STRUCTURAL FISCAL TARGETING AND GOOD GOVERNANCE

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Structural fiscal targeting (the practice of setting of medium-term targets for taxation, government borrowing, spending and regulation) has a rightful place in any sensible longer term economic strategy. But the merits of targeting depend crucially on how and where the targets are set. If the targets are very constraining and arbitrarily set as part of an ideological commitment to "small government", they can limit the scope for governments to achieve an optimal balance between efficiency and equity. Indeed they may advance neither efficiency nor equity. This is especially so in a country like Australia which starts with a relatively small government base and where the community has shown a willingness to accept a reasonable sacrifice of efficiency for the sake of other values.

The aim of this paper is to examine whether the particular structural targets currently in vogue in Australia are consistent with good governance. The paper analyses the present medium-term fiscal stance (section 2) and its implications for economic efficiency (section 3) and for equity (section 4). It then considers whether a policy shift might be desirable (section 5). It starts by attempting to define good governance (section 1).

1. What is good economic governance?

"Good governance" - the benchmark for our evaluation of fiscal targeting - is a fiendishly difficult concept but a sophisticated definition is unnecessary here. For purposes of this paper, it will be seen as integrating three key ingredients - efficiency, equity and legitimacy.

An "e**fficiency improvement**" occurs if winners from economic change or reform clearly outweigh losers i.e. if the winners are able *potentially* to compensate the losers and still remain better off. *Actual* compensation does not have to take place. This concept of an efficiency gain is the one commonly understood in public policy debate [1]. It incorporates improvements in both productive and allocation efficiency and it is arrived at after deducting short-term economic adjustment costs and negative "externalities" [2]

Economic efficiency gains will not necessarily equate with improved community wellbeing if the gains - in whatever form the community chooses to take them [3] -are "inequitably" distributed.

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[1] It represents a "weak" version of the Pareto optimization principle. The stronger, purer version of the principle states that a reform or change only generates an efficiency improvement if the losers are actually and fully compensated i.e. there is a win/win result. This avoids making interpersonal comparisons of utility but ii is too stultifying a principle for practical policy purposes.

[2] . Externalities are effects on third parties which are not reflected in the market value of sales - such as on the congeniality of the living, working and natural environment, the work/leisure relationship, the level of trust and social networking within the community etc. Most studies of prospective efficiency gains from a proposed reform tend to focus on long term equilibrium gains which have market values attached to them and ignore externalities and short term adjustment costs. This is simply because of measurement difficulties.

[3] Efficiency gains can be reflected in higher incomes, improved quality of life, increased leisure, a more pristine environment and so on.

So **equity** - the notion that everyone needs to be given an equal chance to share in the fruits of increased efficiency - is another important dimension of good governance . In the sense used here, it is a marginal concept - i.e. it relates to the distribution of *incremental* gains - and it does not imply "equality" of outcomes. It requires only that the system of distributing incremental gains is consistent with community norms. Although it is an intrinsically elusive policy concept (as community values often conflict with each other), it is an unavoidable requirement of good government, at least in a democracy with universal franchise.

A third and related ingredient of good governance is that diverse and often conflicting values need to be reconciled through policy processes which are widely seen as fair and reasonable. This third dimension can be called **legitimacy.** It requires a wide community perception that, whatever the ultimate outcomes, the institutional and policy-making processes are coherent, consistent, transparent and accountable. Like equity, this is a vague one. As a minimum it presumes ensure equality of treatment under the law and honesty in implementation. But it can be interpreted much more widely.

This paper will side-step such complexities and ambiguities and simply define good governance as:

> *the exercise of political power to achieve a balance between efficiency and equity in a way which is compatible with community values and priorities, and through policy-making and institutional processes which are widely viewed as legitimate.*

It is against this broad criterion that the current set of medium term fiscal targets will be assessed [4].

2. Fiscal trends and parameters

The following tables and charts broadly capture the current fiscal situation in Australia relative to other countries.

[4] The author has attempted crude evaluations of other elements of the reform agenda in another paper (2001b). It concludes that most of the big micro-economic reforms of the 80's and 90's did basically meet the criterion of good governance. However some government asset sales, some extensions of workplace reform and some applications of financial deregulation (such as the opening up of world capital markets to hot money flows) contributed little to efficiency while damaging important dimensions of equity. It is also arguable that inflation targeting has gone too far in some countries (notably continental Europe), enhancing neither efficiency nor equity. Concerns about accountability and legitimacy have also been raised (e.g. Mulgan 1997).

