# Being Fiscally Responsible in Policy Development

*The following is the text of a speech given by Mr Steve French, Assistant Secretary, Budget Policy Branch, Fiscal Policy Division, Treasury to the fifth annual Government Policy Conference, held in Sydney on 4–5 August 1997.*

## INTRODUCTION

I have been asked to speak about 'Being Fiscally Responsible in Policy Development'. In doing so, I would like to cover three main issues:

- first, what is fiscal responsibility?
  - This includes an outline of the framework adopted by the Commonwealth for fiscal policy determination and the enhanced transparency and accountability mechanisms introduced with the Charter of Budget Honesty;
- second, I would like to cover the fiscal strategy being adopted within that framework, and the benchmarks that are being used to assess fiscal policy; and
- third, I would like to give some brief indications about the implications of greater fiscal responsibility and discipline for the development of policies.

## FISCAL RESPONSIBILITY

The meaning of fiscal responsibility is fairly simple and clear, though there are two dimensions to it:

- first, it implies that government budget setting — outlays, revenues, and balances — are determined so that they promote strong, sustainable growth in economic activity and employment. In addition, it implies that government budgets are themselves sustainable, and do not store up problems for future generations, including by racking up high public debts; and
- second, being fiscally responsible implies that government operates efficiently and effectively — in raising revenue and in spending taxpayers' money. This aspect of fiscal responsibility can help to bolster the first.

I'll return to efficiency and effectiveness and the complementarity of policies a little later, but I would like initially to focus on the former set of issues — the macroeconomic aspects of fiscal responsibility.

In the 1990s, the term 'fiscal responsibility' has been associated with the introduction of fiscal responsibility legislation in New Zealand and at the State government level in Australia. In similar vein, the Commonwealth has introduced a Bill for a Charter of Budget Honesty.

Moves towards greater fiscal responsibility are not new. Fiscal responsibility has long been advocated by international organisations, such as the International Monetary Fund (IMF), and national governments themselves.

This has involved the promotion of better budgeting systems — such as the development of budget forward estimates and programme evaluation — and reforms to budget presentation — including the usage of international classifications for government financial estimates, based on economic concepts. In some cases it has also been reflected in attempts to enshrine fiscal rules in legislation or in international agreements, such as those relating to the criteria for European Monetary Union (EMU) eligibility.

These developments have had varying degrees of success — in large part they have been positive developments, though it has to be acknowledged that the implementation of some fiscal rules has not been a success.

In any event, while fiscal responsibility is not 'new', I think that the frameworks now operating and being advanced in Australasia are probably the 'state of the art' amongst developed countries.

Why are these fiscal responsibility frameworks emerging? It is essentially because the fiscal record in many countries is not what it should be. In short, there has been a tendency for governments to spend more than they raise in revenue and to run deficits.

In Australia, the need for improved fiscal outcomes is demonstrated by the persistence of Commonwealth budget deficits over the past twenty years. As Chart 1 shows, there has been a structural deterioration in the Commonwealth's underlying balance since the 1960s, when we were generally running surpluses. The Commonwealth's budget deficits of the past twenty years have been associated with a ratcheting up of Commonwealth general government debt relative to Gross Domestic Product (GDP) over time (as shown in Chart 2).

