Public Debt and Deficits:
DESIGNING A FRAMEWORK FOR AUSTRALIA’S FUTURE

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Foreword

Deficit or surplus is often the only context we hear when referring to Australia’s public debt. Politicians and policy makers have a responsibility to move the discussion beyond whether it is simply a positive or negative number. It is vital that we understand how public debt plays a very important role in Australia’s future prosperity as a nation.

This paper looks at the different forms of government or public debt. Public debt is important but it needs to be understood properly so we are not reduced to an overly simplistic debate. Our future generations depend on us having an informed debate around fiscal policy now. Intergenerational equity has always been part of Australia’s social contract with its people.

We believe a stronger framework is needed for fiscal policy. A framework that ensures longer term consequences of large budget decisions are better understood. A framework that also better understands both the cyclical and structural aspects of debt.

All levels of government need to work together to ensure Australia has its fiscal policy right. So that all Australians including our future generations can look forward to a prosperous future.

Managing Australia’s public debt and getting its settings right is a challenge and there are no easy solutions. The purpose of our future[inc] series is to pose the questions and start the debate.

Welcome to the conversation.

Lee White FCA
CEO, Chartered Accountants Australia and New Zealand
The two core aims of our society are prosperity (the size of the pie) and fairness (how that pie is sliced up).

Governments use fiscal policy—the level of government’s spending and taxing—and the nature and composition of its spending and taxation decisions, to help society meet these objectives.

Australia has an established framework—strategies, objectives, rules and institutional structures—for thinking about fiscal policy. However, this has not prevented some poor policy outcomes in the past.

Most recently, participants in the ‘political economy’ have been focused on achieving surpluses and eliminating debt. While debt management is an important part of managing public finances, it appears that this emphasis has made it harder to progress other policies aimed at Australia’s longer-term prosperity and fairness. The challenge is to address the fiscal pressures without their dominating other policy agendas.

This paper seeks to figure out what went wrong, and, more importantly, how to fix it.

With this in mind, the paper:

1. discusses why public debt matters, but also why public debt is not the only thing that matters;
2. provides a reminder of the framework within which fiscal policy is conducted;

1 The term ‘political economy’ is used to refer to the interaction between political and economic processes within a society.
3. considers some examples where it may have fallen short and understand why; and
4. suggests some options to strengthen it.
This paper does not argue that rigorous policy frameworks do not exist—considered analytical tools and normative standards have been developed—but that these frameworks are not well understood by the public.

At the highest level, there may be similarities in fiscal frameworks across countries. However, country-specific circumstances will bear heavily on whether similar frameworks are effective. This paper does not extend the subsequent analysis abroad; the focus is on Australia.

**FAILURE OF THE POLITICAL ECONOMY**

Despite having in place fiscal objectives, strategies and rules, the stance of fiscal policy has sometimes found itself at odds with sound policymaking, including for example:

1. misreading the structural Budget position;
2. implementing asymmetric fiscal policy; and
3. failing to prosecute long-term Budget pressures.

An earlier Government implemented a series of tax cuts during the mining boom, failing to recognise the transitory nature of the change in Australia’s terms of trade and its impact on government finances.

A later Government provided stimulus measures in the wake of the Global Financial Crisis (GFC), but did not ensure that these measures and others taken at the time were either temporary or offset by other measures so that their longer-term impact was contained.

The legacy of these episodes has been a national debate that has been consumed by debt and deficits, threatening Australia’s policy flexibility in the face of future downturns and distracting policymakers from focusing on the nation’s long-term economic challenges.

**DESIGNING A FRAMEWORK FOR OUR FUTURE**

A stronger framework for thinking about fiscal policy issues is needed to help the public better engage in the debate.

**This framework needs to:**

- fully ensure that the longer-term consequences of large budget decisions are better understood. The forward estimates did not capture the full impact of the decisions in the mining boom and GFC that have been placing more pressure on the budget today;
- develop a better understanding of cyclical and structural aspects of the deficit so that policymakers can, on those occasions when it is required, use fiscal policy effectively in periods of pronounced downturns;
- deepen our understanding of how policy, including fiscal policy, affects intergenerational equity; and
- modify institutional arrangements to foster more independent public debate/review of these issues. That is, that the public dialogue relies less on Treasury’s analysis which, by itself, has proved insufficient in turning some broad fiscal rules into actions in a sustained manner.
This paper makes the following suggestions

1. The Government should establish a new platform to monitor and report on the long-term pressures on the Budget. This platform should be independent of executive government and the central agencies. Consideration should be given to a role for:
   i. the Parliamentary Budget Office (PBO) (preferred approach); or
   ii. an independent institute (along the lines of the Institute for Fiscal Studies in the United Kingdom) or an expert panel (along the lines of Germany’s ‘wise men’, the German Council of Economic Experts).

2. As part of its mandate, this body would be tasked with:
   i. Reviewing, periodically, the assumptions and parameters used by Treasury to estimate the SBB.
   ii. Promoting a greater understanding of the structural budget balance (SBB) in the national debate.
   iii. Undertaking ongoing research to refine the measure of the SBB.

3. The Government should introduce a mechanism to ensure that the fiscal implications of key policy decisions are considered beyond the forward estimates. This is especially important in instances where the biggest fiscal impacts occur beyond the four-year forward estimate horizon. Consideration should be given to:
   i. implementing a requirement that the fiscal impact of key new policy decisions are forecast over a 10 year period and compared to a scenario without the policy; and/or
   ii. mandating a role for the PBO to develop independent estimates of the fiscal impact of key new policy decisions over a 10 year period, compared to a scenario without the policy.

4. The Government should put aside the size of government as a fiscal rule. In the short-term this may have provided Government with the fiscal discipline by making it more aware of the fiscal impacts of decisions. However, the optimal size of government will change over time. The size of government is indeed a vital issue for society - but it is a different issue. Instead, Government should initiate a separate public debate on the appropriate size of government in the context of the appropriate role for government.
Australia has an established framework for thinking about fiscal policy. Notwithstanding, some recent policy choices have run against the grain of good policy. We implemented a series of tax cuts during the mining boom, failing to recognise the transitory nature of the change in our terms of trade. We showed poor fiscal discipline by failing to reverse temporary stimulus measures in the wake of the global financial crisis, while also adopting expensive new commitments during that phase. And more recently we have fallen into a debate about debt and deficits that potentially threatens our policy flexibility in the face of future downturns and distracts us from our long-term economic challenges.

We need to figure out what went wrong, and, more importantly, how to fix it.

1.1 Public debt – what is it?

This paper discusses public debt in the context of a national debate apparently premised on the view that “public debt is too high”. We discuss why public debt matters; but also why public debt is not the only thing that matters.

This paper begins by introducing some concepts for the sake of clarity.

Public debt (alternatively, national debt or sovereign debt) is debt owed by the public sector, that is, by governments and their agencies. A distinction is made between General Government debt, Australian Government debt and State Government debt.
The General Government sector includes central, state and local governments but excludes public trading enterprises (see Figure 1.1). Australian Government debt refers to General Government debt of the Commonwealth, while State Government debt includes General Government debt of the States, Territories and local governments as well as debt owed by public trading enterprises. This paper focuses on Australian Government debt.

Public debt is sometimes confused with foreign debt. Foreign debt can be owed either by the public sector or the private sector. Typically foreign debt owed by governments is more contentious than private sector foreign debt, since private creditors and debtors are generally considered capable of protecting their own interests. The interests of future taxpayers, however, are exposed when current decision makers commit future taxpayers to foreign creditors. Be that as it may, questions surrounding foreign debt are not the focus of this paper.

Figure 1.1: Institutional structure of the Australian public sector
Source: Commonwealth Budget 2016-17
1.1.2 Gross and net public debt

Gross debt of the public sector, usually the highest quoted number and often presented as the signal indicator of public debt, represents the total financial liability of the public sector, that is, General Government debt of the Commonwealth, States, Territories and local governments and their public trading enterprises. The main components of gross public sector debt are Australian Government debt, represented by outstanding issues of Commonwealth Government Securities (CGS), and State Government debt, represented by outstanding issues of semi-government bonds (“semis”).

However, gross debt is only a partial indicator of the public sector’s financial position since it does not incorporate amounts owed to the public sector by external parties. Like individuals and businesses, governments hold assets as well as liabilities, that is, they are owed money as well as owing money. Net debt subtracts the value of public sector assets from gross debt recognising that assets can be sold or pledged to creditors to settle or secure debt.

Net debt of the Australian public sector is shown at Chart 1.1.

Chart 1.1: Net debt of the Australian public sector
Source: Australian Bureau of Statistics (ABS)
Net financial worth is defined as total financial assets less total liabilities. It measures a government’s net holdings of financial assets and includes substantial non-debt liabilities, such as accrued superannuation and long service leave entitlements, as well as other financial assets, such as equities.

Net worth is defined as total assets less total liabilities.

The difference between these two concepts is the inclusion of non-financial assets in net worth. This makes net worth a more comprehensive measure; however, non-financial assets can be illiquid and difficult to value. Non-financial assets comprise mainly structures (such as roads and buildings) and land. State and territory governments own more non-financial assets than the Commonwealth.

**Figure 1.2: Net worth**

However, even net debt is a partial measure of the public sector’s financial position since Commonwealth superannuation liabilities are excluded as equity holdings in the Future Fund. The Commonwealth Budget reports measures of net financial worth and net worth for the Commonwealth, which are both more comprehensive indicators of the Commonwealth’s financial position than either gross or net debt (see Figure 1.2).

