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Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation

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Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation

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Executive Summary

- Australia needs new fiscal responsibility legislation to ensure that fiscal policy is subject to the rule of law and conducted within a framework that requires long-term fiscal sustainability and high levels of transparency and accountability.

- The Howard government's 1998 Charter of Budget Honesty (CBH) has proven inadequate to these tasks. This paper proposes a new federal Fiscal Responsibility Act (FRA) to replace the Howard government's flawed CBH.

- The aim of the proposed FRA is to provide a de-politicised framework for fiscal policy in which the budget balance, the level of Commonwealth net debt, and the revenue and expenditure shares of GDP are subject to legislated and enforceable rules designed to ensure the long-term sustainability of fiscal policy and to restrain growth in the size of government.

- The paper outlines the rationale for fiscal responsibility legislation and a rules-based approach to fiscal policy.

- It examines the shortcomings of the existing CBH, showing how it has failed to prevent growth in the size of government and fiscal policy outcomes that harm the prosperity of the Australian people.

- The fiscal principles contained in the CBH should be re-written.

- Three fiscal policy rules are proposed to give operational substance to these revised fiscal principles: a budget balance rule, a ceiling on Commonwealth net debt, and a rule limiting the federal revenue and expenditure shares of GDP.

- A new body, the Fiscal Commission, should be established to enhance the independence, transparency and accountability of the federal budget process.

- The Fiscal Commission would enforce compliance with the fiscal policy rules included in the FRA and have powers to impose pecuniary penalties on members of the federal parliament for non-compliance.

- A one percentage point breach of the budget balance, net debt, or expenditure and revenue shares of GDP would be penalised on each count by a 1% reduction in politicians' remuneration relative to a baseline determination from the Remuneration Tribunal.

- The very public process of cutting politicians' pay would add to the reputational penalties arising from adverse findings in commission reports.

Introduction

The federal government's taxing and spending powers have far-reaching consequences for the economic prosperity and welfare of the Australian people. An essential requirement of a well-functioning democracy is that these powers be subject to the rule of law. The Australian Constitution lays out a basic framework for the exercise of these powers. Commonwealth legislation, including the *Charter of Budget Honesty Act 1998* (CBH), imposes additional requirements on the government of the day, but much is still left to the discretion of politicians.

Unfortunately, this discretion has not always been used wisely. There is widespread dissatisfaction with the way both sides of politics have used fiscal policy for narrow political purposes at the expense of general welfare. These problems have come into stark relief in the wake of the global financial crisis—with a cyclical deterioration in the budget balance being exacerbated by discretionary fiscal stimulus measures of questionable effectiveness that will harm Australia's economic performance in the longer term through the crowding-out effects of government borrowing.

Australia needs new fiscal responsibility legislation to ensure that fiscal policy is subject to the rule of law and conducted within a framework that requires long-term fiscal sustainability and high levels of transparency and accountability. The Howard government's CBH has proven inadequate to these tasks. The need for legislative reform was highlighted by the Rudd government's proposed overhaul of budget transparency, 'Operation Sunlight'.[1] As Senator Andrew Murray noted in his review of the government's proposed reforms:

Australia needs new fiscal responsibility legislation to ensure that fiscal policy is subject to the rule of law and conducted within a framework that requires long-term fiscal sustainability.

> Budget transparency and financial accountability reforms need to be entrenched through permanent change, and new statute where necessary. If you want high standards, accountability and good governance, you cannot rely on particular individuals in a particular role at a particular time – you have to institutionalise and legislate those standards, so they are there whoever is in charge. Policy fashions and people come and go, but you want good government whoever is in power.[2]

The Rudd government has undertaken to strengthen the CBH, but it has made only minor progress in enhancing the transparency of the federal budget process. In the run-up to the 2009 federal budget, the government made a conditional commitment to hold real growth in Commonwealth spending at no more than 2% per year, but there are no mechanisms to support this discretionary undertaking.[3]

At the same time, federal opposition leader Malcolm Turnbull proposed the establishment of a Parliamentary Budget Office, modeled on the US Congressional Budget Office, and a Commission for Sustainable Futures 'to determine what levels of expenditure are sustainable and consistent with the need to address intergenerational equity.'[4] There is thus something of a bipartisan consensus on the need to reform Australia's fiscal framework.

This paper proposes a new federal Fiscal Responsibility Act (FRA) to replace the Howard government's flawed CBH. The aim of the proposed Act is to provide a de-politicised framework for fiscal policy in which the budget balance, the level of Commonwealth net debt, and the revenue and expenditure shares of GDP are subject to legislated and enforceable rules designed to ensure the long-term sustainability of fiscal policy and to restrain growth in the size of government.

The paper outlines the rationale for fiscal responsibility legislation and a more rules-based approach to fiscal policy. It examines the shortcomings of the CBH, showing how it has failed to prevent growth in the size of government, and fiscal policy outcomes that harm the prosperity of the Australian people. It argues for a rewriting of the fiscal principles contained in the CBH and proposes three fiscal policy rules to give operational substance to these principles: a budget balance rule, a ceiling on Commonwealth net debt, and a rule limiting the revenue and expenditure shares of GDP. We also propose the creation of a new body, the Fiscal Commission, to enhance the independence, transparency and accountability of the federal budgetary process. In particular, it is proposed that the Fiscal Commission enforce compliance with the fiscal policy rules included in the FRA and have powers to impose pecuniary penalties on members of federal parliament for non-compliance.