**Chart 1: Underlying Budget Balance**

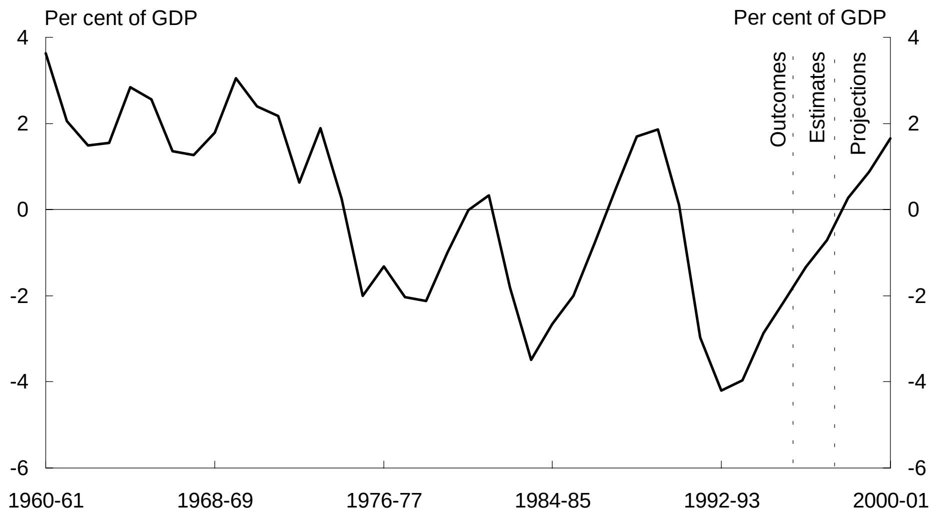
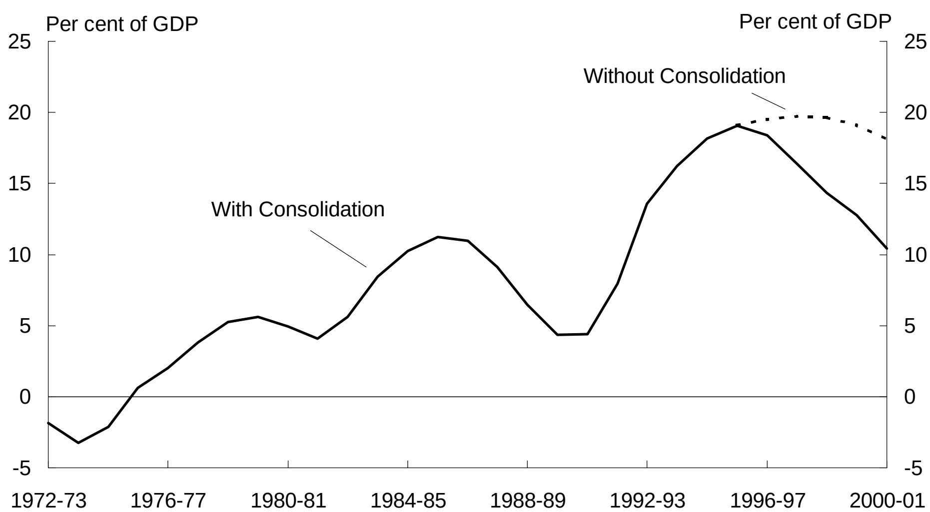



**Chart 2: Commonwealth General Government Net Debt**




This record is the background against which the Charter of Budget Honesty Bill has been introduced into the Parliament. The philosophy of the Bill is to improve fiscal responsibility and discipline by:

- enhancing the transparency of fiscal policy setting and ensuring that governments explicitly outline their fiscal policy intentions; and
- increasing accountability for fiscal policy outcomes, by ensuring that there is transparency in fiscal policy reporting and that comprehensive information on the fiscal outlook is available.

This enables the public and financial markets to judge governments on their fiscal performance.

The philosophy of the Bill is consistent with international experience which suggests that the greater the level of fiscal transparency the better tends to be the record of fiscal discipline.

The Charter ensures that governments determine and set out their policy in a medium-term framework — and explain how the shorter-term budgetary targets that they set themselves fit within that medium-term framework. The Charter is not about setting down prescriptive fiscal rules or what sort of accounting systems should operate. It recognises that there may be a need for governments to account for changing economic circumstances and to have some flexibility in determining and implementing fiscal strategies. But what it does do is ensure that governments outline their fiscal strategies, objectives and targets — and that they are held publicly responsible for delivering against those objectives and targets.

I think it is worth briefly running through the Charter's key elements:

- the framework for fiscal policy setting; and
- the framework for fiscal reporting.

## Fiscal Policy Setting

Under the Charter, governments are required to produce a fiscal strategy statement annually, which must outline:

- the Government's medium-term fiscal strategy;
- key fiscal objectives, targets, and expected outcomes for the budget and three forward years; and
- any actions that are temporary in nature to moderate the cycle, and processes for their reversal.