TABLE 1: GENERAL GOVERNMENT REVENUE AS % GDP 2000:

AUSTRALIA	32.3
AUSTRIA	47.0
BELGIUM	48.2
CANADA	40.3
DENMARK	54.9
FRANCE	49.8
GERMANY	44.4
JAPAN	32.2
KOREA	26.1
NETH.	44.2
NZ	41.2
NORWAY	51.0
SWEDEN	57.3
UK	39.3
USA	31.6
OECD	37.1

Source: *OECD Economic Outlook 12/2000*

TABLE 2: ESTIMATED GENERAL GOVERNMENT OUTLAYS 1965-2000 AS % OF GDP

	Australia		**OECD**	
	Total	**Transfers**	**Total**	**Transfers**
1965	24.6	4.2	26.9	6.5
1970	25.2	3.9	29.2	7.5
1975	31.3	5.9	34.4	10.2
1980	32.3	6.8	35.5	10.7
1985	37.8	7.4	38.1	11.4
1990	33.0	6.9	38.0	11.5
1995	35.4	8.5	39.4	13.2
2000	31.4	8.3	36.5	12.8

Source: *Atkinson/den Noord OECD 2001*

COMMONWEALTH OUTLAYS % GDP

	Health	**Social**	**Debt Int.**	**Other***
1972-3	1.9	5.0	1.6	15.8
2000-01	3.9	9.2	0.9	10.3

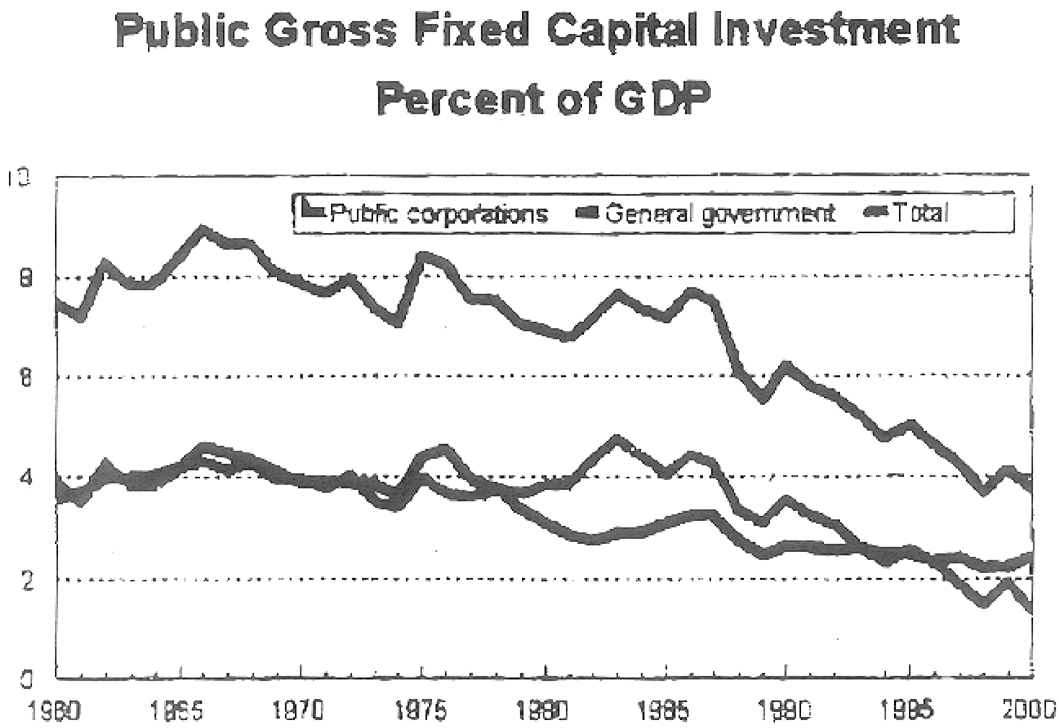
Source: *Commonwealth Budget Papers*
** including capital spending*