Rationale for a rules-based approach to fiscal policy

There has been growing recognition in recent decades of the need for rules to govern the conduct of fiscal policy to prevent governments from abusing their powers to spend and tax. The public choice literature[5] has identified a spending and deficit bias that arises from the responsiveness of the political process to demands from sectional interests for publicly funded benefits at the expense of the community. The potential beneficiaries of government spending tend to be more politically concentrated and, thus, have greater incentives to lobby government than the taxpayers who foot the bill. Future taxpayers are under-represented in the political system and so politicians are often short-sighted or indifferent to the government's inter-temporal budget constraint, which requires that government spending must ultimately be paid for. A pro-spending and deficit bias can also arise from the problem of dynamic or time inconsistency whereby policymakers lack the instruments to make credible commitments in relation to future policy actions.[6]

The pro-spending bias in fiscal policy is reflected in the growth of government spending and revenue shares of GDP as well as public sector debt in many countries since World War II, especially since the demise of the Bretton Woods system of fixed exchange rates and a fixed US dollar-gold parity in the early 1970s. This system reduced both monetary and fiscal policy flexibility, subjecting the governments of the major developed economies to an implicit fiscal policy rule derived from the international monetary regime.[7] The expansion in the size of government in the developed countries between 1960 and 1980 has not been associated with appreciable gains in a wide range of economic and social indicators, implying that the size of government has become excessive.[8] Cross-country studies suggest that increasing the size of government relative to the economy as a whole reduces overall economic growth.[9] While the relatively benign economic conditions of the 1990s and much of the 2000s saw some progress towards fiscal consolidation in a number of countries,[10] these efforts have since been overwhelmed by the global economic crisis beginning in August 2007, in no small part due to discretionary fiscal stimulus packages adopted in many countries, including Australia. Demographic pressures on national budgets are likely to increase in coming decades, underscoring the need for robust fiscal policy frameworks.

There has also been growing recognition, at least in academic circles, of the limits to activist macroeconomic policy.

There has also been growing recognition, at least in academic circles, of the limits to activist macroeconomic policy and the need to limit the discretion of policymakers in relation to both monetary and fiscal policy. There is considerable evidence for the view that activist fiscal policy is ineffective or pro-cyclical.[11] Tanzi and Schuknecht note that 'since the ability of governments to stabilise the economy though countercyclical fiscal policy has proven limited or even illusory in the past, this loss of discretion may actually be desirable.'[12] The current global economic downturn, despite the unprecedentedly large public spending packages by governments around the world, provides further evidence for the ineffectiveness of counter-cyclical fiscal policy.

Since the early 1990s, there have been similar developments in the theory and practice of monetary policy. There has been a worldwide trend to a more rules-based approach built around inflation targets, with central banks given increased independence from government to ensure a greater focus on price stability.[13] Both monetary and fiscal rules aim to increase certainty, transparency and accountability in relation to macroeconomic policy and outcomes. Monetary and fiscal policy rules serve as commitment devices, mitigating the time inconsistency problem by enabling policymakers to more credibly commit to a course of action. Monetary and fiscal rules are also complementary, with fiscal stability reinforcing monetary stability.

The widespread adoption of monetary rules and increased independence for central banks has been associated with improved inflation outcomes as well as improved macroeconomic performance more generally, the recent global financial and economic crisis notwithstanding. The record in relation to fiscal policy rules has been more mixed. Public spending has typically grown more slowly in countries with stronger institutional constraints on fiscal policy.[14] New Zealand's 1994 *Fiscal Responsibility Act* is still widely regarded as a benchmark for fiscal responsibility legislation and has resulted in high levels of fiscal transparency and accountability, although it is not sufficiently prescriptive in relation to fiscal policy outcomes.[15] The Stability and

Growth Pact underpinning European Monetary Union has been honoured more in the breach, but this reflects inherent problems with the long-term viability of the common currency project rather than fiscal policy rules per se. The UK's 1998 Code of Fiscal Stability has also not prevented an explosion in deficit spending and public debt in that country. Japan's 1947 *Public Finance Law* limiting debt issuance to financing public investment spending has been overriden by legislation every year since 1975.[16]

As with monetary policy rules, the counter-factual in which these rules were not adopted is not in evidence, rendering definitive judgments difficult. There is an endogeneity issue whereby countries more likely to pursue sound fiscal and monetary policies may also be the countries more inclined to adopted rules-based approaches to policy. Fiscal and monetary rules are unlikely to be robust in the face of politicians determined to circumvent them or where there is weak commitment to the rule of law. However, in adopting fiscal responsibility legislation, politicians recognise the need to place limits on their own conduct. Governments are more likely to exercise fiscal restraint when given the instruments and incentives to do so.