The Government's fiscal objectives need to be set in accordance with the principles of sound fiscal management. Among other things, that requires governments to:

- contribute to adequate national savings;
- carefully manage financial risks and ensure debt is maintained at prudent levels;
- maintain the integrity of the tax base and stability and predictability in the tax burden; and
- account for the effects of policies on future generations.

## Fiscal Reporting

In addition to the annual fiscal strategy statement, there are a number of other elements of the enhanced fiscal reporting framework under the Charter.

First, economic and fiscal outlook reports must be produced both at the time of the budget and mid-year. Apart from information on the fiscal and economic forecasts and projections for the budget and three forward years, the reports need to include:

- a statement of risks to the fiscal outlook, including contingent liabilities facing the Government and a statement on the sensitivity of fiscal estimates to changes in assumptions;
- information on tax expenditures — that is, concessions in the tax system, the budgetary costs of which would not otherwise be clear; and
- estimates on a general government basis (in addition to the budget sector). These general government estimates are not significantly different from the Commonwealth's budget definitions and presentation, but their publication does ensure that information consistent with international standards (and therefore comparable with other government financial statistics) will be continually available in the future.

Second, a report on the final budget outcome must be produced by the end of September each year (with information on both the budget and general government sectors).

Third, an intergenerational report is to be produced every five years. This must outline the effect of maintaining current budgetary policies over a forty year period. The objective is to provide a clear understanding of the longer-term implications of current budgetary settings and an assessment of whether current policies are sustainable in the longer term and consistent with the overall fiscal objectives of the Government.

Finally, the Charter ensures election campaigns are conducted on the basis of up-to-date information on the fiscal outlook, with a pre-election economic and fiscal outlook report to be produced no later than ten days after an election is called. Provision is also made for the costing of election commitments of the caretaker Government and the Opposition during election campaigns by the bureaucracy. The aim of these arrangements is to enhance the chances of a disciplined approach to fiscal policy and to raise accountability for pre-election policy announcements.

Beyond the Charter, I should note that the Commonwealth and State Governments have also agreed to a uniform presentation framework**,** which ensures a common core of information is produced in Commonwealth and State budgets, notably: three year forward estimates are to be produced for the general government sector; and the publication of mid-year reports (by the end of February each year). This helps ensure that there is fiscal transparency and accountability at both major levels of government in Australia, supplementing initiatives of individual States.

## FISCAL STRATEGY

So how is this framework for fiscal policy setting and determination being put into effect?

The Charter of Budget Honesty, while not yet passed into legislation, is being complied with and the information required by the Charter has been fully outlined in this year's Budget Papers.

A key is the fiscal strategy statement. There are two important components to the fiscal strategy — with the first relating to the underlying budget balance and the second to public debt.

The central plank of the strategy is to lift the level of national saving by increasing public saving. As a guiding principle, the aim is to maintain the budget in underlying balance, on average, over the course of the economic cycle. That is designed, over time, to ensure that the budget helps to address Australia's national saving-investment imbalance. I think it is worth covering this in a little detail.

Australia's current account deficit is the corollary of the imbalance between its national savings and investment — it represents the extent to which Australia has to call on foreign savings to finance its investment. While current account deficits are not necessarily a problem, countries running them do need to maintain the confidence of financial markets.

There has been a structural deterioration in Australia's current account performance over time — averaging a little over 2 per cent of GDP in the 1960s and 1970s, but over 4 per cent since the early 1980s. This has raised some doubts about the sustainability of the current account and has placed Australia in a situation where we are more vulnerable to economic shocks. It has tended to limit our ability to sustain strong economic growth.

Investment, provided that it is soundly based, is what is needed to sustain strong long-term economic prospects; it is inadequate national savings that has been at the root of the deterioration in the current account position. To an important degree, Australia's poor savings performance has reflected the underlying budget deficits run by the Commonwealth over the past twenty years or so. Correcting this deterioration in the fiscal position should help, over time, to improve our current account position and to create the conditions for stronger sustainable economic growth.

