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National fiscal consolidation and the challenge to Australian federalism

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Abstract

Following failure of the stimulatory policies post the 2008 financial crisis and the resulting instability of the Euro, national fiscal consolidation with real sanctions for non-compliance has become a key focus of most governments as they address escalating budget deficits and rapidly rising public debt. The problem is that agreement by central governments to adopt national fiscal rules, whether self-imposed or imposed by some supranational institution, leaves unaddressed how such rules and sanctions should be adopted by (or imposed on) sub-central and local governments. To date, the primary focus has been on whether the encouragement given over recent decades to fiscal decentralisation has worsened public debt levels and made national fiscal consolidation by central governments more difficult. This article argues that what is missing from this discussion is attention to the intergovernmental institutional arrangements and how they and their reform are potentially crucial to both national fiscal consolidation and ensuring retention of the benefits of fiscal decentralisation.

JEL Codes: H62, H63, H77

Keywords

Federalism, fiscal consolidation, fiscal decentralisation, fiscal rules, public debt

Fiscal consolidation challenge

Fiscal consolidation, or policies designed to reduce government deficits and debt accumulation, is not new and nor are the four approaches designed to address these issues, including adopting fiscal rules, improving fiscal transparency and therefore

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accountability of policymakers, strengthening traditional institutions and undertaking radical institutional reform such as enabling independent review of fiscal policy.

As the International Monetary Fund (IMF) Fiscal Rule data set[1] highlights, most central governments (CGs)[2] have a long history of imposing fiscal rules, not only of their own volition but as a result of agreements such as those imposed on member countries in the European Union (EU) (EC, 2012b). Similarly, there is little new in the calls for increased fiscal transparency, with the IMF and Organisation for Economic Cooperation and Development (OECD) having extensively documented both the case for it and what it requires of governments.[3] Attention to strengthening traditional fiscal institutions is also not new with treasurers being supported by finance ministers (where the latter are focused on expenditure review) and by Budget Review Committees (either Parliamentary or from within the government by the executive). Also not new is the pursuit of radical options designed to provide independent reviews of budgets. Here, the rise of fiscal councils and Parliamentary Budget Offices designed to give greater oversight of government budget deficits and public debt levels has attracted particular interest in recent years.

What is new is that when stimulatory policies of governments failed following the 2008 financial crisis, past efforts at fiscal consolidation were quickly overwhelmed by widespread breaches of fiscal rules. The pace and breadth of the fiscal decline and the challenge this has posed to the Euro have seen a clamouring for fiscal consolidation strategies. In the European Commission *Report on Public Finances in the European Monetary Union* (EMU) (EC, 2012b), attention is focused on how a fiscal crisis affects all levels of government and on how fiscal consolidation at any level of government must inevitably involve coordination between all levels. To date, the primary focus has been on understanding the relationship between budget deficits and public debt and decentralisation, what this might indicate about the roles and responsibilities of the different levels of government and the response required to bring about national fiscal consolidation.

The overriding challenge has been how to share the burden of fiscal consolidation through structural reforms while still maintaining and possibly encouraging decentralised government in a zero or negative growth environment. While some attention has been given to this issue, the EU recently acknowledged the importance of gaining a better understanding of how national fiscal decentralisation arrangements influence fiscal outcomes (EC, 2012b, Part IV) and how to ensure that fiscal decentralisation is compatible with budgetary discipline.[4]

This article will argue that while every system of decentralised government is different, what is implied from the literature is that any move towards national fiscal consolidation must give particular attention to the intergovernmental institutional arrangements and how they and their reform are crucial to both national fiscal consolidation and ensuring retention of the benefits of fiscal decentralisation and federalism. It will be proposed that this attention should involve three key elements: an intergovernmental consultative process managed by the CGs, legislated intergovernmental fiscal arrangements and independent monitoring of performance against any intergovernmental arrangements. This way a sustainable, transparent, accountable and comprehensive approach is taken to fiscal consolidation and a reactive, inefficient and potentially divisive policy response by each level of government is avoided. The implications of such an approach for the Australian Federation will be considered.

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National fiscal consolidation and decentralisation

In practice, fiscal consolidation finds application through the adoption of one or more fiscal rules, including an expenditure rule (ER), a revenue rule (RR), a (structural) budget balance rule (BBR) and a debt rule (DR). In its monitoring of the adoption of fiscal rules across some 81 countries since 1985, the IMF[5] has shown that such rules are applied widely at the national level of government. In terms of trends, it has been towards the application of not one but all the rules, accompanied by more rigorous enforcement along with greater involvement by supranational institutions (such as the EU, IMF and OECD). In the case of the EU countries, the formation of the European Monetary Union (EMU) meant that economic stability across the Euro zone was essential for the smooth functioning of the single currency. In response, the 1998 Stability and Growth Pact (SGP) was agreed upon by Member States prior to the introduction of the Euro in 1999 and included fiscal rules requiring member states to avoid excessive budget deficits by limiting their budget deficit-to-GDP ratio to 3% and the public debt-to-GDP ratio to 60% (EC, n.d.-b). While sanctions were to be imposed for non-compliance, in practice, the pact did not enforce substantial penalties for non-compliance.