The flawed Charter of Budget Honesty

Australia's existing federal fiscal responsibility legislation, the *Charter of Budget Honesty Act 1998* (CBH), has not delivered on its main objective, namely 'to improve fiscal policy outcomes' by 'requiring fiscal strategy to be based on principles of sound fiscal management and by facilitating public scrutiny of fiscal policy performance.'[17] The Act calls for fiscal policy to be 'set in a sustainable medium-term framework.'[18] To this end, the Act mandates regular fiscal strategy statements to benchmark and evaluate fiscal policy.[19] The CBH also laid out reporting requirements that were designed to increase transparency and accountability. The government is required to provide a Mid-Year Economic and Fiscal Outlook (MYEFO) between the annual budget statements; a Pre-Election Economic and Fiscal Outlook (PEFO) following the calling of federal elections; a final budget outcome statement; and five-yearly Intergenerational Reports (IGRs) to examine the sustainability of fiscal policy settings over a 40-year horizon. The Act also laid out procedures for the costing of election policy commitments.

Australia's existing federal fiscal responsibility legislation, the Charter of Budget Honesty Act 1998 (CBH), has not delivered on its main objective.

In practice, there has not been a substantial improvement in the conduct of fiscal policy under the CBH. This can be attributed to a number of critical weaknesses in the legislation. The principles of sound fiscal management laid out in the Act are too general, providing no effective limits on fiscal policy outcomes. The Act mandates only that fiscal policy be conducted 'prudently.' A very broad range of fiscal policy outcomes could be rationalised in terms of the Act. The fiscal strategies adopted under the Act are purely discretionary policy commitments. For example, the commitment of both the Howard and Rudd governments to balance the federal budget on average over the economic cycle is a purely discretionary one and is not mandated by the CBH. The fiscal strategy statements issued by the Howard government also undertook to keep the overall tax burden below its 1996–97 level, but the Commonwealth's tax share of GDP still rose to be above its 1996–97 level in 2007–08.[20] The Rudd government has since undertaken to keep the tax share of GDP below its 2007–08 level, illustrating how the goal posts have been moved to accommodate the secular expansion in the overall tax burden.

Even if budget outcomes were thought to be inconsistent with the terms of the Act, there are no enforcement mechanisms, and the legislation explicitly precludes any form of judicial or administrative review. Governments have also taken a highly discretionary approach to the timing of key fiscal statements such as the MYEFO, releasing them according to political convenience rather than a set schedule. It was not uncommon for former Treasurer Peter Costello to release the MYEFO with little or no notice. The Rudd government rejected the Murray review's recommendation that the CBH be amended to ensure that the MYEFO is at least released in November, midway between the annual budgets in May.[21]

The fiscal strategy statements, including the key budget forecasts and projections, are often seen lacking credibility because of a perception that the Treasury is overly beholden to the executive.

For example, 84% of respondents in an online poll in *The Australian* on 21 May 2009 said they did not trust Treasury forecasts (as at 2,503 votes cast). Treasury has been accused of changing its forecasting assumptions, presentation and methodology to suit the needs of the government. Regardless of whether these perceptions are warranted, the very existence of partisan conflict over the budget parameters and the resulting public mistrust undermine the credibility of fiscal policy and divert attention from the substance of policy decisions. In practice, the government and opposition have put little trust in the election policy costing process, in part because the process is seen to lack independence. As the Rudd government has itself noted:

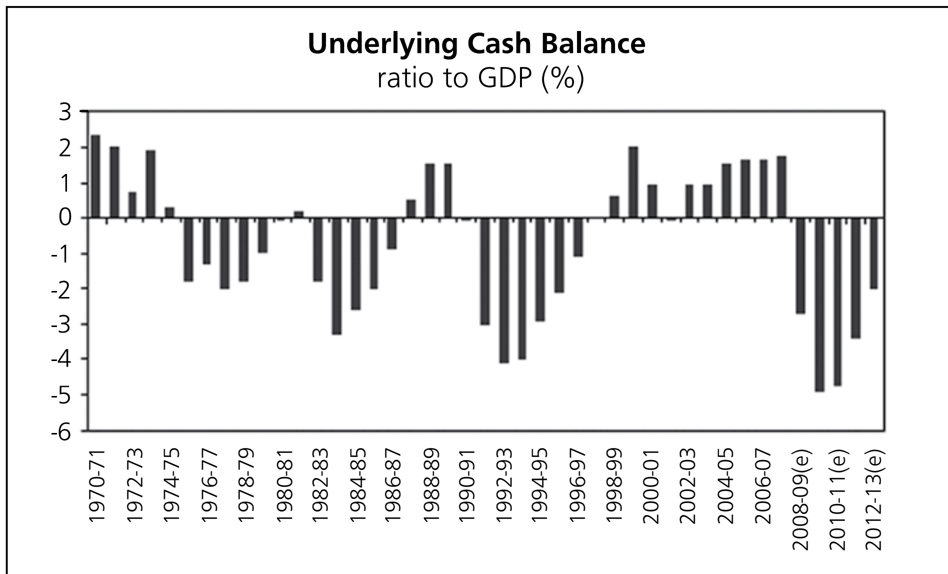
> [P]olicies of governments and oppositions are not costed fairly under the Charter. The Charter is heavily biased in favour of the government of the day including the release of the Pre-Election Economic and Fiscal outcome up to 10 days into the election campaign with no opportunity for independent scrutiny. Access to costing resources for the Opposition only applies during the heat of an election campaign whereas the Government has access year-round.[22]

