TARGET30

REDUCING THE BURDEN FOR FUTURE GENERATIONS

Strengthening Australia's Fiscal Institutions

Stephen Kirchner

THE CENTRE FOR INDEPENDENT STUDIES

T30.06

National Library of Australia Cataloguing-in-Publication Data:

Kirchner, Stephen, 1968- , author.

Strengthening Australia's fiscal institutions / Dr Stephen Kirchner.

9781922184245 (paperback)

Target30 ; T30.06.

Taxation--Australia.

Fiscal policy--Australia.

Budget deficits--Australia.

Other Authors/Contributors:

Centre for Independent Studies (Australia), issuing body.

Dewey Number: 336.200994

Strengthening Australia's Fiscal Institutions

Stephen Kirchner

THE CENTRE FOR INDEPENDENT STUDIES

T30.06

CIS TARGET30 publications

TARGET30

T30.05 Simon Cowan (ed.), *Emergency Budget Repair Kit* (2013)
T30.04 Robert Carling, *Shrink Taxation by Shrinking Government!* (2013)
T30.03 Jeremy Sammut, *Saving Medicare But NOT As We Know It* (2013)
T30.02 Andrew Baker, *Tax-Welfare Churn and the Australian Welfare State* (2013)
T30.01 Simon Cowan (ed.), *Towards Smaller Government and Future Prosperity* (2013)

ACKNOWLEDGEMENT

The author would like to thank Robert Carling for comments on an earlier draft.

Contents

Executive Summary

- The deterioration in the federal government's fiscal position reflects a failure to adhere to a rules-based framework for fiscal policy to guide spending and tax decisions.
- Fiscal policy has been distracted by the pursuit of macroeconomic stabilisation objectives that are inconsistent with the institutional design of Australia's overall macroeconomic policy framework.
- An independent central bank pursuing an inflation target, combined with a floating exchange rate, renders the change in the budget balance as a share of GDP from one year to the next an irrelevance from a cyclical perspective.
- The government's spending and tax decisions still have important microeconomic and efficiency implications that, in turn, influence long-run economic growth outcomes.
- A failure to balance the budget over time can be costly in terms of the burden of public debt interest and the need to increase future taxes in the absence of offsetting expenditure restraint.
- The cost of public sector borrowing is not just the interest rate on outstanding government debt, but also the efficiency cost of future tax increases needed to repay the debt.
- Expectations for the future path for net debt can undermine confidence even if current levels of debt are low by international standards.
- There is a growing international trend of adopting independent fiscal institutions coupled with legislated fiscal policy rules.
- Local and international experience show that independent fiscal institutions and fiscal rules, both individually and in combination, can lead to improvements in budget outcomes.
- Australia should draw on this local and international experience to strengthen its fiscal institutions to better address both the current structural budget deficit and long-term fiscal challenges arising from an ageing population.
- An independent statutory Fiscal Commission should assume responsibility for formulating the fiscal and economic parameters that frame the government's tax and expenditure decisions.
- The commission should also monitor and enforce a new set of legislated fiscal rules.
- These rules include limits on the budget balance, net debt, revenue and expenditure as a share of GDP, along with a rule limiting real growth in federal expenditure on an annual basis.
- The remuneration of all Members of federal Parliament should be reduced by 1% for every percentage point breach of the fiscal rules for the duration of the breach.
- A rules-based fiscal policy regime also provides a framework through which policymakers can focus on reducing the size of all levels of government in Australia to 30% of GDP and below to be achieved over 10 years, as proposed by the CIS' TARGET30 program.

Introduction

The federal budget is in structural deficit and net debt has increased by nearly 14 percentage points as a share of GDP since 2007–08. New big-ticket federal spending programs such as DisabilityCare and extra funding for schools are expected to put further pressure on the budget in the years ahead.

At the same time, a possible slowing in trend economic growth may constrain the revenue side of the budget. Factors that could lead to a persistent slowdown in trend economic growth include problems in the global economy, demographic trends, and a lack of further domestic supply-side reform.

The deterioration in the federal government's fiscal position reflects a failure to adhere to a rules-based framework for fiscal policy to guide spending and tax decisions.

Fiscal policy has been distracted by the pursuit of macroeconomic stabilisation objectives that are inconsistent with the institutional design of Australia's overall macroeconomic policy framework. An independent central bank pursuing an inflation target, combined with a floating exchange rate, renders the change in the budget balance as a share of GDP from one year to the next an irrelevance from a cyclical perspective.

To paraphrase Scott Sumner writing in the US context, the estimates of the fiscal policy multipliers that informed the Rudd-Gillard government's fiscal stimulus during the global financial crisis were 'little more than [incorrect] forecasts of central bank incompetence.'[2] The lack of financial market reaction to the federal government's fiscal policy statements underscores their irrelevance to the economic cycle.

Fiscal rules are a useful way of disciplining fiscal decision-making and encouraging a more systematic approach to the budget.

However, this does not mean that the government's fiscal policy decisions do not have economic consequences. The government's spending and tax decisions have important micro-economic and efficiency implications that, in turn, influence long-run economic growth outcomes. A failure to balance the budget over time can be costly in terms of the burden of public debt interest and the need to increase future taxes in the absence of offsetting expenditure restraint. The cost of public sector borrowing is not just the interest rate on outstanding government debt, but also the efficiency cost of future tax increases needed to repay the debt. Expectations for the future path for net debt can undermine confidence even if current levels of debt are low by international standards.

One of the main advantages of a macroeconomic policy framework based on a floating exchange rate and an inflation targeting central bank is that its allows the government to focus on the role of spending and tax decisions in conditioning incentives to work, save and invest, as well as the need to balance the budget over time, without having to be concerned with their short-run implications for the economic cycle. Monetary policy and the exchange rate largely offset the macroeconomic implications of the change in the budget balance as a share of GDP from one year to the next.

The Rudd-Gillard government's fiscal policies had Australia's macroeconomic policy framework exactly backwards. Former Treasury Secretary Ken Henry has said:

> If it's fiscal stimulus the most important thing is to get the money out the door. But how the money is spent, whether the money is in some sense wasted because there's overcharging or whatever, of course it's an important point but from a macroeconomic perspective it's very much second order, maybe even third order.[3]

In fact, it is the macroeconomic implications of attempted fiscal stimulus that is the second-order issue relative to the misallocation of resources Henry acknowledges in the above quote.