What the 2008 financial crisis highlighted was how quickly any past failure to enforce the SGP fiscal rules, when combined with a severe economic downturn and failed stimulatory policies, resulted in a major fiscal and monetary crisis for the Euro zone countries. The introduction of the 2011 EU Treaty on Stability, Coordination and Governance (TSCG) was a direct response to the failure of countries to comply with the fiscal rules in SGP and to ensure real sanctions would be imposed for any non-compliance. Under TSCG, the national fiscal (3%/60%) rule must be 'implemented in national law through provisions of "binding force and permanent character, preferably constitutional"' (EC, 2011, 2012c). Any country non-compliance will result in the European Court of Justice imposing a financial sanction of 0.1% of GDP, the objective being to fundamentally strengthen economic and fiscal governance in the EU.

What is not clear is how by agreeing to the Fiscal Compact, CGs in EU member states plan to apply and enforce complementary fiscal rules on sub-central governments (SCGs) and local governments (LGs) in an environment of decentralised government where budgets at each level of government are not framed with comparable rules. Three possible options are available: one is for the CG not to offer its loan guarantee (underwriting) to SCG, resulting in financial markets factoring in a greater risk premium on sub-central borrowings in the market which will then limit their borrowing capacity; a second option is to introduce constitutional or legislated constraints on sub-central borrowings and the third option is hierarchical controls where the CG imposes rules on SCG through its intergovernmental funding arrangements.

The market-based approach involves (very) soft budget constraints and relies on SCGs being directly accountable for their budget outcomes. In this case, governments will need to focus on their credit rating because with a high rating comes a small (or no) risk premium when borrowing in the market to fund deficits. However, since decentralisation has typically meant a devolution of expenditure but not revenue raising, the dependence of SCGs on transfers from CGs raises the common pool problem where the debt (and funding) at one level of government (e.g. sub-central) cannot be considered independent of another (e.g. central). In this case, moral hazard is an issue, with SCGs being less

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concerned about budget deficits since they will ultimately be underwritten by higher level governments, which fund their current shortfall between expenditure and funding from own-sources and borrowings.

The EU has made explicit in TSCG that it requires fiscal rules to be legislated, preferably through constitutional change (and therefore less subject to future political debate). This would, in effect, also ensure any rule had applicability across all tiers of government. However, such an approach can have its weaknesses. Most US States have constitution-based balanced budget rules, but these are only imposed on general funds, not on capital, social insurance or social insurance expenditure.[6] Constitutional fiscal rules may also not be sufficient at the national level if private debts can become public debts in a crisis, as arises when governments bail out bankrupt businesses and failed banks. This implies that the introduction of fiscal rules requires complementary regulations to ensure bank liquidity (and adequate risk insurance).

If constitution-based fiscal rules cannot find introduction (because of the difficulties with achieving success in referendums, as in Australia) and SCGs require financial support from the CGs, an option is to impose fiscal rules through hierarchical controls. At its simplest, this could see CGs simply transferring their fiscal adjustment burden to SCGs through some combination of reduced grants, reassignment of expenditure responsibilities or through crowding out SCG tax bases. This might be reasonable where the CG asserts (reasonably) that since it is ultimately responsible for the debts of the SCG, the CG's fiscal rules should be directly complied with by the SCG. This approach also has the advantage of reducing moral hazard related issues arising from the SCG knowing that the CG will ultimately be responsible for debts arising from its fiscal policies. It would also ensure that SCGs do not adopt fiscal policies counter to those policies implemented by the CGs and ensure compliance where institutions do not exist to monitor performance against the rules or impose sanctions where rules are breached.

The problem is that unilateral imposition of national fiscal rules by CGs potentially undermines policies designed to decentralise government and gives little attention to SGP imposition of their own fiscal rules. In fact, the recent EC (2012b: 208–209) study of SGP contribution to national fiscal outcomes found that SGP BBR did not change the relationship between decentralisation and fiscal outcomes but that the DR did act to reduce the adverse effect on fiscal outcomes of a substantial dependency on transfers from CGs by constraining expenditure. The study also concluded that pessimistic statements about how the fiscal deterioration was caused by increasing fiscal decentralisation were not supported by the data and 'probably not ... a result of decentralisation *per se* but of a "bad" design of decentralisation, i.e. one which does not ensure strong financial responsibility of subnational governments' (EC, 2012b: 209–210).

What the European Commission research implies is that any application of a national fiscal rule cannot be undertaken without a focus on all aspects of intergovernmental arrangements, including expenditure assignment, revenue assignment, the extent of vertical fiscal imbalance (VFI) and what fiscal equalisation mechanisms (both vertical and horizontal) are adopted when equity objectives are balanced against distortions to the efficient allocation of resources between levels of government.

Any intergovernmental fiscal framework and related fiscal rules need to be tailored to the characteristics of each specific country. As Foremny (2012) observed, 'the

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choice of tools depends critically on the type of government and the constitutional structure ... political environment and the electoral system' (p. 23). Given the pre-eminent role of the CG both in terms of its role of having to reflect national interest (and respond to supranational agreements) and having access to substantial tax bases, a clear starting point must be leadership of any reform process by the CG. As Blöchliger and Vammalle (2012) (and also cited in Warren, 2012a) found from a study of OECD countries that successfully introduced reforms to intergovernmental financial arrangements in federal countries, the process of managing change is just as important as the change itself because there is no guarantee that good reforms will necessarily find implementation.