The Intergenerational Reports mandated under the Act have underscored the fact that fiscal policy is not being conducted on a long-term, sustainable basis. While the Howard and Rudd governments have paid lip-service to principles of long-term fiscal sustainability, the IGRs have identified massive looming fiscal deficits on a no-policy change basis. According to IGR2, Australian government spending will rise by 4.75% of GDP by 2046–47. Assuming a constant revenue share of GDP, spending will exceed revenue by 3.5% of GDP, while net debt will increase to 30% of GDP by 2046–47 and continue to grow after that. As IGR2 noted, 'such a path for net debt would not be sustainable.'[23] The starting point for the IGR3 fiscal projections will be less favourable given recent discretionary fiscal stimulus measures and the cyclical deterioration in the budget balance, although saving measures announced in the 2009 federal budget may provide some offset. The fiscal strategy statements issued by the Howard and Rudd governments have failed to identify a credible strategy for addressing the long-term fiscal gap arising from an ageing population identified in the two IGRs released under the CBH. As demographic pressures on the federal budget build, the absence of a well-defined fiscal policy framework will increasingly undermine the credibility of policy and the ability of policymakers to manage fiscal policy risks.

The Intergenerational Reports mandated under the Act have underscored the fact that fiscal policy is not being conducted on a long-term, sustainable basis.

Successive federal governments have presided over an underlying cash balance averaging -0.4% of GDP between 1970–71 and 2007–08. However, this average conceals considerable variation in fiscal performance and still points to a deficit bias in Commonwealth finances. A decade of budget surpluses since the mid-1990s (excluding a small deficit in 2001–02) and the elimination of Commonwealth net debt in 2005–06 left Australia with a seemingly strong fiscal position. However, this apparent improvement in fiscal performance relative to the early to mid-1990s was overly dependent on cyclical growth in Commonwealth revenue, while the reduction in net debt owed much to asset sales, contributing around $61 billion to the reduction in Commonwealth net debt from the peak of $96 billion in 1995–96.[24] With the exception of the Howard government's first budget, there has been little discipline in Commonwealth spending in recent years, with growth in real spending averaging 3.3% between 1996–97 and 2007–08 compared to 4% real growth on average between 1971–72 and 2007–08. IMF and OECD estimates of the structural or cyclically adjusted, consolidated general government financial balance point to surpluses of around 0.6% to 0.7% of potential GDP on average in recent years.[25] Treasury maintain that the underlying cash balance has been in structural deficit since 2006–07, noting that budget surpluses 'in previous years were primarily the result of the strength in Australia's terms of trade.'[26] The deterioration in the structural budget balance from 2002–03 indicates that cyclical growth in revenue has been converted into spending measures that have weakened the Commonwealth's long-term fiscal position.

Chart 1



Source: Budget Strategy and Outlook: Budget Paper No. 1, 2009–10. (Commonwealth of Australia, May 12, 2009), 10–6. (e) estimates; (p) projections.

This has set the stage for large budget deficits from 2008–09 as the economic downturn takes hold. The cyclical deterioration in the budget balance has been made worse by discretionary fiscal stimulus packages. Together with the large budget deficits projected in the IGRs, this raises serious questions about the long-term sustainability of the federal government's finances. This in turn can be expected to undermine economic confidence as the public comes to anticipate future increases in the tax burden to pay for currently unfunded spending commitments. New fiscal responsibility legislation is thus urgently needed to replace the CBH to ensure that the recent explosive growth in the Commonwealth's spending and liabilities does not undermine Australia's future prosperity.

The cyclical deterioration in the budget balance has been made worse by discretionary fiscal stimulus packages.

Many of the shortcomings of the CBH have been mirrored at the state level, where existing fiscal responsibility legislation has also failed to significantly improve state government budgetary processes or impose effective fiscal discipline.[27] New federal fiscal responsibility legislation could serve as a model for state governments. However, consistent with principles of competitive fiscal federalism, the states should be encouraged to pursue reform of their own fiscal responsibility legislation to promote competitive fiscal policy regimes at the sub-national level. There is otherwise a danger that fiscal irresponsibility at the state level could undermine any new federal fiscal responsibility framework.

Principles for fiscal responsibility

The aim of the proposed FRA is to provide a de-politicised framework for fiscal policy in which the budget balance, the level of Commonwealth net debt, and the revenue and expenditure shares of GDP are subject to legislated and enforceable rules designed to ensure the long-term sustainability of fiscal policy and to restrain growth in the size of government. Fiscal policy rules should be designed to allow some flexibility for discretionary measures to address the consequences of adverse shocks such as wars and natural disasters. The counter-cyclical role of fiscal policy can be met through the operation of the automatic stabilisers, which cause the budget balance to deteriorate in an economic downturn (and improve during an upturn). The main focus for discretionary fiscal policy should be tax and spending measures targeted at the supply side of the economy and designed to enhance long-term productivity growth. Within this overall rules-based framework, the usual political debates over spending, tax, and other fiscal priorities would take place, but policy decisions would have to be consistent with long-term fiscal sustainability, highs levels of transparency and public accountability, and principles of limited government.

