

## NATIONAL AND STATE FISCAL RULES IN AUSTRALIA: AN OUTLINE AND CRITICAL ANALYSIS

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### **Introduction**

Since the late 1980s, deficits and public debt have been the major preoccupations of Australian fiscal policy. There was a widespread public perception that a number of the States, and then subsequently the national government, were experiencing debt 'crises' or, at the very least, serious debt blow-outs. The net debt of consolidated (ie national, state and local) Australian general government reached a peak of approximately 25 percent of GDP in 1995, up from a previous trough in 1990 of a little below 10 percent. The problem here was the trend rather than the level of public debt, which remained moderate by international standards (even at the 1995 peak, consolidated *gross* general government net debt was approximately 34 percent of GDP, well below the Maastericht benchmark of 60 percent<sup>1</sup>).

The change in the Commonwealth (national government) debt position was particularly marked. The previous trough in Commonwealth general government net debt was about 4 percent, in 1990. This rose more than four-fold, to a 1996 peak of 19 percent. State/local government experienced a less marked, but nevertheless significant, increase, approximately doubling to a peak of 10 percent in 1992-93. Within certain individual States, both the level and growth rate of debt was considerably greater than this average. A number of States experienced downgrading of their credit ratings (by up to two rungs below their previous triple-A gradings). It is therefore unsurprising that the perception of a 'debt crisis' arose firstly at the State level. There were in the

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<sup>1</sup> Gross debt is, of course, not a terribly meaningful measure, and is used in Europe largely because of measurement problems (Balassone and Franco, 2000a: 8). A more meaningful 'broad' measure of the Australian general government debt position (at least in the then cash accounting environment) is given by adding net debt plus unfunded employee liabilities, yielding of figure of approximately 51 percent of GDP.

early 1990s a number of State elections in which debt was a central issue, and in which incumbent (Labor) governments which were perceived to have failed the fiscal responsibility test lost office.

The greater increase in Commonwealth net debt arose partly from the impact of recession in the early 1990s, reflecting the greater cyclical sensitivity of Commonwealth finances. From 1992-93, however, the economy had recovered, but significant deficits continued to be recorded. In 1992-93, the underlying cash deficit was 4 percent of GDP. Three years later, even though year-on-year GDP growth had reached 4.5 percent, the deficit had only been reduced to 2 percent. Unsurprisingly, public finances were a significant issue in the Commonwealth election of 1996, when the Labor government was defeated and replaced by a Coalition (conservative) government headed Prime Minister John Howard.

It was as a reaction to this perceived debt crisis that through the 1990s almost all Australian Governments moved to adopt explicit fiscal rules requiring structurally balanced 'cash' budgets. This required the national government and a number of the States to embark on significant fiscal adjustment programs. Many Governments combined these deficit-elimination policies with explicit debt-reduction programs, to which asset sales programs have made a considerable contribution.

At the end of the 1990s, Australian governments adopted accrual accounting in their general government sectors, a step which to date has been taken by a relatively small number of governments world-wide. This led the Australian national government and a number of the States to re-cast their fiscal rules in accrual accounting terms. A key focus of this paper is upon the implications of the move to accrual accounting for fiscal rules.

## **1. Australian Fiscal Rules under Cash Accounting**

As mentioned above, prior to the adoption of accrual accounting, most Australian governments had during the 1990s adopted explicit rules requiring balanced cash budgets. Upon coming to office in 1996, for example, the present Commonwealth government asserted as its primary fiscal policy rule a

requirement to ‘achieve underlying<sup>2</sup> [cash] budget balance on average over the business cycle’. This was accompanied by a strong medium-term emphasis upon debt reduction or elimination. Many of the States had earlier adopted similar fiscal rules. For example, in New South Wales the rule adopted in 1995 is that ‘the Budget should be at least balanced (on a Government Finance Statistics cash basis) over the course of a full business cycle’, and there was an accompanying explicit medium-term objective of achieving zero net debt by 2020.

Although not made explicit, these governments have in practice, consistent with the focus upon debt reduction/elimination objectives, targeted structural cash surpluses rather than merely balanced cash budgets. This is true notwithstanding that the largest contribution to the reduction of debt levels has come from privatisation and other asset sales.

Why the fiscal objectives of cash surpluses and debt reduction/elimination? Simplistic anti-debt views have been enormously influential. Rising quantum of public debt, arising from cash deficits, are routinely characterised in official fiscal policy statements as a threat to fiscal sustainability. This, of course, constitutes an argument for stabilising the *quantum* of debt (albeit an erroneous one, given that fiscal sustainability may be quite consistent with rising debt as long as the debt/GDP ratio remains contained). The reduction or elimination of public debt has been justified by three further propositions, namely that:

- public debt is an inherently unfair imposition on future generations,
- continuing debt reduction is essential if Australia is to retain the confidence of international capital markets, so as to be able to fund its large external current account deficit (CAD)
- it was essential that triple-A government credit ratings be restored through debt reduction.