In testimony before various parliamentary committees, Henry and RBA Governor Glenn Stevens acknowledged the trade-off between monetary and fiscal policy in the context of the 2008–09 fiscal 'stimulus.' They argued that it was better to rely on a mix of macroeconomic instruments rather than monetary policy alone, citing alleged adverse side-effects from very low nominal interest rates. The Rudd-Gillard government, and now the Abbott government, have delayed fiscal consolidation based on the mistaken view that this will harm short-run economic growth, when the greater risk is to long-run economic growth prospects from an increasingly unsustainable long-term fiscal outlook. As Treasury noted in its 2007 Intergenerational Report (IGR):

> Demographic and other factors are projected to place significant pressure on government finances over the longer term and result in an unsustainable path for net debt towards the end of the projection period.[4]

The federal government's structural fiscal deficit, which provides the starting point for the IGR projections, has deteriorated substantially since then. Expectations of an unsustainable future path for net debt are more likely to hinder near-term economic growth than would a fiscal consolidation based on legislated fiscal rules that stabilises the long-term outlook for net government debt.

In addition to failing to comprehend the implications of Australia's macroeconomic institutions for the appropriate conduct of fiscal policy, successive governments have engaged in ad hoc decision-making and window-dressing of the budget balance projections at the expense of a more systematic approach to spending and tax decisions guided by fiscal rules.

Fiscal rules are a useful way of disciplining fiscal decision-making and encouraging a more systematic approach to the budget. For example, a timetable for achieving a budget surplus (more appropriately, a balanced budget) is useful mainly as a discipline on spending decisions and not because achieving a surplus on a specific date is essential in itself.

While recent governments have articulated various fiscal policy commitments as part of the fiscal strategy statements mandated by the *Charter of Budget Honesty Act 1998*, these commitments were too readily and easily abandoned or relaxed, allowing the budget to slip into a state of long-term disrepair.

Both Australian and international experience with fiscal rules suggests they can be helpful in improving fiscal outcomes, but require a stronger level of commitment and supporting independent fiscal institutions than has been the case in Australia to date. Fiscal rules can also provide a framework for reducing the size of government relative to the economy to 30% over 10 years, as proposed by the CIS' TARGET30 program.[5]

The following report reviews Australia's experience with fiscal policy rules since the mid-1980s, highlighting their successes and failures. The lessons from this experience are then discussed along with recent overseas trends in fiscal institutions and fiscal rules. This experience is then applied to argue for a new framework of fiscal institutions and rules to guide the conduct of Australian fiscal policy in the future.

Australia's experience with fiscal policy rules

Australia has a history of using discretionary fiscal targets and statutory charters to improve fiscal discipline. However, this experience points to the need for stronger fiscal rules and institutions.

The Hawke-Keating government

The Hawke-Keating government adopted a 'trilogy' of fiscal rules in its 1985–86 Budget. These commitments were to apply to the 1985–86 financial year and over the three-year term of the then Parliament.

1. **Not to raise tax revenue as a share of GDP**
   Based on current methods of accounting for tax receipts and nominal GDP, the tax share of GDP rose from 22.6% of GDP in 1985–86 to 23.3% in 1986–87, a level that was not again exceeded until the introduction of the GST in 2000–01.[6] The overall revenue share of GDP also increased.

2. **Not to raise government expenditure as a share of GDP**
   The government had more success with the second commitment. Based on current methods for accounting for expenditure and nominal GDP, federal payments fell from 27.4% of GDP in 1985–86 to as low as 23% by 1989–90.[7] Real spending fell for three consecutive financial years from 1986–87 to 1988–89 using the CPI to adjust for inflation.

3. **To reduce the budget deficit in absolute terms and relative to GDP**
   The third commitment was also met in terms of the underlying cash balance. The underlying cash balance improved from a deficit of around $6 billion or -2.6% of GDP in 1984–85 to a budget surplus of nearly $6 billion or 1.5% of GDP in 1989–90. Although not part of the formal trilogy of fiscal policy commitments, net debt fell from a peak of 10.3% of GDP in 1985–86, close to the same ratio as in 2012–13, to 4% by 1989–90.

These fiscal outcomes reflected economic conditions outside the government's control as well as the government's discretionary tax and spending decisions. The failure to meet the first rule can to some extent be attributed to stronger economic conditions adding to growth in revenue, which also helped achieve the second and third rules by limiting outlays.

However, the trilogy commitments were useful in conditioning the government's approach to both the tax and expenditure sides of the budget. The government was able to cut spending in real terms over three consecutive financial years, which shows that fiscal rules can help impose fiscal discipline.

However, the experience of the Hawke-Keating government is also salutary in demonstrating how quickly fiscal outcomes can deteriorate in the context of the recession that followed in 1991. The deterioration was made worse by a discretionary fiscal stimulus in the February 1992 'One Nation' package, which came too late to offset the contraction in 1991 (assuming a positive fiscal multiplier in the absence of an inflation targeting monetary policy before 1993). As with the Rudd-Gillard government's fiscal stimulus in 2008–09, a misplaced faith in discretionary fiscal stimulus distracted the government from the need to maintain a disciplined approach to spending focused on improving microeconomic incentives rather than macroeconomic stabilisation.

In its 1993–94 Budget, the Keating government adopted a target of reducing the budget deficit from what in today's terms was a deficit of 3.9% of GDP to a deficit of 1% of GDP by 1996–97. This target was achieved, albeit with a reliance on tax increases that contributed to raising the tax share of GDP by over two percentage points and with a change of government in 1996, when the newly elected Howard government implemented a substantial fiscal consolidation in its first budget.

The Howard government

The adoption of federal fiscal responsibility legislation was a recommendation of the National Commission of Audit carried out by the Howard government in 1996, which also set the stage for a substantial fiscal consolidation. The *Charter of Budget Honesty Act 1998* was passed by the federal Parliament in 1998, although the government had been adhering to its principles from the time it assumed office in 1996.

The Act sets out general principles of sound fiscal management; however, it is non-prescriptive as to fiscal targets or outcomes. The Act mandates regular fiscal strategy statements that include fiscal objectives and targets for the next three years as well as a longer-term fiscal strategy.[8]

The Howard government committed to achieving and maintaining a balanced budget over the course of the economic cycle (usually interpreted as an underlying cash surplus of around 1% of GDP). The principles allow for temporary measures (e.g. fiscal 'stimulus') to address cyclical conditions. However, as already noted, this is a distraction from the proper role of fiscal policy given an inflation targeting monetary policy and a floating exchange rate.

The Act also requires regular fiscal and economic updates.

- A Mid-Year Economic and Fiscal Outlook (MYEFO) statement is published in-between annual budgets.
- A final budget outcome report is required within three months of the end of the financial year.
- A Pre-Election Economic and Fiscal Outlook (PEEFO) is prepared independently of government by the secretaries of the departments of Treasury and Finance within 10 days of the issue of a writ for a general election.