TABLE 3:COMMONWEALTH GENERAL GOVERNMENT SECTOR CASH SURPLUS

3-yr.average 1969-70/ 71-72:	+2.7%
3-yr.average 1979-80/ 81-2	-0.3%
3 yr. Average 1989-90/ 91-2	-0.4%
3 yr. Average 1999-00/2001-2*	+0.8%

**Including official projections.*
Sources: *Budget paper No. 1, 2001/2, p.11-13*

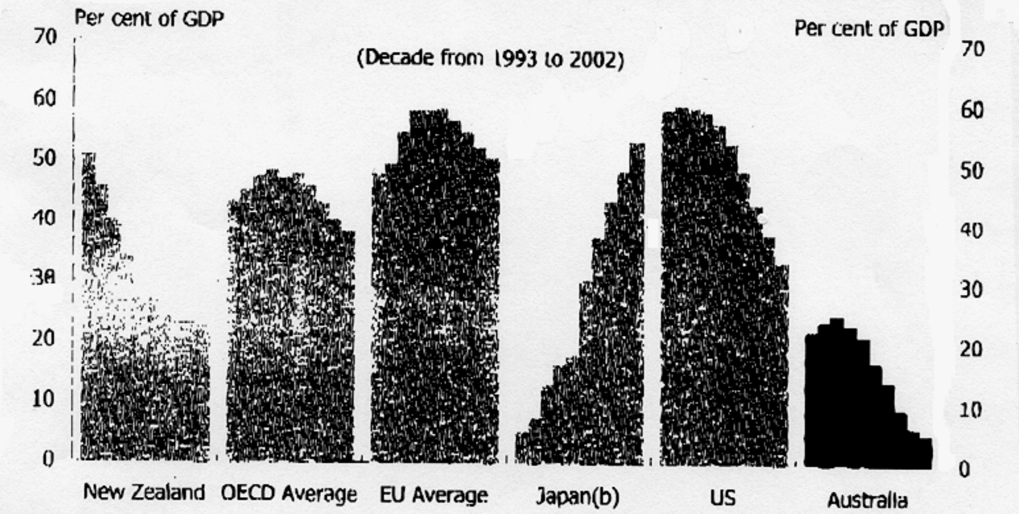
CHART 1 PUBLIC GROSS FIXED CAPITAL INVESTMENT PERCENT OF GDP



Source: *ABS National Accounts Cat 5204.0*

CHART 2 GENERAL GOVERNMENT NET DEBT LEVELS IN SELECTED COUNTRIES

Chart 2: General government net debt levels in selected countries [(a)]



(a) Data are for the total general government sector (that is, the aggregate of all levels of government including the social security sector but excluding the PTE sector).

(b) The above net debt data for Japan are inclusive of assets held by the social security system. Japan's net debt, calculated exclusive of these assets, was estimated by the IMF to be almost 100 per cent of GDP by March 2001.

Source: OECD Economic Outlook 68, Reserve Bank of New Zealand, Monetary Policy Statement March 2001, ABS Public Sector Financial Assets and Liabilities, 1998 (Cat. No. 5513.0), ABS 1999-2000 Government Financial Estimates (Cat. No. 5501.0), ABS 2000-01 Government Financial Estimates (Cat. No. 5501.0), State and Territory 1999-2000 budget outcomes, 2000-01 mid-year reports, 2001-02 Budgets where available and Treasury estimates.

Source: *Budget paper No.1*

The following features are relevant to this paper.

- Total public spending in Australia (Commonwealth, State and Local) is currently running at near-record levels (as a % of GDP). However, the current year figures are inflated by technical factors [5] and special one-off economic forces viz. "pump priming" in response to cyclical economic pressures and the GST. Abstracting from these special factors, the picture remains one of strong trend increase in public spending from the 60's onwards but with a slight trend decline during the 90's.

- The trend increase in government spending in Australia has been broadly in line with other OECD countries and stems mainly from a surge in health and social security spending.
- By contrast, public capital expenditure has declined steadily since the 60's as a % GDP. This decline was partly offset by increased *private* investment in economic infrastructure but this mainly impacted on public corporations and cannot explain the cuts in "general government" infrastructure expenditure shown in the chart. Moreover social infrastructure has proved less amenable to private investment and has suffered more than economic infrastructure.
- The Commonwealth General Government sector's cash balance (broadly equal to net public sector borrowing) turned from surplus to deficit during the 70's and early 80's, stabilized in the 80's and returned to a small surplus during the course of the 90's[6].
- Australia remains in essence a small government country: it has a low overall tax burden, low public debt levels[7], and low government outlays relative to GDP, by comparison with other OECD countries. These days Australia even has a low level of regulation (including labour market regulation)[8].