An appropriate set of fiscal principles are needed to inform the conduct of fiscal policy and to provide a basis for the fiscal rules proposed in the new legislation. The current set of 'principles of sound fiscal management' contained in the CBH are poorly specified. Section 5 of the Act states:

(1) The principles of sound fiscal management are that the Government is to:

(a) manage financial risks faced by the Commonwealth prudently, having regard to economic circumstances, including by maintaining Commonwealth general government debt at prudent levels; and

(b) ensure that its fiscal policy contributes:

(i) to achieving adequate national saving; and

(ii) to moderating cyclical fluctuations in economic activity, as appropriate, taking account of the economic risks facing the nation and the impact of those risks on the Government's fiscal position; and

(c) pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden; and

(d) maintain the integrity of the tax system; and

(e) ensure that its policy decisions have regard to their financial effects on future generations.

These principles are too general and open to interpretation to provide an effective constraint on the conduct of fiscal policy. While the objective of managing financial risks 'prudently' should go without saying, fiscal prudence needs to be defined via an enforceable set of rules that require fiscal prudence as a matter of law rather than as a discretionary policy commitment.

The reference to 'moderating cyclical fluctuations in economic activity, as appropriate' provides policymakers with too much discretion and fails to recognise the limits to activist counter-cyclical fiscal policy and that fiscal policy should be focused primarily on measures to promote long-term economic growth rather than short-term demand management.

An appropriate set of fiscal principles are needed to inform the conduct of fiscal policy and to provide a basis for the fiscal rules proposed in the new legislation.

The CBH principle of contributing to 'adequate national saving' is inconsistent with the view that the budget should be balanced on a structural or cyclically adjusted basis, which would imply no net call on capital markets on average on the part of the Commonwealth, and therefore a neutral position with respect to the level of national saving. Given that the private sector offsets to at least some degree the saving behaviour of the public sector (Ricardian equivalence), it is not clear that the Commonwealth should seek to influence the overall level of national saving through the budget balance—although tax and spending decisions will also have microeconomic consequences for private saving behaviour.

The objective of contributing to predictability in the tax burden is a sound one, but it has been undermined in practice by the failure to adopt enforceable rules, with successive governments accommodating secular growth in the revenue share of GDP. Frequent changes to the tax system have also undermined predictability in relation to the tax burden, with Treasury Secretary Ken Henry recently conceding that the tax system 'now vastly exceeds human scale.'[28] The current and future fiscal gap also implies considerable uncertainty over how currently unfunded spending commitments will ultimately be met. The integrity of the tax system is an issue for tax administration that is somewhat independent from principles of fiscal soundness. The tax system could be administered with integrity without providing any meaningful restraint on fiscal outcomes or growth in the size of government.

A fiscal policy framework that ensures long-term fiscal sustainability and economic efficiency will also satisfy inter-generational and intra-generational equity objectives. It is otherwise difficult to operationalise inter-generational equity objectives in a fiscal policy framework.[29] Equity objectives should be explicitly subordinate to the goal of maximising economic efficiency.

We propose that the flawed principles for fiscal soundness contained in the CBH be replaced with a set of principles that reflect the following considerations.

1. **Accountability.** This is an overarching principle, mandating that:
   - fiscal policy will be conducted under a clearly articulated and stable set of principles and rules;
   - publicly available information will be of such quality and timeliness that adherence to principles and rules will be readily observable;
   - there shall be an expert, independent body to assess and report publicly on adherence to principles and rules; and
   - the government is answerable for any departures from principles and rules and will suffer material consequences as well as reputational penalties for breaching rules.

2. **Transparency.** This is a necessary condition for accountability. Fiscal policy should be conducted in a transparent fashion by providing high quality and timely information to the public. There should be transparency in the setting of fiscal policy objectives, the implementation of policy, and in the publication of fiscal estimates and outcomes. The Commonwealth should observe internationally accepted standards of fiscal transparency (e.g. the 1998 IMF Code of Good Practice on Fiscal Transparency). Not all aspects of transparency can be mandated. It is as much a state of mind of policymakers as a set of rules, but a legislated framework for fiscal responsibility can also help engender the right attitudes.

3. **Economic efficiency.** The emphasis of expenditure and tax policies and the management of government assets should be on maximising economic efficiency and sustainable, non-inflationary rates of economic growth. The setting of aggregate levels of government spending and revenue should recognise that the size of government, and therefore the tax burden, influences economic performance and should be limited. Fiscal policy should proceed from the recognition that long-term economic growth is the best way to achieve both intra-generational and inter-generational equity objectives. A well-designed fiscal policy regime that limits the size of government and maximises economic growth will ultimately increase in absolute terms the total resources available to government to meet equity objectives.

4. **Stabilisation.** Discretionary fiscal policy aimed at short-term macroeconomic stabilisation should be avoided because it is ineffective or even destabilising, but the automatic fluctuations in revenue and expenditure in response to upswings and downswings in the economy should be allowed to occur. These ‘automatic stabilisers’ will result in the budget balance swinging between surpluses in times of economic strength and deficits in times of weakness, but the average (or cyclically-adjusted) position should be approximately balanced. Fiscal policy should not be used for the purposes of short-term demand management. Instead, the proposed FRA should explicitly acknowledge that the Reserve Bank and monetary policy have the primary responsibility for managing short-term fluctuations in aggregate demand to ensure a clear demarcation of responsibility in relation to macroeconomic policy.