If it is accepted that the problems arising for government from the 2008 financial crisis can be clearly specified (i.e. budget deficits and debt-to-GDP ratios), that there is support for adopting fiscal rules and that the timing is now right for implementing such rules, then the Blöchliger and Vammalle (2012) findings would have three key implications for any move to introduce fiscal rules in a decentralised system of government. First, support must be built for reform and here, CG leadership in any consultative process is crucial given its key role in funding SCG. Secondly, agreement on a common proposal to address the problem must be reached (including transitional compensation mechanisms) and any intergovernmental fiscal agreements be legislated along with sanctions for non-compliance, to ensure transparency and accountability at all levels of government. Finally, the benefits of any agreement must be widely communicated along with the costs of non-compliance, accompanied by independent reporting on performance against agreements and how sanctions will be imposed. Any national fiscal consolidation must inevitably involve a high level of intergovernmental cooperation and while considerable attention is given over to those attributes sought for any supporting fiscal framework,[7] considerably less attention is given to the institutional processes involved in implementing fiscal consolidation across a multi-tiered system of government. Based on the discussion above, a holistic approach to the intergovernmental fiscal arrangements could involve the following three key elements:

1. CG-managed intergovernmental consultative framework;
2. Legislated intergovernmental fiscal agreements on
   - How the fiscal decentralisation is applied including the following:
     - Expenditure assignment (with a minimum of shared responsibilities),
     - Revenue assignment (and VFI),
     - Fiscal equalisation principles to be applied in any intergovernmental grant allocation and the administration of this allocation,
     - Deficit/debt funding management.
   - Medium-term (forward estimates) budgetary frameworks.
   - National fiscal rules and associated rules for each level of government.
3. Agreement on independent monitoring of performance including:
   - Independent advice on the allocation of any sub-central grants based on horizontal fiscal equalisation principles assessed on agreed desired outcomes (not inputs or needs);

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- Independent monitoring of performance against grant allocation, both specific and general purpose (with reporting to respective Parliaments);
- Independent assessment of compliance with agreed fiscal rules in the forward estimate (3–4 years) period and over the longer term (20 years) as proposals in relation to sanctions.

Any discussion on national fiscal consolidation is therefore significantly complicated by the need to engage all levels of government in any agreement. To achieve this requires the adoption of a transparent intergovernmental consultative framework and agreement on the full range of intergovernmental fiscal arrangements (including those framed by the constitution). The challenge then is how to implement the three elements above in a way that facilitates fiscal consolidation and improves accountability and transparency across all tiers of government while also encouraging decentralisation.

National fiscal consolidation in the Australian Federation

National fiscal consolidation is about more than imposing fiscal rules on one or more levels of government. It is also about improving fiscal governance and fiscal sustainability more generally, and therefore, an overview is provided in this section of those aspects that go to make up a comprehensive approach to fiscal consolidation in a decentralised system of government. To give context to the discussion, attention will be focused on how the Australian Federation might go about implementing national fiscal consolidation.

Fiscal consolidation in the Australian Federation - Issues

Fiscal rules are already widely adopted by different levels of government in the Australian Federation. What is not evident is intergovernmental consultation on such rules, independent assessment of performance against them and the imposition of sanctions for any non-compliance. In the *Updated Economic and Fiscal Outlook* (UEFO) released in February 2009, as part of the Commonwealth government's strategy to return the budget to a cash surplus, it committed to holding real growth in government expenditure to 2% a year until the economy returns to growth above trend (ER) and the budget to surplus (Australian Government, 2009). It also committed to taxation being kept (on average over the economic cycle) below the tax to GDP ratio in 2007–2008 (RR).[8] In the 2012–2013 Budget, the Australian government reasserted and expanded on its position, indicating that its medium-term strategy was to achieve budget surpluses, on average, over the medium term (BBR); to keep taxation as a share of GDP below the level for 2007–2008 (23.7% of GDP), on average (RR) and to improve the government's net financial worth over the medium term (DR).[9] What was not evident was any commitment to limiting tax expenditures, in part because these are reported separately from the budgetary process. However, this has not prevented tax expenditures from being possible avenues for improving the net fiscal position of the Commonwealth. None of these rules are hard and fast nor result in any sanctions (other than censure by the public as a result of non-compliance with the government's own benchmarks).

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In terms of the process of monitoring these fiscal rules, this takes place under the fiscal policy framework set out in the *Charter of Budget Honesty Act 1998* (Cth), which

> provides a framework for the conduct of Government fiscal policy. The purpose of the Charter is to improve fiscal policy outcomes. The Charter provides for this by requiring fiscal strategy to be based on principles of sound fiscal management and by facilitating public scrutiny of fiscal policy and performance.