Up to about the mid 1980's, fiscal management played an important role (in conjunction with a range of other macroeconomic policy instruments such as banking and capital controls and industrial and wage regulation) as an employment stabilizer and developmental tool. Today fiscal policy tends to be medium term oriented and constrained by a number of rules or conventions.

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[5] The trend is somewhat distorted by one-off state superannuation contributions in 1998-9 (Budget paper No. 1 2001-2 8-12) and by the particular classification of revenue contracting measures (according to the Treasurer, Peter Costello, Age 7/3/01).

[6] The Howard Government's recent huge spending spree (calendar 2000) has been largely a contra-cyclical response to an economic slow-down and if it works, as it seems to be doing, the Coalition will have smoothed the cycle and still retained a cash surplus or at least a cash balance at the end of it all. This implies realization of a structural cash surplus over the business cycle and a trend decline in public debt.

[7] Current general government net debt levels in Australia, already low, are projected to fall close to zero over the next five years: Budget Papers no.1, 2001-2, 8-16. Even if projections prove optimistic and net debt levels stabilize at around the present level of 6 per cent of GDP it would be a very low figure on any historical or international criteria. See chart 2 1-9 of Budget Paper No. 1 2001-2. Most state governments in Australia have a large and rising net worth per capita (Ng/Shead 1999).

[8] The OECD-recently reviewed regulation levels across OECD countries and included Australia among a group of countries described as having "relatively lax employment protection systems" (ECO/WKP(99)18: 45). This is as well as having low levels of product market regulation.

The fiscal parameter currently fashionable in policy circles is that medium term reductions in effective tax rates and in levels of public debt (net of asset sales) are symptomatic of good economic management, while increases are a sign of bad management.

This parameter is reflected in a set of self-imposed rules, guidelines or targets which we will call **the Fiscal trilogy**. They require governments to:

- limit the total amount of tax revenue raised over the medium term (including revenue from bracket creep) relative to GDP, so if more spending is necessary in one area it has to be met by rearranging spending priorities;
- strive for "fiscal balance" over the economic cycle[9], so all government spending, whether of a recurrent or capital nature and whether involving short or long-life infrastructure, has to be paid for out of available revenue; and
- seek private sector finance for those infrastructure projects which cannot be funded out of revenue or defer the projects altogether (however desirable they may be).

The Howard Government has broadly endorsed the substance of the Trilogy both in its rhetoric and in practice. So too have many State Labor Governments[10]. The position of the Federal Labor Opposition is still unclear but it appears to be broadly supportive of the Trilogy[11]. Some "small government" economists want governments to go even further in committing themselves to cuts in government spending, taxes and debt[12].

Fiscal targets (like monetary targets) are not formally binding on governments. The targets can be legally breached at any time. But, once the rules are publicly pronounced and endorsed by politicians, backtracking is far from easy. Financial markets and the electorate build up certain expectations about what is financially and economically "responsible" based on the politicians' own pronouncements. To subsequently depart markedly from the targets involves penalties either of a political or financial market kind.

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[9] This equals the operating balance minus net investment. If the fiscal balance is zero, it means enough revenue has to be raised to pay for recurrent and investment spending.

[10] A recent example is the promise by WA Labor leader (Geoff Gallop) that he would consistently run a "cash surplus" if he won government. One journalist commented that this could require "a halving of the capital works program or savage spending cuts in other areas" (Alan Wood, 16/1/01). Queensland's stronger net financial position enables it to adopt a fiscal stance which is more consistent with "the golden rule" - that revenue should only be used to finance outlays the benefits of which are entirely enjoyed contemporaneously. The Bracks Government in Victoria may also be moving broadly in that direction (Robinson 2001: 61).

