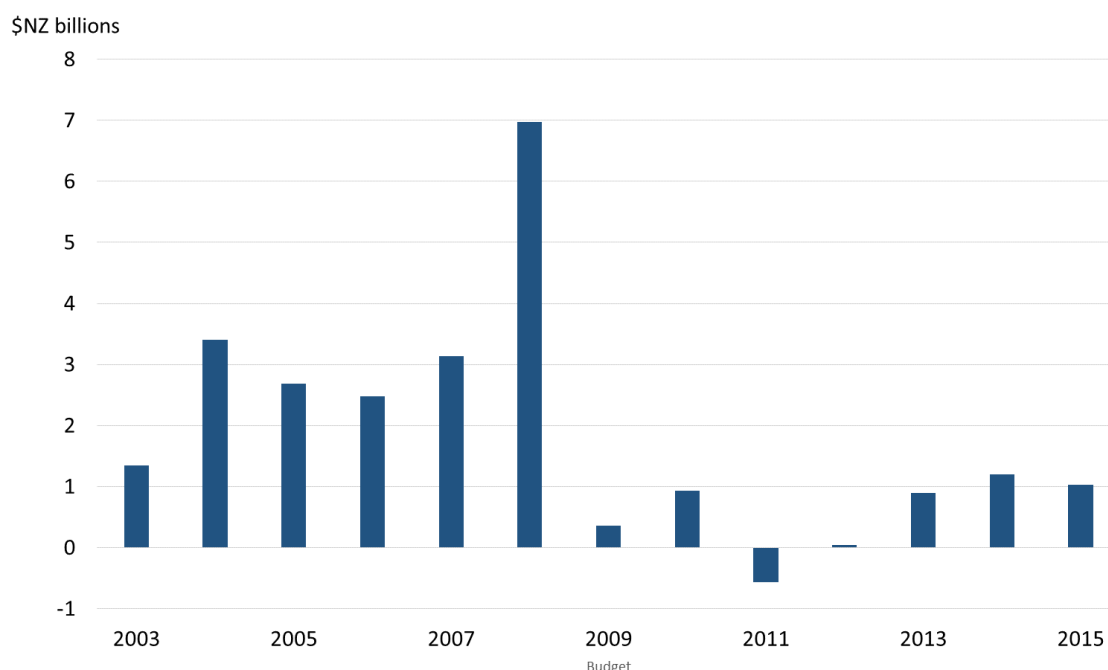


As a result, Budgets from 2011 onwards implemented a fiscal strategy based on reducing the growth of core Crown operating expenses. The Government's priority, called "Better Public Services", was to deliver improved services and results within tight financial constraints. A four-pronged approach was adopted.

Firstly, new operating spending was reduced successively over Budgets 2011-2013, which indirectly provided incentives for efficiency savings and reprioritisation by departments. Direct efficiency savings were then sought on base spending across the state sector. Thirdly, changes were made to specific programmes to control their long-term cost drivers and make them more targeted. Finally, the system of social welfare payments was reformed.

In Budgets 2011 and 2012 almost all new spending was fully offset by efficiency and programme savings and some revenue increases resulting in 'net zero' Budgets (Figure 9). While these were considered relatively tight budgets for New Zealand, they did not involve outright falls in absolute expenditure that were seen in some other countries, and the consolidation was a more "back-loaded" approach than occurred in some of the countries more severely affected by the GFC (The Treasury 2013b). This back-loaded approach to consolidation was permitted by the strong initial fiscal position, more favourable economic conditions, and the early signalling of credible adjustment paths all of which helped to alleviate market concerns.

**Figure 9 – New operating allowances in each Budget (final year impact)**



Budget 2011 included a departmental efficiency dividend of around \$1 billion over three years, the majority of which involved eliminating central funding for various state sector retirement schemes and instead requiring state sector employers to meet these costs through their own funds.

Alongside the efficiency dividend, the Government provided Ministers and departments with more flexibility to allocate resources to spending that was higher value for money. This was achieved through the use of four-year plans, structural changes to appropriations (for example merging department allocations where appropriate, and greater use of multi-year appropriations), increasing financial delegations to Ministers and departments to allow them to retain underspends, to bring forward spending from later years, and to reduce compliance. These changes assisted the Government in taking a longer term perspective on its finances, rather than just focussing on the next financial year.

The Budget aimed to achieve delivery of public services while reducing costs across departments through improving the efficiency of back-office functions. Measures included introducing collective processes such as joint procurement, some departments sharing services such as human resources and information technology, and benchmarking of costs of administrative and support services across agencies.

Budget 2011 was expected to generate average efficiency savings of 0.1% of GDP per year (or 0.3% of total Crown expenditure) over the forecast period, and similar magnitudes were identified in the subsequent four Budgets. These estimates only include the direct efficiency savings and reprioritisation explicitly identified through the Budget process. They exclude any indirect efficiency savings and reprioritisation that have been encouraged within individual departments through tight top-down expenditure constraint.<sup>18</sup>

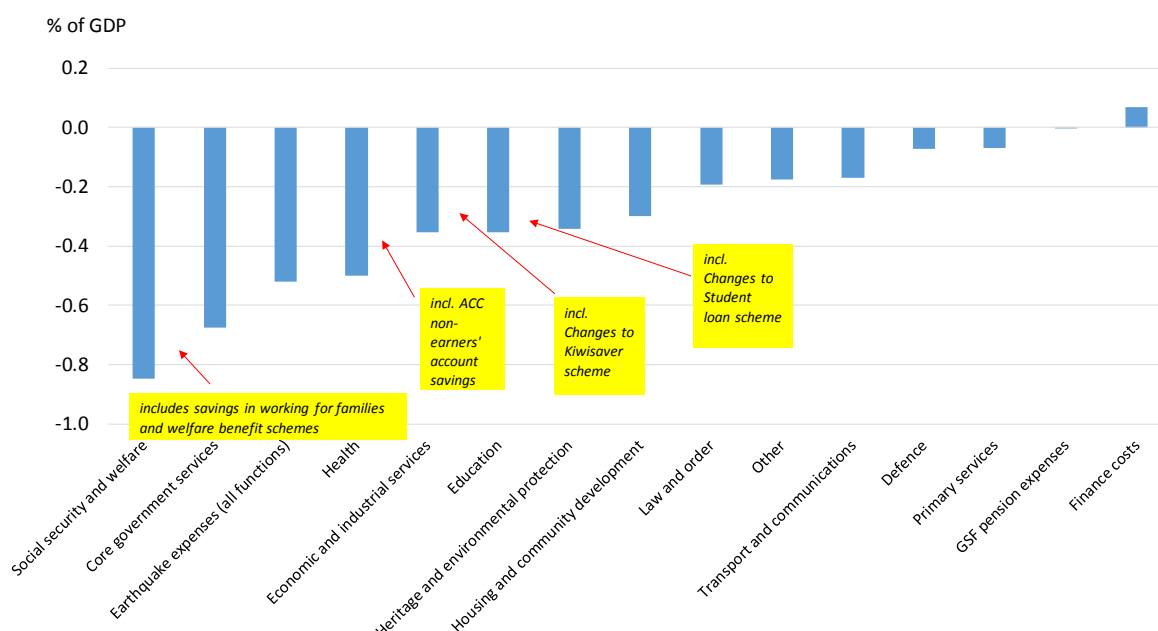
Changes to specific programmes that had experienced rapid cost escalation were also introduced. Contributions to the ACC non-earner's account were reduced along with overall costs of the scheme. Changes were made to the Working for Families scheme to put it on a more sustainable financial footing, lessening any effects on work incentives. A number of