For States and Territories[10] in the Australian Federation, their focus on deficits and debt has been driven by a concern about the recurrent cost of borrowings and therefore on the credit rating of any bond issues. States in the Australian Federation have responded with self-imposed borrowing constraints often enacted through legislation on 'fiscal responsibility' (New South Wales, Victoria and Queensland), 'fiscal integrity and transparency' (Northern Territory), 'budget honesty' (South Australia) and 'budget responsibility' (Tasmania). The effect is to make explicit the criteria States impose on themselves 'with a view to maintaining financial results that are fiscally sustainable in the medium and long term'.[11]

The problem is that these soft budget constraints have become pseudo-hard budget constraints, resulting in States not taking a medium- to long-term view about debt but adopting a short-term focus on 'balancing' their budget. In the case of Western Australia, the *Government Financial Responsibility Act* requires the Government to achieve an operating surplus for the general government sector, to maintain the ratio of total non-financial public sector net interest costs as a share of revenue at or below 5% and to ensure that real per capita own-purpose general government expenses do not increase (Western Australia Treasury Corporation, 2009: 18). The problem is that a strict focus on the budget balance (BBR) can be counterproductive during an economic downturn when States respond to declining revenue and increased expenditure demands with increased tax rates, new taxes, reduced expenditure and calls for increased intergovernmental grants.

With LGs having no constitutional recognition and being constituted under state statutes,[12] States have retained direct control of LG funding from own-sources. In recent years, this has posed real funding problems for LG, especially for infrastructure. While there are technically no constraints on LG borrowing, such borrowing is of direct concern to state governments as they have ultimate responsibility for LG debt. Attention has, as a consequence, been focused on a combination of council amalgamations to yield scale efficiencies along with avenues to fund infrastructure.[13] Fiscal rules for LG are therefore less of an issue in the Australian Federation.

What the discussion in this section has highlighted is how fiscal rules are already in place across levels of government in the Australian Federation. However, what is not in place is a high level of coordination between and across the different levels with respect to their various fiscal rules nor is independent monitoring undertaken of outcomes or sanctions imposed for non-compliance. Copious literature exists on the criteria against which to assess fiscal policy rules, which Kopits and Symansky (1998) summarised as requiring fiscal rules to be well defined, transparent, adequate with respect to goals, consistent with macroeconomic policies, simple to communicate to the public, flexible enough to

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accommodate economic cycles and shocks, enforceable and supported by policies designed to improve overall economic efficiency. Australia's current ad hoc approach to imposing fiscal rules across levels of government does not satisfy all criteria and would require a higher level of intergovernmental consultation than is currently the case on this issue.

Consultative framework on intergovernmental fiscal relations in Australia

Wyplosz (2012) found from a review of the international experience with fiscal rules that they are unlikely to exist unless they are associated with supporting institutions and that 'effective arrangements are those that give institutions the authority to apply legal rules or to act as official watchdogs' (p. 24). What was clear from earlier discussion is that although fiscal rules are imposed they are subject to self-assessment without sanctions for non-compliance (except for political risk).

If the objective was to implement an intergovernmental agreement on fiscal consolidation in the Australian Federation, this would need to be undertaken through the peak intergovernmental forum, the Council of Australian Governments (COAG),[14] where discussions focus on promoting policy reforms of national significance or where coordinated action is required by all Australian governments (Figure 1). Unlike the situation for EU member countries, such discussions would not need to reflect any supranational agreement by the Commonwealth, which would otherwise need to form the foundations of any intergovernmental consultation. Given that States fund only 29% of their total general government expenditure from taxes, and LG just 35% of their expenditure through municipal rates,[15] the Commonwealth has a critical role in funding States and LGs. Therefore, leadership must come from the Commonwealth in any intergovernmental consultation on fiscal consolidation.

Figure 1 outlines the current framework for discussions on intergovernmental financial arrangements in the Australian Federation.[16] While State leaders have their own consultative framework, the Council of Australian Federation (CAF), as do Heads of State and Territory Treasuries and their Deputies, these forums are primarily focused on discussing issues to be raised at COAG meetings. While the intergovernmental framework in Figure 1 is not formally constituted in law, it has proven flexible enough in the past to be able to respond to the widely varying demands placed upon it over time with the Commonwealth avoiding any rigidities that might be introduced by providing it with legislative foundations. Where the framework has been more subject to criticism is the assertion that any agreement reached between governments is not constituted in law so that an agreement does not need to include all jurisdictions and even if agreed to, can be opted out of at any stage.[17]

Intergovernmental fiscal agreement on fiscal consolidation

The COAG framework with its Commonwealth government leadership is one which could be applied to any intergovernmental consultation on national fiscal consolidation. However, in contrast to discussions on intergovernmental fiscal arrangements, the scope of any agreement on fiscal consolidation would need to be far broader and involve agreement on five key issues:

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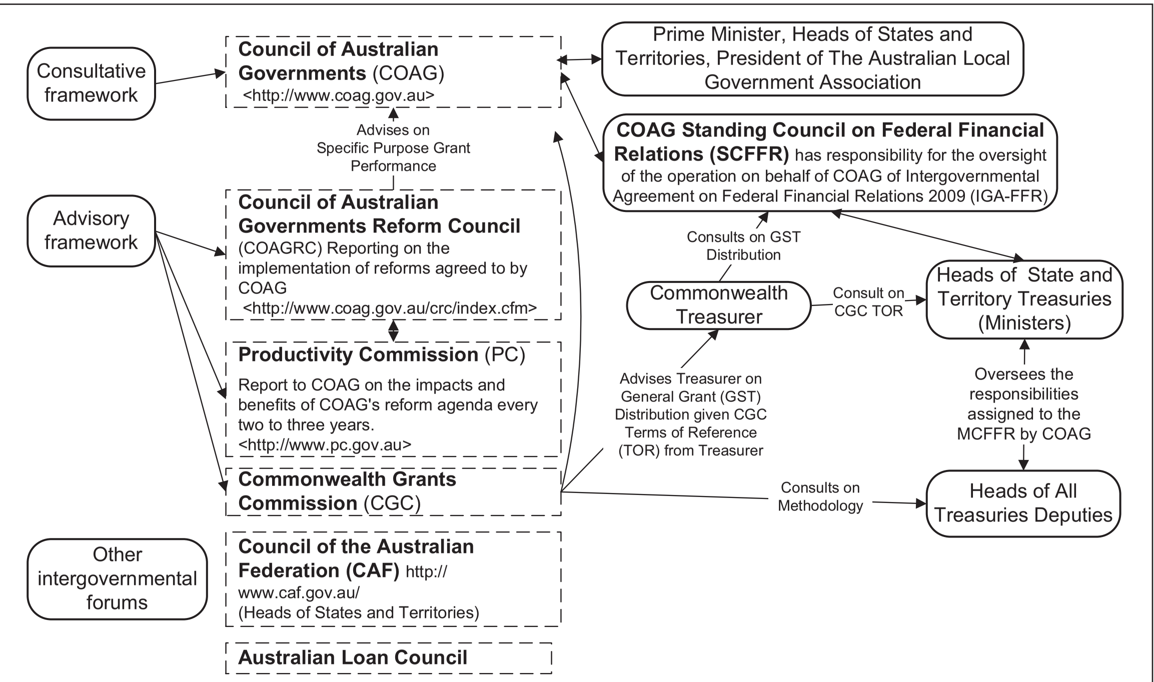

Figure 1. Intergovernmental consultative and advisory framework in Australia.
Source: Warren (2010) and available at: http://www.federalfinancialrelations.gov.au (accessed 15 January 2013).

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1. Tax and expenditure assignment;
2. Intergovernmental transfers and associated fiscal equalisation;
3. Fiscal rules by level of government;
4. Independent review of performance against agreement;
5. How to regularly review the arrangements in (1), (2), (3) and (4).

It is generally accepted that transparency about roles and responsibilities is crucial but less certain is whether these should be formally defined (constitution or legislated) or by agreement (which is informal and non-binding), or some combination of legislated and non-binding arrangement as in the Australian case (Kildea and Lynch, 2011a, 2011b). What is apparent from past debate on roles and responsibilities of the various levels of government within the Australian Federation is that any agreement is difficult to achieve. At the national *2020 Summit* in April 2008, which was to identify national priority areas, particular attention was given to the need to review roles and responsibilities within the federation in the areas of health, housing, water and taxation and particularly the lack of transparency associated with who is responsible for the delivery of public services and their funding.

When the Commonwealth Treasury prepared *Australia's Future Tax System* (Australia's Future Tax System Review Panel, 2009; hereafter the Henry Review), nearly 20 of the 138 recommendations related to State tax reform and States funding more of their expenditure from own-sources. The overriding theme in the Henry Review recommendations was to replace current State taxes with broad-based centrally administered taxes where, in most cases, both the base and rates would be aligned (Warren, 2010). However, the review did recognise that the management of the process of implementing changes was crucial when in Recommendation 119 it was proposed that

> Reforms to State taxes should be coordinated through intergovernmental agreements between the Australian government and the States to provide the States with revenue stability and to facilitate good policy outcomes. (Henry Review, 2009: 684)

This recommendation by the review has five distinct limitations that would need to be avoided in any intergovernmental agreement on fiscal consolidation. First, the review opted to delegate to the Productivity Commission (in Recommendation 108) the critical issue of the design and operation of the federation. Second, it felt disposed to make State tax reform recommendations before addressing expenditure assignment within the federation. Third, it made all its tax recommendations without considering how those reforms interact with intergovernmental transfer arrangements (Warren, 2010). Fourth, the Review gave little attention to the process for and timing of the implementation of State tax reforms, instead assigning this for resolution by COAG (Recommendation 119). And, finally, it gave only passing attention to the vital precursor to any discussion about State tax design, which is the consideration of issues of tax administration.

In its favour, the Henry Review did at least appear to recognise that the historical trend of 'creeping centralism' in the Australian Federation does have its limits and that a comprehensive reassessment of roles, responsibility and relationships across levels of

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government is timely and necessary. However, this did not prevent the Review from proposing State tax reforms, which further centralise revenue raising and worsen VFI. While addressing VFI does not appear to be a Commonwealth priority, concern over the allocation of intergovernmental grants has been an ongoing issue for State governments and resulted in the Commonwealth in 2011 announcing a review into the allocation of general purpose grants. In its final report, the Commonwealth GST Distribution Review (2012) opted for a focus on reforms to the 'leaves' rather than branches or roots, driven in large part by terms of reference, which meant that any reform needed to be revenue neutral at a time of increasing Commonwealth and State budget stringency. The failure to examine expenditure assignment or the revenue raising powers of States substantially undermined the scope for this review to make recommendations with a long-term perspective on the direction of necessary change.