The aim of these regular fiscal updates is to increase fiscal transparency and accountability in the intervals between the annual budgets and to ensure better-informed public debate on fiscal issues, especially during elections. However, there is arguably too much discretion in relation to the timing of the release of the MYEFO. Recent governments have also issued fiscal statements immediately before the calling of an election and the release of the more independent PEEFO in an effort to constrain Treasury and Finance in preparing the latter report.

One of the innovations contained in the *Charter* was a requirement for the government to prepare IGRs at least every five years to assess the sustainability of federal fiscal policy over a 40-year horizon. The first IGR was produced in 2002, with subsequent reports in 2007 and 2010. The Rudd-Gillard Labor government committed itself to producing these reports at three-year rather than five-year intervals, although it did not produce one in 2013.

Successive IGRs have highlighted a large prospective fiscal gap at a 40-year horizon based on the technical assumption that the tax share of GDP remains constant while expenditures continue to grow under current policy settings.

The IGRs have focused public attention on the long-term sustainability of current government spending programs and encouraged debate about tax and expenditure reform. The IGRs have also lengthened the time horizon over which the budget implications of government programs are considered. Recent budgets have sought to reconcile the regular budget fiscal strategy statements with the IGR projections to better connect short-, medium- and long-term fiscal strategies. The IGRs were a significant innovation in fiscal reporting internationally, and have also been adopted by some state governments.[9]

The statutory charter model of fiscal responsibility legislation put in place by the Howard government has a number of shortcomings. While significantly improving fiscal transparency and accountability, the lack of specific and legislated fiscal rules as opposed to just discretionary targets has allowed governments to shift the goal posts on their fiscal policy commitments in response to changing economic and political circumstances. For example, the Howard government's fiscal strategy included a commitment to keeping the federal tax share of GDP below its 1996–97 level of 22.4% of GDP. The tax burden subsequently rose to nearly 23% of GDP by 1999– 2000 before the introduction of the GST the following financial year.

The adoption of federal fiscal responsibility legislation was a recommendation of the National Commission of Audit carried out by the Howard government in 1996, which also set the stage for a substantial fiscal consolidation.

Some fiscal targets were set as public commitments separate from the fiscal strategy statements under the *Charter*. For example, the Howard government made a public commitment to maintain budget surpluses equal to 1% of GDP, although this was at a time when budget surpluses were typically more than 1% due to positive revenue surprises from a booming terms of trade after 2003. Rather than restraining spending, this commitment became a rationale for increasing it to maintain the budget balance broadly steady as a share of GDP and as revenue grew strongly on the back of a rising terms of trade. Fiscal targets should be set to impose discipline rather than simply codify existing fiscal outcomes.

It is sometimes argued that the Howard government 'squandered' the positive revenue surprises from the terms of trade boom through a combination of increased spending and tax cuts, despite establishing a sovereign wealth fund (the Future Fund) in 2006. Federal spending increased by 3.3% in real terms and 6.3% in nominal terms on average between 2001–02 and 2007–08, although the expenditure share of GDP fell by nearly two percentage points over the same period due to relatively strong nominal GDP growth.

The suggestion that the federal government should have saved more of the addition to revenue from the terms of trade boom assumes that increased saving by the federal government during the boom years would have been spent more responsibly by subsequent governments in later years. In the absence of a more rigorous rules-based fiscal policy framework than was put in place by the Howard government, this is an unlikely counterfactual, especially in view of the subsequent record of the Rudd-Gillard government (see below). It is important to recall that government saving is just deferred government spending in the absence of a commitment to future tax cuts.

It is also incorrect to argue that tax cuts are 'wasted.' Income tax cuts such as those implemented by the Howard government boost the supply side of the economy, all else being equal, through increased labour force participation (which increases the tax base). Government saving via the Future Fund reduced the scope for supply-side enhancing tax cuts and government expenditure on productivity-enhancing infrastructure. Households can be expected to spend more responsibly than government that part of the increase in after-tax disposable income which is not saved, although saving can be expected to be larger for an unfunded than a funded tax cut (i.e. a tax cut funded through reductions in government spending). Empirical estimates for Australia find that around half of any change in government saving is offset by changes in private sector saving.[10] This limits the scope for increased public saving to increase national saving, as well as the scope for discretionary fiscal policy to stabilise the economy.

The Rudd-Gillard government

The Rudd-Gillard government left the *Charter of Budget Honesty* largely unchanged, although measures were adopted at the margin to increase the transparency with which the Act operated as part of Operation Sunlight reforms.[11] The government assumed office in November 2007 with a public commitment to increasing budget surpluses to 1.5% of GDP and paying surpluses above that figure into the Future Fund.

In the event, the Rudd-Gillard government did not maintain a balanced budget or contribute to the Future Fund. This is partly attributable to the downturn in the domestic and world economy during the 2008–09 financial crisis and the associated discretionary fiscal stimulus introduced in late 2008 and early 2009, but also the cumulative effect of structural spending commitments.

The Rudd-Gillard government could have avoided many of these problems by resisting the siren call of discretionary fiscal stimulus.

In its fiscal strategy statements, the government also committed to holding the tax share of GDP below the 2007–08 level on average, the level bequeathed by the Howard government. This target has been met, although largely for cyclical rather than structural reasons.

The 2010–11 Budget set out a 'deficit exit strategy' that included 'holding real growth in spending to 2 percent a year until the budget returns to surplus.' This was later modified to 2% 'on average.' Based on actual fiscal outcomes to the end of 2012–13, this commitment was met, although it largely reflected the rolling-off of temporary fiscal stimulus measures and window-dressing of the underlying cash balance. Federal spending rose 0.4% per annum on average between 2010–11 and 2012–13, coming off very large increases in spending in the immediately preceding years (pre-2010).

The one-off fiscal stimulus of 2008–09 did temporary rather than permanent damage to the federal budget, although the increased debt has raised net public debt interest payments to 0.5% of GDP and will also increase the future tax burden in the absence of offsetting expenditure restraint.

However, the main objection to the temporary fiscal stimulus was not its one-off contribution to the deterioration in the budget balance or the increased debt burden. The more important objection is to the misallocation of resources due to poor quality spending that was not subject to appropriate cost-benefit tests, and did not have the claimed macroeconomic benefits in the presence of an inflation targeting central bank and a floating exchange rate.

Ironically, the fiscal stimulus likely resulted in more disciplined fiscal decisions in subsequent years as the government sought to recover fiscal credibility in the eyes of the electorate by forecasting a return to surplus. However, the drive to book a surplus made many of the associated tax and spending decisions look arbitrary because of a lack of a deeper economic rationale for these measures. When the projected surplus proved elusive, the government abandoned its timetable for a return to surplus on the mistaken grounds that further fiscal consolidation would damage the economy in the short run.