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<sup>2</sup> The ‘underlying’ budget balance was an adjusted version of the cash budget result in which privatisation receipts and other ‘net advances’ are treated as equivalent to borrowing (ie as ‘financing transactions’) rather than as equivalent to revenue. The practice of adjusting the cash budget balance for the impact of privatisation receipts was also adopted in most States by the mid-1990s.

These rather traditional arguments were joined in the early 1990s by a new theme. The elimination of cash deficits was increasingly presented as a key means by which national savings could be increased, thus reducing the requirement for external funding of private sector investment and thereby reducing the CAD. Initially at least, this argument was based upon the (false) assumption that the cash deficit was a measure of government dissaving.

## **2. Accrual Accounting and Fiscal Rules**

As will be obvious, recent Australian fiscal policy has been characterised by a pervasive failure, particularly at the political level but also at the bureaucratic level, to distinguish between deficits/debt arising from public consumption and deficits/debt arising from public investment. A key advantage of accrual accounting is that it clearly distinguishes between consumption and investment. The accrual *operating balance* measures the gap between revenue and consumption (operating expenses), whereas the cash balance measures the gap between revenue and outlays (capital as well as current).

I have argued elsewhere that the "golden rule" of public finance is best expressed as a rule requiring that the operating balance average zero over the business cycle (Robinson, 1998). The golden rule is, of course, primarily concerned with intergenerational equity. From a golden rule perspective, to require balanced *cash* budgets is inequitable because it requires that all general government capital expenditure be contemporaneously tax-financed, even though the benefits generated by such capital expenditure will accrue over potentially considerable periods into the future. It is more appropriate that the costs of such capital should be met by taxpayers over time in accordance with the inter-temporal distribution of the benefits which public capital generates for the community. The principle of a balanced accrual budget (a zero *operating* balance) implies precisely this, because taxpayers in each time period are paying the costs (measured by depreciation and interest payments on borrowing used to fund capital expenditure) of the existing public capital from they derive benefits.

To formulate the golden rule as a requirement that the accrual operating balance average zero over the business cycle is approximately equivalent to a stipulation that there be a structural cash deficit equal to general government *net* investment. This in essence is the British version of the golden rule (Robinson, 1998). It may be contrasted with another traditional version of the golden rule, enshrined for example in the German constitution (Balassone and Franco, 2000b: 15), which permits cash deficits equal to *gross* general government investment. Such a version of the golden rule would mean that current taxpayers make no fiscal contribution to the costs of the capital assets from which they are deriving benefits: a situation which does not appear consistent with the principle of intergenerational equity.

As Balassone and Franco note (2000b: 13), an important issue concerns the types of public sector investment to which one should apply the golden rule approach to the intertemporal allocation of the cost of capital assets. Simplifying a little, one can distinguish between *commercial* public sector investment and *social* public sector investment. Commercial investment refers to public enterprise investment aimed at producing outputs to be sold in market transactions, in the expectation that price at which those outputs are sold will at least cover their costs of production. Social investment, on the other hand, refers to investment in assets such as (non-toll) roads, school buildings and infrastructure, parks and museums, which generate benefits of a non-financial nature for the community. Social investment is focused in the general government sector, and commercial investment in the public enterprise sector. So the question is, does the golden rule apply to both types of investment, or only to one or the other?

Some economists regard the golden rule as a rule applicable to all public investment (Buiter, 1999). Others take it to certainly apply to commercial public sector investment, but as of uncertain relevance to social investment (eg Verbon and van Winden, 1993: 5-6). My view is that, at least as an approximation, the golden rule should apply to social investment but not to commercial investment. The intertemporal allocation of the costs of commercial capital investment is determined by pricing policy rather than by taxation principles. If one believes that allocative efficiency ought to be the principle criterion for setting prices, the application of the golden rule to commercial public sector investment becomes inappropriate. Equity (including

the principle of intergenerational equity) is, by contrast, a taxation policy criterion of central importance. Hence the view that the golden rule should apply only to social investment and, therefore, that it should be interpreted as relevant to the *general government* operating balance, and not to the operating balance of the consolidated public sector.

To assert that the golden rule guarantees intergenerational equity in fiscal policy would be to absurdly oversimplify the complex issue of intergenerational equity. Nevertheless, it can be argued that the golden rule, if supplemented by other policies, may represent the best practicable approximation of the intergenerational equity principle, and that the golden rule is certainly much superior in this respect to a balanced cash budget rule.

