

**MERCATUS CENTER**  

---

**GEORGE MASON UNIVERSITY**

**TESTIMONY**

**From**

**The Hon. Maurice P. McTigue, Q.S.O.  
Vice President of the Mercatus Center  
Director, Government Accountability Project**

**For**

**Senate Homeland Security and Governmental Affairs Committee's  
Subcommittee on Federal Financial Management, Government  
Information, Federal Services, and International Security**

**June 26<sup>th</sup> 2008**

**On**

**“In the Red: How to Address our Nations Fiscal Challenges?”**

Mr. Chairman and members of the sub-committee, I am delighted to be invited to give testimony on the important issue of deficit financing. My learned colleagues also giving testimony this afternoon will give you much information about the gravity of the problem, the causal factors of the increase in America's debt and its rate of escalation. I am going to take the opportunity to examine the experiences of other developed nations and the actions taken by their governments to try and discipline their governments spending.

The Mercatus Center at George Mason University where I work has been advancing the principles of transparent and accountable government at the state and federal level for over a decade. During my time as an elected member of the New Zealand Parliament and a member of the New Zealand Cabinet, the government implemented a series of reforms that dramatically increased the government's transparency and resulted in better government, heightened prosperity, and improved public approval ratings for government organizations. This is the philosophy driving

Mercatus's Government Accountability Project, which strongly advocates reforms that make government more open, transparent, and accountable to the people.

The research done at the Mercatus Center at George Mason University and other organizations over the last ten years shows a very strong linkage between high levels of transparency and disciplined decision-making. However, the effectiveness of transparency mechanisms is very dependant on the quality of the information available. For transparency to be effective, the information released must enable the reader to easily and accurately develop an informed opinion of the state of affairs in the subject area under consideration.

Currently, in my opinion, the American federal government system of accounting does not allow the public to readily attain real knowledge of the state of the finances of its government. In this day and age, and with the sophistication of our society, it is unacceptable for the government to use cash accounting as the basis for its disclosure to the public. According to laws passed by Congress, the performance of all activities in our economy must be disclosed to the public on a full accrual basis. ***It is time the federal government impose on itself the same standards of disclosure and accountability as it demands of the non-government sector and adopt a full accrual accounting standard for government.***

Why do I place such high value on accrual accounting? The answer is personal experience. In 1987, the New Zealand government was one of the first in the world to fully convert its government accounting procedures over to full accrual accounting. I would be the first to admit that this was a difficult and time consuming process that took about five years to complete. One of the greatest difficulties of the transition was educating elected members of the parliament to cope with financial information and government accounts in a totally different format than they had used for decades. However, the value of disciplining public behavior was enormous.

The first full set of accrual accounts were presented to the public in 1992. The balance sheet for the government of New Zealand showed that the government had negative equity equivalent to about 20% of GNP. It was surprising to us in government that the media and the public focused on this figure and described the government of New Zealand as being technically insolvent. In succeeding years, this was the figure that attracted the most public comment.

Coincidentally, 1993 was the first year that the government declared a fiscal surplus after twenty-three successive years of deficits and accumulated debt equaling 68% of GDP, a position about equivalent to that of the United States today. New Zealand is now in its 16<sup>th</sup> successive year of surpluses. By 1996, the New Zealand accounts showed that the government had positive equity, and there has been improvement since then. New Zealand has devoted almost all of the surpluses to debt reduction and repaid all foreign denominated public debt and virtually all locally denominated public debt. It is now one of the few debt-free nations. At the same time, the New Zealand government

used a significant portion of recent surpluses to pre-pay the New Zealand equivalent of Social Security, which is currently paid through about 2025.

What altered public opinion about the acceptability of continuous deficits?

What changed the behavior of politicians to move away from deficit financing?

What created the discipline among politicians not to spend surpluses but rather to invest them in debt reduction and a strategy of limiting future liabilities?

In my view these changes were, in large part, a result of the transparency of the parlous situation of the New Zealand government when it became evident that the government's liabilities exceeded the nation's assets.

Along with fiscal transparency, the New Zealand government also passed a law in 1994 called the Fiscal Responsibility Act. New Zealand's Fiscal Responsibility Act was passed as an answer to the fiscal recklessness that led to a national economic crisis. The Act requires the government to transparently disclose (at regular intervals and before elections) its total revenues, total expenses, net worth, debt, tax policy, and the plan for managing fiscal risk. The Act also requires the government to publish economic forecasts every six months and use accrual accounting to manage its books. The Act established five principles for responsible fiscal management that governments are expected to follow:

- 1) Reduce total debt to prudent levels.
- 2) Manage debt by ensuring that, on average, total operating expenses do not exceed total operating revenues.
- 3) Achieve levels of government net worth that provide a buffer against future shocks.
- 4) Manage risks facing government prudently.
- 5) Pursue policies that provide a reasonable degree of predictability about the level and stability of tax rates.