A focus on the narrower debt measure rather than net worth could lead a government to dispose of non-financial assets as a means of reducing gross indebtedness. Taken in isolation, such decisions could lead to future revenue losses (if the assets generate income larger than the interest savings earned on the sale proceeds) or higher government spending (such as if government buildings are sold, requiring alternative space to be leased at a cost that is greater than the interest savings earned on the sale proceeds).²

### 1.2 Why has debt become so contentious?

#### 1.2.1 Circumstances have raised the notoriety of public debt

Government balance sheets have come under increasing scrutiny. Most recently, the issue of budget deficits has occupied the national debate, drawing attention to the related issue of public debt.

Some of this attention is unsurprising since public debt as a share of GDP has increased significantly over the past decade (Chart 1.2).

² More broadly, the Productivity Commission (2014) has noted that privatisation should be undertaken to achieve a more efficient outcome for the community: “Privatising other government businesses should only occur following a scoping study that demonstrates there are net benefits in the form of efficiency gains from doing so.” That is, the considerations are wider than simple financial outcomes for the Government – in particular, the long term impact on consumers is also very relevant here.
Furthermore, the risks of public indebtedness, including the European sovereign debt crisis and the debt ceiling standoffs in US Congress, dominated global headlines in the years following the 2008-09 Global Financial Crisis (GFC).

On the other hand, put into longer term historical context, public debt has been significantly higher in the past (Chart 1.3). The financing requirements of the Second World War were met through the issuance of War Savings Certificates to domestic retail investors. Australian Government gross debt peaked at around 120% of GDP in 1945. In the decade following the Second World War, relatively tight fiscal policy halted the growth in gross debt, while high inflation underpinned a sharp reduction (Di Marco, et al. 2009).

![Chart 1.2: General government gross debt – Selected countries (% of GDP)](source: IMF (2016))

### 1.2.2 There is an ingrained misunderstanding of fiscal sustainability

Public debt is not unimportant but the fervour it generates in public discussion is surprising. Australia’s experience through the early to mid-2000s may have pre-conditioned public expectations to some extent. For example, in a recent speech to Young Liberals, former-Treasurer, Peter Costello, remarked (Costello 2016):

“... a generation can indulge at the expense of another. One of the easiest ways to do that is through deficit financing.”

Public sentiment aligns well with this statement.
Chart 1.3: Australian Government gross debt (at 30 June) a,b

Indeed, the notion that society is ‘mortgaging our future’ by taking on more debt fails to distinguish between borrowing for consumption and borrowing for investment. Borrowing for ‘public sector capital formation’, that is, public investment, has the potential to raise economic potential (and hence public sector revenue) by more than enough to service the resulting debt. Accordingly, public debt is neither good nor bad in itself. Much depends on the economic return and risk to which public balance sheets are exposed as public debt levels rise. Along with potentially higher returns, higher levels of public debt can increase an economy’s vulnerability to shocks.3

In the public mind good economic management often boils down to

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a Care should be taken when making comparisons over time due to structural breaks in the series; these include the move from cash to accrual accounting and the change to mark-to-market accounting for debt.

b Data from 1908 to 1982 are from Barnard Source Papers in Economic History 1986. Commonwealth Government Securities on issue are used for the period 1983 to 2008. For consistency reasons, GDP data for 1908 to 1982 are derived from Source Papers in Economic History 1986. GDP data for the period 1983 to 2008 are from the ABS National Accounts, cat. no. 5206.0.

3 One other concern, which made headlines at the peak of the austerity versus stimulus debate during the European sovereign debt crisis, was research suggesting that government debt above a certain threshold level will negatively impact economic growth (Rogoff and Reinhart 2010). However, other work undertaken since has indicated that the relationship was not robust. A simple rule will overlook the fact that the quality of government spending, not just the amount financed by borrowing, is more important for an economy’s growth prospects.
delivering budget surpluses. Fiscal sustainability is a component of good economic management but not all there is to it; and neither is running budget surpluses all there is to fiscal sustainability (see Chart 1.4).

At its simplest, fiscal sustainability refers to the financial solvency of government, that is, the government’s ability to fulfil its financial commitments on an ongoing basis. One rule of thumb is that a government will remain solvent as long as the economy grows faster than the growth of interest payments required to service public debt. In other words, to achieve fiscal sustainability, a government must ensure that its ‘primary surplus’, that is, the excess of revenue over outlays excluding interest payments on public debt, is large enough to cover the cost of servicing public debt.

This need not mean that a primary surplus must be achieved every year, nor does it mean that outstanding debt must be paid down. Rather, as Ley (2010) shows, achieving a stable public-debt-to-GDP ratio over time is sufficient to deliver fiscal sustainability (see Appendix B). On the other hand, continuous primary deficits imply continuously rising public debt levels as more borrowing is required to service interest payments on existing debt. This is fiscally unsustainable, with government insolvency the inevitable result.

Notwithstanding, public debt should not be thought of in the same way as household debt. Government balance sheets differ from household balance sheets and government solvency is not usually in question. In particular, although there are obvious limits, governments (unlike households) can raise additional taxes to service their debts and can also (again unlike households) print new money to repay debt.

1.2.3 Much commentary on public debt lacks context

In the right circumstances, raising public debt can improve outcomes for individuals, businesses and governments – with benefits lasting for generations. For instance, borrowing by Commonwealth and state governments over the years allowed Australia to:

- build the Sydney Harbour Bridge and inner-city rail tracks and roadways;
- finance military defence during the two world wars; and
- restrain the extent of unemployment during recessions and depressions.

A narrow focus on public debt and deficits may needlessly constrain governments’ capacity to improve the economic welfare of Australians.

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4 It must also be true that a government can ‘roll over’ part or all of its debt as it falls due. If the first part of the rule is satisfied, then this second condition generally will be as well.

5 This is a necessary but not a sufficient condition. The IMF has a more detailed Debt Sustainability Framework which assesses the current debt situation; identifies vulnerabilities in the debt structure or the policy framework; and examines the impact of alternative debt-stabilising policy paths if there are issues identified. Available at: https://www.imf.org/external/pubs/ft/dsa/
A comparison of debt across countries has been a popular tool for discussion. Against this metric, Australia’s general government gross debt level as a percent of GDP is lower than most other OECD countries. However, this comparison misses the point which we have been trying to make; it is not just the debt level which matters, but what is behind it.

For example, Japan’s general government gross debt to GDP was 233% as of 2016, while the same ratio for Greece was 185%. Despite Japan having a higher ratio than Greece, there has not been the equivalent level of concern (or hysteria) expressed about its debt levels.

So, what is the difference?

Both of these countries have different institutional frameworks, which is important as these institutions give their governments differing levels of credibility as well as different degrees of policy flexibility in a crisis. Greek Government institutions lacked both credibility and flexibility. Creditors did not have confidence that the Greek Government would make the decisions required to ensure their debt is paid back. The Greek Government also has limited policy flexibility as they have given up control of their currency and the ability to set interest rates as part of joining the Eurozone.

The inability for Greece and other peripheral Eurozone economies to devalue their currency or have their central banks intervene in government bond markets were one of the complicating factors that made the European sovereign debt crisis much harder to deal with, as it meant the sovereign governments were unable to inflate away their debt burdens.

In contrast, Japan has both policy flexibility (it has control over monetary policy) and is a credible lender in the eyes of its borrowers, which are largely from within Japan.

How does Australia compare? As Chart 1.4 shows the Australian Government’s gross debt position is far lower than either Greece or Japan. But importantly, like Japan and unlike Greece, Australia has a broader suite of policy tools to employ in a crisis – including a monetary policy lever. Nonetheless, Australia is a capital importing country and a substantial share of Australia’s Government debt is held overseas. While this is far from an issue currently, foreign creditors are more likely than domestic creditors to withdraw during a crisis, which could see the cost of financing Australia’s debt increase.

**Chart 1.4: General government gross debt for select OECD member countries**
Therefore, to understand whether government borrowing makes sense, such decisions should be considered within the broader context of achieving these objectives. That is, it should be considered with regard to fiscal policy—a government managing the level of spending and taxes—as well as the nature and composition of its spending and taxation decisions.

There may be situations where the government experiences shortfalls in revenues. This could be due to reduced economic activity, such as during a recession. In these situations, it may be preferable for governments to issue debt rather than to raise taxes, as the latter will exacerbate the downturn in growth. Part of this policy decision is weighing the cost to future taxpayers against the potential benefit to current and future generations. Essentially, the use of debt is merely a means to an end.

1.2.4 The state of the political economy has made matters worse

This message is not new, but participants in the ‘political economy’ seemed to have failed to understand this. Arguably, this is partly because some of the nuanced messages have been lost amid the noise. The advancement of technology and media has allowed the public greater access to government decision making processes. However, some of the methods often employed by the media such as the ‘15 second grab’ are not conducive to delivering best policy; nonetheless, this is the reality of the current environment.

On the other hand, the failure to understand may also be exacerbated because policymakers have lacked the appropriate frameworks with which to engage with their constituents in the right way. This paper does not argue that rigorous policy frameworks do not exist—as academics have laboured over many years to provide policymakers with analytical tools and normative standards—but that these frameworks may not be well understood by the public.

It is important for the public to know—and understand—what our governments are and are not doing. This is a vital part of a healthy democracy. It is critical to sound policymaking—policymaking that meets society’s objectives.

With this in mind, the subsequent chapters in this paper seek to: provide a reminder of the framework within which fiscal policy is conducted; consider some examples where it may have fallen short and understand why; and suggest some options to strengthen it.

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6 The term “political economy” is used to refer to the interaction between political and economic processes within a society.
The policy framework

Key points:

• Fiscal policy, therefore deficits and debt, should be assessed in context of its impact on society’s objectives of prosperity and fairness, including intergenerational equity.