The golden rule version of intergenerational equity is that each time-period (financial year) should pay for itself, without fiscal transfers from other time periods. The golden rule thus represents, in a sense, a *time-period* version of the benefit principle. The key problem here is that time-periods are not, of course, 'generations'. The question therefore arises: if one were to define intergenerational equity as a state in which each *generation* (as opposed to each time period) pays for itself, without fiscal transfers from other generations, what relationship would a medium-term fiscal rule designed to assure intergenerational equity bear to the golden rule?

A threshold problem in answering this question is, of course, the inherently ambiguity of the concept of a 'generation'. However, whether one defines generations as birth-cohorts (a la generational accounting) or in some other related manner, it can be shown that there is a clear relationship between the golden rule and intergenerational equity in this sense of a ban on intergenerational fiscal transfers (Robinson, 1999). In summary, this is that:

- If each 'generation' pays for itself in each financial year, the golden rule will be complied with,
- Intergenerational transfers are not the only reason why generations may not pay for themselves in each time period. The other reason is, of course, inter-temporal transfers (life-cycle) within generations,
- In the presence of such inter-temporal transfers within generations, the outcome of a ban on intergenerational transfers would be the golden rule

*modified by* the fiscal consequences of these inter-temporal transfers within generations.

The conclusion that the golden rule is a superior approximation to the intergenerational equity principle than is a cash balance rule follows directly from this. If it were possible to operationalise fiscal policy rules couched in terms of the lifetime treatment of generations (in the broad spirit of generational accounting), then this would be better still. However, as experience with the application of generational accounting has demonstrated, this is not a practicable matter. It is arguably more practical to combine the golden rule approach with specific policies designed to deal with fiscal problems arising from intertemporal transfers within generations, and more particularly from the impact of demographic discontinuities in areas such as social security and health expenditure (eg increased contributory, as opposed to pay-as-you-go, funding of pension/superannuation schemes).

The Australian emphasis upon fiscal policy as a tool of national savings policy endows accrual accounting with further relevance because it is the accrual operating balance—and not the cash budget balance—which measures government savings. This means that, insofar as fiscal policy aims to ensure that government makes a non-negative contribution to national savings, what is required is that the government achieve a structurally balanced operating balance, or even that it target a structural operating *surplus* of a certain magnitude. This point is further discussed below.

The adoption of accrual accounting therefore can be seen as presenting an opportunity to significantly recast medium-term fiscal policy rules. This is not, of course, to suggest that the cash budget balance measure has become irrelevant—it is perfectly possible to accept the continued relevance of cash accounting to fiscal demand management, while endorsing accrual accounting as the appropriate language for the expression of medium-term fiscal rules.

Two State governments (Queensland and Victoria) have responded to the opportunity presented by the arrival of accrual accounting by adopting fiscal rules broadly consistent with the golden rule approach (see below). The national government and a majority of the State governments, however, have retained essentially the same approach to fiscal policy. Why then have these

governments bothered to adopt accrual accounting? The explanation of this apparent paradox is that the adoption of accrual accounting within the Australian general government sector has been driven not by fiscal policy considerations, but by perceived managerial benefits (associated particularly with product costing and asset management).

The fact that the fiscal policy framework has for the majority of Australian governments remained essentially the same following the introduction of accrual accounting does not, however, mean that the move to accrual accounting has been inconsequential for fiscal policy. At the Commonwealth level, the basic fiscal rule has since the introduction of accrual accounting been reformulated in terms of a new deficits/surplus measure, the so-called *fiscal balance*. The fiscal rule is now 'fiscal balance, on average, over the course of the business cycle' (Treasury, 1999a: 2).

### **3. Fiscal Balance**

Fiscal balance is defined in flow terms, as the general government operating balance<sup>3</sup> minus general government net acquisition of non-financial assets (net investment for short). The concept is nevertheless most readily understood in stock terms.

It helps here to remind ourselves of the distinction between financial assets/liabilities and non-financial assets. Non-financial assets are assets held by general government agencies which yield non-financial benefits (e.g. non-toll roads and school buildings). Financial assets and liabilities are those which entail flows of money, such as bonds, superannuation and leave liabilities to government employees, certain lease commitments, revenue accruals, government holdings of traded shares and (in the case of the general government balance sheet) the government's equity in commercial public enterprises. Net financial worth is the market value of all financial assets minus the market value of all financial liabilities. It follows that:

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<sup>3</sup> Defined in terms of the Australian Government Finance Statistics system. The measurement of the operating balance is discussed further below.



$$\text{Assets} - \text{Liabilities} = \text{Net Worth} = \text{Non-Financial Assets} + \text{Net Financial Worth}$$