As noted above, this is based on a misunderstanding of Australia's main macroeconomic institutions. The Rudd-Gillard government could have avoided many of these problems by resisting the siren call of discretionary fiscal stimulus, placing greater weight on monetary policy for macroeconomic stabilisation, and keeping fiscal policy focused on the supply side of the economy.

One innovation of the Gillard government was the formation of the Parliamentary Budget Office (PBO), a proposal also supported by the federal Coalition when in opposition. The PBO commenced in July 2012 following the 'Agreement for a Better Parliament: Parliamentary Reform' negotiated with independent MPs following the 2010 federal election.

The PBO is a parliamentary department and the parliamentary budget officer reports to the parliament rather than the government. The PBO is expected to have a staff of 35 by 2013, approximately double that of its Canadian counterpart on which it is loosely modelled. The mandate for the Australian PBO is broader than for other comparable parliamentary budget organisations. The role of the PBO is to 'inform the Parliament by providing independent and non-partisan analysis of the budget cycle, fiscal policy and the financial implications of proposals.'[12] The independence of the parliamentary budget officer is similar to that of other statutory officers such as the auditor-general.

The PBO is seen as addressing some of the shortcomings in the process for costing election policy commitments under the *Charter of Budget Honesty* and its failure to provide a process for subjecting the government's fiscal policies to independent scrutiny. It remains to be seen how the PBO performs in practice over the longer term, but it is potentially a significant reform that can be built upon. A better model would be an independent statutory fiscal commission, as proposed in this report.

Assessment and lessons learned from Australia's experience

The introduction of fiscal responsibility legislation by the Howard government was associated with a significant improvement in fiscal policy outcomes.

While fiscal responsibility legislation is not necessarily a causal factor in these outcomes, it can be argued that the legislation helped reinforce the political commitment to improved fiscal outcomes, and provided a framework for politicians to better articulate these commitments.

Assessment of reforms

The reforms to Australia's overall macroeconomic policy framework, including the adoption of explicit inflation targeting by the Reserve Bank of Australia in August 1996, saw an improvement in macroeconomic performance that in turn underpinned fiscal outcomes. It is thus conceptually and empirically difficult to separate the specific contribution of fiscal responsibility legislation to fiscal outcomes from a counterfactual in which the legislation was not adopted.

On average, the federal budget has been close to balance at -0.2% of GDP since 1996–97. This is broadly consistent with the objective of a balanced budget over the course of the economic cycle, although the average for the underlying cash balance conceals a significant structural deterioration in the budget more recently.

Australia's improved fiscal performance was also evident in a number of other indicators.

The spread between Australian and US 10-year government bond yields narrowed significantly in the mid-1990s, coinciding with the introduction of formal inflation targeting and the *Charter of Budget Honesty*. This suggests a reduction in sovereign default and inflation risk premia on Australian dollar-denominated assets, lowering Australia's cost of borrowing. This was a significant macroeconomic benefit from a more rules-based approach to both monetary and fiscal policy.

Australia's improved fiscal performance was also evident in rating actions by credit ratings agencies. Having been downgraded during the 1980s, the Commonwealth of Australia saw sovereign ratings upgrades from Standard & Poor's in May 1999 and February 2003; Moody's in October 2002; and Fitch in February 2003 and November 2011.[13] These upgrades mostly occurred before the onset of the terms of trade boom in 2003.

Abstracting from the economic cycle, fiscal stimulus, and other temporary influences on the budget, the federal budget balance is estimated by the PBO to have been in structural surplus between 2001–02 and 2007–08 under the Howard government, before going into structural deficit between -3.25% and -4.25% of GDP by 2011–12.[14] In its 2013 PEEFO, Treasury used a different methodology estimating the structural deficit as between 1% to 3% of GDP in 2012–13.[15]

The PBO estimates the federal budget will remain in structural deficit until 2016–17, although these estimates are necessarily subject to considerable uncertainty. The structural deficit demonstrates that the recent deterioration in the budget balance cannot be attributed to the state of the economy or the one-off fiscal stimulus of 2008–09, but to the accumulation of discretionary spending and tax measures.

The reforms to Australia's overall macroeconomic policy framework, including the adoption of explicit inflation targeting by the Reserve Bank of Australia in August 1996, saw an improvement in macroeconomic performance that in turn underpinned fiscal outcomes.

It is important to appreciate that tax and spending decisions can have persistent effects on the budget over long horizons. For example, the introduction of the Age Pension in 1909 now heavily conditions the expenditure side of the budget more than century later. The fiscal institutions and strategies pursued by successive governments have failed to adequately discipline fiscal policy, even though they likely represent an improvement on the outcomes that might have been seen in the absence of the *Charter of Budget Honesty*.

If the Rudd-Gillard government's fiscal rules of 2% average real growth in spending and the tax share of GDP held constant at 23.7% of GDP were allowed to lapse, the federal Treasury estimates that real spending will grow at 3.5% over the next decade.[16] This is in line with the average growth in real spending since 2001–02. At the same time, the tax share of GDP would rise to 25.5% over the same period. While this would see the budget balanced and net debt return to near zero in around 10 years, it would come at the expense of a significant expansion in the size of government as a share of GDP. By contrast, maintaining the previous government's unlegislated fiscal targets would contain growth in the relative size of government.

Lessons learned

Several lessons stand out from this review of Australia's experience with fiscal policy rules.

1. Governments have allowed themselves to become too easily distracted by macroeconomic stabilisation objectives in the context of an economic downturn.

2. Governments need to better understand and articulate the implications of Australia's macroeconomic institutions for the effectiveness of discretionary fiscal stimulus.

3. In particular, they need to recognise that the expected fiscal policy multiplier is zero in the presence of an inflation targeting central bank and a floating exchange rate. While monetary policy mistakes are always possible, this is an argument for better monetary policy and monetary institutions rather than for increased reliance on fiscal policy. Some have mistakenly argued that the zero lower bound on nominal interest rates is a constraint on monetary policy, but overseas experience with quantitative operating instruments demonstrates that this is not the case.

4. Another lesson from the Australian experience is that the specification of, and adherence to, fiscal policy rules have been overly discretionary with a lack of independent scrutiny and enforcement mechanisms, allowing governments to shift the goal posts and redefine the rules based on changing economic and political circumstances. This in turn has set the stage for a long-term drift in the structural budget position.

