



NATIONAL COMMISSION OF AUDIT

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5 – Approach to government and new fiscal rules

5.1 Fiscal framework and rules

The sustainability of Australia's public finances is central to the Commission's deliberations. It has been asked to assess the adequacy of current budget practices and rules (including specified timeframes and targets) in promoting efficient and effective government, disciplined expenditure, long-term fiscal sustainability and budget transparency.

The previous section outlined many of the challenges which lie ahead. One of these challenges — for all governments — is to develop credible strategies to strengthen public finances.

It has become increasingly difficult for governments to make the commitments needed over the medium term to create confidence that the future path of budget balances and public debt will be sustainable.

As outlined in Chapter Four, under the Commission's 'Business as Usual' scenario the Commonwealth Government will face ongoing budget deficits from now until 2023-24. This would mean an unprecedented 16 years of successive budget deficits.

Fiscal settings need to be tightened, in a clear and transparent way, to enable the Commonwealth to move back to surplus and start paying down debt.

Without tightening, net debt will stay above its current level for the next decade. Having deteriorated by around 15 per cent of GDP since the global financial crisis, the danger is that a future macroeconomic shock would see Australia's net debt level rise to levels not experienced for the past four decades.

Crises can take longer to arrive than people think, however they usually hit with great speed and severe consequences.

The imposition of clear fiscal rules and frameworks is one way of strengthening our defences against future crises.

Australia has had fiscal rules of some sort since 1985. *The Charter of Budget Honesty Act 1998* places a legislative requirement on Commonwealth Governments to uphold a level of budget transparency and fiscal responsibility. This is a good thing.

The Charter requires the government to release a fiscal strategy at its first budget to inform future policy decisions. The strategy should be based on principles of sound fiscal management and underpinned by a sustainable medium-term framework.

The fiscal strategy increases community awareness of government fiscal direction and establishes a benchmark for evaluating its conduct.

In keeping with the Charter's principles of sound fiscal management, a comprehensive fiscal strategy needs objectives around:

- the government's financial performance on an annual basis reflecting developments around tax collections and spending outcomes (for example, the need for budget surpluses);
- the health of the government's balance sheet (for example, the need to build up financial wealth or reduce outstanding debt over time); and
- constraining the size of government (for example by limiting government spending, or limiting government taxation).

Together these objectives would illustrate the government's annual financial performance and long-term sustainability of its finances as well as imposing a discipline to encourage responsible government.

There is a range of different indicators to measure these objectives. Possible annual (or flow) measures include objectives for the underlying cash balance, headline cash balance, fiscal balance, structural balance and net operating balance.

Possible measures for strengthening the balance sheet (the stock objective) include net debt, net financial worth, net financial liabilities, net worth and gross debt (defined as total Commonwealth Government Securities on issue).

Each of these indicators has strengths and weaknesses. One option would be to encompass a range of different indicators within the fiscal strategy. However, this leads to significant additional complexity, which could limit the broader usefulness of the strategy.

For simplicity and transparency, it makes sense to continue using underlying cash balance as the main flow indicator and net debt as the main stock indicator. Other measures would continue to be reported in the Budget papers, thereby allowing relevant comparisons as required.

Other fiscal rules, such as the Golden Rule and the Debt Brake Rule have been tried in European countries, but they are more complicated and have the same enforcement problems as simpler targets. Under a Golden Rule, governments balance recurrent spending and capital spending is excluded from the Budget balance. Further details on the Golden Rule and the Debt Brake Rule are included in the Appendix at Section 6.1.

Successive Commonwealth governments have adopted a broad fiscal strategy with high-level goals, underpinned by a set of operational rules which set out how the strategy will be achieved on a year-by-year basis. This gives governments the flexibility to implement their policy priorities within a framework that helps ensure the nation's finances are headed in the right direction.

However, as outlined above, in recent years the announced fiscal strategy has not succeeded.

Nonetheless, the Commission considers retaining the central elements of the fiscal strategy, in place for nearly two decades, is warranted to promote stability and consistency in Australia's overall fiscal framework.

Steps are now required to ensure the fiscal strategy is successfully executed. This requires a more prescriptive approach with a new set of operational rules to better frame fiscal policy choices and enable a better and more transparent assessment of governments' fiscal performance.

The Commission considers the surplus target of 1 per cent of GDP, included in its terms of reference, is appropriate and should be part of the new fiscal rules.

A surplus of this size is necessary to place net debt on a downward path.