• Intergenerational considerations in setting fiscal policy are not straightforward, but do not simply relate to balancing budgets and eliminating debt.

• It is important to measure the right things; otherwise policymakers may do the wrong things.

• In Australia, the frameworks to ensure discipline in fiscal policy making have included: (i) broad principles; (ii) fiscal rules; and (iii) the institutional framework.
2.1 The role of government and fiscal policy

Two core aims of our society are prosperity (the size of the pie) and fairness (how that pie is sliced up). Fairness includes how the slices of the pie are distributed between different parts of society at present, as well as the slices that are taken from or left for future generations (that is, intergenerational equity).

Fiscal policy, the level of government’s spending and taxing, and the nature and composition of its spending and taxation decisions, allow governments to help society meet these objectives:7

- Government can have an impact on the size of the pie through spending to boost the productive capacity of the economy. This may take the form of investments in physical assets such as energy infrastructure, road, rail and port facilities, or, through investments in human capital in the form of education and training programs.

- Redistributing slices of the pie can take the form of spending on social assistance programs such as unemployment benefits and universal health care. Governments can also redistribute these slices between current and future generations, such as through the pension system – or, indeed, through running stronger or weaker recurrent budget positions in the present.

- Government raises revenues through taxation to fund its spending proposals. To differing degrees all taxes create some level of economic distortion or additional burden on consumers and producers. Therefore, the choice of tax also influences the two objectives, for example, taxes on inheritance have implications for intergenerational equity.

Since the GFC there has been a renewed interest in research into the role of fiscal policy and how fiscal policy should be set. With the onset of the GFC and the use of discretionary fiscal policy by governments around the world to inject stimulus into their economies, government borrowing and public sector debt has increased. Governments have typically managed their budgets with reference to some indicator of government borrowing and the overall size of the public debt, among other indicators. Given this, it may be no surprise that the recent debate has focused on the need to rein in debt. Proponents have argued that higher levels of government debt will lead to higher risk premiums applied to government borrowing and the overall size of the public debt, among other indicators. Given this, it may be no surprise that the recent debate has focused on the need to rein in debt. Proponents have argued that higher levels of government debt will lead to higher risk premiums applied to government borrowing that will raise the cost of debt servicing. At the same time, some commentators have cast doubts over the solvency of governments.

However, economic theory is sometimes not as straightforward. The thinking about the impact of fiscal policy on economic activity has progressed over

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7 Government’s usually have recourse to other policy tools, such as legislation and regulation. The public sector more broadly, often through an independent central bank, also has access to monetary policy.
Ricardian equivalence assumes that fiscal deficits—governments raising debt to fund spending—has no real impact on the economy. Ricardian equivalence suggests that households would respond to the increase in fiscal deficits by increasing their savings in anticipation of the higher future taxes needed to repay the debt. In other words, a reduction in government savings will be offset by an increase in households’ savings, leaving the overall level of savings unchanged. This implies that societies consist of households in which the parents are purely altruistically motivated with regards to providing bequests to their children. While some studies have found evidence of a partial offset between public and private savings, there is no empirical evidence that Ricardian equivalence (that is, a full offset) holds in practice (Brittle 2010).

Figure 2.1: Ricardian equivalence

Setting fiscal policy around the objectives of prosperity and fairness will involve trade-offs; the appropriate balance of these trade-offs is assessed with respect to the social welfare function.

Against this background, this paper seeks to make the following points:

• Fiscal policy, therefore deficits and debt, should be assessed in context of its impact on society’s objectives of prosperity and fairness.

• Arbitrary deficit targets and debt level limits are often inadequate metrics for setting fiscal policy.

In order to make these points, it is argued that fiscal policy should instead be set to achieve (optimal) national savings and should have regard for intergenerational equity in a manner that best generates the prosperity and fairness outcomes that society seeks.
2.1.1 National savings and intergenerational equity

To the extent that conventional wisdom dictates that governments should keep deficits down, there is research questioning the arbitrary setting of levels of debt. A recent analysis challenging this conventional wisdom argued that “an optimal fiscal policy should be designed with reference to the balance between present and future consumption.” (Barrell and Weale 2010). The analysis indicates that government debt simply serves to transfer resources from future generations to the present, and notes that budget deficits are not the only policies which have this effect. Therefore, fiscal policy being set to achieve a given budget deficit is too narrow a focus. This is not to say that there should not be pressure on governments to avoid spending too much. Instead, the point is that an artificial level—deficit target or debt ceiling—can miss the bigger picture. It is assumed that the current generation has some preference for their level of consumption. The current generation will adjust its savings to deliver a level of consumption that maximises their welfare. A decision to save is effectively a decision to defer consumption. The reasons why individuals may want to defer consumption are to smooth consumption over time and take advantage of the return on these savings. For example, increasing savings in periods of higher income during your working life allows you to maintain consumption in periods of lower incomes during your retirement.

A decision by the current generation on their preferred level of consumption (and savings) also implies a decision about the level of consumption afforded to future generations (this is further discussed in Figure 2.1).

This naturally brings us to the idea of intergenerational equity.

Consider an intergenerational equity problem, for example, how much CO₂ should be mitigated? The answer to this question has long-run implications, as the stock of pollutants will affect the well-being of future generations. If one way to address this problem is to apply a tax to market activity today that generates CO₂, making a decision on the level of the tax will be making a decision on the trade-off between the well-being of the current generation and the well-being of future generations. Essentially, the costs have to be borne today while the benefits are spread over the long-run.

Within Australia, the discussion about intergenerational equity has been placed within the context of fiscal sustainability, particularly in the Intergenerational Report (IGR). The Department of the Parliamentary Library (2003) conducted research on the assumptions and rationales implicit in the 2002-03 IGR, and, among other things, found that:

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8 Barrell et al. (2010) notes “When land prices rise for any reason the consumption possibilities of those who own land are increased and, since a change to land prices has no bearing on productive capacity, it is hard to see that this increase in current consumption can come except at the expense of future consumption.” This has lessons for the current episode of strong property prices.

9 The IGR assesses the long term sustainability of current government policies and how changes to Australia’s demographic profile may impact on the economy, labour force and public finances over a 40 year time span.
• Fiscal equity is not a necessary precondition for sustained living standards into the next generation. Passing on debt or a tax burden to the next generation may not compromise future quality of life.

• Our obligations to future generations can compete with our obligations of justice to contemporaries. Arguably, just how extensive our obligations of sustainability are to the future will have to be decided in terms of the needs and entitlements of our contemporaries, both in this country and outside it.

• Even if the principle that people should pay for what they benefit from might support policies of fiscal sustainability, it may also preclude the current generation from paying for things such as nuclear waste disposal facilities that only future people will benefit from.

The intergenerational considerations in setting fiscal policy are not straightforward, but it is clear that it does not simply relate to balancing budgets and eliminating debt. However, more fundamentally, intergenerational equity is a philosophical question about our moral obligation to future generations. It requires a value judgement.

The desirable level of national savings (desired by a social welfare maximising government) will seek to maximise the utility (that is, the satisfaction from consumption) of people living now and those living in the future. This is achieved by balancing the distribution of consumption over time.

The optimal pattern of consumption over time will have reference to some target for living standards. The appropriate level for this target is a judgement by society, for example, “we want our children to be better off than us.”

Guest and McDonald (2001) consider the impact of population ageing on living standards, and identify five links (two that reduce living standards and three that increase living standards):

Reduces living standards
1. falling employment participation;
2. higher consumption demands per capita as old persons consume more;

Increases living standards
3. reduced capital requirements with a relatively smaller workforce;
4. reduced consumption demands per capita from fewer children; and
5. higher labour productivity with an older workforce.

If we exclude the ability for the domestic economy to borrow from the external sector, living standards (or consumption per capita) are sustained by cash flows which are accrued from output less investment. Therefore, the question is whether future output produced by employing labour and capital, in light of these demographic influences, can sustain future consumption.

To the extent that demographic change is expected to be a burden on future living standards, then higher current savings may be required to share that future burden between those alive now and those alive in the future.

There is a separate consideration regarding the split between public sector savings and private sector savings. This is related to the discussion around the size of government (Appendix C) and what role society feels it should have. This includes considering: (i) relative efficiency and the deadweight loss of taxation; (ii) government’s role in supporting income transfers between individuals who pay tax and families who require assistance; and (iii) government’s role in providing a social safety net.

Figure 2.2: The (optimal) level of national savings
2.2 How is fiscal policy discipline ensured?

Given our understanding of the above objectives for fiscal policy, it is useful to understand which frameworks help ensure that our objectives are translated to policy settings.

Nobel prize-winning economist, Joseph Stiglitz (2009) noted that “What you measure affects what you do. If you don’t measure the right thing, you don’t do the right thing.” Although this was in relation to a report examining the appropriate metrics of economic prosperity, the lesson undoubtedly applies to fiscal policy making as well.

In Australia, the frameworks to ensure discipline in fiscal policy making have, by and large, been formed on three levels:

1. broad principles to establish an overarching structure for ensuring that policy is formulated in a transparent and disciplined manner, e.g. the Charter of Budget Honesty Act 1998 (the Charter);
2. specific operating rules, that are directed at fiscal pressures and designed to manage potentially conflicting policies; and
3. institutions, that report on progress against these rules and principles and provide advice to the Government on behalf of the community.10

2.2.1 The broad principles

Currently, the broad principles that underpin fiscal policy within Australia are set out in the Charter.