The fiscal principles embodied in the *Charter* are for the most part too flexible in their expression to be enforceable, while the fiscal targets that are meant to give effect to those principles are entirely discretionary. The current legislation specifies that 'nothing in the Charter of Budget Honesty creates rights or duties that are enforceable in judicial or other proceedings.'[17] There is no provision for an independent audit of fiscal strategy statements or outcomes. These shortcomings can be addressed by adopting new fiscal institutions and rules that draw on Australian and international experience.

Overseas experience

There is a growing international trend to combining independent fiscal policy councils with fiscal policy rules to increase budget transparency and accountability and improve fiscal outcomes.

As of January 2013, there are 29 fiscal councils identified by the IMF, including Australia's PBO.[18] The majority of these fiscal councils are associated with the adoption of fiscal rules, and have a mandate to monitor compliance with these rules. Whereas in 1990, only seven countries were found by the IMF to use fiscal rules, by 2009, this had increased to 80 countries, including 21 advanced economies.[19]

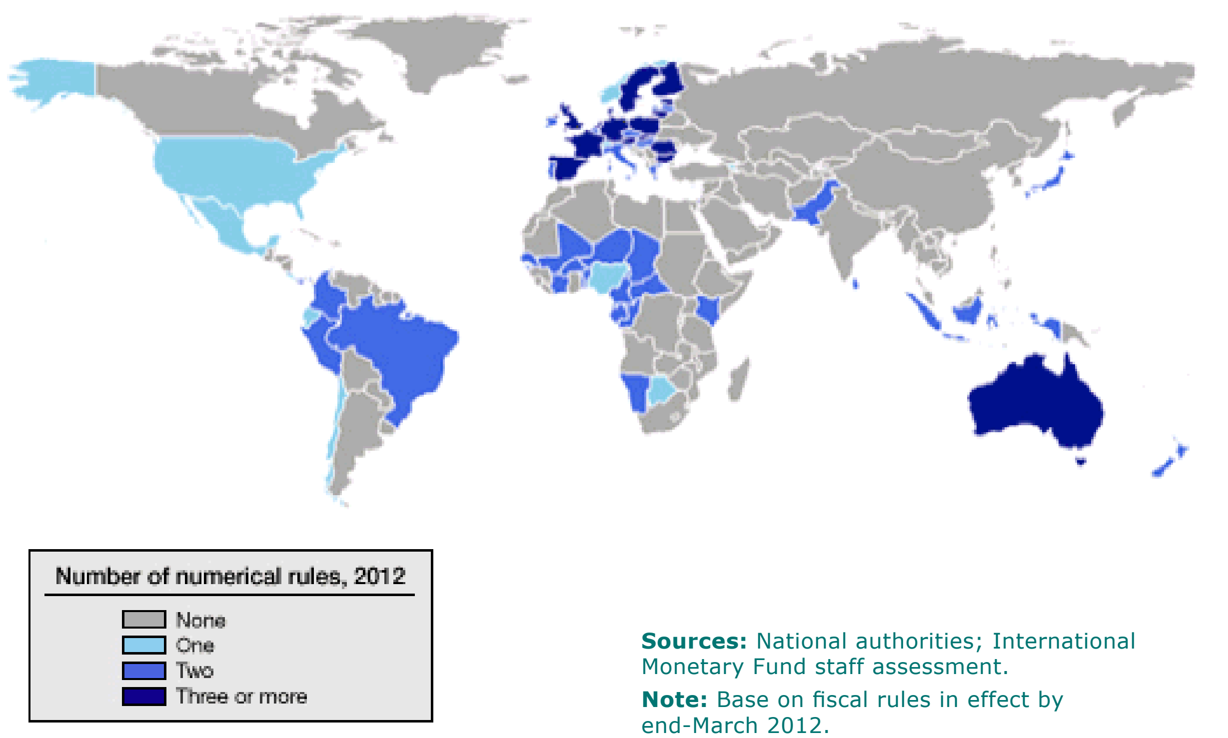
Both fiscal policy councils and fiscal policy rules have been shown to improve fiscal outcomes, especially in combination, although the direction of causality is debatable. It is widely acknowledged that fiscal policy councils and fiscal rules are not a substitute for political will, but are nonetheless useful complements to the process of securing electoral and political support for responsible fiscal policies, while improving fiscal transparency and democratic accountability.

Fiscal policy councils have also been shown to produce more accurate and less biased economic forecasts than official government forecasts. In some cases, for example, Canada and Sweden, these bodies have led to an improvement in the government's official forecasts because of competition from the independent fiscal council.[20] This reduces the risk that governments will increase spending based on inaccurate or overly optimistic forecasts.

In the United Kingdom, Treasury is required to use the five-year economic and fiscal forecasts produced by the independent Office of Budget Responsibility (OBR), subject to a 'comply or explain' provision whereby Treasury has to publicly explain any choice not to use the OBR forecasts. The Bureau for Economic Policy Analysis (CPB) in the Netherlands also independently prepares the macroeconomic forecasts used by the Dutch government in its budget.

In Canada and Sweden, independent fiscal policy councils have assumed a high profile in public debate,

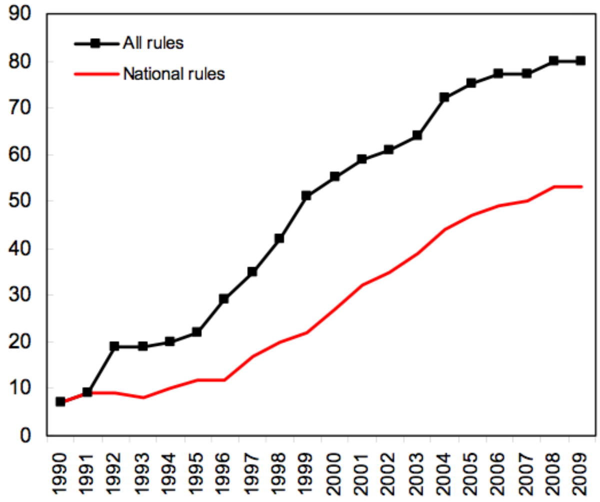
Figure 1. Countries with fiscal rules (national and supranational), 2012



Sources: National authorities; International Monetary Fund staff assessment.

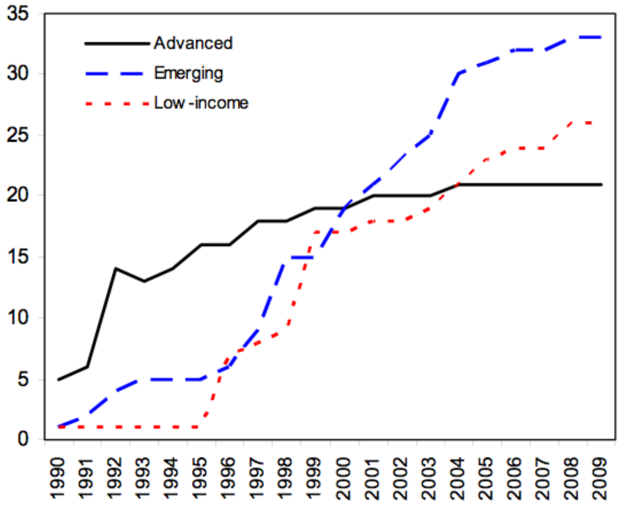
Note: Base on fiscal rules in effect by end-March 2012.