While Australia's net debt is low by international standards, recent experience in the Eurozone and elsewhere suggests that shocks can have a dramatic impact on debt levels.

This being the case, a relatively low level of net debt is important, to ensure Australia has a buffer against such shocks. As the Australian economy is now more exposed to economies in our region which have higher levels of volatility, a fiscal buffer is even more important.

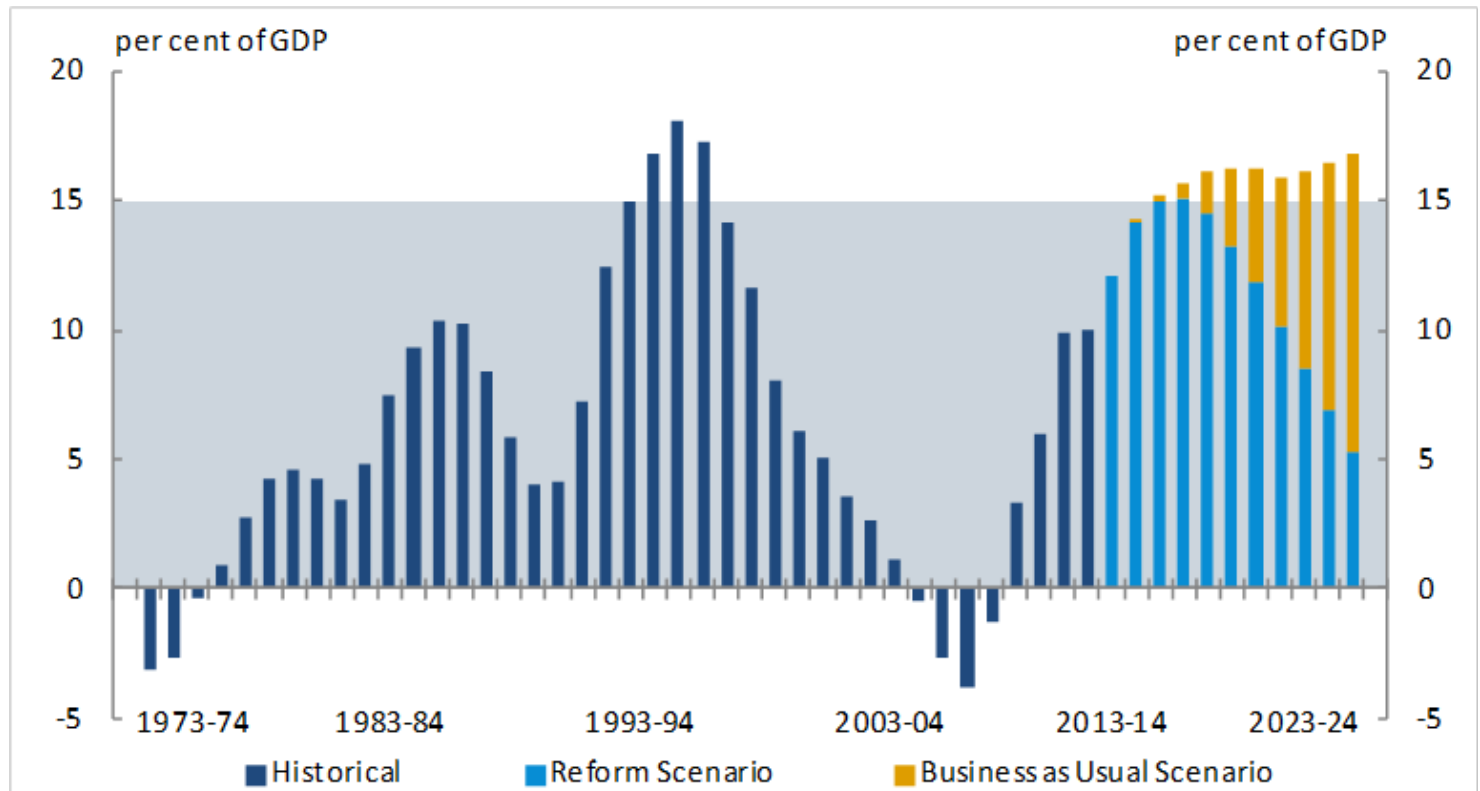
There is ongoing debate about the level at which government debt becomes problematic.

World financial markets are sensitive to a country's level of debt and can impose very high costs on governments with a large debt stock in the event of a major economic shock. Relatively low debt levels generally favour the ability of governments to manage their own budgets. Moreover there seems little doubt that economic, political and social costs over and above the interest cost of servicing debt rise with the levels of government and national debt.