The stated aim of the Charter is “to improve the discipline, transparency and accountability applying to the conduct of fiscal policy” (Commonwealth Budget, 1996-97). Among other things, the Charter requires that the Government specifies its fiscal objectives and targets. The Charter also requires government to produce an IGR at least every five years.

The primary fiscal objective that Australia adopted with the introduction of the Charter was in the form of a medium-term fiscal strategy “to maintain budget balance, on average, over the course of the economic cycle.”

A coherent medium term fiscal strategy—setting out a framework of fiscal policy goals over time—is an important part of setting expectations for both private and public sector decision makers. However, as noted above, ensuring that the fiscal strategy measures the right things will help ensure that policymakers do the right thing.

10Within our democratic political system, regular ‘free and fair’ elections help ensure that those who are affected by the outcomes of fiscal policy have a say in its implementation. However, this report does not explore this aspect of accountability.
2.2.2 Fiscal rules

The strategy is often designed around a set of ‘fiscal rules’ or guidelines to assist in the development of more specific Budget measures over time.

Yet such rules can pose problems. Tying down fiscal strategy to a simple set of specific rules is difficult. In its 2010 paper, Strategies for Fiscal Consolidation in the Post-Crisis World, the IMF noted that:

“While many countries articulate medium-term fiscal objectives or rules, their effectiveness as a guide for fiscal policy-making is often limited by ambiguities regarding precise target values or time horizons. Furthermore, these objectives are not always supported by the kind of comprehensive and binding medium-term budget frameworks needed to translate those objectives into detailed plans for the future evolution of revenue and expenditure. Finally, independent validation of the macroeconomic assumptions and fiscal judgments underpinning the government’s fiscal strategy remains the exception in advanced countries and emerging countries.”

The US debt ceiling crises in 2011 and 2013 are examples in which the use of fiscal rules has led to unintended consequences.

On both occasions, the politically-motivated delay in raising the debt ceiling led to financial market volatility and the first ever downgrade of the US credit rating. For example, the delay to raise the debt ceiling in 2011 was driven by a group of conservative Republicans opposing the Obama healthcare reforms, rather than being a concern over the solvency of the US Government (which was not in question). In 2013, the US debt ceiling became a bargaining chip for desired policy outcomes.

The ‘2013 debt ceiling crisis’ lasted 10 months, beginning in January 2013 when the US Government reached their debt ceiling. President Obama warned that “not raising the debt ceiling would cause delays in payments including benefits and government employees’ salaries and lead to default on government debt.” inability to reach a consensus in Congress led to the debt ceiling being temporarily suspended till May 2013 to prevent the US defaulting on their loans. The debt ceiling was reinstated after the suspension period however it was estimated to be reached again in October. Republicans demanded the following policies be enacted before they would agree to an increase in the debt ceiling: privatise Medicare and/or social security; means testing for social security; raise the retirement age; and tax reform. This led to the shutdown of the Federal Government on 1 October 2013, placing 800,000 employees on temporary leave. The Federal Government shutdown and 2013 debt ceiling crisis ended on October 16 with a continuing resolution to fund the Government until January 2014 and a suspension of the debt ceiling until February 2014. This was a powerful example of the debt ceiling being used as a tool for political gain with severe consequences.

The Australian Government introduced a debt ceiling of $75 billion in 2009, which was raised to $300 billion in 2012. The debt ceiling was introduced as a means to maintain fiscal prudence against the running up of debt. Arguments against the debt ceiling point out that it largely duplicates the Senate’s power to reject Budget bills. Rather, a debt ceiling increases the risk that an unscrupulous holder of the balance of power could threaten a government shutdown. The debt ceiling was abolished by the Australian Government in December 2013.

Figure 2.3: The debt ceiling
By and large, in Australia in the years up to the 2007-08 Budget, the primary objective had been the same. However, the specifics of the nation’s fiscal objectives have varied in the years since.

In the 2008-09 Budget of the incoming Government, there was a shift in the language describing the primary objective to ensuring "fiscal sustainability over the medium term." At the time Australia was facing inflationary pressure, then-Treasurer, Wayne Swan, announced that it was necessary to have "a strong surplus to anchor a strong economy... to ease inflationary pressures in the economy." The government introduced a supplementary objective of "Achieving budget surpluses, on average, over the medium term."

As the GFC was creating "the most challenging global economic conditions since the Great Depression", the Government announced that the 2009-10 Budget would provide "fiscal stimulus in the short term by allowing the budget to adjust automatically... and through further discretionary policy action." At the same time, the Government also committed to "bring the budget back to surplus and pay down debt in the medium term."

Over time the nuance around achieving budget surpluses has arguably been lost, which seems to reflect a change in the broader public narrative emphasising the unqualified desirability of Budget surpluses.

The primary objective in the current Budget (2016-17) is to "achieve budget surpluses, on average, over the course of the economic cycle."

From time to time, these Government objectives have been supplemented by specific operating rules. These rules have evolved over time as circumstances have changed.

Sound fiscal policy rules ensure that government decisions are considered against the following characteristics:

- Sustainability: that the government remains solvent over time and ensures readiness for counter-cyclical action against any major economic shock.
- Preparedness: readiness against inter-generational pressure.
- Discipline: the size of government reflects its role and the scope of government reflects its purpose.

The literature on the fiscal strategy and fiscal rules is extensive. The National Commission of Audit (2014) noted that a comprehensive fiscal strategy would be expected to have objectives around:

- Flow metrics: the government’s financial performance on an annual basis reflecting developments around tax collections and spending outcomes (for example, the need for budget surpluses, on average, over the medium term).
- Stock metrics: the health of the government balance sheet (for example, the need to build up financial wealth or reduce outstanding debt over time).
- Size of government: the amount of the economy supported by the government.

Along these lines, the specific rules implemented by the Australian Government have broadly involved the following:
• Targets for government borrowing: for example, “Deliver sustainable budget surpluses building to at least 1 per cent of GDP as soon as possible.”
• The size of public debt: for example, “… stabilising and then reducing net debt over time.”
• Targets for the size of government: for example, “Keeping taxation as a share of GDP on average below the level for 2007-08” and “… the payments-to-GDP ratio falling.”

This paper does not assess the merits of the individual rules, as there already exists substantial analysis from many different commentators. Nonetheless, it is worthwhile to note the following:
• The first two examples may be interpreted as a targeting of deficits and debt as described in Section 2. Considered in isolation, they miss the broader context.
• Advocates of smaller government tend to argue that it is more efficient. As noted in Section 2, taxes can be distortionary. However, a rigid adherence to such a rule overlooks the fact that the composition and nature of public sector activity is more important.

No set of rules can anticipate all circumstances that arise, as the UK Treasury has argued, a balance needs to be struck between “a rigid mechanical approach and an approach based on unfettered discretion” (Howard 2002). Nonetheless any discretion must be exercised in a way which retains market credibility and public trust:

“A government’s approach to fiscal policy is also critical to imparting certainty and credibility to markets through the application of sound macroeconomic policies. Credibility in policy making contributes to reduced uncertainty and creates a more attractive environment for business. A disciplined fiscal policy with credibility over the medium term allows business to make investment decisions with greater confidence.”
National Commission of Audit (2014)

2.2.3 The institutional framework
It is the institutional framework within which fiscal policy is conducted that ensures this credibility.

“No set of rules can anticipate all circumstances that arise, as the UK Treasury has argued, a balance needs to be struck between “a rigid mechanical approach and an approach based on unfettered discretion” (Howard 2002). Nonetheless any discretion must be exercised in a way which retains market credibility and public trust:

“Political representatives and parties in government, come and go. Increasingly, between elections, Ministers and even First Ministers have been coming and going too. The stable core of ‘government’—its deep, enduring infrastructure—are the public service and public institutions. How these are constituted and how they behave and perform are in my view central to the public’s trust in policy, and in government itself.”
Gary Banks (2013) 11

The Commonwealth Government’s primary economic advisor is the Commonwealth Treasury. The Charter sets out the accountability and transparency framework under

11 The former Chairman of the Productivity Commission.
which the Treasury must produce a number of publically available Budget documents. The Treasury works with other government departments, such as the Department of Finance, to produce these documents, including:

- The Commonwealth Budget Papers are produced annually and provide a detailed account of Australia’s fiscal position including expenditure and revenue estimates over a four year period. The Budget Papers also provide projections of fiscal deficits or surpluses over a ten year period.
- The Mid-Year Economic and Fiscal Outlook (MYEFO) is another important budget document that provides a mid-year update on Australia’s fiscal position, in-between the publication of the annual Budget papers.
- The Pre-Election Economic and Fiscal Outlook (PEFO) is another budget document mandated by the Charter. Treasury is required to produce the PEFO within ten days of the issuing of the writs for a general election. It attempts to take into account all policy decisions that have been made by Government before the issuing of the writs. This document is signed off by the Secretaries to the Department of Treasury and the Department of Finance.
- The Treasury also produces an IGR every five years that provides an estimate of Australia’s fiscal position over a 40 year period.

Underpinning the Budget forecasts in each of these documents are the Treasury’s forecasts for the economy. Treasury conducts four economic forecasting rounds a year following the release of each set of national accounts (GDP figures) by the Australian Bureau of Statistics (ABS). The economic forecasts are then used by the Treasury and other government departments to forecast Government expenditure and revenue.

These documents produced by Treasury are generally regarded to be of a very high standard and for the most part independent of undue Government influence (it should be noted that all of these documents and their contents except for PEFO are signed off by the Government). They therefore provide a robust base for public debate around Australia’s fiscal position.

Another important Commonwealth institution is the Parliamentary Budget Office (PBO). The PBO was founded in 2012 with a mandate to support the Australian Parliament. As well as producing high quality independent analysis on Australia’s fiscal position it also provides detailed and independent policy costings to any Member of Parliament upon request.

