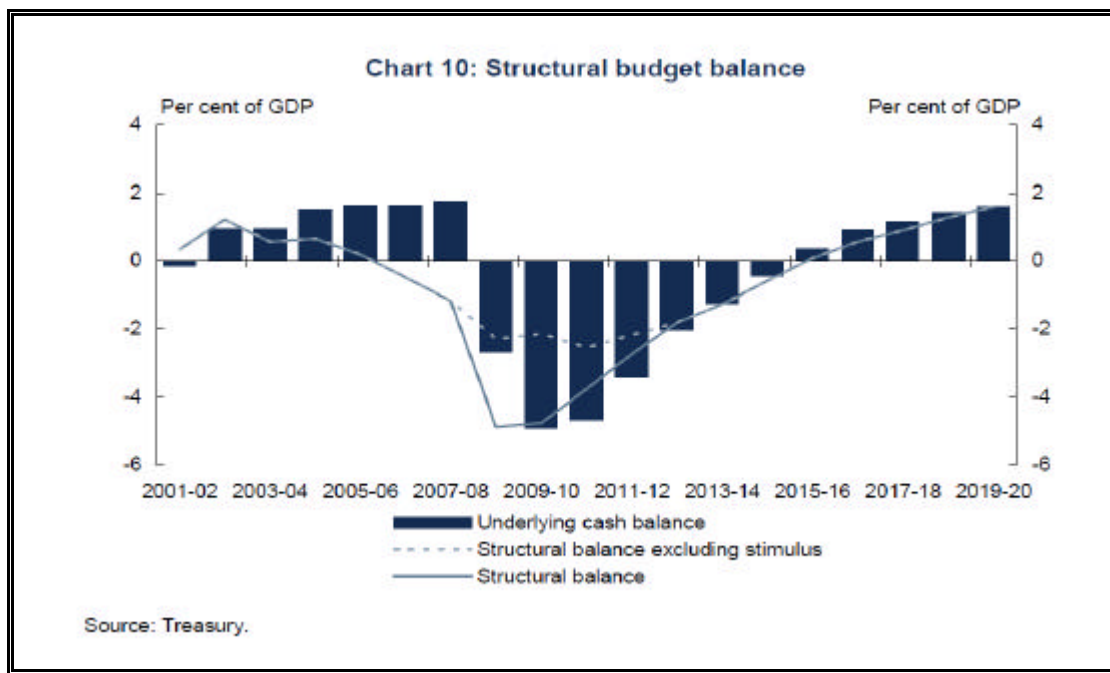




## Measuring fiscal responsibility

Both the Coalition and the Labor Party have described themselves as 'fiscal conservatives'. But the recent sharp contraction in revenue raises doubts about that claim. In fact, information released in the last budget papers reveals that both political parties have not been living up to this claim. The relevant information is included in Chart 10 of Budget Paper Number 1 Statement 4, which shows the state of the budget when the cyclical effects are removed. Knowing what is happening to that magnitude is essential information to any Treasurer, particularly one who claims to be a fiscal conservative. The relevant measure of the budget balance is called the structural balance. When the structural balance changes the government is changing fiscal policy – stimulating the economy when the structural balance deteriorates or restraining the economy, when the structural balance improves. All other changes to the budget bottom-line reflect the operation of cyclical factors interacting with the built-in stabilizing properties of the tax and welfare system.



Inspection of Chart 10 reveals, from the structural balance line, that until 2005-06 Mr Costello was indeed running structural surpluses. That could justifiably be described as fiscally conservative. But it is also apparent that by 2006-07 Mr Costello was using fiscal policy to stimulate the economy at the height of the boom because the structural balance was deteriorating. The degree of stimulation actually increased as a percentage of GDP in 2007-8. Running a structural deficit at the height of a boom can hardly be described as fiscal conservatism.

Furthermore, presenting the underlying cash balance as a surplus and a badge of fiscal conservatism under those circumstances is a sham well known to economists – it confuses a cyclical surplus with a structural surplus. It is now obvious that the surplus represented by the underlying cash balance in 2007-08 is entirely cyclical and therefore prone to vanish as soon as the economy slowed.

Similarly Mr Swan's first budget, before the GFC and the various stimulus packages, recorded an even larger structural deficit. Follow the dotted line marked structural surplus before the stimulus. But like Mr Costello, Mr Swan paraded Treasury forecasts of an underlying cash balance in surplus (not shown in Chart 10) as evidence that the budget was fiscally conservative. That was equally a sham. The following statement from the 2008-09 Federal Budget reveals the extent of the delusion:

*"Through a genuine commitment to fiscal responsibility, the Government has ushered in a new era of responsible economic management.*

*An underlying cash surplus of \$21.7 billion (1.8 per cent of GDP) is expected in 2008-09 — the largest surplus as a proportion of GDP since 1999-00 — with further strong surpluses projected in the following three years."*

What these two episodes reveal is a failure by both parties to measure the fiscal position correctly. That position now seems to have been corrected in this year's budget but not before the damage to the structural budget had been done. Failure to anticipate the magnitude of the loss of revenue in the face of the global slowdown in 2008-9 is partly attributable to the failure to recognise that the underlying cash surpluses reported in the budgets since 2005-06 were entirely cyclical. When the cycle ended those surpluses vanished revealing the structural deficits in 2008-09 and beyond. This seems to have taken the Labor government somewhat by surprise.

In addition to the confusion on the part of the two political parties, questions should also be asked about the role of the Treasury. As noted by a Treasury paper referenced in the Budget Papers the Australian Government (the Coalition?) ceased publication of structural fiscal indicators on the grounds that their construction required 'arbitrary assumptions'. Apart from the fact that all economic analysis requires what could be described as 'arbitrary assumptions' both the IMF and the OECD regard the calculation of structural fiscal indicators as good practice. At the very least Australia has not been keeping up with best practice.

That is particularly apparent after a read of an OECD working paper from 2006 by David Turner titled: *Should measures of fiscal stance be adjusted for terms of trade effects?* Turner answers in the affirmative and explains that commodity exporters like Australia are subject to terms of trade booms and busts that can distort traditional structural fiscal indicators. In particular the close correlation between traditional measures of the structural balance and the underlying cash balance breaks down in the face of significant movements in the terms of trade. Taking a plausible profile for Australia's terms of trade behaviour Turner shows that Australia's fiscal surpluses in 2004 and 2005 were largely cyclical. Although there is room for debate about the assumptions underlying this analysis that is not the issue here.

What is at issue is the lack of any mention of Turner's methodology in the Budget papers. Without information on the Treasury assessment of the structural budget balance and the assumptions on which it is based the transparency of the budget process is compromised. In that respect, the re-instatement of a measure of structural budget balance in the budget papers is a step in the right direction and should be included in all budget reports including the Mid-Year Financial Outlook and formally incorporated into the Charter of Budget Honesty.

Failure to follow best practice in this regard has undermined the claims of both parties to fiscal responsibility and undermined confidence in Treasury forecasts.

**Assoc Professor Colin Rogers**  
**Senior Research Associate**  
**SA Centre for Economic Studies**

20/05/2009

**Disclaimer:** This study, while embodying the best efforts of the investigators is but an expression of the issues considered most relevant, and neither the Centre, the investigators, nor the Universities can be held responsible for any consequences that ensue from the use of the information in this report. Neither the Centre, the investigators, nor the Universities make any warranty or guarantee regarding the contents of the report, and any warranty or guarantee is disavowed except to the extent that statute makes it unavoidable.