<sup>18</sup> Reductions in expenditure not associated with explicit reductions in outputs have been referred to as "efficiency savings". Whether efficiency really increased is not measured. While outputs continue to be produced, contemporaneous service quality is not measured.

families higher up the Working for Families income scale were to receive less than before. Tighter restrictions were placed on eligibility for student loans and more stringent criteria for student loan repayments were introduced. The regular government contributions to KiwiSaver were halved (offset by increased contributions coming from members and employers).

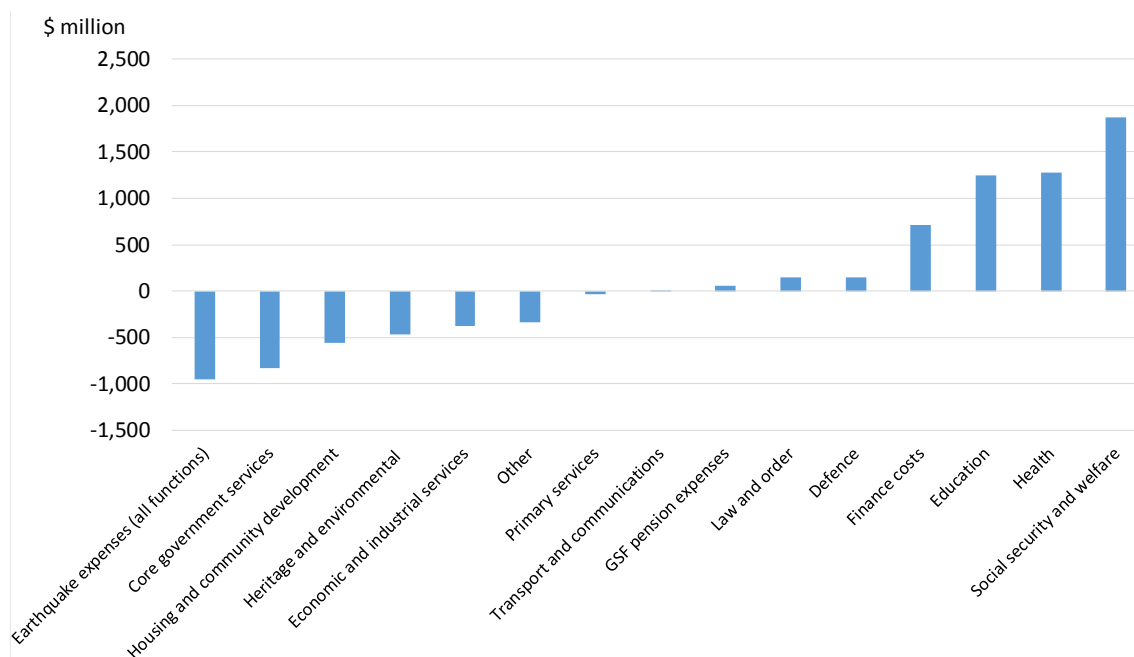
Overall these changes were expected to generate average savings on programmes of about 0.5% of GDP per year by the end of the forecast period. Some of the largest savings as a proportion of GDP since 2011 were in the areas of health, education and social security, despite these areas seeing an absolute increase in funding over that time (Figures 10 and 11). The difference is due to these large expenditure classifications rising slower than GDP growth in that time.

**Figure 10 – Changes in core Crown expenses (2010/11-2014/15) (% of GDP\*)**



\* Calculated as expense-to-GDP ratio for 2014/15 minus the ratio for 2010/11

**Figure 11 – Changes in core Crown expenses (2010/11-2014/15) (\$ billions)**

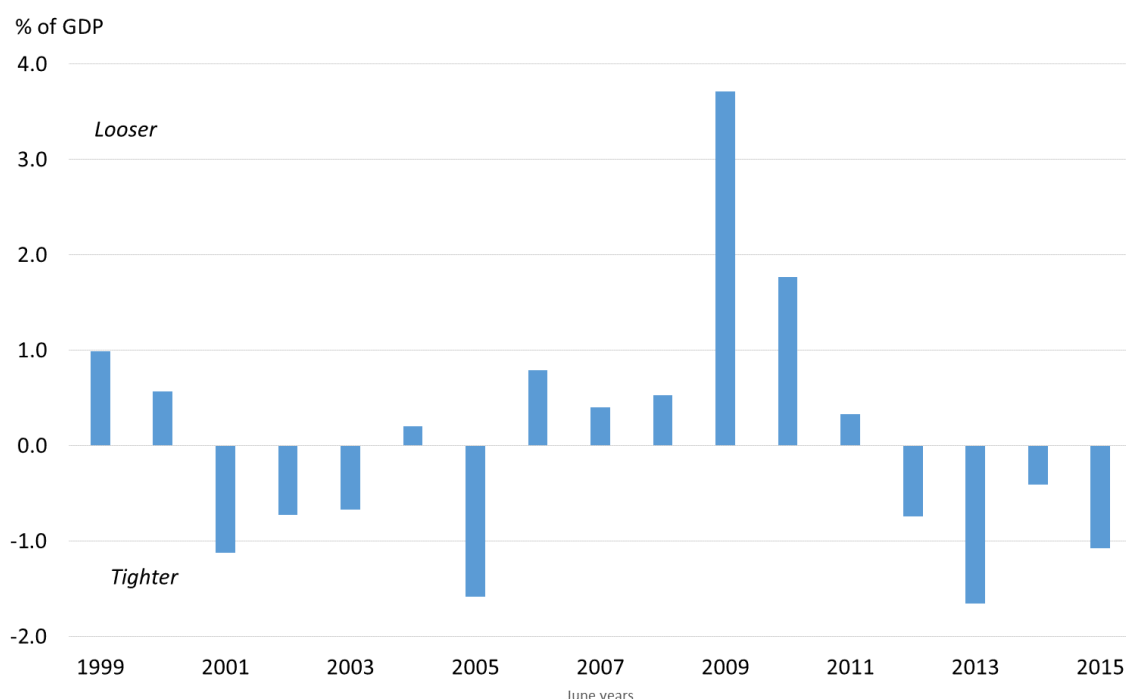


Having been expansionary since the GFC, fiscal policy began to have a contractionary effect on aggregate demand from 2012 (Figure 12). The pace of consolidation was motivated by a number of factors, including the effect on the overall economy and the expected increase in activity from the Canterbury rebuild.