5. **Fairness.** Inter-generational, horizontal and vertical equity are legitimate objectives of fiscal policy, but should be made explicitly subordinate to the goal of maximising economic efficiency, recognising that attempts to reshape the vertical distribution of income and wealth—particularly through tax policy—undermine economic efficiency and are often counter-productive.[30]

6. **Fiscal sustainability.** Government should manage public assets, liabilities and fiscal risks in such a way as to ensure that the fiscal position is sustainable over the long term. Net debt and net financial liabilities should be capped. Proposed expenditure and tax measures should take into account their effects on the fiscal position, not only over the forward estimates but also over the longer term. The effects of such measures on the long-term fiscal gap should be quantified.

7. **Predictability.** Government should adhere to commitments to long-term policy stability. Frequent and erratic fiscal policy changes (quite apart from their content) are harmful to confidence and the willingness of the private sector to take risks and make long-term decisions. Policy changes should not apply retrospectively and should be announced and exposed to public debate well in advance of their implementation.

Rules for fiscal responsibility

A fiscal policy rule can be defined as a permanent constraint on the conduct of fiscal policy in terms of one or more measures of fiscal performance.

The most significant shortcoming of the CBH is the lack of enforceable rules that would give substance to principles for fiscal soundness. A fiscal policy rule can be defined as a permanent constraint on the conduct of fiscal policy in terms of one or more measures of fiscal performance.[31] In practice, such rules usually reference the budget balance, public sector borrowing, or the level of public sector debt. Fiscal policy rules are often designed to give effect to fiscal consolidation objectives or to entrench existing fiscal discipline. These rules can give additional credibility to fiscal policy from the perspective of the public and financial markets. Greater fiscal policy credibility will lower the cost of government borrowing in capital markets, freeing up resources that might otherwise be consumed by higher risk premia in interest rates. Fiscal policy rules can also reinforce the credibility of the Reserve Bank's inflation target and monetary policy by reducing the risk that unsustainable public sector deficits might be monetised.

Budget balance rule

Budget balance rules can take a number of forms—from a strict, balanced budget rule to rules that specify a range for the budget balance over time or on a cyclically adjusted basis. These rules need to strike a balance between providing an effective constraint on government spending and taxing while also allowing sufficient flexibility to respond to economic or other shocks. An overly inflexible rule would lack credibility in the face of actual or potential shocks, jeopardising the sustainability of a rules-based framework for fiscal policy.

Fiscal strategy statements under the CBH have mandated that the budget be balanced over the economic cycle. Contrary to popular myth, this is a discretionary policy commitment, not one embodied in the CBH. In practice, the irregular frequency of the business cycle makes it a poor basis for a fiscal policy rule. In Australia, the commitment provided little meaningful guidance in the context of an 18-year economic expansion. An alternative approach, reflecting the same principle, would be to balance the budget on a structural or cyclically adjusted basis, but this requires judgments about the size of the structural budget balance. A problem with this approach is that it is not possible to directly observe the underlying or trend level of economic activity that would provide a definitive basis for determining when the budget is in balance on a structural basis, undermining fiscal transparency and accountability.

Instead, it is proposed that the FRA include a rule requiring the federal fiscal balance to be maintained within the range of +/-2% of nominal GDP coupled with a net debt ceiling of 10% of GDP (see next section), which would constrain both the magnitude and duration of fiscal deficits and surpluses. These rules should apply both *ex ante* in terms of budget forecasts and *ex post* in terms of budget outcomes but with enforcement by the Fiscal Commission (see below) applied *ex post*. A range of +/- 2% for the budget balance (four percentage points of GDP in total) and +/-10% of GDP for net debt would provide sufficient flexibility to allow the automatic stabilisers to operate in response to the economic cycle. It would also allow some room for discretionary

policy actions, although these should be limited to measures that support long-term growth rather than short-term demand management. In recent decades, the underlying cash balance (excluding Future Fund earnings) has ranged from 2.0% of GDP in 1999–2000 to -4.1% of GDP in 1992–93 following the early 1990s recession. The 2009–10 budget deficit is forecast at 4.9% of GDP, but this is an outlier relative to historical experience, reflecting the largest real growth in public spending since the Whitlam government.

The cyclical fluctuations in the budget balance have been exacerbated by discretionary policy actions that have been ineffective or pro-cyclical in the short term and have likely subtracted from growth in the long term through crowding-out effects. For example, around one-third of the deterioration in the budget balance forecast in the 2009 budget reflected discretionary policy decisions. The main effect of the proposed budget balance rule would be to limit the scope for discretionary policy actions while still allowing the cyclical component of the budget balance to adjust to fluctuations in the level of economic activity. Given the desirability of a predictable tax regime, it is expected that once tax reform is fully implemented any further discretionary policy adjustments would be focused on the expenditure rather than the revenue side of the budget and aimed at promoting long-term productivity and economic growth rather than short-term demand management.