[11] The present Leader of the Opposition, Mr. Beazley, has committed himself to "no increase in any taxes on ordinary Australian families", which at least does not commit a Labor Government to actually cut taxes, as promised by the prime minister. Labor is also committed to the maintenance of "fiscal balance" which the Budget papers interpret as a cash balance between revenue and total spending (recurrent and capital). In a speech to CEDA (Bulletin October 2000), he appeared willing to depart from the "cash balance" bind, only promising that Labor would "not borrow to finance current spending over the cycle". It is not clear if this represents a firm change in policy, as subsequent Labor statements have been more ambiguous. It is worth noting that Labor governments in the past have been very zealous supporters of variants of the Trilogy. It was a Labor Government under Hawke which in 1984 bound itself over the life of the parliament not to increase total taxation, total government expenditure or the size of the budget deficit as a percentage of GDP.

[12] Wofgang Kasper is a strong exponent of limiting government spending to a no more than 25% of GDP (Kasper 2001 and Policy, Summer 200-2001:33))

This is precisely why the Trilogy has strong support among market economists and business and financial interests, who see it as a "discipline" on governments and as a means of ensuring lower levels of taxation and public borrowing than otherwise.

Yet, ideology aside, the Trilogy's rationale is far from clear. Is it as beneficial for economic efficiency and growth as most of our policy elite appear to believe? And what are its implications for equity and legitimacy? The first question is addressed in section 4 and the second in sections 5 and 6.

4. Is the Fiscal Trilogy good for economic efficiency?

Sub-section 4.1 reviews the efficiency benefits of the trilogy and 4.2 notes some often overlooked efficiency costs.

4.1 Potential efficiency gains

Those who see the Trilogy as positive for economic efficiency argue their case on various grounds, including the following:

- it is in line with sound public financing practices across the world;
- it helps set a limit on the deadweight and administrative costs normally associated with taxation;
- it leaves more room for individual choice and results in a more optimal allocation of resources;
- the private sector is a more efficient borrower than the public sector;
- global capital markets prefer conservative fiscal strategies like the Trilogy and these markets can have a great influence on the economic well being of Australians;
- Australia needs to be fiscally conservative because of its acute national saving problem and
- --- the prospective ageing of its population.

These arguments all have a core of truth but they need to be viewed with more than a little scepticism.

(i) The Trilogy is in line with sound public financing practice across the world

Well designed, and in the right circumstances, structural fiscal targeting has merit both as an economic tool and as a technique of public management:

- by setting out a clear set of financial norms, standards and values, it injects greater stability and predictability into the policy environment and helps to create a more stable financial market environment;
- it helps to shelter governments from unreasonable interest group spending pressures; and
- it can enhance accountability [13].

[13] The Federal Charter of Budget Honesty requires the Government to be transparent (issue periodic statements on the budget outlook, make explicit the premises of the economic projections annually, produce a set of inter-generational accounts etc.). But it does not preclude a financially irresponsible budget stance i.e. one which runs

Structural fiscal targeting therefore has a rightful place in any sensible public financing strategy. The issue is not whether governments should set themselves structural targets but *what form* targeting should take. It is questionable whether structural targeting of the radical Trilogy kind constitutes best practice financial management.

First, Australia's target of zero net borrowing over the business cycle is generally more restrictive than is common in other fiscally prudent OECD countries. The UK, for example, seeks only to balance *current* spending with current revenue over the cycle and the Chancellor recently reiterated his two fiscal rules as "borrowing only to invest and keeping debt at a sustainable level" (The Economist 10/3/2001: 62). The EU countries try not to exceed a cash deficit of 3 per cent of GDP over the cycle [Economist 6/6/99; 3/7/99].

Secondly, to the extent that the Trilogy embodies an ideological preference for "small government" values (low taxation and public spending), it appears to lack democratic legitimacy as it is far from clear that a majority of Australians share these same values[14].

Thirdly, the Trilogy dictum that current revenue should finance capital spending over the economic cycle is not consistent with intergenerational equity (Argy 1998: 73-75 and Robinson 2001).

(ii) Taxes have deadweight and administrative costs

Taxes have some efficiency costs. Two commonly noted are:

- the so-called deadweight costs or excess burdens that result when taxes distort the decisions that people make; and
- the compliance and collection costs associated with taxing and transfer spending.

These two costs can in theory be minimized through well-designed taxes e.g. simple, uniform and flat taxes or taxes on pure economic rent or taxes which fall on negative externalities like environmental pollution. But these are not equitable or politically practicable.