While Australia has in place a framework in which any intergovernmental discussion on roles and responsibilities within the Federation could be had (and would be required with any move towards national fiscal consolidation), history has shown that there has not been a willingness by the Commonwealth or the States to address in this forum the substantial issues necessary for any long-term policy responses. Crucial here is that intergovernmental agreements are not binding in law, which implies an inability to impose sanctions for non-compliance with agreed fiscal outcomes. If binding agreements cannot be reached, one option for the Commonwealth is to take advantage of the dependency of States for funding, and impose sanctions where there is any non-compliance and where non-compliance and the level of sanctions are assessed independent of all governments.

Independent reporting on performance

Compliance with agreed fiscal rules (and the imposition of sanctions) requires monitoring of outcomes to be undertaken by a credible institution with an unfettered ability to actively disseminate its findings (Hagemann, 2011). This has been interpreted as requiring an independent review of fiscal rules focused on strengthening fiscal discipline through ensuring transparency about government's commitment to fiscal rules, its commitment to improving public finances and limiting how contingent events impact budget outcomes by constraining any fiscal policy responses.

Governments have not always been willing to subject themselves to independent review, preferring to adopt a self-regulatory approach as with the New Zealand's Fiscal Responsibility Act or the Australian Charter of Budget Honesty. As indicated earlier, the latter provides a framework for improving fiscal policy outcomes, 'by requiring fiscal strategy to be based on principles of sound fiscal management and by facilitating public scrutiny of fiscal policy and performance'. While support for the adoption of a self-regulatory approach is preferable to where the alternative is no review, such self-assessments are undertaken without fear of sanction (except from the public) for non-compliance.

Independent and impartial scrutiny is clearly preferable as are sanctions for non-compliance. In the remainder of this section, it will be shown that while independent statutory reviews of government ex ante fiscal outcomes are not new, what is new is the

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focus on introducing both ex post and ex ante independent statutory reviews and of publicly (and privately) funded reviews that are external to all government agencies. A common objective in all cases is that independent reviews are crucial to ensuring accountable, transparent and fiscally sustainable governments.

Independent statutory authority reporting to Parliament. Historically, Parliaments have always had in place capacity for ex post reviews of government expenditure and tax programmes. This typically occurs through the auditor-general function and the Australian National Audit Office (ANAO) whose 'purpose is to provide the Parliament with an independent assessment of selected areas of public administration, and assurance about public sector financial reporting, administration, and accountability' (ANAO, 2013; see also Audit Office of New South Wales (NSW), n.d.). SCGs also have similar agencies with comparable functions such as undertaking performance audits, financial statement audits and assurance reviews. These functions are also often complemented by an ombudsman's responsibility to address issues arising from the community's dealings with government agencies. Again, the focus is on undertaking investigations and audits with the objective of encouraging good public administration. In the case of both these institutions, there is a preponderance of focus on historical events and appropriate responses by government and the public administration.

Governments often respond to auditor-general and ombudsman reports to Parliament by initiating ad hoc reviews, especially where a more forward-looking response is necessary. This is especially the case where the focus is on major expenditure and revenue programmes and their sustainability over the long term such as with health, education, welfare and taxation.

In a recent document on *Draft Principles for Independent Fiscal Institutions*, the OECD Working Party of Senior Budget Officials on the Public Governance Committee observed that while the independence, leadership, terms of reference and funding of the independent fiscal institutions varied widely, they found that the best practice definition of such an institution was one which was

> ... a publicly funded independent body under the statutory authority of the executive or the legislature which provides non-partisan oversight and analysis of, and/or advice on, fiscal policy and performance. Critical to this definition are two concepts: (1) that the independent fiscal institution has a 'watchdog' function and (2) that it has an ex ante diagnostic task (in contrast to public audit institutions which perform an equally indispensable ex-post task). (OECD, 2012: 2)

The role envisaged in such an independent fiscal institution is clearly much broader and more forward looking that that of the auditor-general or ombudsman.

Calls for an independent fiscal institution in Australia are not new. In a budget reply speech in May 2009, Malcolm Turnbull, Member of Parliament (MP) (then leader of the main opposition parties), called for a Parliamentary Budget Office (PBO). In 2011, the Business Council of Australia (2011) proposed an independent statutory Commission of Budget Integrity whose contribution would be 'through the light it could shed' on all fiscal-related issues, including tax reform options.

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With the election of a minority Commonwealth government in October 2010, the incoming government signed an agreement with the minor parties on the formation of an Australian PBO (Parliament of Australia, 2012) – the legislation for which was finally enacted in February 2012.[19] The functions of the Parliamentary Budget Officer are

> (1) to prepare budget analyses and policy costings on request by Senators and Members; (2) to prepare submissions to inquiries of Parliamentary Committees; and (3) at its own initiative, to conduct and publish research on the budget and fiscal policy settings. The PBO's analyses of the budget are not constrained to the annual budget but extend to the entire budget cycle. (Bowen, 2012)

States in the Australian Federation have examined the benefits of a PBO, with the Australian Capital Territory concluding that it was too small a jurisdiction for such an office (Halligan, 2011). The Victorian government (Public Accounts and Estimates Committee, Parliament of Victoria, 2011) has committed itself to such an office and New South Wales introduced a PBO in 2010 (Parliament of NSW, n.d.).

In the United States, at the central level of government, the US Congressional Budget Office advises Congress on a range of fiscal issues, including analysing the proposed budget using its own assumptions, providing scores on any new legislative proposals, and undertakes a broad range of analyses and reports. State Budget Offices are also found in numerous US States (such as Wisconsin, West Virginia and Michigan) and at the city level as with the New York City Independent Budget Office.