The effect of fiscal policy on domestic output (the fiscal multiplier) was considered to be smaller in New Zealand than in some other countries (Treasury, 2013b). Monetary policy was not constrained by the zero lower bound on interest rates (interest rates never fell below 2.5% during this period) which meant that a fiscal contraction could lead to lower interest rates, and less pressure on the New Zealand dollar. More stimulatory monetary policy than otherwise would have been the case was expected to stimulate aggregate demand and shift resources toward the export-facing sector, softening the impact of fiscal tightening on the economy.

The planned fiscal adjustment was forecast to subtract from aggregate demand at a time when private sector and earthquake-related spending would be adding to it. Forecasts at the time showed capacity in the economy being gradually taken up over the coming year and for inflation to settle around the middle of the Reserve Bank's 1-3% target range.

**Figure 12 – Estimates of fiscal impulse**



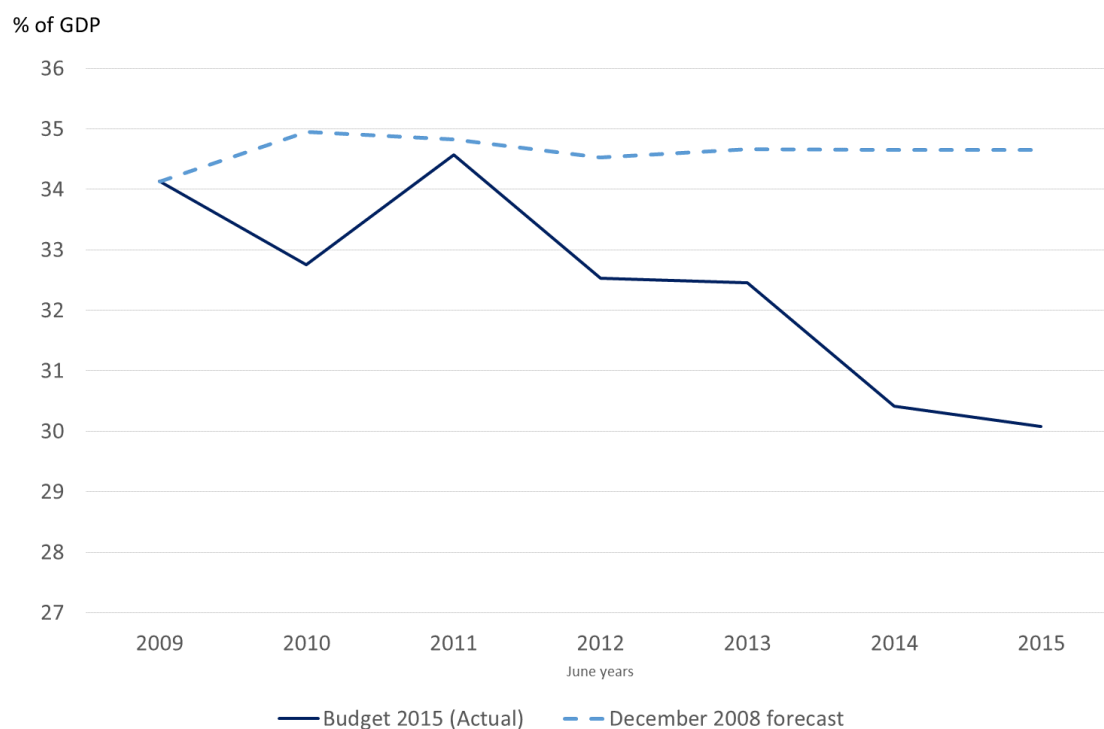
After 2013, the economy recovered broadly as expected, partly owing to a strong increase in population growth (from net migration) and high terms of trade. By Budget 2014 the economy was growing steadily and growth rates of between 2 and 4 percent were forecast over the next four years. The output gap was estimated to be close to zero, and monetary policy had been tightened. Forecasts of future tax revenue growth were revised up, and the Treasury was projecting a significant improvement in the fiscal position. In Budget 2014 the Government announced an increase in future Budgets' operating allowances, to be used for a mix of spending and revenue initiatives. Net debt was projected to fall to 20% of GDP in 2020, and the main constraint on fiscal policy was a concern not to add to pressure on monetary policy.

By the Budget in May 2015, the optimism from Budget 2014 had begun to dissipate as dairy prices had begun to fall. While the real economy was still forecast to grow at just below 3% on average, nominal GDP growth forecasts were revised down due to declining export prices and weaker than expected inflation. Monetary policy began to ease in June 2015.

Falling dairy prices were expected to reduce farm incomes and consequently tax revenue growth was expected to slow. As a result, the Treasury forecast a small deficit in 2014/15 and a small surplus in 2015/16. However, there is significant uncertainty when forecasting, and the final year accounts for 2014/15 showed that a small surplus had been achieved. The structural balance was also estimated to be in a small surplus. Another surplus has been announced for 2015/16.

Overall, the return to surplus has been achieved largely through a reduction in expense growth, which lead to a decline in expenses-to-GDP (Figure 13). Core Crown expenses (excluding earthquake expenses) are estimated to have declined by 4 percentage points of GDP since 2011<sup>19</sup> (Figure 14). Direct efficiency savings and reprioritisation and programme savings since Budget 2011 are estimated to have contributed around 0.5% of GDP each to reducing expenditures. The reduction in expense growth likely also reflects slower public sector wages growth and reprioritisation within individual government departments in response to tight fiscal constraints (for example, savings in rental costs resulting from reduced floorspace).