Figure 2. Number of countries with fiscal rules



Source: International Monetary Fund.

Figure 3. Number of countries with fiscal rules by type of country group



Source: International Monetary Fund.

directly criticising government policy when appropriate. As the IMF notes:

> [Sweden's Fiscal Policy Council] has established its independence and built up its reputational capital. It has achieved this through the quality of its independent analysis and its willingness to take a stance and criticise the government on key fiscal policies when needed. This normative approach has helped the council gain credibility and to win over the initially reluctant opposition parties.[21]

Overseas experience also points to the usefulness of legislated penalties in securing compliance with fiscal policy rules. The Canadian provinces of Ontario, Manitoba, Alberta and Yukon all have experience with legislated penalties for failure to meet fiscal targets established in the 1990s, although these rules have now been largely superseded by subsequent legislation. Pay cuts of between 20% and 50% were applied to members of the executive council if fiscal rules were not met, with penalties typically increasing the longer the targets were breached.[22] Other legislated fiscal rules at the provincial level in Canada provided for the dismissal of the executive and the triggering of elections if breached.[23]

Fiscal policy rules at the provincial level have been shown to improve fiscal outcomes in Canada.[24] In the United States, fiscal rules in the states have been shown to improve budget outcomes[25] and reduce macroeconomic volatility by limiting pro-cyclical discretionary fiscal policies,[26] although it should be noted that these findings pre-date the most recent recession in the United States.

A new approach to fiscal institutions and rules

Australia's fiscal institutions need to be redesigned to ensure that fiscal policy remains focused on long-term fiscal sustainability and supply-side efficiency, and not distracted by demands for short-term fiscal stimulus and politically popular spending.

This can be done through a new independent statutory fiscal commission and new legislated fiscal rules to improve on the *Charter of Budget Honesty Act 1998*.

As the IMF notes, the main role of independent fiscal bodies is to raise the 'reputational and electoral costs of undesirable policies and broken commitments.'[27] The IMF defines a fiscal council as:

> A permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government's fiscal policies, plans and performance against macroeconomic objectives related to the long-term sustainability of public finances, short-medium-term macroeconomic stability and other official objectives. In addition, a fiscal council can perform one or several of the following functions: (i) contribute to the use of unbiased macroeconomic and budgetary forecasts in budget preparation (through preparing forecasts, or proposing prudent levels for key parameters), (ii) identify sensible fiscal policy options and possibly formulate recommendations, (iii) facilitate the implementation of fiscal policy rules and (iv) cost new policy initiatives.[28]

The CIS has previously proposed an independent federal statutory Fiscal Commission (the commission), with commissioners appointed in consultation with the states, much like the Australian Competition and Consumer Commission commissioners.[29]

The IMF notes that a stand-alone institution 'offers the best guarantee of legal and functional independence.'[30] This argues against the parliamentary/congressional budget office model adopted in Australia and which is necessarily subordinate (as opposed to just reporting) to Parliament. The IMF also notes a growing trend in the appointment of foreign experts to fiscal councils, enhancing independence and giving access to a global talent pool.[31] Appointments to the Fiscal Commission should not be limited to Australian nationals.

Role of the commission

The role of the commission would include defining the parameters for the annual budget and other fiscal policy statements, including the economic forecasts and fiscal projections, as well as producing analytical reports such as estimates of the structural budget balance, IGRs and policy costings according to its own, preferably fixed, timetable.

The commission would thus subsume the functions of the PBO. Unlike the PBO, the commission would serve the public rather than parliament. Only election and other policy proposals with significant economic and fiscal implications would be costed by the commission. The commission should assume a prominent role in the public debate over fiscal policy, in much the same way the Productivity Commission does on industry policy and productivity issues.

How would it work?

The federal government would formulate its budget within the parameters defined by the commission, but subject to legislated fiscal rules the commission would monitor and enforce. The federal government would still enjoy substantial discretion to make tax and spending decisions within this overall framework, but the fiscal rules would serve to tie down expectations in relation to long-run fiscal outcomes in much the same way the Reserve Bank ties down long-run inflation expectations.

The proposed Fiscal Commission would take some of the politics out of key elements of the budget process. A persistent problem with the conduct of fiscal policy in Australia is the perception that the technical assumptions and parameters underpinning the budget have been politicised. This has led to pointless partisan debate over economic and fiscal parameters at the expense of debating the substance of tax and expenditure measures. While the degree of politicisation has been exaggerated, the perception is itself damaging and difficult to remedy without fundamental institutional change.[32]

New fiscal policy rules

Before describing the proposed fiscal policy rules, it is important to emphasise that these should be made subject to well-defined caveats or escape clauses similar to those contained in the Reserve Bank of New Zealand's Policy Targets Agreements. These caveats would allow for temporary breaches of the rules in the event of war, natural disaster, and other severe supply shocks. Such caveats are widely used in fiscal policy rules in other countries. Aggregate demand shocks should be accommodated through monetary policy and the operation of automatic fiscal stabilisers. This approach provides an explicit framework for departure from the rules, and limits the scope for fiscal opportunism or ineffective attempts at demand management and macroeconomic stabilisation through fiscal stimulus.

A set of fiscal policy rules should be written into a new Fiscal Responsibility Act to replace the existing *Charter*, as proposed by Robert Carling and Stephen Kirchner.[33]

1. The first fiscal rule would require the federal fiscal balance to be maintained within a range of +2% to -2% of GDP on both an actual and forecast basis. A four-percentage point range would have been sufficient to accommodate most of the cyclical variation in the budget balance in recent decades. The traditional objection to a budget balance rule is that it might force a poorly timed fiscal contraction. But this is not a problem in the presence of an inflation targeting central bank. Budget balance rules and fiscal 'austerity' have been a problem in some US states in the context of the most recent recession and the Eurozone economies, but only because they lack independent monetary and exchange rate policies.