What is missing in this debate about the merits of an independent PBO is the relationship between each of the offices at different levels of government. Little attention appears to have been given to this issue. After all, funding issues for the central level cannot be divorced from those at the SCG level. Whenever the institution is a Commonwealth statutory authority, it is reasonable to expect its focus to be only on issues directly related to the Commonwealth. This is where independent ad hoc reviews by a non-government fiscal agency could have an advantage.

Ad hoc independent government reviews. Incoming governments regularly undertake independent audits of the financial position they inherit from the previous government. The newly elected 2010 Victorian Government undertook an Independent Review of State Finances (Public Accounts and Estimates Committee, Parliament of Victoria, 2011), the 2011 elected New South Wales Government, a financial audit (Lambert Review) (NSW Government Treasury, 2011), and the 2012 elected Queensland Government, a commission of audit (Queensland Commission of Audit, 2012). Selected issues are also reviewed on an ad hoc basis by all governments as with the 2009 Henry Review and the New South Wales 2008 review of its tax system ('Final report – review of state taxation (Report to Treasurer)', 2008). Fiscal risk analysis from issues such as an ageing population is now also common practice.[20] While these independent ad hoc reviews are helpful in providing insights critical to governments of the day, what they lack is adequate integration into a holistic long-term approach considering the fiscal risks confronting not only the government initiating the review but also all governments and over the long term. It is here that an independent,

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non-government, comprehensive approach to assessing national fiscal issues could have a role.

Independent non-government fiscal institution. In the United Kingdom, the Institute for Fiscal Studies (IFS) releases each year an unofficial Green Budget in which it assesses the key issues confronting the UK government in its upcoming budget deliberations (IFS, 2012). The IFS undertakes its assessment completely independently of Parliament and of political influence. The downside, however, is that it is not privy to detailed historical information from government agencies in making its assessment of the fiscal situation confronting government. This shows that fully independent fiscal agencies might not be able to utilise maximum available information. The issue is how to balance the tension between needing access to government resources (both financial and statistical) and maintaining a non-partisan approach. Debrun et al. (2009) argue that the independent fiscal agencies should be seen as not replacing but complementing existing institutions and enhancing the effectiveness of any fiscal rules. Also, that the focus of such agencies and their structure should be seen as unique to the fiscal situation and the political, constitutional, legal and policy environment in which they operate.

A key constraint on statutory independent fiscal agencies is that their mandate typically has focused on adding greater transparency to government policies and their fiscal implications (thereby enhancing accountability). This could see them focused on current fiscal developments and the cost of possible budget initiatives using independent macroeconomic forecasts where it is mandated to provide normative assessments of policy, including of the government's fiscal policy stance.

In contrast, an independent non-government agency would not be constrained in any way in the scope of its commenting on current government policy objectives or on possible alternative instruments available to government. An intermediate approach for all governments might be to legislate the rules and then leave an independent external agency to monitor performance against those rules. This is the approach adopted by the EU in relation to countries' performance against fiscal rules where non-compliance sanctions will be imposed by the European Court of Justice (European Central Bank, 2012). This EU approach raises an additional question about the possible role of supranational fiscal agencies.

Supranational fiscal institutions. What the 2008 financial crisis highlighted was how rapidly the crisis in one jurisdiction can spill over to others. This was most obvious in the EU where the US sub-prime crisis exposed the financial and economic weaknesses of various member states of the EU. When the resulting economic crisis became a financial crisis and brought into question the European monetary system (and Euro), it was no longer a national issue. It was here that supranational institutions such as the EU and the supranational agencies such as the European Central Bank had an important role through adopting policies that supported fiscal discipline at supranational government level, by funding territorial authorities to address deficits and debt, by setting standards for the budget framework and by ensuring consistency and integrity in penalty arrangements.

It is also no coincidence that the IMF and OECD have contributed significantly to the debate on fiscal rules and governance since the financial crisis (as noted above). The

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OECD through its Country Budget Reviews, budget officer networks[21] and providing guidelines on budget principles and objectives creates an environment for peer recognition and review. Similarly, IMF country assessments and monitoring of fiscal rules as well as research into best practice help to guide countries in the adoption of transparent, accountable and sustainable fiscal policies. However, what Hagemann (2011) has shown is that while independent fiscal institutions are a necessary condition for achieving disciplined fiscal performance, alone they are not sufficient: 'Without strong and sustained political commitment to a medium-term fiscal goal and, where relevant, to the mandate of a fiscal council, durable improvements in fiscal performance will remain elusive' (p. 95).

Fiscal consolidation: process over politics

Despite the EU recently receiving the 2012 Nobel Peace Prize for achieving peace and cooperation in Europe, Feldstein (2013) notes that cooperation has not really been a hallmark of the EU response to the financial crisis even though 'a currency realignment is a challenge that calls for coordinated action' (p. 10). Not only have EU countries resisted European Commission oversight of their budgets, individual countries have been left largely to manage their own budget crises in an environment characterised by tighter fiscal rules and their more rigid enforcement. This is not a cooperative or consultative approach but a unilateral one, bringing with it risks to political stability in member states as well as across the union. However, a cooperative approach designed around supporting those countries in a crisis can also be divisive, leading dissenting countries (such as the United Kingdom recently) to threaten holding a referendum on leaving the EU if its budgets are to be overseen by some supranational institution or where it must financially support nations confronting a fiscal crisis.