Why do we talk about the underlying budget balance? Traditionally, the main measure of the budget balance has been the simple difference between outlays and revenues — what we call the 'headline balance' today. However, the main focus of the Commonwealth's fiscal strategy has been the 'underlying balance' — which excludes the impact of net advances (that is, net policy loans and purchases and sales of equity assets). This is because this measure approximates net lending in the national accounts, which gives the best indication of the Government's direct impact on national saving. Moreover, as the underlying measure excludes transactions such as asset sales it can give a better indication of the sustainability of fiscal policy. Asset sales in recent years have been quite large, but they cannot be expected to continue forever boosting budget outcomes.

In addition, what do we mean when we talk about balance over the cycle? This is not saying that governments cannot run deficits during an economic downturn. Governments may wish to operate fiscal policy flexibly in a downturn. It may be necessary to allow 'automatic fiscal stabilisers' to operate in order to cushion the negative effects of a downturn — for example, to allow for the 'automatic' higher expenditure on social welfare associated with rising unemployment.

However, there has been a tendency for governments over a long period, not only in Australia, to operate fiscal policy in an asymmetric way — to take discretionary measures to ease fiscal policy in a downturn, but not to reverse them in the upswing. The goal of balance over the cycle addresses that tendency — requiring that if deficits are run in the downturns, surpluses need to be achieved in more favourable economic circumstances. This is bolstered by the requirement I mentioned earlier in the Charter of Budget Honesty, that governments identify the way in which any temporary measures to ease the effects of a downturn will be unwound in the upturn.

The second plank of the fiscal strategy is to achieve and maintain prudent levels of government debt. The extent of accumulated net debt is a key measure in judging the overall strength of a government's fiscal position. High levels of net debt impose a cost on future taxpayers in servicing the debt and meeting the public debt interest burden can limit a government's fiscal flexibility.

By most international standards, Australia's general government net debt is relatively reasonable. At around 25 per cent of GDP, it compares well with the OECD average of 45 per cent of GDP and 60 per cent in OECD Europe. However, it is not clear we should be judging ourselves against those poor benchmarks and, as noted earlier, there has been some tendency for Commonwealth net debt to ratchet up over time. The concern is to address that tendency, so as to ensure the fiscal stance is sustainable in the longer term and to reduce the vulnerability of the fiscal position to economic shocks.

I think the obvious and key point to draw from all of the foregoing is that as we are now more than five years into the economic upturn, it is important that there is now a move into budget surplus and a reduction in our stock of net debt.

That is why the key fiscal targets which have been set down in the recent budget — within the overall medium-term framework — have been to get back into balance by 1998-99 and to maintain surpluses thereafter, while economic growth remains solid.

The fiscal consolidation being implemented to achieve those targets is reflected in the projected outcomes for the underlying balance — with the projected surplus by the turn of the century reaching around 1½ per cent of GDP (see Chart 1) — and Commonwealth general government net debt falling from almost 20 per cent of GDP in 1995-96 to just over 10 per cent by the final outyear.

The underlying budget balance and net debt are two central benchmarks for fiscal policy at the Commonwealth level. Of course there are other measures of fiscal soundness or stance.

For example, the Commonwealth is developing an accruals framework for its budget, so that there will be a clearer understanding of its accumulated assets and liabilities, its operating balance, and the changes in its net assets. That will allow for a better appreciation of the full costs of policies — including those that may be deferred. The implementation of accrual budgeting will not, however, make the need for government to contribute adequately to national saving any less — there will be a continued need for government to focus on its own contribution to net lending.

Moreover, beyond the broad aggregates of budget balances and debt, considerable importance is clearly attached by government to other objectives. In particular, strong efforts are currently being made by the Commonwealth to reassess budget priorities and to enhance the quality of budget policies.