2. The second rule would limit the net debt to GDP ratio to 10%. The CIS first advocated this rule in 2009, when net debt was around 3% of GDP. Net debt has since risen to 10.1% of GDP in 2012–13, so this rule would now act as a binding constraint on the budget in the short term, requiring a fiscal consolidation of around 1% of GDP to balance the budget and get back under the proposed net debt limit. More generally, the proposed net debt ceiling is above the average net debt to GDP ratio for recent decades, although below the peak seen since the early 1990s recession. It would prevent governments from running continual budget deficits, although governments would have the flexibility to run deficits in the short run while under the ceiling. It would also serve to tie down expectations in relation to the future path of net debt, which recent IGRs have projected will rise unsustainably on a 'no policy change' basis. This projected path for net debt is potentially the most destabilising aspect of fiscal policy settings from an expectations management perspective, creating uncertainty about the future tax burden.

   Limiting net debt as a percentage of GDP should not be confused with the debt ceilings expressed in absolute dollar terms that have recently been the subject of debate in the United States and Australia. These debt ceilings are not fiscal rules as such, but part of the machinery for legislative authorisation of government borrowing. The original purpose of these debt limits was to give the US Treasury discretion in implementing its debt issuance program, without having to seek legislative authorisation for individual debt issues. Unfortunately, in the United States, and more recently in Australia, this legislative machinery has been politicised and used as a proxy for a properly specified and enforced set of legislated fiscal policy rules.

3. The third rule would cap the federal revenue and expenditure shares of GDP. Previously, CIS proposed a ceiling of 25% for the revenue and expenditure shares of GDP, although this does not preclude setting targets for reductions in the relative size of government as proposed by the CIS' TARGET30 program. The Rudd-Gillard government had a discretionary fiscal strategy commitment to maintain the tax share of GDP below the level of 2007–08, which was 23.7% of GDP based on the latest budget papers. Adding non-tax revenue of 1.4% of GDP gives a revenue share of 25.1% of GDP in 2007–08. A 25% ceiling on the revenue share would only serve to codify a policy commitment on the part of the previous government. The ceiling on the relative size of government should be gradually reduced over 10 years to lock in the reductions in expenditure and taxation relative to GDP envisaged by TARGET30. It should be noted that this would limit the size of government in relative terms, but not in absolute terms. To the extent that anchoring long-run fiscal expectations and containing the overall tax burden yields stronger economic growth, this can be expected to yield even more resources for government in absolute terms for a given revenue share of GDP.

Australia's fiscal institutions need to be redesigned to ensure that fiscal policy remains focused on long-term fiscal sustainability and supply-side efficiency, and not distracted by demands for short-term fiscal stimulus and politically popular spending.

Federal spending was 24.3% of GDP in 2012–13, down from a cyclical peak of 26.1% of GDP in 2009–10. The projections contained in Treasury's 2013 PEEFO imply that the expenditure share can be kept below 25% of GDP by limiting real growth in federal expenditure to 2% on average over the next 10 years. With population growth running at 1.8% in the year ended March 2013, this implies close to zero real spending growth in per capita terms. A rule capping real growth in federal spending at 2% per annum is a useful complement to a progressively reduced ceiling on the expenditure share of GDP. In particular, it ensures that temporary increases in revenue attributable to the terms of trade or other factors are not converted into structural spending programs. With an inflation target of 2.5%, this would yield average expenditure growth of 4.5% in nominal terms. This is less than trend nominal GDP growth of around 6% for the low inflation period in Australia since 1993 and should see the expenditure share of GDP contract over time. However, if trend growth in real GDP turns out to be more subdued than historical experience due to problems in the world and domestic economy, this may require a lower expenditure growth rule given the constraints this would impose on revenue growth.

Parameters and limitations

The parameters for these proposed rules are necessarily somewhat arbitrary, although they are designed to be consistent with the range of federal fiscal policy outcomes seen in recent decades, as well as the policy commitments articulated by recent governments. The proposed rules simply put into law what politicians have already largely promised to do in the past, but have not been willing to put into legislation. The specific parameters for the rules are less important than the need for a well-defined fiscal policy framework that anchors long-run expectations in relation to the future path of net debt, while allowing policymakers to retain discretion over policy priorities within the chosen parameters. The fiscal policy choices made within this legislated framework are then a matter for governments and the Parliament to determine on a discretionary basis.

Enforcement problems have been a significant limitation on the effectiveness of fiscal policy rules both in Australia and other countries. We have proposed an enforcement regime that would see the Fiscal Commission impose pecuniary penalties on all members of federal Parliament for breaches of the rules not subject to one of the well-defined legislated caveats or escape clauses, as determined by the commission.[34] This would involve cutting federal politicians' overall remuneration by 1% for every percentage point breach of each fiscal rule for the duration of the breach. All members of federal Parliament should be penalised to emphasise their collective responsibility for fiscal outcomes. The pecuniary penalty is less significant than the loss of political reputation that would accompany the imposition of such penalties by an independent commission. Unlike the *Charter of Budget Honesty*, the provisions of the new Fiscal Responsibility Act should be made subject to administrative and judicial review.

Conclusion

Australia has a long-term fiscal problem reflected in a structural budget deficit, the starting point for an expected long-term deterioration in the federal budget position that may end in a potentially explosive path for net debt at horizons of 40 years or more based on the federal Treasury's IGR projections.

With the exception of unemployment benefits, most federal spending is structural and reflects the cumulative policy decisions of successive governments.

Only structural reform of the expenditure side of the budget can keep the budget balanced over the long term without increasing the overall tax burden. Raising the tax burden is a self-defeating strategy for balancing the budget, as it will impose increased efficiency costs on the economy, consequently reducing economic growth, the size of the tax base, and the resources available to government in absolute terms.

This highlights the importance of putting in place stronger fiscal institutions and rules that will discipline spending and tax decisions today to prevent a more serious fiscal crisis in the future such as that now confronting many other advanced economies.

The proposed rules simply put into law what politicians have already largely promised to do in the past, but have not been willing to put into legislation.

Fiscal policy at the federal level needs to be based on a sounder understanding of Australia's two main macroeconomic institutions. An inflation targeting central bank and a floating exchange rate render the change in the budget balance as a share of GDP largely irrelevant to the economic cycle. While the economic cycle explains the short-run variability in revenue and expenditure, the change in the budget balance from one year to the next has minimal implications for the economy. This explains the lack of financial market reaction to the government's fiscal statements.

These macroeconomic institutions allow fiscal policy to focus on long-term fiscal sustainability and supply-side efficiencies without being distracted by cyclical considerations. Indeed, this is an important reason why Australia's macroeconomic performance has improved since the early 1990s relative to earlier decades when Australia had a managed exchange rate and the Reserve Bank failed to provide the economy with a nominal anchor. Yet much of the debate about fiscal policy mistakenly assumes that it is the budget that drives the economy rather than the other way around. Tax and expenditure priorities have been distorted and fiscal consolidation delayed because policymakers have failed to properly understand the fundamental implications of these key macroeconomic institutions.