Net debt rule

Public sector debt rules are usually directed at stabilising or reducing the net debt to GDP ratio. These rules prescribe limits for public sector liabilities, ensuring that growth in these liabilities does not assume an explosive, unsustainable path. Since the budget balance largely determines the change in the stock of public sector debt, the combination of a budget balance rule and a public sector debt rule provides a flexible framework for ensuring long-term fiscal sustainability.

A low level of public sector debt is desirable, not least because government debt is simply deferred taxation, which imposes future welfare losses on society, on top of those losses already incurred from the current tax burden. High levels of public sector borrowing crowds-out private capital and can lead to a less efficient capital stock and lower future economic growth. A 10% net debt ratio would be higher than the average Commonwealth net debt ratio of 5.7% of GDP seen since 1970–71, [32] but well below the cyclical peak seen in the wake of the early 1990s recession of 18.5% of GDP and the 13.6% of GDP currently projected for 2012–13. This would allow the Commonwealth to run budget deficits of variable size and for variable lengths of time, largely reflecting economic conditions, subject to the cap on the stock of net debt. Once the debt ceiling is reached, governments would need to purchase additional fiscal flexibility by paying down some of the stock of net debt through a program of fiscal consolidation.

A low level of public sector debt is desirable, not least because government debt is simply deferred taxation.

In addition to the net Commonwealth debt ceiling, federal government borrowing from the Reserve Bank should be proscribed by the FRA. However, the RBA should retain the power to engage in outright purchases of Commonwealth government securities so that it may resort to quantitative easing in the event the zero bound on nominal interest rates becomes a constraint on conventional monetary policy implementation via the official cash rate. This ensures that any decision to monetise government debt rests with the RBA rather than the government and is used only for monetary rather than fiscal policy purposes.

Limited government rule

The combination of budget balance and net debt rules cannot in itself constrain growth in the size of government because both the revenue and expenditure shares of GDP can expand without breaching either rule. There is a strong theoretical and empirical case for limiting growth in the size of government. Once government expands beyond a certain size, it begins to hinder rather than facilitate economic growth—with rising transactions costs limiting the efforts of the private sector to capture the gains from trade. Tanzi and Schuknecht find that for developed countries, the optimal size of government is likely to be less than 30% of GDP.[33] The size of government in

Australia is currently around 34% of GDP—based on ABS government finance statistics estimates of operating expenses for all levels of government in 2007–08. This proportion is set to rise as the economy slows and government spending accelerates. Even John Maynard Keynes, in private correspondence with Colin Clark, agreed that '25% as the maximum tolerable proportion of taxation may be exceedingly near the truth.'[34] The literature on the optimal size of government for the United States and New Zealand suggests that the combined federal, state and local tax share of GDP should be set at around 19–23%.[35] Given that the Australian economy is structurally similar to the US and NZ economies, it is likely that the optimal tax share of GDP in Australia is also in this range.

There is a strong theoretical and empirical case for limiting growth in the size of government.

The welfare costs of big government can be enormous. Scully estimates that the United States has sacrificed $4 of income for every dollar of tax paid in excess of this optimal level of taxation (for New Zealand, Scully estimates $2.64). With Commonwealth, state and local GFS operating revenues running at around 37% of GDP in 2007–08, it is likely that Australia is suffering similar losses in national income. As Scully also notes, the excess tax burden lowers overall revenue collections by reducing long-term economic growth. A limited government rule could actually allow for more government spending in absolute terms, not less, which will leave the federal government better placed to realise equity and other policy objectives.

Capping the Commonwealth revenue and expenditure shares of GDP at 25% would serve to limit what has been a secular expansion in the size of government in the post-War period and prevent further increases in the government spending share of GDP foreshadowed in the IGRs. The Commonwealth revenue and expenditure shares of GDP are currently somewhat above this level, so the FRA would mandate a transitional fiscal consolidation effort ahead of the start date for the legislation. Eliminating fiscal churn could reduce the size of government in Australia by around six percentage points of GDP.[36] Fiscal consolidation need not be contractionary for the economy. As Kopits and Symansky have noted, 'as the fiscal adjustment under such a rule is perceived as permanent, expected increases in future output, as well as expected declines in future interest rates and tax rates, tend to encourage present investment and consumption, while mitigating the negative withdrawal of demand.'[37] Failure to limit further growth in the size of government will come at a high cost to future growth in national income and welfare in the long term, not least through a reduction in the absolute amount of revenue available to the Commonwealth.

Caveats

The FRA should include explicit caveats that would allow for temporary breaches of the fiscal policy rules. These caveats could include war and natural disasters as well as severe supply shocks. The latter could be objectively and transparently defined as a greater than 1.5 standard deviation movement in the Australian dollar-denominated RBA commodity price index in the previous 12 months. Demand shocks would be accommodated through the operation of the automatic stabilisers. Shocks should be viewed symmetrically, with the caveats being applied to be both positive and negative shocks. Determinations in relation to caveatable shocks and the duration of any permissible breach of the fiscal rules would be made by the Fiscal Commission (see below).

The Fiscal Commission

Another key shortcoming of the CBH is the lack of an independent process for the formulation and evaluation of fiscal policy that ensures high levels of transparency and accountability in relation to the budgetary process and fiscal policy outcomes. As Tanzi and Schuknecht note, 'the process leading to the "production" of the budget document is … fundamental in promoting fiscal prudence.'[38] The proposed Fiscal Commission would be charged with monitoring and enforcing compliance with the fiscal policy principles and rules laid out in the FRA to achieve the desired degree of transparency and democratic accountability.