If we were then to define net financial liabilities as financial liabilities minus financial assets (and thus as a measure equal in absolute value, but opposite in sign, to net financial worth), this could be expressed as:

$$\text{Net Worth} = \text{Non-Financial Assets} - \text{Net Financial Liabilities}$$

It is useful to clarify the relationship between net financial liabilities and net debt. Net Debt is the market value of a *sub-set* of financial liabilities (bonds issued to the public) minus the market value of a *sub-set* of financial assets (principally debt owed to government and government cash holdings). Net financial liabilities, by contrast, is the value of *all* financial liabilities minus *all* financial assets. The difference is non-debt financial assets (such as public enterprise equity) and non-debt liabilities (such as employee liabilities). In a sense, net financial liabilities might be considered to constitute a type of *broad (net) debt* measure. Any changes in net debt will also affect net financial liabilities, but net financial liabilities is also affected by any movements in non-debt financial assets and liabilities.

If we ignore, for simplicity, breaks in the "articulation" of flow in stock concepts which arise principally from so-called "revaluations" (many of which are attributable to what economists term valuation effects), it can be said that:

$$\text{Operating Balance} = \Delta \text{Net Worth}$$

and:

$$\text{Net Acquisition of Non-Financial Assets} = \Delta \text{Non-Financial Assets}$$

and therefore that:

$$\text{Fiscal Balance} = \Delta \text{Net Financial Worth} = - \Delta \text{Net Financial Liabilities}$$

This makes it clear why the fiscal balance is regarded by the Commonwealth Treasury as 'the accrual counterpart of the underlying cash balance' (Treasury, 1999b: 1.14). Whereas the stock counterpart of the cash

budget balance is conventional net debt, the stock counterpart of the fiscal balance is broad (net) debt. These two stock concepts are, as noted above, closely related. Also of importance here is the fact that the earlier version of the government's fiscal rule focussed upon the *underlying* cash budget balance. The underlying cash balance excludes privatisation receipts<sup>4</sup> from the conventional cash balance measure. The stock counterpart of the underlying cash balance is therefore net debt plus public enterprise equity. Thus the difference between fiscal balance and the underlying cash balance is, approximately speaking, the change in net financial liabilities *other than* net debt and public enterprise equity. Over time movements in the sum of conventional net debt plus public enterprise liabilities will tend to correlate reasonably highly with movements in net financial liabilities.

Nevertheless, movements in the sum of conventional net debt plus public enterprise liabilities can in any particular year diverge quite substantially from the movement in net financial liabilities. Thus, even though the re-formulation of the Commonwealth government's medium-term fiscal rule in terms of the fiscal balance rather than the cash budget balance has occurred within the context of fiscal policy continuity, this re-formulation does have non-trivial implications for the government's fiscal stance.

#### **4. Fiscal Sustainability, Net Financial Worth and the Fiscal Balance Rule**

The inter-temporal budget constraint (ITBC) is, of course, the usual starting point for any analysis of fiscal sustainability, and is also the foundation stone for generational accounting. The ITBC requires that the present value of future primary (cash) deficits equals (and here formulations differ) either initial the public sector net wealth or the negative of initial net (or even gross) debt. As Balassone and Franco remind us (2000a: 8), the stock and flow variables

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<sup>4</sup> And certain intra-public sector loan repayments which had been previously treated as income flows. The concept of the underlying cash balance was introduced into the official Australian Bureau of Statistics government accounting framework in the first half of the 1990s as a response to the widespread use by governments of receipts from privatisations and certain other transactions in order to "improve" their cash budget outcomes.

employed in the ITBC must be congruent. If one expresses the ITBC in terms of net debt, it is obviously necessary that both capital payments/receipts *and income flows* associated with non-debt financial assets and liabilities be treated as revenue or expenditure relevant to the calculation of the primary deficit. This means, for example, the inclusion of income derived from public enterprises, income from government holdings of shares in private-sector companies<sup>5</sup>, and superannuation payments to retired public servants. The primary deficit is in this case defined as all payments and receipts other than those associated with debt.

If, by contrast, one chooses to express the ITBC in terms of net wealth, then (approximately speaking) all payments and receipts associated with *all* assets and liabilities will need to be excluded in the measurement of the primary deficit. If one defines the concepts of assets and liabilities conventionally in terms of formally contracted entitlements and legal ownership, the concept of 'net wealth' clearly corresponds closely to that of general government net financial worth as defined in the preceding section. It is relevant here that the fundamental valuation principle employed by the Australian Bureau of Statistics in estimating net financial worth is that all financial assets and liabilities should be valued according to their *economic value*<sup>6</sup>.