At a state and territory level there are departments (such as the Department of Treasury and Finance in Victoria) that perform similar functions to the Commonwealth Treasury, however at this time no state or territory currently has an equivalent to the PBO.

The Reserve Bank of Australia (RBA) is Australia’s independent central bank. While its primary responsibility relates to monetary policy, it does from time to time provide commentary on Australia’s fiscal policy through both the public comments of its senior staff and a range of publications.

Outside of the public sector, academics and independent think-tanks also produce research and opinion pieces
on fiscal policy. Furthermore, a range of international organisations also provide sophisticated commentary on Australia’s fiscal position. Examples include the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and the World Bank, all of which produce commentary on the Australian economy, including analysis of its fiscal policy.

At the highest level there may be similarities in fiscal frameworks across countries; as an example, Figure 2.4 summarises the fiscal policy framework in New Zealand. However, country-specific circumstances will bear heavily on whether similar frameworks are effective. This paper does not extend the subsequent analysis abroad; the focus is on Australia.

In New Zealand, the framework to ensure discipline in fiscal policy making is all set out in the Public Finance Act 1989 (PFA). The PFA ensures prudent and transparent fiscal policy decision making through three key elements:

1. Broad principles – the PFA provisions specify a set of principles for responsible fiscal management in the conduct of fiscal policy. These principles focus on reducing and maintaining total debt to prudent levels, maintaining a buffer against future adverse shocks and intergenerational equity.

2. Short term and long term objectives – under the PFA, the New Zealand Government is required to annually report their short and long terms objectives through the Budget Policy Statement and Fiscal Strategy Report respectively and address whether these objectives and intentions are consistent with the principles.

3. Institutions – the PFA requires regular and independent economic and fiscal reporting by the New Zealand Treasury, including updates at Budget time, between budgets, a pre-election update, a statement on the long-term fiscal position at least every four years, and an investment statement on the Crown’s balance sheet at least every four years.

New Zealand does not prescribe fiscal targets through legislation and instead relies on the PFA framework outlined above to ensure fiscal policy discipline. The rationale is that allowing each Government to decide what level of public debt is prudent will act as an effective incentive to achieve the self-determined level. This transparency-based framework, under the PFA, provides the New Zealand government with greater flexibility in fiscal policy decision making than the adoption of legislated fiscal rules.

The current medium-term strategy of the New Zealand Government is to reduce net government debt to 20% of GDP by 2020. In the 2016 Budget Policy Statement, the stated focus is on maintaining rising operating surpluses to generate cash surpluses and to reduce net government debt in dollar terms. The 2016 Fiscal Strategy Report aims to reduce net debt to 8% of GDP by 2026 and increase capital spending in infrastructure through reprioritisation of the Crown’s balance sheet.

The New Zealand Treasury statement on the long-term fiscal position, ‘Affording our Future’, supported the Government’s 2016 stated objectives to maintain prudent short and medium term fiscal strategies that reduce net public debt.

**Figure 2.4:** New Zealand’s fiscal policy framework
Failure of the political economy

Key point:
- The current fiscal policy framework has not prevented some poor policymaking.

Despite having in place fiscal objectives, strategies and rules, the stance of fiscal policy has sometimes found itself at odds with sound policymaking, for example:
1. Misreading the structural Budget position;
2. Implementing asymmetric fiscal policy;
3. Failing to prosecute long-term Budget pressures.
### 3.1 Misreading the structural Budget position

As has become clear in Australia over the last 15 years, structural changes and cyclical fluctuations in revenue and expenditure are not the same thing. One is permanent, the other is not. With hindsight it is possible to see that those additional revenues reflected a temporary boom.

Chart 3.1 shows the effect of the economy (blue line) and government policy (green and blue bars) on the Commonwealth Budget balance.

The mining boom (2003–2011) provided a substantial temporary windfall to the Budget, which peaked prior to the GFC in 2008.

Governments of both political persuasions handed back the additional revenue through tax cuts (green bar) and new spending policies (dark blue bar). Since the peak of the mining boom in 2011, the economy has acted as a drag on government revenue, largely in the form of lower company and personal income tax.

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**Chart 3.1: Cumulative impact of the economy and policy changes on the budget balance**

*Source: Treasury Budget Papers, Deloitte Access Economics*
income tax collections. However, as the chart shows, most of the policy decisions made on the back of the temporary revenue gain still remain.

The above estimate of the structural budget balance (further discussed in Section 4.2.1) indicates that in the few years prior to the GFC, underlying cash surpluses were supported by temporary (cyclical) factors (Chart 3.2). That is, the underlying cash balance in the 2005-06 to 2007-08 financial years were higher than the estimates of the structural budget balance in those years.

In the case of the Australian Government’s response to the mining boom, politicians from all sides of politics wrongly assumed that the windfall gains were permanent.

The period of the Mining Boom Mark 1, which occurred from 2003 through to the GFC brought with it ‘rivers of gold’ in the form of substantially elevated government tax receipts.
While some of the excess revenue was used to pay down government debt, a larger component was used to fund new spending commitments and was handed back in the form of tax cuts.

On the latter, as then-Prime Minister, John Howard, stated on the 2003-04 Budget:

“... our principle is that if you have paid off your debt ... and you have a surplus, you have no right to keep more than the surplus you need. And we therefore take the view that when ... you have met your priority areas of spending like defence and health and so forth, you should then give what is over back to the people who own it – that is the Australian taxpayers.”

This approach to policy advocates tax cuts at times when revenues are buoyant – that is, in economic booms – and a tighter Budget when weaker economic conditions hurt revenues – precisely the opposite of good policy. This pro-cyclical approach to fiscal policy was carried throughout subsequent Budgets, with personal income tax cuts granted between 2003-04 and 2007-08.12

However, the then-Prime Ministers’ view seemed to be widely-held, as the incoming Rudd Government at the time chose to match these tax cuts and carried through their own cuts to income taxes in the 2008-09 Budget.

Instead, the surpluses of the mining boom could have been used to prepare for the inevitable reversal, such as by saving (or at least investing in the non-mining sectors of the economy).

### 3.2 An inability to implement symmetrical fiscal policy

Temporary deficits are a natural reflection of the tax and transfer system and reflect the work of ‘automatic stabilisers’ during periods of both economic strength and weakness.13 During periods of severe negative economic shocks, there may also be a role for discretionary fiscal policy.

The medium-term fiscal objective of achieving budget balance, on average, over the economic cycle is consistent with cyclical fiscal management.

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12 ‘Pro-cyclical’ fiscal policy refers to policy settings which exacerbate the direction of the economic cycle. In other words, a government increasing public spending and cutting taxes to support demand during an economic boom, and reducing public spending and increasing taxes during a recession.

13 See Section 4.2.1.
Furthermore, a balanced budget over the medium term gives fiscal policy greater flexibility during major shocks, and allows for the use of counter-cyclical fiscal policy.

On the whole, the Australian Government successfully navigated the economy through the worst of the GFC. However, as the economy recovered, government spending was not reduced. This meant that the success of fiscal policy during the crisis was undermined by the failure to return to a more sustainable policy stance when the economy started to grow again and business investment rebounded.

Rather, the Government attempted to show that the Budget was returning to surplus inside the forward estimates period by making adjustments such as shifting the timing of company tax receipts. Such decisions to adjust the Budget position through tax timing shifts are directed at achieving target surpluses rather than lasting reform. While they may have been deemed necessary because a surplus was thought to be the measure of responsible fiscal policy, they provide no lingering benefit to the nation’s fiscal finances.

So, while counter-cyclical fiscal policy was implemented during the crisis, it was sorely lacking as the economy recovered. Discretionary fiscal policy must be applied in a symmetric manner.

While a medium-term fiscal strategy of ‘balance’ implies that discretionary fiscal policy expansion or contraction should eventually be reversed, seeking to exit from expansionary policy has tended to be more challenging, at least politically. The message of symmetry is understandably more difficult in the context of, for example, reversing temporary tax cuts. The 2009-10 Budget included the following operational fiscal rules:

- Allowing the variations in receipts and payments, which are naturally associated with slower economic growth, to drive a temporary underlying cash budget deficit.
- Using additional spending to deliver timely, targeted and temporary stimulus, with the clear objective of other budget priorities and new policy proposals being met through a reprioritisation of existing policies.

14 Even though there was some waste associated with it, taken as a whole the stimulus program played an important role in ensuring that the Australian economy did not go into recession like most other comparable economies. In particular, those components that could be described as ‘timely, temporary and targeted’ were of most use. At the same time, the resulting Budget deficits didn’t significantly crowd out investment or exports, since interest rates have remained below their medium term levels. They didn’t lead to price increases either, given the subdued inflationary pressures seen over this period.

15 Deloitte Access Economics’ Budget Monitor #82.
It is important to recognise that fiscal policy is not the only lever that government can use to meet its objectives. By changing regulations government can influence decisions made by the private sector. For example, there are alternative ways that government can influence the level of savings over time to address the issue of an ageing population, such as by ensuring a higher level of private sector savings through mandatory superannuation and lifting the retirement age to increase the level of participation in the future workforce.

The first point serves to highlight the impact of the automatic stabilisers during an economic downturn. The second point indicates that stimulus will have the characteristics of “timely, targeted and temporary.” So despite there being explicit recognition in the fiscal rules that stimulus measures should be temporary, it has not panned out this way.

At the same time, we note that these rules only recognise one side of the cycle.