If stability of the Euro requires realignment based around coordinated policy responses, then a transparent and open process of consultation and coordination should form an important part of any policy assessment process. The difficulty of undertaking such a process cannot be underestimated as it would involve not only coordination between national governments but also between levels of government in each nation. Here, internal stability pacts designed to complement national fiscal rules with involvement of all levels of government, such as through Belgium's High Council of Finances (Federal Public Service Belgium, 2012), would acknowledge and work with these interdependencies to ensure sound budgetary policies that are imposed by the CGs.[22] However, such internal stability pacts based around a consultative and coordinated approach are not common.

If the approach to be taken to fiscal consolidation is to encompass the three elements outlined in the section 'National fiscal consolidation and decentralisation', then the CG-managed intergovernmental consultative framework and any legislated intergovernmental fiscal agreements should also be independently monitored by an institution with only that purpose. In the case of fiscal consolidation in the Australian Federation, an independent fiscal institution could assume responsibility for monitoring any intergovernmental agreement on fiscal rules in the Federation (or against any international agreement). This would also facilitate a better understanding of the relationship between CG, SCG and LG budgets and their management and what implications this has for any

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moves towards national fiscal consolidation given the long-term trend towards fiscal decentralisation. Equally, the development of an international fiscal institution could bring greater transparency to national budgets and with it, increased accountability of national governments and scope for agreement on cooperative and coordinated policy responses across all government levels.

While CG leadership and authority is essential to fiscal consolidation in a decentralised system, the challenges involved in agreeing on and legislating intergovernmental fiscal agreements cannot be underestimated nor the difficulties involved in agreeing on forming an independent fiscal institution. However, not to adopt an all-government comprehensive approach risks undermining any CG national fiscal consolidation objective whether self-imposed or imposed by some supranational institution.

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Notes

1. See International Monetary Fund fiscal rules data set (IMF, 2012a) and its tracking of fiscal rules used in a financial crisis (IMF, 2012c).
2. Central government consists of those units responsible for the whole of a country while sub-central government consists of units that operate below the central government level but above local government, where the latter involves only a localised part of the economy.
3. The IMF has a long history of focusing on fiscal transparency (IMF, 2012b). This has been delivered through a *Code of Good Practices on Fiscal Transparency*, a *Manual on Fiscal Transparency* as well as country monitoring programmes (IMF, 2007). The Organisation for Economic Cooperation and Development (OECD) also complements similar initiatives, supporting networks of public officials and communication of good budget practices (OECD, 2013).
4. The European Commission recently acknowledged the importance of this issue and the lack of related research. In response, it initiated a conference and commissioned papers in late 2012 (EC, 2012a),
5. See Note 1.
6. Some 49 US states (excluding Vermont) in 2009 had some form of budget balance rule (BBR) as did several Canadian provinces and territories. See discussion in Office of the Parliamentary Budget Officer, Ottawa, Canada (2010).
7. See objectives outlined for national fiscal frameworks in EU countries, (EC n.d.-a).
8. For an historical perspective on the fiscal rules adopted by the Australian Commonwealth Government, see IMF (2012a).
9. See Australian Government (2012–2013), Statement 3: Fiscal strategy and outlook.
10. The Australian Federation comprises six states (New South Wales, Victoria, Queensland, Western Australia, South Australia and Tasmania) and two territories (Northern Territory and Australia Capital Territory) and will hereafter be referred to as States.

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11. See purpose, objects and application of Act in the Fiscal Responsibility Act (New South Wales) (2005).
12. The Commonwealth Parliament is currently reviewing whether to hold a referendum to give local government (LG) constitutional recognition. See Australian Government Department of Regional Australia, Local Government, Arts and Sport (2013).
13. See the reviews by the Government of Western Australia (2012) and New South Wales Government (2012).
14. See outline of Council of Australian Governments (COAG) role in COAG (n.d.-a).
15. See discussion in Warren (2010, 2012b) and statistics in Australian Bureau of Statistics (ABS) (2010–2011).
16. For an outline of the Federal Financial Relations Framework, see COAG (n.d.-b), and for the role of the Standing Council on Federal Financial Relations, which has oversight of the Intergovernmental Agreement on Federal Financial Relations (2009), see Standing Council on Federal Financial Relations, Australia (n.d.).
17. Nonetheless, there have been calls for the COAG process to be formally constituted in law as discussed in Kildea and Lynch (2011a, 2011b).
18. *Charter of Budget Honesty Act, 1998* (Cth), No. 22, 1998, b Schedule 1, Part 1, Section 1.
19. For a brief overview of the political evolution of the Australian Parliamentary Budget Office, including the agreement with minor parties (and its anticipated staffing level of 35), see Parliamentary Budget Office Australia (2012).
20. See, for example, the Commonwealth government's Intergenerational Report (2010) and comment by David Grant from the Federal Treasury (Australian Government, The Treasury, 2012).
21. The OECD supports a Senior Budget Official Network and a network of Parliamentary Budget Officials, information on which as available at OECD (2013).
22. See discussion in EU Committee of Regions Temporary Ad Hoc Commission on the Budget of the European Union (2012).

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