## REASSESSING BUDGET PRIORITIES

The quality or the composition of the budget is important. Budget policies affect the economy and the community not just through the broad macroeconomic settings. Saying that does not reduce the importance of getting the overall fiscal settings right — as unless we create the conditions for stronger growth in activity and employment, we cannot improve the lot of ordinary Australians. However, particular taxes and outlays programmes and changes in them can obviously affect people and affect the way they behave. It is necessary to ensure that social goals of programmes can be achieved, while also promoting efficiency in the operation of the economy — for example, by providing adequate support for the unemployed while minimising work disincentives.

If programmes can achieve the right mix — and it is by no means the case that the goals of equity and efficiency need conflict — then that not only promotes better outcomes at the microeconomic level, but can also produce an economy that performs better and achieves better social outcomes overall. If programmes are delivered at least cost, and most efficiently and effectively, that can also contribute to getting the overall fiscal settings right. Therefore, what we need to strive for is policies — both the macro and micro aspects of the budget — that are mutually supportive. I'll give some specific examples a little later.

In addition to the overall fiscal imperative, there are a couple of factors which underline the need to improve the quality of the budget.

First, the Government has a commitment not to introduce new taxes or increase existing tax rates over the term of this Parliament, while ensuring that all taxpayers pay their fair share of tax. The aim — consistent with the principles of sound fiscal management in the Charter of Budget Honesty — is to avoid an undue tax burden on the community, while maintaining the integrity of the tax system.

One consequence of this objective is that there needs to be a focus on reducing budget outlays in order to implement the needed fiscal consolidation. This is reflected in Chart 3, which shows that revenues as a share of GDP are broadly stable through the forward estimates period (between 24 and 25 per cent of GDP), while underlying outlays are falling (reaching around 23 per cent of GDP by the end of the forward estimates period). The discretionary savings measures taken since 1996, equivalent to around 1½ per cent of GDP through the outyears (Chart 4), almost entirely reflect outlays savings.

This focus on outlays is a desirable one, I believe, as international experience suggests that fiscal consolidation efforts which have been based on outlays restraint have been more successful and durable than those based on additional revenue raising.

**Chart 3: Underlying Budget Aggregates**

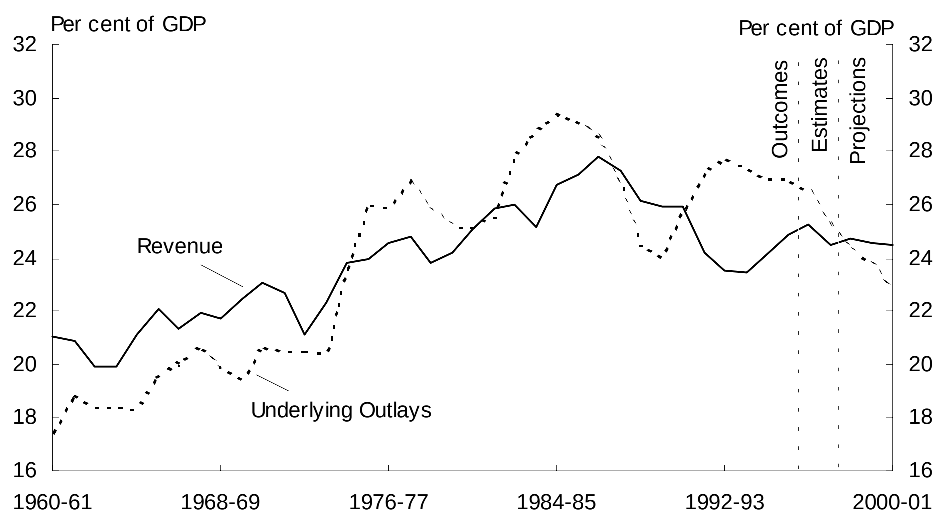
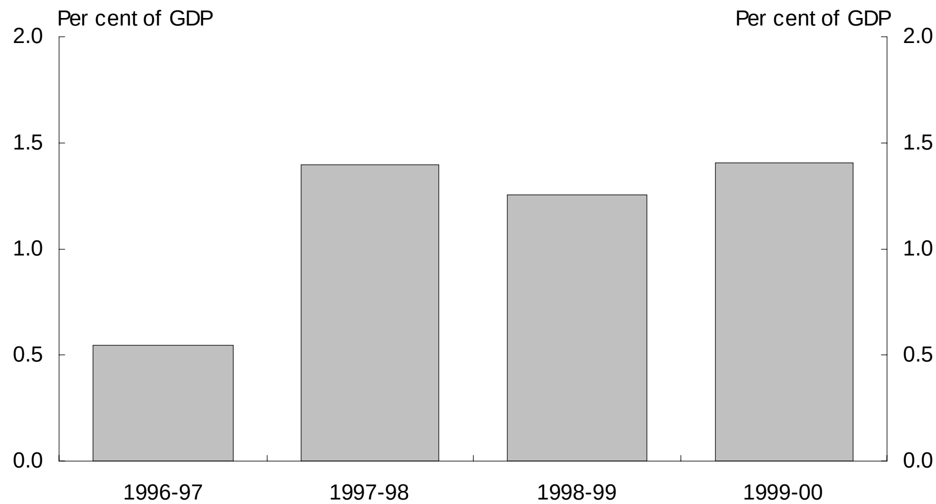


