ENHANCING THE EFFECTIVENESS OF FISCAL CONSOLIDATION THROUGH TRANSPARENCY

Submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration

Introduction

Over the past decade and a half the Australian economy has undergone wide ranging reforms. Many of these reforms have exposed parts of the Australian economy to international competition. The response from Australian producers and consumers has been to embrace the opportunities presented by a global market place. Globalisation and the internationalisation of the Australian economy have improved GDP growth, export growth and productivity growth – with associated increases in living standards for the Australian community. Consumers have had access to a wider variety of goods at lower prices, while producers have had access to new techniques and products, as well as better access to capital.

Financial liberalisation facilitated product market reforms.

Greater competition in product markets has been facilitated by reforms to financial markets. The financial sector was one of the first areas to be reformed. This began with the floating of the dollar in 1983 and the liberalisation of capital flows.

Recently, severe international financial instability in some countries has raised a number of questions, including whether international financial markets should be more regulated. Australia was relatively unaffected by the recent financial crises. This is in part due to the strong macroeconomic fundamentals in the Australian economy. It was also due to the structural reforms that have been undertaken over the past 15 years.

Given the substantial benefits Australia has drawn from globalisation, any proposals to re-regulate financial markets should be treated with considerable caution. Regulations of this nature are a blunt instrument and it is difficult to tailor them to individual country circumstances.

The Commonwealth has a key role to play in instilling confidence in financial markets.

A more appropriate way to reduce Australia's vulnerability to instability is by gaining the confidence of international lenders that our debts will be repaid in a timely manner. This confidence will be influenced, in part, by the macroeconomic situation and related government policies. Therefore, the Commonwealth has a special responsibility for instilling international confidence. The following submission discusses how the potential for financial market instability has been reduced through fiscal consolidation carried out within a legislative framework characterised by transparency.

An Overview of Recent Fiscal Policy History

Fiscal policy is focussed on boosting national savings.

Fiscal policy pursues social and economic objectives by targeting government expenditure and taxation. The economic objectives can be broadly categorised as low and stable inflation and strong growth. Policy options include demand management and national saving measures.

During the latter half of the 1990s, fiscal policy has been firmly focussed on national saving objectives. To this end, the Government achieved an improvement of $11.5 billion in the budget position in the space of two years. The budget balance was turned from an underlying deficit of $10.3 billion in 1995-96 to an underlying surplus of $1.2 billion in 1997-98. Fiscal surpluses are projected for each of the forward years to 2002-03.

Fiscal consolidation through expenditure reductions plays a role in enhancing market confidence.

This has been done primarily through reductions in expenditures. The Government's approach to fiscal consolidation, through expenditure reduction, appears to be the method favoured by financial markets. Outcomes are usually more successful when authorities tackle the roots of the budget problem, which often appear to be on the spending side. Financial markets may be aware of what actions most effectively address budget problems faced by governments and reward the economy through improved business confidence and lower risk premia.[1]

The Government's pre-emptive action on its finances eased market concerns that the current account deficit was being driven, in part, by unsustainable budget deficits. This has helped engender market confidence in the Australian economy and its capacity to finance these loans.[2]

Fiscal consolidation was carried out within a framework characterised by transparency.

The Government's success in moving the budget balance back into surplus has played an important role in allaying market jitters during the recent bouts of international financial instability. However, just as importantly, this achievement has occurred within a fiscal framework characterised by transparency. This has provided markets with credible information about the sustainability of public finances. The remainder of the submission discusses the importance of transparency as a bulwark of fiscal policy.

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[1] IMF (b), p. 61.

[2] Paul Krugman of the Massachusetts Institute of Technology has highlighted the importance of confidence to financial markets, particularly noting Australia in this context:

> …financial markets have a double standard. When the currency of a country in which they have confidence, say Australia, plunges, they see it as an excuse to buy; the country benefits, and the market's good opinion is confirmed. When the same thing happens elsewhere - in Indonesia, for example - investors flee, the country suffers, and the market's bad opinion is ratified.

(Karene Witcher and David Wessel, "Australia Evades Contagion Amid Solid Banking System", *The Asian Wall Street Journal*, April 29, 1999, p. 1.)

Transparency is needed to buttress fiscal policy

Fiscal transparency can enhance government credibility...

Government credibility can be enhanced by increased fiscal transparency through the provision of comprehensive information about fiscal policy and the public sector's financial standing. This can then buttress the positive effects of fiscal consolidation as markets can easily see government efforts to improve budget balances.