The commission should be independently resourced, with a funding formula defined by the legislation. The commissioners would be appointed by a process similar to that for the Australian Competition and Consumer Commission (ACCC), with majority support required from the

state and territory governments and in consultation with the leader of the federal opposition. Commissioners should serve for five-year terms with staggered initial appointments to ensure that appointments are renewed at different intervals. The commission could also assume the functions of the existing Australian Office of Financial Management (AOFM) and produce regular debt management reports under the Act. Increased independence for the AOFM would limit the ability of the federal government to use Commonwealth debt management operations to channel benefits to sectional interests such as the recent intervention in the market for residential mortgage-backed securities to subsidise non-bank mortgage lenders.[39]

The Fiscal Commission would be charged with preparing the parameters for the regular fiscal policy statements, including the annual budget, MYEFO and PEFO, according to a fixed timetable specified in the FRA. Any government policy decisions would proceed on the basis of the forecasts and projections contained in these statements and would be required to comply with the fiscal policy rules on an *ex ante* basis. The government would be free to announce ad hoc tax and spending packages, but the commission would define the parameters for these statements and assess the budgetary implications of any new measures. A key role for the commission would be to cost government tax and spending initiatives. This would act as an important discipline on governments—ensuring that their tax and spending proposals receive independent scrutiny. The government would be required to submit a public pre-budget report to the commission for evaluation at the same time as the release of the MYEFO. These measures should give the public and financial markets greater confidence in the integrity of the key assumptions on which the annual budget and other fiscal policy statements are based. It would also minimise pointless partisan conflict over budget parameters, ensuring that political debate was focused on the substance of the government's spending and tax decisions.

The commission would also be charged with ensuring that Commonwealth accounts comply with internationally recognised accounting principles, producing a reconciliation of cash, operating, and balance sheet statements. This would limit the scope for governments to manipulate budget parameters based on arbitrary or ad hoc accounting treatments. Again, this should give the public and financial markets greater confidence in the assumptions underpinning the budget process.

The commission should produce regular analytical reports, including estimates of the structural budget balance and estimates of the budget implications of tax and expenditure proposals (with or without reference from the government). The commission should prepare Intergenerational Reports every three years, as recommended by the Murray Review, with estimates of the fiscal balance and other key budget aggregates over a 50-year horizon on a no-policy change basis. The focus of these reports should be on long-term fiscal sustainability rather than inter-generational equity. The commission should make fiscal policy recommendations that would assist in maintaining fiscal sustainability over the longer term without embroiling itself in debates over distributional and equity issues.

The commission should be authorised to impose penalties on the remuneration of all members of federal parliament.

The Fiscal Commission would also monitor compliance with the fiscal policy rules laid out in the FRA. In particular, it would determine whether any of the legislated caveats to the fiscal policy rules can be invoked in response to positive or negative shocks. The compliance implications of current government policy would be discussed in the regular fiscal statements. The commission would have the capacity to inflict reputational penalties on the government of the day through adverse or critical reports.

Where the Commonwealth government is found to be in breach of the fiscal rules on an *ex post* basis, the commission should be authorised to impose penalties on the remuneration of all members of federal parliament. For example, a one percentage point breach of the budget balance, net debt or expenditure and revenue shares of GDP could be penalised on each count by a one percent reduction in politicians' remuneration relative to a baseline determination from the Remuneration Tribunal. The very public process of cutting politicians' pay would add to the reputational penalties arising from adverse findings in commission reports.

The Fiscal Commission, together with the Commonwealth Auditor-General, could also be mandated with monitoring any diversion of Commonwealth activities into off-balance sheet vehicles to circumvent the fiscal policy rules. In particular, the commission could count such off-balance sheet activity as *de facto* breaches of the rules for the purposes of applying reputational and financial penalties.

Conclusion

The problem of how to bind the current and future behaviour of sovereign entities is one of the most difficult in political economy. International experience with fiscal policy rules to date has been mixed. In the context of the global financial crisis, existing fiscal frameworks have not prevented the implementation of large discretionary stimulus and other fiscal policy measures that are likely to undermine long-term economic growth while also being ineffective in addressing short-term problems.

A new fiscal policy framework built around fiscal policy rules will help rather than hinder politicians in meeting these long-term fiscal challenges.

Australia has been no exception, with the existing Charter of Budget Honesty proving inadequate to the task of ensuring long-term fiscal sustainability. In the current environment, it may seem unlikely that politicians would want to bind themselves to a new set of fiscal policy rules. However, the current crisis serves to highlight the enormous risks governments around the world, including in Australia, are taking in terms of long-term fiscal management. Demographic trends render current policy settings unsustainable. This unsustainability can only resolve itself through a combination of higher taxes and reduced government spending, but only the latter option is consistent with maximising long-term growth prospects. A new fiscal policy framework built around fiscal policy rules will help rather than hinder politicians in meeting these long-term fiscal challenges. Only by adopting a binding legislative framework for fiscal responsibility such as the one proposed here can Australia be sure of a prosperous future.

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