**Chart 4: Cumulative Decisions**




Second, the Government also made it clear in the recent budget that there were a number of high priority expenditure areas that it wished to enhance or protect. For example, at the commencement of the last budget process, there were clear public statements made to the effect that the social safety net was not at issue in the fiscal tightening being pursued. Given the clear desires and commitments to maintain or develop certain programmes, it is necessary to be better and smarter in achieving reductions in outlays.

There are a number of aspects to this, but it essentially means being concerned with the efficiency and effectiveness of programmes and their delivery. There are systems and reviews for Commonwealth agencies in place to ensure that this happens, encompassing three main elements.

First, there need to be continual reassessments of whether government should have a role in providing some services or whether they would be better discontinued; whether services should be delivered by another level of government; or whether there is not a case for greater user charging for services.

Government clearly has a role in providing services which the private sector cannot provide or under-provides. These are what economists call public goods — street lights are consumed by everyone, but it is difficult to charge for that consumption and they would not be provided unless financed by taxes. Over the years, however, governments have become involved in providing services that could be provided by the private sector — or partially so — or are more properly the responsibility of those that benefit. In the latter case, there may at least be strong justification for user charging.

One example of reassessments of the need for government involvement in services (albeit outside of the budget sector) has been the airline industry, where there has been the withdrawal of government involvement — through sales of government businesses to the private sector — across the world. The historical reasons for government involvement in this sector have long evaporated and such services are now very effectively delivered, and at lower costs to consumers, outside the government sector. Historical reasons for the public provision of other infrastructure services — essentially because of ‘natural’ monopolies in areas such as electricity generation and distribution and communications — are being eroded by the advance of technology and the development of systems that allow for market provision.

Activities that have been thought of as part of the traditional budget sector are also increasingly being examined as areas which need not be delivered by government. An important example is the various Department of Administrative Services’ businesses that have recently been sold to the private sector.

Boundaries between the public and private sectors are not necessarily neat, with activities best falling in one sector or another. For example, while there may be justification for the public provision of higher education services, there is equally an argument that those that primarily benefit — students who subsequently command higher incomes in the workforce — should make a personal contribution to the provision of those services. This is a central rationale for the Higher Education Contribution Scheme (HECS). HECS not only has the effect of ensuring that those undertaking higher education do so with clearer knowledge of both the benefits and the costs, but helps achieve more equitable outcomes. Taxpayers without higher education — and earning less than those who benefit from it — do not contribute to the full cost of providing higher education services. This is a case where the goals of equity, efficiency and fiscal discipline are quite consistent.

Second, there needs to be a focus on the outputs of government programmes, whether they are effective and achieve their objectives, and whether they conflict with other objectives. Historically, there has been considerable emphasis on the inputs to programmes, but not on output and whether programmes achieve their goals.