Fiscal transparency covers several aspects including fiscal policy intentions, public openness about the structure and functions of government (including the legal and institutional framework), public sector accounts and fiscal projections.[3]

… by allowing for the timely identification of emerging financial issues.

Transparency offers an important contribution to crisis prevention through the timely identification of emerging policy issues or the pinpointing of institutional weaknesses. This can then prompt governments to smooth and correct problem areas. Greater information will give investors more confidence in the underlying financial soundness of government securities and reduce the incentive to dump these securities when global financial instability flares. In this way transparency also benefits governments in the form of lower borrowing costs (through lower risk premia) and larger and more stable flows of portfolio and direct investment.[4]

The Prime Minister's Task Force on International Financial Reform suggested that there is merit in having the IMF prepare a *Transparency Report* for each country in the context of its Article IV consultations. The task force suggested that Australia could take the lead in the preparation of such a report to provide a format for other countries to follow.[5] In accordance with this recommendation the Treasurer released a *Transparency Report* for Australia at the March 1999 meeting of the Manila Framework Group.

In addition, Australia, like many other countries, has requested that the IMF publish a Public Information Notice (PIN) at the conclusion of each IMF Article IV consultation. The practice of issuing PINs is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies.

What measures have been taken to promote fiscal transparency?

Australian governments have undertaken significant initiatives to further promote fiscal transparency.

The *Transparency Report* is one of the latest in a substantial list of initiatives Commonwealth Governments have undertaken to promote transparency. In large measure, government initiatives are reflective of the external market discipline that has applied to fiscal policy since the floating of the dollar in 1983 and the liberalisation of capital flows.

Australian governments have shown a strong commitment to fiscal transparency. The following significant initiatives are discussed in turn:

- underlying cash budget balances;

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[3] International Monetary Fund (a), *Manual on Fiscal Transparency*, Washington D.C., March 1999, p. 6.

[4] Peter Costello, *Report of the Task Force on International Financial Reform*, Commonwealth of Australia, Canberra, 1998, p. 7.

[5] Costello, p. 7.

- Financial Management and Accountability Act; Commonwealth Authorities and Companies Act and the Auditor-General Act;
- the *Charter of Budget Honesty Act 1998*; and
- accrual budgeting.

Underlying cash budget balance

Underlying balances better reflected net public lending.

Although accrual budgeting has superseded cash budgeting, the final three cash-based budgets (1996-97 to 1998-99) aided transparency by primarily focussing on the underlying balance. Underlying cash budget balances differ from headline balances by abstracting from net advances (which have no impact on net public lending).[6] Therefore, the underlying balance was a better measure of the contribution of the Commonwealth budget sector to the national saving/investment balance.

The FMA Act, the CAC Act and the Audit Act 1997

The FMA, CAC and Audit Acts provide a principles-based legislative framework for the governance of Commonwealth entities.

The *Financial Management and Accountability Act 1997* (FMA), together with the *Commonwealth Authorities and Companies Act 1997* (CAC Act) and *Auditor-General Act 1997* collectively up-hold the Commonwealth's financial management reforms by providing a principles-based legislative framework which emphasises devolved responsibility, performance, propriety and accountability in the governance of Commonwealth agencies, authorities and companies.

Broadly speaking, the FMA Act outlines the regulatory, accounting and accountability framework for managing the money and property of the Commonwealth. Its scope covers the underlying principles that govern the activities of persons in organisations that, financially, act as agents of the Commonwealth. The Act vests key responsibilities and powers in the Minister for Finance and Administration and provides that he or she may delegate all those powers other than the power to make 'Finance Minister's Orders'. The Act also makes each Agency chief executive responsible and accountable for the efficient, effective and ethical management performance of the Commonwealth Agency of which he or she is head.

The Act improves the quality and clarity of understanding of the Commonwealth's financial management framework and sharpens accountability for financial management performance. These, in turn, translate into efficient, effective and ethical use of the Commonwealth's resources.

Amendments to the FMA Act to remove fund accounting arrangements are operative from 1 July 1999 and align the legislative framework with recent reforms that implement an accruals-based 'Outcomes/Outputs' business structure for Commonwealth agencies and authorities.

The CAC Act provides a single set of core reporting and auditing requirements for directors of Commonwealth authorities and sets out standards of conduct for officers based on comparable areas of the Corporations Law as it applies to private sector companies. The overall aim is to ensure that Ministers and the

[6] Net advances consist of net policy lending (new policy loans and advances less repayments) and net equity injections (injections/purchases of equity less equity sales).

Parliament are well informed of the authorities' activities. The approach adopted by the Act enables the governance and accountability requirements of all Commonwealth controlled bodies to be viewed as a whole and significantly streamlines the Government's and the Parliament's interests.