Automatic stabilisers should be allowed to operate in both directions. That is, variations in receipts and payments are associated with both slower and stronger economic growth, and can drive temporary deficits and surpluses. This means that allowing discretionary fiscal policy to play a role in response to large shocks is also to allow the use of discretionary policy to take counter-cyclical action to moderate economic booms, such as to provide fiscal reserves against future downturns.

3.3 An inability to address long-term pressures

Fiscal policy should have regard for long-term Budget pressures. One of the attempts to frame thinking about intergenerational issues has been through the IGR.

Tools such as the IGR can provide governments and the broader community with the knowledge required to prepare for inter-generational pressure. This is because it can provide an understanding to the public of the need for policy decisions to be made to address ongoing and longer-term issues.

For example, the challenges of an ageing population will put pressure on public finances. These pressures will build over time. If a decision is made to address these demographic pressures by taking action today, then society would need to accept a higher level of savings and, by default, lower current consumption. However, taking action now can help smooth these pressures over time rather than leave the economy open to a sudden shock.

Short-sightedness in policy making is not new. To a certain degree it reflects the imperatives of a system built around elections every three years. A degree of short-sightedness can be seen in each of the examples mentioned above, particularly the squandering of the benefits from the mining boom.

Tools such as the IGR were created to counteract the pressure of short-sighted decision making. Recently, short
sightedness has seen these tools co-opted for political reasons, significantly reducing their effectiveness.

In a way the 2015 IGR was no different to those which preceded it as it outlined how changing demographic trends will impact on the Commonwealth Budget over time. However, part of the document was used by the Government to make a short-term political point in the form of a comparison of the budget outlook under their policies and a ‘scenario’ showing the outlook under the previous Government. This made it easier for critics to dismiss the document as overtly political and for the community to ignore the long-term issues facing Australia, which to a large degree remain unresolved and ignored.
Designing a framework for Australia’s future

Key points:
We suggest that the government should:

1. Have a nominated platform to monitor and report on the long-term pressures on the budget.

2. Introduce a mechanism to ensure that fiscal implications of key policy decisions are considered beyond the forward estimates.

3. Put aside the size of government as a fiscal rule.
Key points:

A stronger framework for thinking about fiscal policy issues is needed to support a more robust national debate.

This paper makes the following suggestions:

1. The Government should have a nominated platform to monitor and report on the long-term pressures on the Budget. This platform should be independent of executive government and the central agencies. Consideration should be given to a role for:
   i. the Parliamentary Budget Office (PBO) (preferred approach); or
   ii. an independent institute (along the lines of the Institute for Fiscal Studies in the United Kingdom) or an expert panel (along the lines of Germany’s ‘wise men’, the German Council of Economic Experts).

2. As part of its mandate, this body would be tasked with:
   i. Promoting a greater understanding of the structural budget balance (SBB) in the national debate.
   ii. Reviewing, periodically, the assumptions and parameters used by Treasury to estimate the SBB.
   iii. Undertaking ongoing research to refine the measure of the SBB.

3. The Government should introduce a mechanism to ensure that the fiscal implications of key policy decisions are considered beyond the forward estimates. This is especially important in instances where the biggest fiscal impacts occur beyond the four-year forward estimate horizon. Consideration should be given to:
   i. implementing a requirement that the fiscal impact of key new policy decisions are forecast over a 10 year period and compared to a scenario without the policy; and/or
   ii. mandating a role for the PBO to develop independent estimates of the fiscal impact of key new policy decisions over a 10-year period, compared to a scenario without the policy.

4. The Government should put aside the size of government as a fiscal rule. In the short-term this may have provided Government with fiscal discipline by making it more aware of fiscal impacts of decisions. However, the optimal size of government will change over time. Instead, Government should initiate a separate public debate on the appropriate size of government in the context of the appropriate role for government.
The current fiscal strategy, fiscal rules, and institutional framework have not prevented some poor policy outcomes in the past and could also risk poor policy decisions in the future. It has allowed an overemphasis on achieving surpluses and eliminating debt to take precedence over sound policy.

While economists and policy experts can offer advice, our politicians bear the responsibility for making decisions on the policies to implement. And decisions taken by politicians reflect the preferences of the constituents that elect them. Therefore, changing the national debate is critical to changing the policy direction.

A stronger framework for thinking about fiscal policy issues is needed to help the public better engage in the debate.

This framework needs to:

- ensure that the longer-term consequences of large budget decisions are better understood. The forward estimates did not capture the impact of the decisions in the mining boom and again in the aftermath of the GFC that have been placing more pressure on the budget today;
- develop a better understanding of cyclical and structural aspects of the deficit so that policymakers can use fiscal policy in periods of pronounced downturns;
- deepen our understanding of how policy, including fiscal policy, affects intergenerational equity; and
- modify institutional arrangements to foster more independent public debate/review of these issues.

### 4.1 Establishing a new platform for intergenerational issues

To say that the Budget is healthy today does not imply that you can get away with a ‘do nothing’ policy given the known impact of an ageing population on the one hand, and relatively faster cost growth in health care on the other. In other words, the focus on Budget sustainability in terms of the underlying cash balance (UCB), fiscal balance (FB) or structural budget balance (SBB), has typically been decidedly medium-term. Were this focus to push out further, it would have to allow for the long-term upside risks to expenses and downside risks to revenue associated with ageing, health care costs and environmental costs.

As noted above, the Treasury IGRs are the platform selected by Government to consider the long-term fiscal challenges. The IGRs make projections of Australia’s population size and structure, workforce participation and productivity improvements, and analyses the implications for public finances. The IGRs provide these projections based on a format that assumes that “*current government policies will continue over the next 40 years, without change*”. (IGR 2015). While it will always be difficult to make predictions, the intent is not about creating a precise profile of the distant future, but to illustrate the potential impacts of fundamental trends if we ‘do nothing’.

The platform should raise awareness about these long-term policy issues and, if necessary, provide these issues with the public profile and urgency they deserve. However, the latest IGR was
subject to much criticism that it was politicised. For the first time, the IGR charted the course for Australia under the previous Labor government’s policies and spending levels, and argued that “Without the Government’s proposed policies, or alternative measures with an equivalent fiscal impact, the budget will not return to surplus at any point over the next 40 years.” The Shadow Treasurer, the Hon. Chris Bowen MP, said at the time, “This is a highly political document which is a massive missed opportunity” (ABC 2015). While the point about how politicised that IGR was may still be in contention, it is inarguable that the issue distracted focus from the policy substance.

Against this background, there are questions to the credibility of the IGR as the ongoing platform to consider the long-term fiscal challenges. Irrespective of whether these doubts are well founded, there is a case to strengthen its credibility. Along these lines, an independent body could be established with the mandate to conduct research into relevant aspects of fiscal and related policies as they apply to long-term trends in the Budget.

The appropriate nature of the independent body is a matter for careful consideration. Our primary fiscal policy institutions are within the Australian Public Service, which makes them responsible to the Government of the day. While this ensures that government has access to the resources required to support their policymaking, it may give rise to perceptions that these institutions lack independence.

In Australia, the PBO is an independent statutory authority that already provides an independent voice on fiscal policy, much like the Congressional Budget Office (CBO) does in the United States (although hopefully more effectively). It could be well placed to take on formal responsibility for delivering the platform to discuss the long-term pressures on our Budget. However, as the PBO is a public institution, albeit answering to the Parliament rather than the Government of the day, perceptions of partisanship remain a risk.

At the extreme end of the spectrum, to ensure greatest independence from the political process, a role could be outsourced to an academic body or

17 Some also noted that the IGR failed to adequately capture the issue of climate change, which was downgraded from a chapter in the 2010 IGR to only a handful of pages.

18 The United States model sees both the CBO and the Presidential Office of Management and Budget take a role in formulating fiscal policy and reporting on the outlook for fiscal policy.

The CBO has a much larger role in providing general fiscal policy advice than the PBO has in Australia. The CBO provides short and long term forecasting of economic and Budget forecasts that underpin discussion about policy alternatives. The expanded role for the CBO partly reflects the different institutional settings in the United States where Congress sets fiscal policy rather than the President.

The stronger voice given to an independent institution has not managed to improve fiscal policy outcomes in the United States.
the private sector on a rotational basis. Australia already devotes significant resources to researching such issues outside the public sector. However, it is often difficult to encourage debate on findings which have been delivered by ‘expert panels’. It is likely that academic and private sector bodies could continue to support a robust debate, but the core analysis may be best placed within the official sector.

Regardless of where this role is established, there are practical considerations around the governance structure, and transparency and accountability mechanisms that are needed to ensure this body is effective.

**Suggestions:** The Government should have a nominated platform to monitor and report on the long-term pressures on the Budget. This platform should be independent of executive government and the central agencies.

Consideration should be given to a role for:

- the Parliamentary Budget Office (PBO) (preferred approach); or
- an independent institute (along the lines of the Institute for Fiscal Studies in the United Kingdom) or an expert panel (along the lines of Germany’s ‘wise men’, the German Council of Economic Experts).

## 4.2 Elevating the national debate on the Budget

### 4.2.1 By promoting a better understanding of the structural position of the Budget

While estimating the structural position of the Budget may be a complicated endeavour, the concept is reasonably straightforward and important to understand. Ideally, it should be given greater exposure in the national debate.

Many, including the Commonwealth Treasury, have highlighted the difficulties of attempting to measure the structural Budget position. Indeed, estimates can differ significantly depending on methodology (Chart 4.1). As the structure of the economy changes, the relevant adjustments could also change. Yet while these measures are far from perfect, they help to fill a vital gap in the current fiscal framework by indicating where the Budget sits after accounting for economic cycles. Therefore a relevant measure of the structural position of the Budget should be one that is subject to ongoing analysis.
Given the sensitivity of the SBB to the assumptions and parameters used to construct it, if the SBB were to play a larger role in public discourse, there is value in ensuring that they are as credible as possible. Along these lines there may be a role for an independent reviewer to report on the veracity of the adjustments.