Assessing whether programmes are effective requires good evaluation. For some while, the Commonwealth has had programme evaluation requirements and no new policy can be agreed without a programme evaluation strategy. There are always difficulties in implementing effective evaluation strategies and some activities or outputs are more amenable to evaluation than others. However, evaluation and the demonstrated success — or otherwise — of programmes can be crucial in deciding whether they should be continued or amended.

The reforms to the delivery of labour market programmes are a case in point, where even early evaluations of some programmes indicated they were not running as planned, and not achieving their goals. The evaluations of the existing programmes were important in influencing the direction of reforms, so that the ineffective programmes — such as public sector make work schemes — were discontinued and resources were focussed on more promising forms of assistance for unemployed people.

It should also be noted that this sort of evaluation is not only relevant for outlays programmes. For example, the tax system has also been used regularly as a mechanism to provide assistance to certain groups or activities within the community. The National Commission of Audit noted that such assistance has generally been subject to less regular monitoring and evaluation compared with similar assistance provided through government outlays. In response to the Commission's findings, the Government announced in the 1996-97 Budget a comprehensive review of tax expenditures with the aim of clearly understanding their cost, whether their objectives are still relevant, and whether they should continue or might be better delivered through an outlays programme — where the costs and benefits are more transparent both to taxpayers and to those that benefit from the concession.

Third, there needs to be a focus on efficiency in delivering programmes and on whether they are cost effective. In one sense, this is essentially a technical issue. However, there are a number of mechanisms emerging — particularly market based mechanisms — to ensure that programmes are delivered most efficiently, at lowest cost to the taxpayer. Following an Industry Commission review on competitive tendering and contracting, it has been decided that Commonwealth agencies will be required to systematically review their activities and to determine whether some of those mechanisms can be employed. These may not always turn out to be the most cost effective, but it is desirable to examine them before determining the approach adopted.

Again, the reforms to labour market programme delivery provide an example of some of those mechanisms.

A clear separation of purchasing and providing functions has been introduced in the provision of social security services and labour market assistance. This should provide for clearer specifications of the output required, accountability if it is not provided, and more cost efficient delivery.

In the case of labour market assistance, service delivery has been opened up to competition, with the aim of ensuring that service providers strive to deliver the best and most effective output, at least cost to taxpayers. Private providers will be able to tender for government contracts to provide services. Public provision will continue, but this will be done in a way that is consistent with the principles of competitive neutrality — ensuring that neither the public nor private sector deliverers have an unfair competitive advantage over others. Effective competition maximises the chances that taxpayers benefit to the fullest extent possible. Competitive contracting and outsourcing is also being pursued in the area of information technology services for government, with considerable budgetary outlays savings expected to be achieved.

## IMPLICATIONS FOR POLICY DEVELOPMENT

In conclusion, what does all that imply for the development of programme policies? I think I can be fairly brief as the answers flow from my earlier comments; in some cases, the conclusions are perhaps rather obvious and/or are not novel, particularly to those who are close to the policy development process.

First, in an environment where there is greater focus on fiscal discipline and outlays restraint, programmes need continually to justify their existence — that is, to justify that there is a need for government involvement and that programmes are effective and well targeted in delivering their objectives. If they are not, there is little scope to continue with the ineffective in today's fiscal environment — programmes need to be adjusted and developed to ensure they are achieving their goals or they should be discontinued.

Second, new policies need to jump the same hurdles as those facing existing policies. There has to be a clear and demonstrated need for them. In addition, their adoption by governments is more likely to be successful if they are replacing programmes that are ineffective, so that the budgetary savings from discontinuing these ineffective programmes can create the scope for more effective, higher priority programmes.

Third, policies that can satisfy more than one goal have greater chances of remaining in place, or being implemented. While programmes need not necessarily satisfy multiple goals, if they have regard to both efficiency in the operation of the economy and maximising overall social welfare then they have a higher chance of being adopted or maintained. The budgetary costs of programmes also need to be consistent with the overall macroeconomic goals of fiscal policy — and the programme of fiscal consolidation that is currently underway. That will be all the more likely if some of the new mechanisms for delivering programmes are used, where they are appropriate.