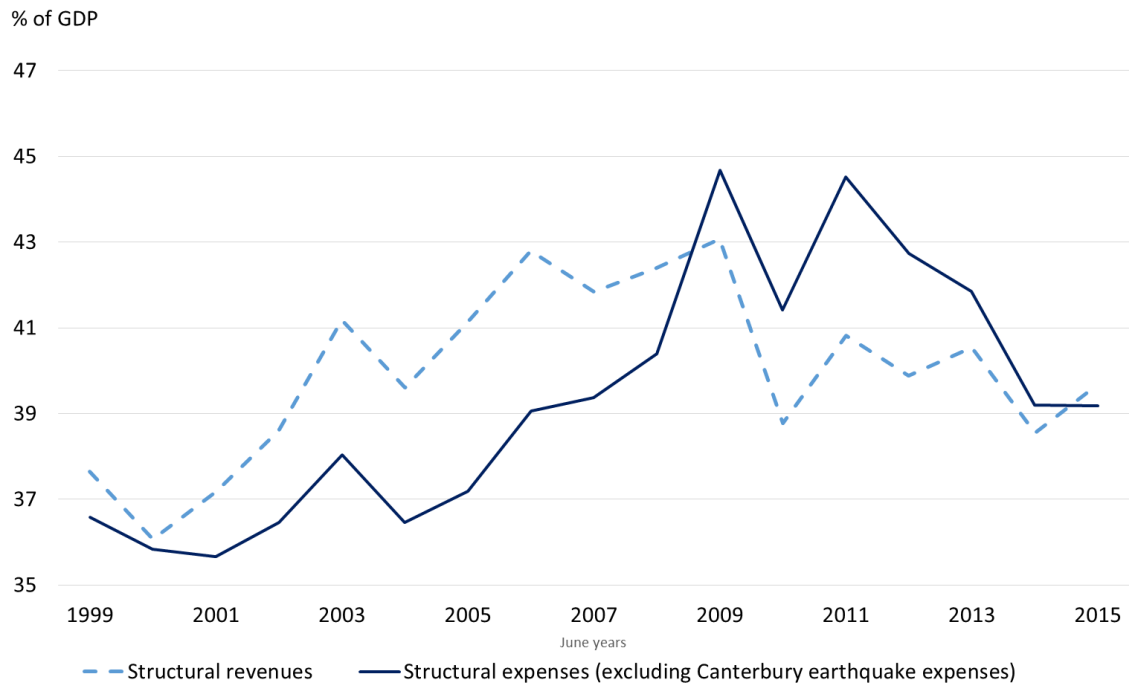
**Figure 13 – Core Crown expenses**



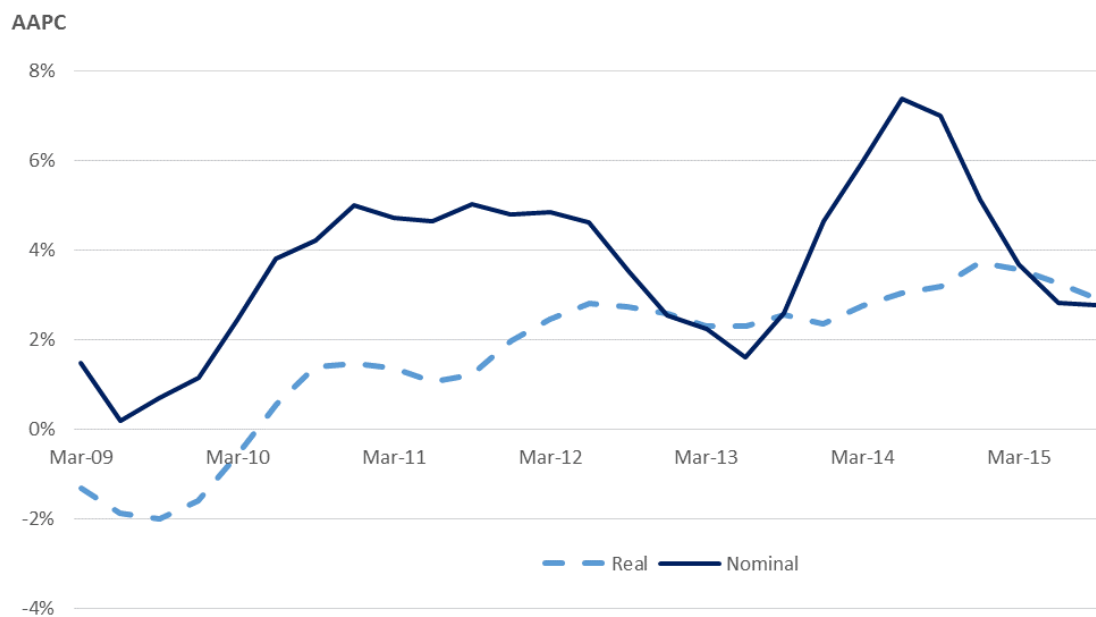
While the economic recovery was slower and more drawn out than initially forecast, a strong terms-of-trade helped nominal GDP growth rates remain relatively strong (Figure 15) and, in turn, meant revenue outturns were higher than they might otherwise have been. Across the period as a whole, the tax-to-GDP ratio turned out weaker than had been expected in December 2008 (Figure 16), but there were no large tax policy changes and structural revenues were relatively stable from 2011 to 2015 (Figure 14).

<sup>19</sup> Budget 2011 included significant non-repeated costs, additional to earthquake related expenses, which have since reduced such as: financial assistance for weathertight homes; Treaty-related costs; reduction in Emission Trading Scheme expenses; funding for rail and the ACC non-earners premium. These are estimated to be around \$2.2 billion, or 0.9% of GDP.