In addition, this Act required the government to prevent future debt by allowing full transparency to act as a constraint to political action. The main features of these provisions are:

- The government, prior to incurring a deficit, must go to Parliament and seek permission from Parliament to go into debt.
- The request must identify the cause of the projected deficit.
- The request must identify how long the government will be in debt.
- The request must identify the amount of accumulated debt that will be incurred.
- The request must also identify how the government intends to repay the accumulated debt and over what period of time.

The net result of these requirements is that **no** government has sought permission to go into debt, and the country has a history of balanced budgets where surpluses are a regular feature of government fiscal management.

New Zealand is not alone in seeking greater transparency as a means of producing fiscal responsibility. The Australian Government passed a law called The Charter of Budget Honesty Act.

Australia's Charter of Budget Honesty Act, passed in 1998, is also grounded in transparency. The purpose of the legislation is to improve fiscal policy outcomes by requiring the government to adhere to responsible fiscal policy management principles and making fiscal policy and performance very open to the public. Like New Zealand's Fiscal Responsibility Act, the Charter requires the government to publicize a fiscal strategy statement and an economic outlook report with each budget. The New Zealand government must release an economic outlook report half way through the year and before general elections. Additionally, the government must release a budget outcome report within three months of the fiscal year's end.<sup>1</sup>

In a similar manner, the Government of Great Britain pursued a process of increased transparency to try and improve fiscal responsibility. The British initiative was enshrined in a code of practice, The Code for Fiscal Stability. Britain formulated its framework for fiscal policy in 1998, and the Code was given the force of law in the 1998 Finance Bill. The Code states explicitly that its purpose is to improve the quality of information provided to the public, the "lack of which in the past was an important factor underlying policy mistakes."

Five key principles of fiscal management are central to Great Britain's legislation: transparency, stability, responsibility, fairness, and efficiency. The Code also includes stringent reporting requirements: the government must report on its short and long term fiscal policy objectives and justify any deviations. The government must release a financial and economic report prior to the budget and after the budget is adopted. Finally, the government must publish a report indicating how they plan to manage their debt. All of these reports must be fully accessible to the public.<sup>2</sup>

The Australian and British governments have also taken initiatives to move towards some form of intergenerational accountability. Every five years, the Australian government requires government agencies to make an assessment of the consequences of current policies fifty years forward. In the case of the British government, the requirement is for government agencies to assess the consequences of current policies forty years forward every three years. The purpose of these initiatives is to identify policies or policy changes that may appear affordable in the short term but have disastrous consequences for future generations.

In addition, countries like Singapore and Hong Kong have, for many years, operated under a system of balanced budgets.

---

<sup>1</sup> <http://www.comlaw.gov.au/ComLaw/Legislation/ActCompilation1.nsf/framelodgmentattachments/1AF5822889419466CA256F710051FA64?OpenDocument>

<sup>2</sup> [http://www.hm-treasury.gov.uk/media/2/9/fiscal\\_stability.pdf](http://www.hm-treasury.gov.uk/media/2/9/fiscal_stability.pdf)

So, what can we learn from the actions taken by other national governments? First they are all struggling with similar problems concerning fiscal responsibility. Second they seem to have settled on increased transparency as the mechanism to help discipline spending behavior by governments. Third they seem to have also settled on some type of legislative action as the means of ensuring disclosure that will discipline spending behavior.

Now to consider the American deficit and accumulating debt problem. Over the last forty years, the federal government has produced surpluses in only five years: 1969, 1998, 1999, 2000, and 2001. The federal government did not use these surpluses to retire debt but were soon extinguished by increased spending. Given current policy mixes, the likelihood of surpluses in the near future is highly improbable.

American accumulated debt is growing steadily as a proportion of GNP save policy decisions already taken and future demographic factors will dramatically worsen the situation in the future.

Congress has developed a very undesirable practice of using Supplementary Appropriation Bills as a mechanism for making spending decisions on items that are clearly not of an emergency nature. It must be assumed that this is a device to minimize scrutiny of items that might otherwise be controversial. Congress needs to clarify and restrict the definition of emergency spending to a mechanism that will allow emergency spending only to be included in these bills.

With an election imminent, it appears neither candidate nor political party places a high priority on fiscal responsibility or deficit reduction. This indicates that either the fiscal situation of the American government is not a high priority in the minds of American citizens, or they are not aware of the deteriorating financial situation of their government.

## **POSSIBLE SOLUTIONS**

What might Congress do to return the United States's budgets to surplus as a norm?

- Require that budgets and financial reports cover a much longer time horizon of at least ten years forward.
- Return the supplementary appropriation process to one that accommodates emergency spending only.
- Pass a law that defines fiscal responsibility and requires the United States government to operate in a fiscally responsible manner.
- Move the whole of the federal accounting process to full accrual accounting.
- Introduce an appropriation process based upon the purchase of outputs designed to produce given outcomes.

Yours respectfully,

Hon. Maurice P. McTigue