We note that the PBO has already published research on structural Budget measures and looks to be emerging as an important part of the nation’s governance on Budget-related matters.

While the Treasury will necessarily continue to estimate the SBB as part of its core role in the Budget process, expanding the remit of the PBO and providing it with additional resources to develop parallel estimates of the SBB will allow the PBO to play the role as an ‘honest broker’ in the debate around the veracity of the numbers in the Budget papers. In practical terms, there may be
little difference in the modelling outputs, but if there is more confidence in the process there is likely to be greater engagement and it would help to focus attention on the policy issues at hand rather than their political context.

Furthermore, the PBO could be provided with a formal mandate to conduct ongoing research to ensure that the measure of the SBB is up-to-date and remains best practice – going beyond the parallel forecasting in response to the Budget. While Treasury, as well as others in academia and the private sector, have also been undertaking this research, this work has been ad hoc. By giving the PBO the responsibility to do so on an ongoing basis we are seeking to avoid the situation whereby Australia misread the transitory nature of the mining boom.

At the same time, discretionary fiscal policy applied in a counter-cyclical manner must have an exit strategy. There should also be appropriate discipline to ensure that fiscal policy decisions that lead to structural increases in expenditure are accompanied by decisions for structural increases in revenue.

While the fiscal strategy and fiscal rules remain important elements for driving discipline around Budget balance and the symmetrical application of policy, Section 2 has identified instances where these have been inadequate. Against this background, we note that additional discipline is needed.

At present, the Budget includes projections for Government revenue, expenses and its financial position for three years beyond the current fiscal year (that is, ‘the forward estimates’). The forward estimates have been published since 1983. The Department of Finance defines the forward estimates as:

“A system of rolling three-year financial estimates of the revenues and costs of ongoing government policy decisions, after allowing for estimated movements in economic parameters (after the budget year). The forward estimates include the level of expenses proposed by the Government for future years (based on relevant economic, demographic and other forecasting assumptions).”

Suggestions: The Government should encourage greater consideration of the Structural Budget Balance by giving the PBO the mandate to:

• promote a greater understanding of the SBB in the national debate.
• review, periodically, the assumptions and parameters used by Treasury to estimate the SBB.
• undertake ongoing research to refine the measure of the SBB.

4.2.2 By incorporating symmetry in policy decisions

A fiscal strategy should also be flexible enough to adjust to temporary factors such as cycles in the real economy.

The World Bank noted that the forward estimates operate as a disciplinary mechanism in the budgeting process that enables a greater focus on strategic policy issues. In light of recent experience,
which has seen Government decisions fail to adhere to the tenets of the temporary nature of stimulus, there may be merit in including a new requirement that discretionary fiscal policy should be assessed over a timeframe which also models its exit.

At the same time, this requirement need not only apply to temporary fiscal stimulus. A longer timeframe of analysis would also help identify policies that lead to a structural increase in spending, but are not supported by a structural increase in revenue. For example, requiring such transparency may have helped to focus the discussion about the National Disability Insurance Scheme (NDIS) on the fact that it is a structural reform.

However, projections of the Budget position (SBB or otherwise) are highly sensitive to modelling assumptions and are less accurate (and useful) as we project further out into the future. An important goal of this exercise is to draw attention to the trade-offs implied by a decision to implement this policy. Against this background, it may be useful to present a view of the net impact of the policy by presenting a comparison of the following:

- the Budget position with the policy in place over a 10-year period; and
- the Budget position without the policy in place over the same timeframe.

It should not be expected that all policies would be subject to this framework, as the cost of this additional measure should be balanced against the benefit.

Although discretionary counter-cyclical policy should be made temporary, and key structural reforms should be supported by structural changes in the Budget; these should be subject to the framework.

This requirement could be implemented within Treasury’s Budget process; alternatively, the Government could mandate a role for an independent body, such as the PBO, to undertake this analysis. Giving this role to an independent body could help promote greater confidence in the analysis being non-partisan.

**Suggestions:** The Government should introduce a mechanism to ensure that the fiscal implications of key policy decisions are considered beyond the forward estimates. This is especially important in instances where the biggest fiscal impacts occur beyond the four-year forward estimate horizon.

Consideration should be given to:

- implementing a requirement that the fiscal impact of key new policy decisions are forecast over a 10 year period and compared to a scenario without the policy; and/or
- mandating a role for the PBO to develop independent estimates of the fiscal impact of key new policy decisions over a 10-year period, compared to a scenario without the policy.
4.3 Pursuing a separate discussion on the size of government

Over time in Australia we have seen the size of government increase. During the 1970s, Commonwealth Government expenditure accounted for an average of 22% of the economy. The proceeding decades has seen government expenditure average 24% or 25% of GDP. At the same time, taxation as a share of GDP has increased from an average of 19% in the 1970s to around 22% over the past decade.

As noted in Section 2.2, fiscal operating rules often have included targets around the size of government. While it is not unreasonable to inject discipline into government taxing and spending decisions, arguably, an arbitrary level for size of government does not apply the correct discipline. Instead, it applies an artificial constraint on the way a government can fund its spending decisions.

Typically, fiscal rules around the size of government have been anchored in reference to some prior level. For example, the 2008-09 to the 2013-14 budgets included a rule to “keep taxation as a share of GDP on average below the level for 2007-08” as a means to deliver budget surpluses (Chart 4.2). This objective was achieved, although it was largely supported by the sharp decline in revenues at the time of the GFC. While fiscal discipline is important, a fiscal rule around the size of government is a blunt instrument.

![Chart 4.2: Australian Government general government sector taxation receipts](source)

Source: Commonwealth Budget 2016-17

Deloitte Access Economics analysis of Budget Paper
Rather, the appropriate size of government should be thought of in the context of what it means for government’s ability to achieve its objectives of promoting prosperity and fairness.

The introduction of the NDIS is an example of how using the size of government as a barometer of its effectiveness is misleading. The NDIS seeks to help improve the wellbeing of people with disabilities, their family members and carers and is designed to help achieve higher levels of social and economic participation. The full implementation of the NDIS will require a substantial increase in the size of government, with some estimates putting the total cost at around 1% of national income each year.

A decision that the Government should invest in the NDIS, which aims to achieve higher levels of social and economic participation from people with disabilities, their family members and carers, should be based on the merits of the policy itself – what it means for prosperity and fairness. Along these lines, such a decision should be accompanied by a social mandate to assume the financial responsibility for delivering these outcomes, that is, taxation. An artificial constraint on the ability of Government to raise taxes means that funding such a policy will fall to reducing other potentially worthwhile spending decisions or raising debt. If at the same time there is an aversion to raising debt, then it or other government policies are put at risk.

Within a decision for the public sector to spend on disability care and support services is an assessment that these functions are better performed by the public sector (compared to the private sector). This assessment should be based on health policy considerations. An overall size-of-government fiscal target, or an immediate desire to achieve target surpluses, should not bear on such important decisions. This cautionary tale should similarly apply to capital spending decisions that bring net benefits over time.

Society has a role to ensure that government fiscal policy decisions meet society’s objectives for the role of government, that is, to deliver prosperity and fairness. Therefore, reasonable criteria for assessing the merits of individual policy decisions will be society’s desire to achieve these objectives.

This means that a larger role for government in the economy does not necessarily reflect a poor outcome, as long as it reflects the role that society has prescribed for it. That is, that the scope of government reflects its purpose. Appendix C discusses some of the considerations for the optimal size of government.

Suggestions:

• The Government should put aside the size of government as a fiscal rule. In the short-term this may have provided Government with fiscal discipline by making it more aware of fiscal impacts of decisions. However, the optimal size of government will change over time.

• The size of government is indeed a vital issue for society – but it is a different issue. The Government should initiate a separate public debate on the appropriate size of government in the context of the appropriate role for government.
## Glossary

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
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<tbody>
<tr>
<td>ABS</td>
<td>Australian Bureau of Statistics</td>
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<tr>
<td>CBO</td>
<td>Congressional Budget Office</td>
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<tr>
<td>CGS</td>
<td>Commonwealth Government Securities</td>
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<td>DAE</td>
<td>Deloitte Access Economics</td>
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<tr>
<td>FB</td>
<td>Fiscal Balance</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GFC</td>
<td>Global Financial Crisis</td>
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<td>IGR</td>
<td>Intergenerational Report</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>MYEFO</td>
<td>Mid-Year Economic and Fiscal Outlook</td>
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<tr>
<td>NDIS</td>
<td>National Disability Insurance Scheme</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
</tr>
<tr>
<td>PBO</td>
<td>Parliamentary Budget Office</td>
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<tr>
<td>PEFO</td>
<td>Pre-Election Economic and Fiscal Outlook</td>
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<tr>
<td>PFA</td>
<td>Public Finance Act of 1989</td>
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<tr>
<td>RBA</td>
<td>Reserve Bank of Australia</td>
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<tr>
<td>SBB</td>
<td>Structural Budget Balance</td>
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<tr>
<td>UCB</td>
<td>Underlying Cash Balance</td>
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<td>US</td>
<td>United States of America</td>
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</tbody>
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Howard, M. (2002), The Limits of Economic Consensus?, Thoughts on fiscal policy, Speech to the CPS.


Appendix A: Constructing the Structural Budget Balance

There are a number of different methodologies which have been applied in Australia to estimate the structural budget balance (SBB).