**Figure 14 – Structural revenue and expenses**



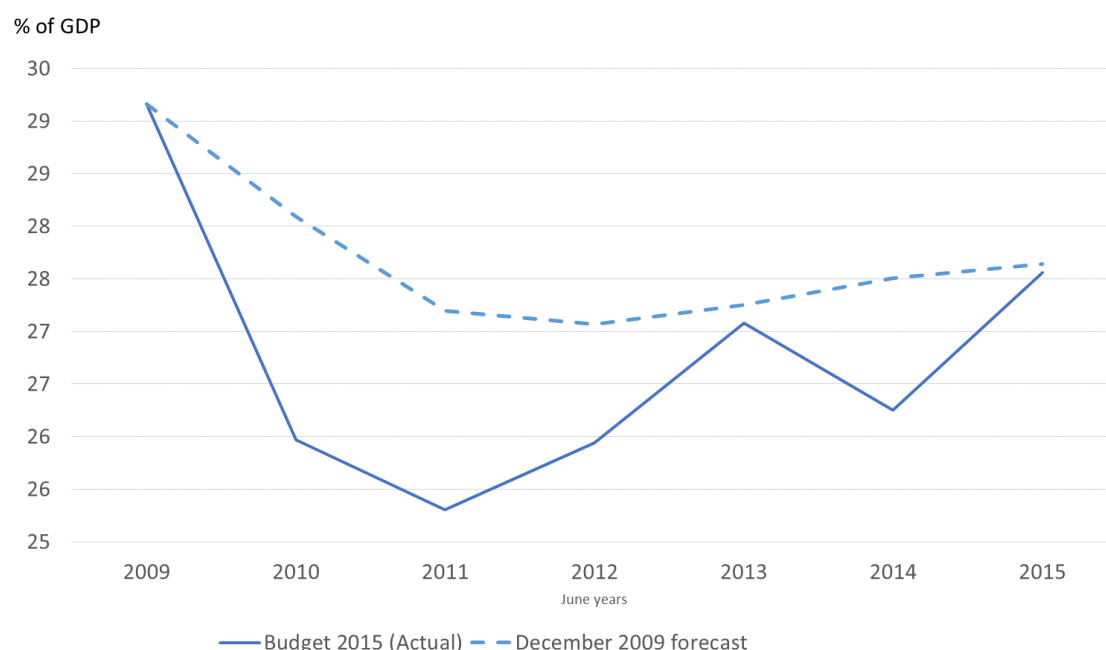
**Figure 15 – GDP growth**



Source: Statistics New Zealand



**Figure 16 – Core Crown tax revenue**



### 3 Institutional factors supporting fiscal consolidation

Internationally, the reforms of fiscal frameworks have gained momentum after the GFC with several countries moving in two directions: the introduction of formal, legislated rules and procedures concerning the control of public finances, and the creation of independent fiscal institutions (Cioffi, Franco and Marino, 2012). As discussed below, New Zealand's fiscal framework has relied on legislated principles rather than mandated rules, with fiscal objectives self-imposed by the government of the day since the 1990s. Also, New Zealand has relied on the Treasury to provide independent fiscal advice and reporting to the government, Parliament and the public instead of independent fiscal institutions.

#### 3.1 Fiscal policy framework and fiscal targets

For more than two decades, fiscal policy has been conducted in New Zealand within a framework that emphasises transparency as a key element to support fiscal responsibility and sustainability. New Zealand's fiscal policy framework differs from many other countries in that it emphasises principles, rather than mandatory numerical targets. The principles of responsible fiscal management are outlined in Part 2 of the Public Finance Act 1989 (PFA) and include reducing debt to prudent levels and, once those levels have been reached, running operating surpluses, managing fiscal risks facing the government, having regard to the interaction between fiscal policy and monetary policy, the impact on present and future generations, and ensuring that the Crown's resources are managed effectively and efficiently.

The PFA requires the publication of an annual Fiscal Strategy Report which must be delivered alongside the Budget. In this report the government must outline its specific long-term fiscal objectives (10+ years) and short-term fiscal intentions (3-5 years), and the extent to which these objectives and intentions are consistent with the principles of responsible fiscal management.

In practice, governments have used a range of targets to communicate their strategy, typically an operating balance target, a long-term debt target and sometimes a target for operating expenses.

The level and specification of the debt objective have changed through time, as circumstances changed. Prior to the GFC, the target was for gross debt of around 20% of GDP (equivalent at the time to net debt of around 10% of GDP). Following the crisis, the target was to keep net debt below 40% of GDP – this was subsequently lowered to below 30% of GDP – and to reduce net debt to 20% of GDP over the medium term. As the fiscal projections have improved, the goal has been to reduce net debt to around 20% of GDP by 2020, and then maintain net debt within a range of around 0-20% of GDP.

Successive fiscal targets have typically had strong political support, across changes of government, although the exact targets themselves have changed at the margin. In part, the fact that the principles in the PFA allow governments to outline their own targets, rather than imposing a target on them, means that meeting the targets has often been seen as a sign of political credibility. This gives the Minister of Finance in particular a strong motivation to achieve the targets set.

Political commitment to the target has been particularly strong in the case of the Government's target to return to surplus in 2014/15. This may partly reflect the fact that the target was brought forward from 2015/16 to 2014/15 during the 2011 election campaign. Achievement of the target came to be seen by some as a sign of the Government's fiscal credibility.

The return to surplus target itself had benefits. When it was introduced in 2011, the headline operating deficit was 9% of GDP. In these circumstances, the target to return to operating surplus helped focus attention across the state sector on the need for fiscal consolidation, and this was assisted by the strong political commitment. This helped focus attention on effectively managing operating revenue and expenses to turn around a large fiscal deficit. Nevertheless, the specification of the target presented a number of challenges.

The target was specified in terms of the actual balance, rather than the structural balance. A target for the actual balance has the advantage of being more easily measured and less subject to real time uncertainty than a structural balance, and as such, it is more easily understood by government, Parliament and the general public. Using a standard measure like the operating surplus and an easily understandable goal of more than zero helped ensure the target was easy to communicate and understand.

However, a target for the actual balance creates a risk that it could lead to pro-cyclical fiscal policy, by encouraging spending reductions if the economy turns down. In this case the intent of the target was not to result in pro-cyclical fiscal policy, and this was to be achieved by introducing conditionality around the target, in that it was "subject to any significant shocks". In practice, it was unclear when this explicit "escape clause" would be applied, and it did not receive much attention.

The target focused on a particular year – the 2014/15 fiscal year. This worked well when the target was a few years out, as it encouraged a medium-term approach to Budgets and fiscal policy. However, as the target date approached, it increasingly focused attention on the short-term forecast revisions by the Treasury. In particular, forecast revisions led to questions over what they might mean for achieving surplus as well as whether any offsetting policy response would be required.

A focus on the total Crown<sup>20</sup> operating balance had pros and cons. A benefit was that as it is the difference between total Crown operating revenues and expenses, it encouraged the Government to focus on all parts of the Crown. This led to greater focus and understanding around parts of the Crown outside of the narrow departmental sector (such as Crown entities and state-owned enterprises).

However, at the margin, it created greater focus on operating spending relative to capital expenditure (which does not directly affect the operating balance). Achieving a surplus does not necessarily translate into reductions in nominal net debt – as this requires core Crown cash flows to be positive.

Nevertheless, the longer term target of debt reduction that drove the initial surplus target and a much greater focus on indicators such as net worth has led to an increased focus on the sustainability of the balance sheet and the nature of long term liabilities. Quantifying the likely impacts of future welfare liabilities remains an ongoing effort of identifying future risks to balance sheet strength.

## 3.2 Fiscal management approach

New Zealand's fiscal management approach constitutes a flexible set of rules applied to the day-to-day decisions of government to inform decision-making and assist the Government in achieving their fiscal strategy<sup>21</sup>. The fiscal management approach is made up of two main parts: fixed nominal baselines for most existing spending; and allowances (operating and capital) to fund new initiatives and some cost increases.