There are considerable advantages to be gained from the use of general government net financial worth rather than general government net debt as the key fiscal sustainability indicator. Perhaps the most important advantage is that net financial worth cannot be manipulated via transactions which transform debt into non-debt financial assets/liabilities. Asset sales are not the only form such transactions may take. Another example of a transaction which reduces general government net debt without (necessarily or commensurately) increasing general government net financial worth is what might termed the 'capital restructuring' strategy. This technique, of which extensive use was made in Australia in the 1990s, involves governments requiring public enterprises to borrowing additional funds in order, supposedly, to raise their

<sup>5</sup> Which might, for example, be held by public employee superannuation funds.

<sup>6</sup> This means, approximately speaking, the present value of associated future financial flows or, if the asset is to be sold, its market value.

gearing ratio to more commercial levels. The public enterprise then transfers the borrowed funds to the general government sector as a 'repatriation of equity capital'. The result is an entirely illusory reduction of general government net debt (and of the cash deficit). Once the focus is upon net financial worth rather than net debt, such strategies become useless as a means of window-dressing the budget.

Whatever the choice of stock variable used in the ITBC, it is not appropriate to include assets which do not yield (direct) monetary income. The economic value of 'social' assets is the present value of the non-financial benefits which these assets generate for the community. If one were to include such assets in the ITBC 'net wealth' measure, it would be necessary also to treat these non-financial benefits as imputed expenditure when measuring the deficit. Not only would this be a rather impractical business, but it would arguably be an exercise with little relevance to the issue of fiscal sustainability, which is fundamentally concerned with government's capacity to meet its financial obligations.

As noted above, under the new Australian government balance sheet conventions, net worth equals the sum of net financial worth and non-financial assets. General government non-financial assets overwhelmingly comprise 'social' assets which yield no financial returns. In terms of fiscal sustainability, it is therefore net financial worth rather than net worth which is relevant. The balance sheet 'valuation' of non-financial assets has, moreover, little to do with the economic value of the assets concerned. It is, broadly speaking, an accounting valuation based upon depreciated cost<sup>7</sup>. This yields a concept of net worth which is consistent with the traditional golden rule view that the intergenerational equity in relation to capital expenditure, which requires that the *cost* of *social* assets be distributed over time in accordance with the intertemporal in terms of the non-financial benefits generated by those assets. This cost-allocation approach to intergenerational equity has considerable practical merit.

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<sup>7</sup> Albeit unnecessarily complicated through the application of what accountants term 'deprival value' methodology — see Robinson, 1998.

Net financial worth is, as noted above, the stock counterpart of the new fiscal balance measure. The fiscal rule requiring a zero structural fiscal balance therefore implies that (volatility related to revaluations aside) net financial worth remain constant in dollar terms. Clearly this is not necessary from a fiscal sustainability point of view. It is, of course, sufficient that the net financial worth/GDP ratio have moderate upper and lower bounds. Just as a small continuing structural cash budget deficit is perfectly consistent with fiscal sustainability, so also is a small continuing deficit on the fiscal balance.

## 5. Zero Fiscal Balance versus the Golden Rule

Because the zero fiscal balance rule is so closely related to the zero cash balance rule, a comparison with the golden rule approach is straightforward. We first contrast their net worth implications, and then their implications for net financial liabilities (broad debt).

Revaluations aside, the golden principal of a balanced accrual operating statement implies that general government net worth remain constant. By contrast a zero fiscal balance rule implies that there is an operating surplus equal to net investment. This means that if general government net investment is positive, net worth will be rising. This perhaps helps to explain why the Commonwealth has with the arrival of accrual accounting articulated a new ancillary fiscal policy objective: that of 'improving the Commonwealth's net assets [ie net worth] position over the medium to long term' (Treasury, 1999a: 1.15, 1.19). It is, however, one of the problems of accrual accounting that there is a tendency for the uninformed to assume that to increase net worth is a self-evidently desirable thing. From the golden rule perspective, however, the pursuit of *increasing* net worth implies undue imposts upon current generations, and reflects what Treasury itself correctly identified in 1995 as a misconceived 'presumption that increases in net worth are good' (Treasury, 1995: 5).

Although if general government net investment is positive this rule implies rising net worth, it is possible for net investment to be negative, in which case such a rule is consistent with an operating deficit and reduced net worth. "Net investment" (more formally, net acquisition of non-financial

assets) will be negative if the sum of depreciation and sales of assets such as excess land exceeds new capital expenditure. Negative net investment is not merely a hypothetical possibility. In 2000-2001 Commonwealth general government net investment is projected to be *minus* \$3.6 billion. Significant sales of general government assets made an important contribution to this outcome. This means that the Commonwealth could, if it wished, run an operating deficit of up to \$3.6 billion during 2000-01 while still achieving a zero fiscal balance. Thus it can be said that the zero fiscal balance rule unintentionally opens the door to short-run manipulation by fiscally-irresponsible governments.