The Treasury, PBO, International Monetary Fund (IMF) and Organisation for Economic Cooperation and Development (OECD) have all developed methodologies for estimating the SBB for Australia.

The IMF and OECD apply a general framework which has been developed to estimate SBBs across all member countries. At their simplest, both these organisations estimate the variability of government revenue to the economic cycle and then apply that calculation to the output gap – the difference between actual and potential output or income generated by the economy. These models assume that government expenditure does not vary with the economic cycle. In this case the SBB can be given by the equations:

\[
SBB = RevP - Exp
\]

\[
UCB = Rev - Exp
\]

Therefore, \( SBB = UCB + RevP - Rev \)

Where: UCB is the government’s underlying cash balance; Rev is government revenue; Exp is government expenditure; RevP is expected government revenue at trend GDP; and Revcyc is the cyclical component of revenue.

The Treasury and PBO have both developed estimation methodologies for the Australian context. These models take into account the particular characteristics of Australian government’s tax and spend policies. The Treasury SBB methodology is driven by estimating the gap between actual and trend nominal output. This comprises both a real output gap (the business cycle) and a gap between the GDP deflator and its structural level.

More information on the Treasury SBB model can be found in Win et al. (2013).

The GDP deflator measures the economy wide change in prices.
The real output gap is the difference between actual real GDP and estimated structural GDP. Treasury estimates structural GDP based on assumptions for productivity, the size of the working age population, workforce participation rates, employment rates and average hours worked per person.

The gap between the GDP deflator and its structural level is dependent on Treasury’s assumption for the long run level of the terms of trade (price of Australia’s exports relative to the price of imports) and a domestic price growth assumption consistent with the RBA’s inflation target.

The cyclical component of receipts is estimated by multiplying the nominal GDP gap by the receipts to GDP ratio excluding capital gains tax as this is modelled separately. The Treasury also account for the positive relationship between nominal GDP growth and the rate of tax collections by applying an elasticity of tax receipts to nominal GDP of 1.25.

Capital gains taxes are incorporated into the model separately to account for the high degree of volatility of asset price cycles and their resulting impact on the Budget.

Unlike the general methodology employed by the IMF and OECD, Treasury assumes that some government expenditure is dependent on the economy such as unemployment benefits. This is incorporated into the model by estimating the cost to the government stemming from the gap between the current unemployment rate and the long term structural level of unemployment in the economy, which is equal to the Treasury’s estimate for the non accelerating inflation rate of unemployment (NAIRU).

Treasury’s methodology for estimating the SBB is represented by the equations below.

\[ SBB = UCB - Rev_{cyc} + Exp_{cyc} \]

\[ Rev_{cyc} = GDP_{cyc} \times \left( \frac{Rev}{GDP} - \frac{CGT}{GDP} \right) \times E_{Rev} + (CGT - CGT) \]

\[ Exp_{cyc} = UBR - UBR^T = UBR - NSARate \times NAIRU \]

\[ 22 \text{ This equation is the same as the generic SBB equation with the addition of a cyclical expenditure component.} \]
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>SBB</td>
<td>Structural budget balance</td>
</tr>
<tr>
<td>UCB</td>
<td>Underlying cash balance</td>
</tr>
<tr>
<td>Rev(^{cyc})</td>
<td>Cyclical component of government revenue</td>
</tr>
<tr>
<td>Exp(^{cyc})</td>
<td>Cyclical component of government expenditure</td>
</tr>
<tr>
<td>GDP(^{cyc})</td>
<td>The ‘output gap’ or estimate of the cyclical share of GDP</td>
</tr>
<tr>
<td>Rev(^{GDP})</td>
<td>Government receipts to GDP ratio</td>
</tr>
<tr>
<td>CGT</td>
<td>Capital Gains Tax receipts</td>
</tr>
<tr>
<td>CGT(^{GDP})</td>
<td>CGT receipts to GDP ratio</td>
</tr>
<tr>
<td>E(^{Rev})</td>
<td>Elasticity of tax receipts to nominal GDP</td>
</tr>
<tr>
<td>UBR</td>
<td>Total unemployment benefits paid</td>
</tr>
<tr>
<td>UBR(^{T})</td>
<td>Amount of unemployment benefit paid at the structural level of unemployment</td>
</tr>
<tr>
<td>NSARate</td>
<td>Average Annual rate of NewStart Allowance paid</td>
</tr>
<tr>
<td>NAIRU</td>
<td>Non-Accelerating Inflation Rate of Unemployment</td>
</tr>
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</table>
Appendix B: Government solvency

Ley (2010) demonstrates that fiscal policy is sustainable if the government’s solvency condition is satisfied.

The solvency condition requires the net present value of primary surpluses to be equal to the net present value of debt obligations. Ley recognises that in a growing economy, there is no reason why public debt has to be paid out entirely. The only requirement at the heart of the solvency condition is a non-explosive debt ratio. Stabilising the debt-to-GDP ratio satisfies the solvency condition.

The solvency condition is often misunderstood through requiring it to be truncated at a terminal time. As Robert Eisner (1994) states, “the notion that the debt incurred by current generations has somehow to be paid off eventually by future generations is a confusing, or confused, effort to use a mathematical principle of solvency where it does not apply.”

The debt-to-GDP ratio is a measure of what a country owes compared to what the country produces and is used to indicate a country’s ability to pay back its debt. Stabilising the debt-to-GDP ratio involves setting the change in the debt-to-GDP ratio to zero. This gives us the debt-stabilising balance.

The debt-stabilising balance is the required government primary surplus (including seigniorage) to make the change in the debt-to-GDP ratio equal to zero. A larger government primary surplus will decrease the debt-to-GDP ratio. However, it is important to note that while the primary balance affects the debt-to-GDP ratio, what finally matters for debt dynamics is the overall balance. This is why stabilising the debt-to-GDP ratio is a necessary but not a sufficient condition.

Assuming a primary balance that evolves over time in line with nominal GDP growth implies that the debt-stabilising balance remains constant. A constant debt-stabilising balance (change in debt-to-GDP ratio is equal to zero) satisfies the solvency condition. This implies that a stable debt-to-GDP ratio satisfies the solvency condition.

23 Seigniorage is the difference between the value of money and the cost to produce it. Essentially, it is the profit made by governments in issuing currency.
Appendix C: Size of Government

At the highest level, the optimal size of Government should be assessed in context of the impact of government activity on society’s objectives of prosperity and fairness.

Australia ranks one of the lowest among OECD countries for the size of the public sector (Chart 4.3). This likely reflects a preference for a smaller government in Australia compared to many other developed countries. As noted in Section 2, advocates for small government believe that the public sector is less efficient than the private sector.

**Chart 4.3:** Annual general government spending by country, 2014

*Source: OECD*
In this regard, society’s preference for smaller government is appropriately reflected in the efforts of successive Australian Governments to maintain or reduce the size of government. The fiscal rules in recent Budget papers from both sides of politics have included constraints on both spending and taxing:

- 2007-08 Budget: “Not increasing the overall tax burden from 1996-97 levels.”
- 2008-09 Budget: “Keep taxation as a share of GDP on average below the level for 2007-08.”
- 2016-17 Budget: “Maintaining strong fiscal discipline by controlling expenditure to reduce the Government’s share of the economy over time... [with] the payments-to-GDP ratio falling...”

This paper does not assess the merits of the efficiency argument. A wide body of research exists on this, and a future discussion on the size of government could usefully review this preference. Simes (2003) notes that “Cross-country comparisons, in fact, provide little evidence that the overall size of government is correlated with economic growth.” Importantly, low public sector spending is not evidence of a lean public sector – efficiency will depend on the composition of spending and the design of spending programs.

However, the use of a size of government indicator as a means of engendering discipline against fiscal profligacy is not easily dismissed. The above fiscal rule examples and the political economy in Australia since the Hawke and Keating governments suggest that the size of government presents a genuine constraint (for better or for worse).

Nonetheless, the underlying principle is that a fiscal rule around the size of government reflects society’s objectives for government and takes into account current economic circumstances. Structural changes in the economy and shifts in the preferences of society, if not reflected in a fiscal rule governing the size of government, limits the Government’s ability to achieve society’s objectives. At the very least, a size of government fiscal rule, if adopted, should be flexible (separately, any flexibility must not be able to be abused).

The Gonski reforms (2011) to school funding represented a significant effort to help “address Australia’s schooling challenges and achieve a high-quality, internationally respected schooling system.” Despite society’s shared desire to arrest the decline in the performance of Australia’s schooling system compared to international benchmarks, the political debate has been contentious. While such significant reform deserves scrutiny, and part of the debate over the past few years has focused on the effectiveness of the reforms in achieving better outcomes, the most recent debates have been around the level of funding. The latter has seen the Government pare back education expenditure in the name of prudent budgeting. Arguably, the debate should have been more focused on increasing the size of government to ensure the right level of education spending. An increase in spending should not be discussed in isolation of an increase in taxation.
The size of government should be the end product, rather than the starting point for the debate. Rather, society should decide what activities government should undertake based on a set of criteria, with the ultimate aims of prosperity and fairness always kept front and centre.

The role and scope of government is a matter of judgement with the correct balance differing according to individual preferences. Given this diversity of opinion, there needs to be a common starting point whereby discussions about the role and scope of government should begin. In our view, answers to the questions below form a good starting point for this debate to occur.

• Is there a ‘market failure’? Is there a good or service that the community needs that is not being provided by the private sector?
• Does it increase society’s net worth? Does government action make the community better off even when you consider the cost of paying for it through higher taxes?
• Is it efficient for the government to provide? Would government do a better job than the private sector at providing this outcome?