New Zealand has had fixed nominal baselines since the early 1990s. Fixed nominal baselines means that the amount of funding an agency receives each year does not automatically increase to adjust for inflation. Instead agencies are expected to absorb price increases; in effect this acts as an annual efficiency dividend on government expenditure.

For the majority of expenditure, appropriations are 'fixed' and a specific policy decision is required to make adjustments. Funding increases are sought through the Budget process, where increases have to be met from a limited pool of funding allocated for net new spending called the "operating allowances" and traded off against spending proposals in all other areas of government.

The operating allowance is the pool of new operating funding available at each Budget – in Budget 2016 this was set at \$1.6 billion a year (0.6% of GDP). The allowance is set in advance of the Budget in accordance with the Government's fiscal strategy, and an allowance for future Budgets is also included in the forecasts. The allowance is the amount allocated for new policy initiatives (net of savings and revenue items), and in 2010 coverage of the operating allowances was expanded to cover cost increases in existing policy. In practice, the size of allowances have tended to be reviewed each Budget, to adjust the pace of fiscal consolidation in order to achieve the government's fiscal targets.

The fiscal management approach outlined above implies that, in the first instance, agencies should manage the cost of wage settlements within baselines. In practice, some sectors seek full or partial Budget funding for settlements, particularly where operational flexibility to manage wage costs is limited.

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<sup>20</sup> The total Crown reporting entity includes all government-owned entities including commercial entities

<sup>21</sup> A comprehensive guide to the Fiscal Management Approach including the operating allowance framework can be found in "Guide to New Zealand Budgeting Practices" at <http://www.budget.govt.nz/budget/guide/budgeting-practices/index.htm>

This approach means that the government and the Treasury apply a high level of scrutiny to new spending. In order to receive funding for cost pressures, the burden of proof rests on agencies to demonstrate that they will not be able to deliver services effectively within existing funding levels. The government must then trade off increasing spending on existing programmes against any new policies. To help make these trade-offs within tight fiscal constraints, recent Budgets have moved towards having groupings of Ministers making trade-offs between themselves (eg, the “Business Growth Agenda Ministers” group).

This system of fixed nominal baselines combined with a fixed nominal increase in spending gives the Government a high degree of control over most categories of spending. In the mid-2000s, some expense growth was due to increases in the cost of existing programmes which at the time were not “counted” against operating allowances such as higher than forecast uptake of early childhood education or secondary schools retaining pupils longer than anticipated. As mentioned above, this was changed in 2010 and since then nearly all increases in the cost of existing programmes have been counted against the operating allowance, helping to give the Government a greater degree of control over total expense growth.

### 3.3 State sector reform

While the PFA and the fiscal management approach were well entrenched on the public policy landscape leading into the GFC, departments had grown accustomed to an absence of serious funding pressure. The relatively good fiscal backdrop of consistent surpluses and relatively high levels of allowances meant in some cases relatively frequent funding increases.

The reduction in operating expenses has meant that each department had to manage its expenditure more closely than previously. The Government expressed a desire for departments to move away from a culture where value-for-money is a secondary consideration towards an environment where public servants are motivated to continuously innovate and improve. In a programme called “Better Public Services” amendments were made to the State Sector Act, the Public Finance Act and the Crown Entities Act to allow departments to work more closely together, sharing of information, services and functions and contestability of service provision, including non-government providers.

Each department was required to produce a four-year plan outlining the proposed delivery of services within their fixed nominal baseline or expose the trade-offs they would face in achieving this. Four-year plans allowed departmental chief executives to show the impact they were having and the savings they were making, while reducing the need for constant centralised monitoring.

Initially these forecasts were accompanied by predictions of increased risk of delivery failure. However, outputs in major programmes continued to be delivered as departments were able to find their own ways of delivering services more efficiently. Departmental forecasts are improving with each Budget and the search for efficiencies has become the norm. Four-year plans have also helped departments move to a more medium-term approach to planning across the state sector, rather than a focus only on the next Budget.

As with the original intent of the fiscal management approach, the introduction of four-year plans has shifted the onus back onto departments to make the case for new funding. This discipline contributed to the fiscal consolidation by encouraging efficiency savings and reprioritisation. Consolidation was achieved without major policy changes – most of the major expenditure programmes put in place during the 2000s have been maintained, although some parameters have been adjusted.

Other factors may have contributed to the ability for departments to find efficiency savings. It is possible that the large increases in funding many departments received during the mid-2000s may have made it easier to find savings. In addition, the sustained period of low inflation, combined with tight expenditure control, has contributed to a slowing in public sector wage growth. From typically growing faster than private sector wages prior to the GFC, public sector wages have grown at a significantly slower pace since then (Figure 17), which will have made it easier for departments to manage within baselines. This may partly reflect the weaker global labour market, particularly in the health sector.

**Figure 17 – Wage growth**



Source: Statistics New Zealand

More recently, the introduction of the investment approach to social spending further focussed departments on outcomes rather than dollars. Using information technology to better analyse data collected by departments for their service requirements, evidence of what works can be determined and services adjusting accordingly. Much of the focus of this strategy is on early investment to achieve better long-term results for people and helping them to become more independent. This should reduce the number of New Zealanders relying on social services and the overall costs for taxpayers over the medium term.