What about the debt implications of the two approaches? Valuation effects aside, the zero fiscal balance rule naturally implies constant general government net financial liabilities (broad debt). This is, of course, merely an accrual version of the constant net debt consequences of a cash balanced budget. The consistent observation of a zero fiscal balance rule over time would (cyclical issues to one aside) be that general government net financial liabilities would be zero. By contrast, the golden rule (in the balanced accrual budget form) implies that increases in net financial liabilities equal increases in the general government capital stock. And if the golden rule were observed consistently throughout time, net financial liabilities would equal the balance sheet value of the general government capital stock (and net worth would therefore be zero) (Robinson, 1998, 1999).

Thus the golden rule only implies rising (broad) debt if the general government capital stock is increasing. Over the long run, the public capital stock should rise, and in this sense the golden rule certainly does imply rising net financial liabilities. Nevertheless, given irregularities and discontinuities which tend to affect public capital expenditure, it is perfectly possible that even governments committed to maintaining the level of services provided by the public capital stock will at times preside over periods during which new investment will be less than depreciation. (This is true even if the government is not conducting significant sales of general government assets, of the type referred to above in relation to Commonwealth negative net investment during 2000-01). During such periods, the golden rule would actually imply reductions in broad debt (see Robinson, 1996b).

This result incidentally stands in contrast to the alternative version of the golden rule referred to above, which would permit cash deficit equal to *gross* general government investment. Such a version of the golden rule would imply that the general government net debt could only move in one direction: upwards. It would also imply, approximately, that a reduction in net worth each year equal to the magnitude of depreciation.

It hardly requires mention here that the golden rule does not claim to guarantee fiscal sustainability as well as intergenerational equity. It needs to be accompanied by an explicit 'debt' ceiling, along the lines of what the British call their "sustainable investment" rule. Following the discussion in the previous section, a case can be made that the most appropriate way of formulating such a ceiling is in terms of a *maximum* ratio of general government net financial liabilities/GDP. This should, naturally, be accompanied by rigorous capital budgeting procedures designed to ensure that all social capital expenditure passes a social cost/benefit test. It should also be noted that, as pointed out by Buiter (1999: 18), the golden rule should not be taken to imply a *stable* debt/GDP ratio.

## 6. National Savings Policy

As noted above, boosting national savings is a fundamental element of current Commonwealth fiscal policy. Originally, this policy was based upon the presumption that budget surpluses (in cash terms, or in fiscal balance terms) measure government savings (Fitzgerald, 1993). This was, of course, an incorrect view, because it failed to distinguish between consumption spending and investment spending. Saving, by definition, is income (revenue) minus consumption (operating expenses). The proper measure of government savings is therefore not the fiscal balance (or, for that matter, the cash balance), but the operating balance. Thus a zero fiscal balance implies, not that government savings are zero, but rather that savings equal net investment.

Policy-makers no longer suffer from this illusion. They now clearly recognise that what the fiscal balance measures is not government savings, but rather government net lending to/from the private sector. The zero fiscal balance rule is defended by the Commonwealth Treasury on the grounds that it

is appropriate that government should not draw on private sector savings to fund its own investment. This policy approach raises issues which are very familiar to all economists from debates in past decades about fiscal crowding out. The basic problem is that a policy requiring that savings equal investment is that it can be achieved not only by increasing savings but also by reducing investment. Such a policy also makes it difficult to deal with inherent irregularities in capital expenditure requirements.

As in the US, there has been debate amongst Australian economists both about whether increasing public sector savings is an appropriate means of increasing national savings and, more fundamentally, about whether a low savings ratio is a problem at all (see, eg Pitchford, 1990; Jonson, 1989). Even if one accepts that it is appropriate in the medium-term for fiscal policy to target a positive level of government savings, there are policy alternatives to the current approach. Governments could set defined savings targets which are not linked to the magnitude of public investment. An operating surplus equal to a specific percentage of GDP might, for example, be targeted. Like the zero fiscal balance policy, this would, of course, imply rising general government net worth—but as a matter of temporary policy expedience to address the CAD problem rather than as a matter of basic fiscal principle.

## **7. Further Remarks on Fiscal Measurement Issues**

Notwithstanding the advantages of accrual accounting, it has to be frankly acknowledged that the introduction of accrual accounting has created some fiscal transparency problems in Australia. The new accrual-based Budget Papers are very confusing even to many trained economists, let alone to Ministers, parliamentarians and other lay uses.