High net debt can also have perverse effects on spending decisions. Government borrowings and a run up in debt can reduce the discipline of the Budget process. When additional government spending does not need to be matched by extra tax revenue, policy makers and the public will generally worry less about whether the additional spending is appropriate.

Since 1970, net debt in Australia has averaged less than 6 per cent of GDP. Other than in the period after the recession in the early 1990s, net debt has always been well below 15 per cent of GDP.

Chart 5.1: Commonwealth Government net debt (share of GDP)



Source: Mid-Year Economic and Fiscal Outlook 2013-14 and National Commission of Audit.

As shown in Chart 5.1, under the Commission's 'Business as Usual' Scenario, Australia's net debt rises above 15 per cent of GDP and remains elevated through to 2023-24 and beyond.

In contrast, under the 'Reform' Scenario (which produces a surplus of 1 per cent of GDP by 2023-24) net debt would decline to just over 5 per cent of GDP. Maintenance of small surpluses while economic conditions are sound beyond this time would see net debt reduce further.

The Commission considers that fiscal policy should be set with a view to reducing net debt over time.

In effect, this strategy of keeping net debt relatively low (or slightly negative) is designed to provide a 'corridor of stability' or safe harbour within which governments can operate. It will help ensure that the nation's finances are kept in good order and act to shock-proof the economy from future crises.

Governments need the discipline of a rule on tax to GDP to limit the size of the burden of taxation on Australians.

A pragmatic approach should be to adopt a tax to GDP cap of 24 per cent which is around the average level of tax receipts recorded over the period from 2000 to the onset of the global financial crisis. It would allow for some growth to occur in the tax to GDP share from the current tax level of 21.8 per cent of GDP as the economy strengthens.

The three new rules — achieving a surplus of 1 per cent of GDP by 2023-24, substantially reducing net debt over time and ensuring tax receipts remain below 24 per cent of GDP — are predicated on the economy operating within a normal range.

In the event of a rare economic shock (for example of the order of the global financial crisis), the automatic stabilisers in the Budget should be allowed to operate, with discretionary fiscal policy used to support macroeconomic demand as appropriate.

In these circumstances, the core elements of the proposed rules would remain, possibly with an 'escape clause' which allows temporary adjustments to the timing and/or size of surplus target, so as not to damage short-run growth.

Conversely, a temporary boost to tax receipts — arising from, for example, an unexpected and marked rise in the terms

of trade — that pushed taxes over 24 per cent of GDP could be accepted as long as it was temporary and the proceeds were not spent but used to pay down debt.

The prudent design of escape clauses can provide flexibility to rules in dealing with rare events and are advocated by the International Monetary Fund as an acceptable part of a suite of fiscal rules. They do, however, need to be carefully specified.

Recommendation 1: Fiscal framework and rules

The imposition of clear fiscal rules and frameworks is one way of strengthening the nation's finances. The Commission recommends the Government adopt a high-level fiscal strategy which seeks to achieve underlying cash surpluses, on average, over the cycle; improve the government's balance sheet over time; and limit the size of government, as a proportion of GDP.

It should do this by adopting the following fiscal rules which set out how the fiscal strategy is to be achieved on a year-by-year basis.

- Achieve a surplus of 1 per cent of GDP by 2023-24.
- Substantially reduce net debt over the next decade.
- Ensure taxation receipts remain below 24 per cent of GDP.

Monitoring progress against the fiscal strategy and rules

Currently, there is no official mechanism for reporting the government's progress against, and adherence to, the fiscal strategy. Including such a mechanism would improve accountability and transparency of government's fiscal situation and direction.

Within Australia, the Parliamentary Budget Office was recently established to inform the Parliament by providing independent and non-partisan analysis of the budget cycle, fiscal policy and the financial implications of proposals.

The Commission considers the Parliamentary Budget Office could play a formal role in assessing fiscal policy and tracking the government's decisions against the fiscal rules.

The Charter of Budget Honesty Act 1998 should be amended to require the Parliamentary Budget Office to report progress against the government's medium-term fiscal strategy following the release of the Final Budget Outcome each year.

Recommendation 2: Reporting against fiscal rules

To report the Government's adherence to the fiscal strategy, the Commission recommends the Parliamentary Budget Office report progress against the fiscal rules following the release of the Final Budget Outcome each year.

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