The *Auditor-General Act* provides for the Auditor-General to conduct financial statement and performance audits of Commonwealth agencies, authorities and companies. In this way, the Parliament is provided with a single source of independent audit of the operations of public sector entities.

Charter of Budget Honesty Act 1998

A key ingredient of transparency is legislation or reporting frameworks which clearly specify overall fiscal policy goals and report against these goals. This is the objective of the *Charter of Budget Honesty Act 1998*.

The Act requires that, in fiscal strategy statements, governments must:

The Charter of Budget Honesty requires governments to specify overall fiscal goals and report against them.

- specify their long-term fiscal objectives within which shorter term fiscal policy will be framed;
- explain the broad strategic priorities on which the budget is or will be based; and
- specify the key fiscal measures against which fiscal policy will be set and assessed.

Although the legislation was not enacted until 1998, the Government had already implemented most of its requirements before this.

- The Government commenced reporting its fiscal strategy and targets in Statement 1 of Budget Paper No.1 from the 1996-97 Budget.
- Mid-year Economic and Fiscal Outlook (MYEFO) reports have been produced each year from 1996-97.
- The reporting of estimates of revenue forgone as a result of tax concessions (tax expenditures) have been enhanced in the budget papers and in Treasury's annual tax expenditure statement.
- Statements of financial risks facing the Commonwealth have been included in all the Budget and MYEFO reports since the 1996-97 MYEFO.
- The 1997-98 Budget introduced a new budget paper, specifically to report policy decisions. (Budget Paper No.2, Budget Measures).

Accrual budgeting

Accrual budgeting increases the accuracy and information value of published budget information...

Beginning with the 1999-2000 Budget, the Commonwealth has adopted accrual based public accounts, which, *inter alia*, increase the accuracy and information value of published budget information relative to cash-based budgeting systems. The Government and Ministers now have a better idea of what is being delivered for what price, quality and quantity.

The adoption of accrual budgeting represents international best practice in public sector financial management and reporting. The accrual framework also supports the principles of sustainability and sound fiscal management expressed in the *Charter of Budget Honesty Act 1998* by:

…by accounting for the full cost of government operations...

- providing a more comprehensive indication of the total activity of government and the longer term effects of current fiscal policy than cash measures;
  - this is done by recording the full extent of the resources consumed in delivering government goods and services and achieving government outcomes. Though the cash statement is important for shorter term financial analysis, stakeholders can also examine short and medium term financial performance, both at the whole of government and agency level, through the operating statement and balance sheet.
- ensuring government policy decisions have regard to the financial effects on future generations.

… and accounting for intergenerational impacts.

  - Under accrual budgeting it is now possible to gain insight into the intergenerational position of the government. For example, a large negative equity position may indicate an inequality between current and future generations. That is, it can reflect the extent to which high past or current spending limits the fiscal options open to governments in future periods.

Outcomes and outputs shift the focus onto results and deliverables.

A key element of the move to an accruals framework is the shift in emphasis from programs and processes to outcomes (results) and outputs (products and services). Outcomes and outputs and associated performance information form a consistent core of information for planning, budgeting, managing and reporting. This moves the focus onto results and deliverables and, therefore, accountability.

As well, agencies’ planned performance as presented in their Portfolio Budget Statements will be reported on the same basis in their annual reports. As a result, Parliament and the Australian community will be in a better position to assess planned versus actual performance.

In short, accrual budgeting aids in transparency by ensuring that agency reporting accounts for the full cost of goods and service delivery and incorporates a “whole of government” approach. In this way it provides a comprehensive indication of the total activity of government and the longer-term effects of current policy.

Conclusion

Fiscal prudence and transparency cannot eliminate the potential for financial instability but they can reduce it.

Governments can act to reduce the risk of financial crises but they cannot eliminate the risk. Even over an extended period sound management of monetary and fiscal policy provides no guarantee against major economic crises.[7] Some elements which may have contributed to the development of financial crises, such as uninformed herd behaviour on the part of financial market players, are simply beyond government control.

Reducing the risk of international financial instability requires, in part, the exercise of fiscal prudence over the medium to long term. The long lags in establishing fiscal credibility should then be an incentive for governments to ensure public finances remain on a sustainable footing. Transparency reinforces this process by providing markets with information about a government's fiscal responsibility. This information imposes a further discipline upon governments while simultaneously reducing the scope for ill-informed decisions on the part of markets.

[7] International Monetary Fund (c), *World Economic Outlook*, Washington D.C., May 1998, p. 11.

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