In framing its fiscal policy, the Abbott government should affirm that aggregate demand management is the responsibility of the Reserve Bank, the exchange rate carries much of the burden of adjusting to external shocks, and the expected fiscal policy multiplier is zero.

There is a growing international trend of adopting independent fiscal institutions coupled with fiscal policy rules. Local and international experience show that independent fiscal institutions and fiscal rules, both individually and in combination, can lead to improvements in budget outcomes. Australia should draw on this local and international experience to strengthen its fiscal institutions to better address both the current structural budget deficit and long-term fiscal challenges arising from an ageing population.

An independent statutory Fiscal Commission should assume responsibility for formulating the fiscal and economic parameters that frame the government's tax and expenditure decisions. The commission should also monitor and enforce a new set of legislated fiscal rules. These include limits on the budget balance, net debt, revenue and expenditure as a share of GDP, along with a rule limiting real growth in federal expenditure on an annual basis.

A rules-based fiscal policy regime also provides a framework through which policymakers can focus on reducing the size of all levels of government in Australia to 30% of GDP and below over 10 years, as proposed by the CIS' TARGET30 program. Ceilings on the revenue and expenditure shares of GDP together with an expenditure growth rules can be used to lock in permanent reductions in the relative size of government as envisaged by TARGET30.

Endnotes

1 Commonwealth of Australia, *Pre-Election Economic and Fiscal Outlook* (Canberra: 2013).

2 Scott Sumner, *Why the Fiscal Policy Multiplier is Roughly Zero* (Arlington: Mercatus Center, George Mason University, September 2013).

3 ABC Television, 'Former Treasury head slams euro and sees Aussie boon,' *7:30 Report* (15 May 2012).

4 Commonwealth of Australia, *Intergenerational Report* (Canberra, April 2007).

5 Simon Cowan (ed.), *TARGET30: Reducing the Burden for Future Generations* (Sydney: The Centre for Independent Studies, 2013).

6 All fiscal data taken from Commonwealth of Australia, *Final Budget Outcome, 2012–13* (Canberra: 2013), unless otherwise indicated.

7 Real-time data on government spending, taxing and their ratios to GDP would have differed slightly from those reported here due to different accounting conventions and subsequent revisions to nominal GDP.

8 *Charter of Budget Honesty Act 1998.*

9 David Gruen and Duncan Spender, 'A Decade of Intergenerational Reports: Contributing to Long-Term Fiscal Sustainability,' *Australian Economic Review* 45:3 (2012), 327–334, doi:10.1111/j.1467-8462.2012.00697.x.

10 Shane Brittle, 'Ricardian Equivalence and the Efficacy of Fiscal Policy in Australia,' *Australian Economic Review* 43:3 (1 September 2010), 254–269, doi:10.1111/j.1467-8462.2010.00597.x.

11 Andrew Murray, 'Review of Operation Sunlight: Overhauling Budgetary Transparency' (June 2008).

12 Phil Bowen, *The Parliamentary Budget Office: An Independent Institution of the Australian Parliament*, keynote address to the CPA Congress 2012 (Canberra: 16 November 2012).

13 Parliamentary Library, *Australia's Credit Rating*, Flag Post (Canberra: 28 February 2013).

14 Parliamentary Budget Office, *Estimates of the Structural Budget Balance of the Australian Government, 2001–02 to 2016–17* (Canberra: Parliament of Australia, 2013).

15 Commonwealth of Australia, *Pre-Election Economic and Fiscal Outlook*, as above, 64.

16 As above, 61.

17 *Charter of Budget Honesty Act 1998*.

18 International Monetary Fund, *The Functions and Impact of Fiscal Councils* (Washington, DC: International Monetary Fund, 16 July 2013), 11.

19 International Monetary Fund, *Fiscal Rules—Anchoring Expectations for Sustainable Public Finances* (Washington, DC: International Monetary Fund, 16 December 2009).

20 International Monetary Fund, *The Functions and Impact of Fiscal Councils*, as above, 39.

21 International Monetary Fund, *Case Studies of Fiscal Councils—Functions and Impact* (Washington, DC: International Monetary Fund, 16 July 2013), 41.

22 Suzanne Kennedy and Janine Robbins, *The Role of Fiscal Rules in Determining Fiscal Performance*, Working Paper 2001–16 (Ottawa: Department of Finance, 2001), 13.

23 Office of the Parliamentary Budget Officer, *Canadian Experiences with Fiscal Consolidations and Fiscal Rules* (Canada: Office of the Parliamentary Budget Officer, 21 October 2010), 24–25.

24 Stephen Tapp, 'The Use and Effectiveness of Fiscal Rules in Canadian Provinces,' *Canadian Public Policy* 39:1 (2013).

25 Henning Bohn and Robert Inman, 'Balanced Budget Rules and Public Deficits: Evidence from the US States,' *Carnegie-Rochester Conference Series on Public Policy* 45:1 (1996).

26 Antonio Fatas and Ilian Mihov, 'The Macroeconomic Effects of Fiscal Rules in the US States,' *Journal of Public Economics* 90:1–2 (2006).

27 International Monetary Fund, *The Functions and Impact of Fiscal Councils*, as above, 1.

28 As above, 8.

29 Robert Carling and Stephen Kirchner, *Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation*, Policy Monograph 98 (Sydney: The Centre for Independent Studies, 2009).

30 International Monetary Fund, *The Functions and Impact of Fiscal Councils*, as above,48.

31 As above, 18.

32 Stephen Kirchner, 'Independent body needed to preserve integrity of fiscal forecasts,' *The Conversation* (21 May 2012).

33 Robert Carling and Stephen Kirchner, *Fiscal Rules for Limited Government*, as above.

34 As above.

TARGET30

REDUCING THE BURDEN FOR FUTURE GENERATIONS

Author

Dr Stephen Kirchner is a Research Fellow at The Centre for Independent Studies, and Editor of *POLICY* magazine. He is also a Senior Fellow at The Fraser Institute.

Acknowledgment

The author would like to thank Robert Carling for comments on an earlier draft.

THE CENTRE FOR INDEPENDENT STUDIES

CIS TARGET30 • T30.06 • ISSN Print: 2201-7615 • ISSN Online: 2202-3240 • ISBN: 978 1 922184 24 5 • AU$9.95
Published December 2013 by The Centre for Independent Studies Limited. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers.

This publication is available from the Centre for Independent Studies.
PO Box 92, St Leonards, NSW 1590 Australia • **p:** +61 2 9438 4377 **f:** +61 2 9439 7310 **e:** cis@cis.org.au