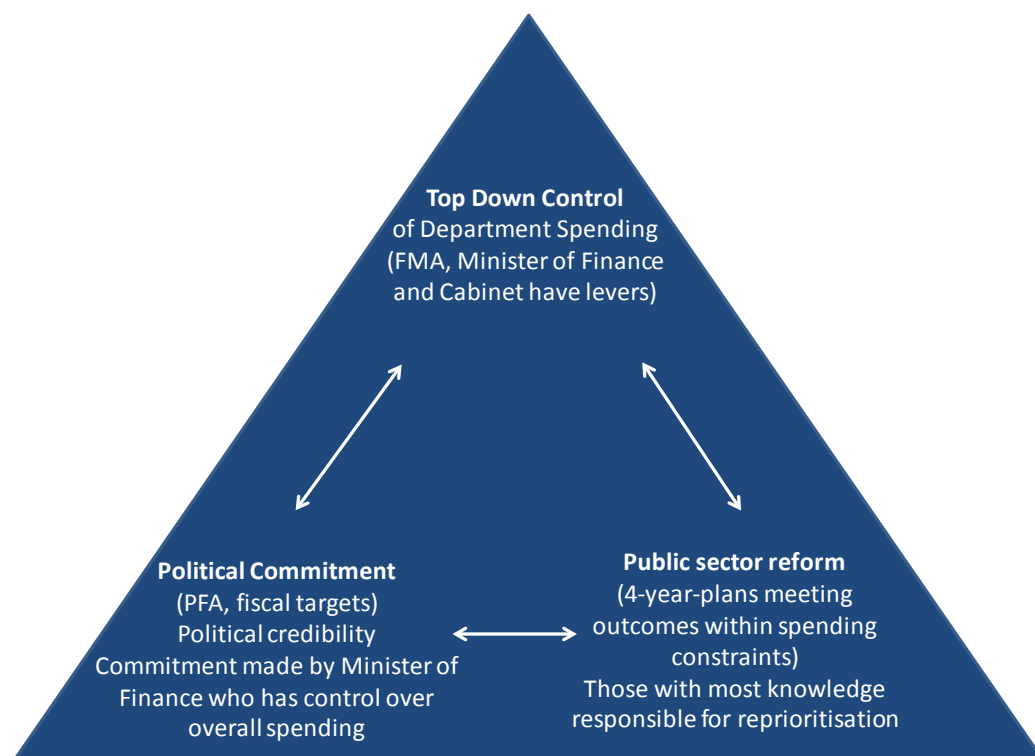
The focus on outcomes is data and information intensive and requires departments to set clear, measurable goals. Measurement of outcomes and effectiveness needs to be improved to enable better evaluation of service delivery. Importantly, because the aim is for government to purchase results rather than specific inputs, funding can be moved to the most effective services irrespective of whether they are provided by government or non-government agencies, or a combination of organisations. Given the long term nature of the programme it is too early to assess fully how effective the approach has been, although reforms have contributed to an estimated \$12 billion reduction in future welfare liabilities<sup>22</sup>.

<sup>22</sup> The full valuation report is available at <http://www.msd.govt.nz/about-msd-and-our-work/newsroom/media-releases/2016/2015-valuation-of-the-benefit-system-for-working-age-adults.html>.

### 3.4 Summary

The high-profile surplus target provided the motivation to achieve the consolidation, while the fiscal management approach with its effective top-down constraints on spending provided the tool to deliver on the target. The state sector reform shifted the onus on managing within limits to the agencies, who are best placed to figure out ways to deliver on results in their areas. These factors were mutually-reinforcing (Figure 18). Together, they allowed the fiscal consolidation to occur while still delivering public services.

**Figure 18 – Complementary nature of Fiscal Institutions**



## 4 Conclusion and future challenges

Looking back at the fiscal consolidation episode, the achievement of an operating surplus in 2014/15 is an important milestone. At the onset of the GFC projections were for a succession of operating deficits and net debt rising to almost 40% of GDP. That the latest results show net debt peaked just above 25% of GDP and is forecast to fall below 20% of GDP in the early 2020s is a notable achievement. Nevertheless, the return to surplus is only the first step on the journey of fiscal consolidation, and achieving the remaining steps will require addressing a number of challenges.

New Zealand's experience through the crisis years shows the benefits of the significant fiscal buffers that were built up in the boom years prior to the GFC. With net debt at only 5% of GDP, there was space to allow the automatic fiscal stabilisers to operate and to provide support to the economy through the recession and subsequent earthquakes. Consolidation mostly took effect after the economy had begun to recover.

Although the operating balance has returned to surplus, net debt to GDP remains close to its peak. Reducing net debt will likely require operating surpluses to be sustained and increased. While the structural balance is currently estimated to be in a small surplus, it is unclear how much this is being boosted by the terms of trade, which remain at historically high levels. Sustaining surpluses could prove difficult if the economy is hit by negative shocks or natural disasters.



The high profile surplus target was extremely effective at eliminating the fiscal deficit. It played an important role in decision making because it focused the attention of Ministers and departments. However, because the target focused on a particular fiscal year it encouraged a focus on short-term decision making, particularly as the target date approached and the Treasury forecasts were revised.

Following the achievement of the 2014/15 surplus target, the Government recently reviewed its fiscal targets. There has been some change to make the next fixed date target – to reduce net debt to around 20% of GDP by 2020 – more flexible (previously it was below 20% rather than around) to try to avoid undue focus on a particular year. Nevertheless, as 2020 approaches, there is a risk that it becomes difficult to allow net debt to fluctuate too far from this target. This again risks too much focus on short-term decision making and could lead to pro-cyclical fiscal adjustments if the economy were to weaken.

Delivering on the forecasts also requires ongoing tight fiscal management to meet operating allowances. The ability of departments to adapt to tighter fiscal conditions has been greater than initially expected. However, as time goes by, many departments are likely to be getting nearer to the “efficiency frontier”, and the ability to continue to manage within tight fiscal constraints in the absence of significant changes to service delivery models is not clear. The ability to continue to find efficiency savings is likely to require ongoing changes to the way the state sector operates. While the investment approach may lead to longer-term savings, there can be costs of change in the short term. If the ability to continue finding efficiency savings is not sustainable, there may come a point where delivering the fiscal strategy requires more difficult decisions about spending programmes.



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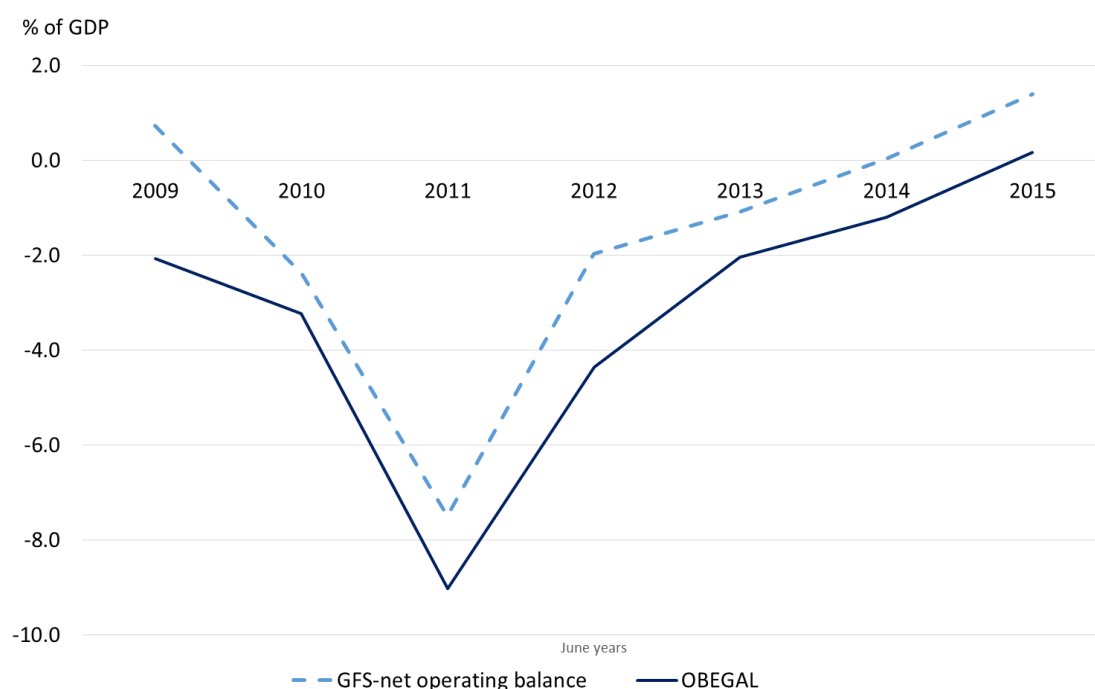
## Appendix 1: New Zealand's Fiscal Indicators