There are a number of reasons why this confusion is much greater than it ought, by rights, to have been. One key problem is that the Australian public sector has adopted not one accrual accounting system, but two. There is the system based upon Australian Accounting Standard (AAS) 31. And there is the Government Finance Statistics (GFS) system developed by the Australian Bureau of Statistics (in conformity with international standards developed by the International Monetary Fund and United Nations). The numbers generated



by these two systems tend to differ quite significantly. For example, the 1999-2000 Commonwealth general government operating balance was \$13.5 billion on a GFS basis. By contrast, the AAS 31 general government operating balance before abnormals was \$9.5 billion (and, just to confuse things even more, there was a \$22.9 billion AAS 31 operating balance *after* abnormals). GFS general government net worth was minus \$11.6 billion, while AAS 31 net worth was minus \$52.9 billion (Treasury, 2000).

Merely having two accounting systems is a serious retrograde step in Australia. Prior to the introduction of accrual accounting in Australia, there was great progress towards the standardisation of government budget accounting, based upon the cash accounting version of GFS. This progress has now been reversed.

Why two systems? AAS 31 is driven by the idea that government accounting should operate just like private sector accounting, whereas GFS is tailor-made for public sector policy purposes. This means that AAS 31 incorporates accounting policies which do not necessarily make a great deal of sense in a government context. Perhaps the most important concrete difference between the two systems relates to the treatment of 'revaluations'. AAS 31 treats a range of 'revaluations' as if they were ordinary revenue or expenses, whereas GFS excludes revaluations from the operating statement.

The ABS defines revaluations as "changes in stocks that arise from price movements" (ABS, 2000: 9), although it might be more complete to add that they may also arise from changes in expectations even where there is no market price which changes. An example of a revaluation which AAS 31 recognises in the operating statement is a change in the market value of debt which arises from altered expectations about forward interest rates and which does not reflect any underlying lending transaction. Another example is gains/losses on any government external debt arising as a consequence of exchange rate movements.

The problem with factoring in valuations effects of this type into fiscal policy variables such as the operating balance or the fiscal balance is obvious. It would mean that any such revaluations would need to be offset fully and immediately by adjustments to public sector consumption. For example, if a change in forward interest rate expectations led to a significant fall in the

market value of public debt, it would then be permissible to immediately increase current expenditure by the full amount of the capital gain. Conversely, if there were a capital loss, it might be necessary to cut current expenditure forthwith so as to fully offset the loss. I have argued elsewhere that such a policy would make very little sense indeed (Robinson, 2000), and I would imagine that most economists would take a similar position. Of particular concern here is the volatility (and even rapid reversibility) of valuation changes.

This is also the view of the Commonwealth Treasury in Australia. The new fiscal balance measure was defined earlier in this paper as equal to the operating balance (in GFS terms) minus net investment. However, the Treasury's definition of the fiscal balance is in fact specified in terms of the AAS31 operating balance, and is the AAS 31 operating balance *excluding* revaluations minus net investment. Treasury argues that the exclusion of revaluations is appropriate because revaluations 'do not reflect changes in the Government's resource position' (Treasury, 1999b: 13; 1999a: 1.30).

This is relevant to the issue of the valuation of public debt. Some economists who argue that public debt should be valued at face value rather than market value, because fluctuations in market value are of little or no relevance when debt positions are relatively stable over long periods of time. Underlying this argument is the valid concern that fiscal policy should not be destabilized by an inappropriate requirement that immediate fiscal adjustments be made in response to volatile valuation effects. The problem, however, is that any measure of debt based upon face value is of dubious meaning. To add together the face value bonds of different yields is essentially to add incommensurable quantities. The only valid principle according to which a meaningful debt aggregate can be obtained is, arguably, economic value, which naturally changes with changes in expected forward interest rates. Market valuation is a proxy for economic value. As Chalk and Hemming (2000: 17) remind us, where the secondary market for public debt is thin, market valuation may not be a very good proxy for economic value. This is, however, not a problem in Australia or in OECD countries generally.

In a cash accounting environment, fiscal policy destabilisation arising from valuation effects does not arise if the primary fiscal policy targets are formulated in terms of the fiscal flows rather than stocks, because the cash

balance (and variant thereof) are not impacted upon by valuation effects. In an accrual accounting environment it is also possible to exclude such destabilizing influences by focusing upon flow rather than stock variables, if one defines the key flow variable (whether it is the operating balance or the fiscal balance) in the GFS manner so as to exclude valuation effects.

## 8. Fiscal Policy at State Level

The Australian States have historically played a pre-eminent role in the provision of public infrastructure, and have as a consequence undertaken more general government capital expenditure than the Commonwealth government. In the context of significant economic and population growth, the greater the level of capital expenditure undertaken by a government, the more difficult it becomes to insist that all general government capital expenditure be funded without the use of debt. Thus the adoption during the 1990s of balanced cash budget rules was necessarily more difficult for most States than it was for the Commonwealth. Traditionally, and indeed right into the 1980s, most States did not in fact aim to achieve balanced cash budgets. Rather, most sought to achieve balanced cash *current accounts* (ie, a position where ordinary revenue covers current, but not capital, expenditure)<sup>8</sup>. This approach is equivalent to the version of the golden rule which permits cash deficits equal to *gross* (as opposed to net) investment. As mentioned above, this means that current taxpayers make no fiscal contribution to the costs of the capital assets from which they are deriving benefits, and amounts to an unduly lax fiscal position.

For most States, it was the debt scare of the 1990s which led to a fiscal policy shift. Hence, for example, the New South Wales move in 1995 to a policy of balanced cash budgets and debt elimination, alluded to earlier. Queensland had adopted very similar policies a couple of years earlier, and other States such as Victoria and South Australia adopted the policy of balanced cash budgets while seeking to reduce rather than eliminate debt (Robinson, 1994, 1995, 1996c).

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<sup>8</sup> In earlier times, this principle was expressed differently, with the use of separate capital funds.

In more recent times, there has been a major shift in fiscal policy in Victoria and Queensland. Taking advantage of the move to accrual accounting, both States have adopted fiscal rules broadly consistent with the golden rule approach. In late 1999, the Queensland Government indicated that henceforth its principal fiscal rule would be to achieve 'an overall General Government operating surplus'. In practice, this has meant a very small operating surplus. The following year, the Victorian Government indicated that it also would pursue a fiscal policy designed to 'maintain a substantial budget sector operating surplus'. The aim for a *substantial* operating surplus has been rationalised as a means of building in a shock-absorber to prevent the emergence of an operating deficit during recession (this itself raises interesting issues which cannot, unfortunately, be explored here). So as to guarantee fiscal sustainability as well as inter-generational equity, Victoria also committed itself to 'maintain state government net financial liabilities at prudent levels', with a short-term goal to maintain the State's triple-A credit rating.

## **9. Fiscal Responsibility Legislation**

This paper has explained and analysed the recent Australian approach to medium-term fiscal rules. As in many other parts of the developed capitalist world, there has in Australia been a further response to recent fiscal challenges: the development of legislative fiscal responsibility frameworks. Prior to concluding this paper, it may be useful to provide a little background on these developments.

There is no balanced budget or similar requirement in either the Commonwealth Constitution nor in any of the constitutions of the Australian States. Nor had there historically been any serious attempt to legislate fiscal responsibility rules in Australia. This statement needs to be qualified marginally, in that a number of States in the past had legislation requiring that their budgets be balanced on a so-called "consolidated fund" accounting basis. However, given that borrowings were counted as a form of revenue for consolidated fund purposes, this requirement was worthless in policy terms.

In the first half of the 1990s, there were demands from some quarters, including Australia's principal business organisation (the Business Council of

Australia), for legislation to stipulate and enforce medium-term fiscal policy rules. Public debate ensued, with the ultimate consequence that the Commonwealth and many of the States have adopted fiscal responsibility legislation. Most of this legislation has been heavily influenced by the New Zealand fiscal Responsibility Act of 1994. With the partial exception of New South Wales, this body of legislation does not stipulate specific and concrete fiscal rules. For example, the Commonwealth's 1996 Charter of Budget Honesty articulates a number of quite elastic "principles of sound fiscal management" including "prudent" debt levels, and a "reasonable" degree of tax stability and predictability. The Charter legislation purports to "require" governments to stipulate specific fiscal rules and targets consistent with these broad principles, but provides no sanctions which would enforce this requirement.

The main significance of the Charter and similar State fiscal responsibility legislation arguably lies in provisions which significantly and hence fiscal transparency. These include New Zealand-style requirements that, prior to elections, governments should release fiscal projections which are certified by key Treasury officials (Robinson, 1996a).

## **Conclusion**

The fiscal challenges faced by Australian government during the 1990s may not have been very serious by international standards, but they were taken very seriously in Australia. They led directly to a strong emphasis upon fiscal responsibility, the centrepiece of which has been the adoption of clear medium-term fiscal policy rules. For most Australian governments, the rule has been balanced cash budgets, and even after the shift to accrual accounting, essentially the same rule has continued to apply. For two State governments, however, the shift to accrual accounting has been accompanied by a more fundamental fiscal policy shift, towards versions of the golden rule. Even where there has been no such fiscal policy shift, the introduction of accrual accounting has had non-trivial implications for Australian fiscal policy.

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