The New Zealand government's financial statements are prepared in accordance with New Zealand generally accepted accounting practice (GAAP) designed for public entities. This differs from the IMF's government finance statistics (GFS) framework<sup>23</sup>, which is commonly used for international comparisons. Some of the key differences relate to entity coverage as well as differences in the treatment of some transactions (defence weapons and some levies).

### Operating balance

The targeted measure of surplus/deficit in New Zealand is the operating balance before gains and losses (OBEGAL), which is the balance between operating revenue and operating expenses. The OBEGAL is reported for the total Crown reporting entity (which includes all government-owned entities including commercial entities). Gains and losses that reflect changes in market prices are excluded, but movements that reflect the impact of policy decisions are included (eg, impairments and write-offs on financial assets (like student loans) and earthquake provisions). In contrast, the GFS operating balance (or net lending/borrowing) includes local governments but excludes commercial entities and valuation effects which are captured separately under 'other economic flows'. The OBEGAL has been lower than the GFS-operating balance primarily because it includes valuation changes on assets and liabilities (Figure 19).

**Figure 19 – Alternative operating balance measures**



Sources: New Zealand Treasury, Statistics New Zealand

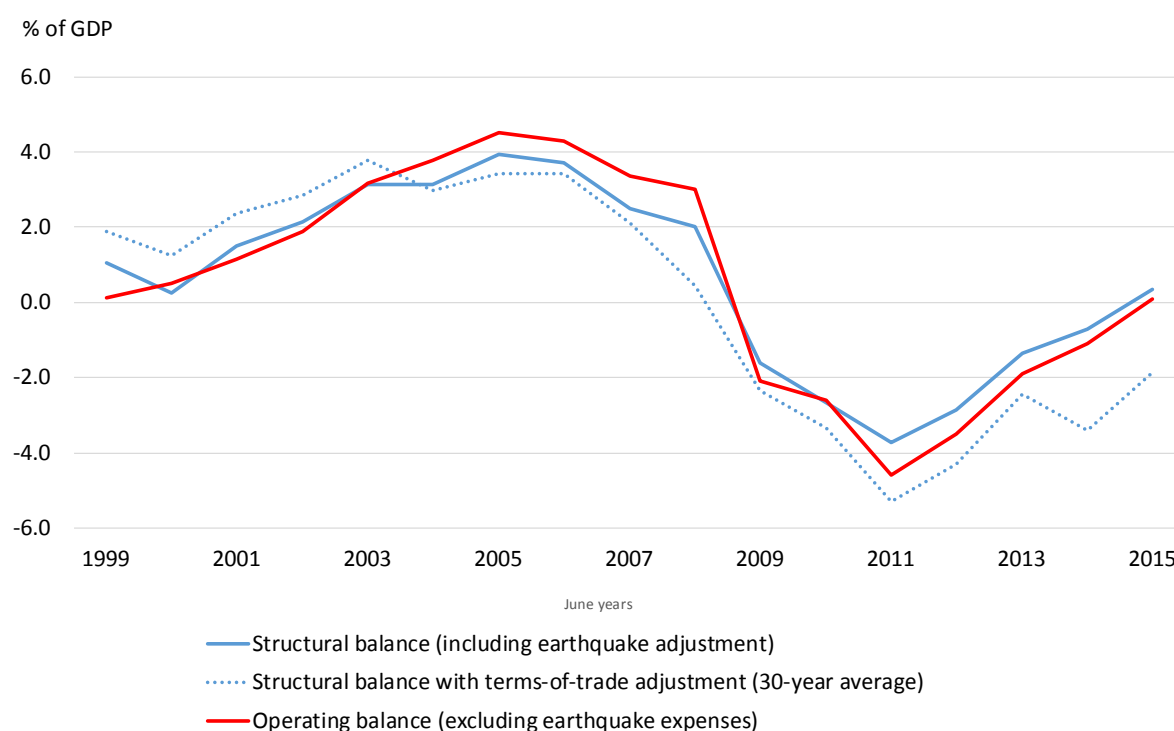
<sup>23</sup> IMF's Government Finance Statistics Manual 2014. See <https://www.imf.org/external/Pubs/FT/GFS/Manual/2014/gfsfinal.pdf>

## Structural balance

The structural balance adjusts the OBEGAL for the cyclical position of the economy and significant one-off factors. The structural balance is subject to uncertainty because it uses estimated variables and is sensitive to new information, particularly regarding the output gap. Significant “one-off” impacts on expenses from the Canterbury earthquake are removed from estimates of the structural balance. This is to give a better indication of underlying fiscal performance. The Treasury also publishes a terms-of-trade adjusted structural balance (Figure 21). For more details on the calculation, see Parkyn (2010).

The structural balance relates to the total Crown reporting entity. As such, estimates of structural revenue and structural expenses in this paper also relate to the total Crown. This contrasts to the Government’s expense target of 30% of GDP, which relates only to core Crown expenses.

**Figure 20 – Structural balance**



## Fiscal impulse indicator

The fiscal impulse indicator is the Treasury’s estimate of the extent to which discretionary fiscal policy is having an expansionary (positive) or contractionary (negative) impact on aggregate demand (Figure 12). Although the year-to-year change in the structural budget balance is a rough indicator of the contribution of discretionary fiscal policy to aggregate demand, the fiscal impulse indicator aims to provide a more accurate guide. It calculates the change in a cash-based version of the fiscal balance (a cyclically-adjusted primary balance supplemented by capital expenditure), excluding some expenditure items that are assessed to have a limited direct impact on aggregate demand (for example, capital expenditure on defence which is mostly imported equipment). For more detail on the calculation see *Additional Information*, Budget Economic and Fiscal Update 2015.