The deadweight costs of taxation are hard to quantify. Some economists have high estimates[15] but these are based on questionable assumptions[16]. The fact that Australia is a low tax country (see later evidence) with a low tax wedge (OECD/Economist 19/2/00), also helps to keep the marginal deadweight losses well down.

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unsustainable deficits and is inconsistent with intergenerational equity. Fiscal targeting can fill this accountability gap.

[14] SeeWithers/Edwards 2001 and Canberra Times 30/6/01.

[15] For example, Campbell/Bond (1997) calculate the effect on labour supply and hence the welfare cost of a 1 per cent increase in marginal tax rates. They find that a project needs a benefit cost ratio in the range of 1.19 to 1.24 to improve social welfare. Other studies have even higher figures.

[16] For example they assume that in the absence of taxation the economy would find itself in an efficient, distortion-free equilibrium (Putterman et al 1998). They also assume zero unemployment (of the involuntary kind) and strong work disincentive effects from marginal tax rates at the high end of the income scale - all of which are disputable (Argy 1998: 83-85. Finally they assume that "the consumption of human services represents a cost burden on the goods producing sector of the economy" (Quiggin 2001).

As to the administrative and compliance costs of our tax system, they are high at present but should hopefully contract once the GST is firmly bedded and other taxes abolished or simplified.

All this is not to deny that there are efficiency costs associated with taxation, but they are likely to be relatively small in a prosperous, growing economy, especially if (as argued below) there are offsetting economic benefits on the spending side. .

(iii) Taxes and government spending reduce freedom of choice

A second and quite different argument used to justify constraining tax and public borrowing is that such government interventions prevent individuals from exercising their own individual preferences. Their choices are "distorted" relative to the optimal.

Economists agree that free markets and individual choice will generally tend to optimize consumer wellbeing, but this will not happen where:

- externalities are important and not easily internalized;
- competitive markets do not work well e.g. there are natural barriers to entry or high "transaction costs" in collecting and evaluating information;
- there is a degree of inter-dependencies among individuals; or
- citizens place high value on communal services relative to market goods.

There is a tendency for small government economists to assume that the public sector provides goods and services which are peripheral to human well-being. This is an increasingly archaic view. With the nation wealthier and the more basic needs met, "it is the adequacy of human services such as health and education that is most critical in determining human well-being" (Quiggin 2001).

This being so, it is *inefficient* to start with a presumption against public goods, which is what the fiscal trilogy does[17].

Cynics argue that, whatever the theoretical arguments, governments are unable to successfully correct for market failure because they have neither the competence nor the knowledge nor the integrity to intervene effectively in economic or social affairs[18]. As a generalization, this is sheer ideology and unworthy of comment. The more specific claim that much of government social spending has proved unproductive or ineffective is discussed later.

[17] One could argue (as some like the present Governor of the RBA did in a talk to CEDA27/4/1995) that there is at present a bias in favour of higher government spending, because of pressures from numerous interest groups, so a distortion the other way only redresses the balance. This might have been true in the past but these days the dominant interest groups are business and finance and they strongly favour lower taxes over higher spending.

[18] An extreme version of so-called public choice theory.

(iv) The private sector is a more efficient financier of public infrastructure than the public sector.

There are no overwhelming *macroeconomic* arguments to justify giving preference to the private sector over the public sector in the financing of public infrastructure[19]. The economic effects on interest rates, inflation, the current account deficit etc. are broadly the same whether a new infrastructure project is financed out of Government borrowing or out of private borrowing. The choice between public and private financing must therefore be determined on m*icro-economic* or cost-effective grounds and here too, there is no justification for starting with any prior presumption either in favour of or against the private.

At the micro level, it is the effective cost of capital which is crucial. The mere fact that governments can raise capital more cheaply (at lower interest rates) is irrelevant. As liberal economists rightly point out, a proper evaluation of the public sector cost of capital (relative to the private sector) needs to allow for the implicit taxpayer guarantee to cover future project risk. It is the intrinsic risk characteristics of the project and the relative ability of public and private sectors to manage that specific risk profile which are important.

However some liberal economists go too far the other way and argue that, in today's sophisticated capital markets, the private sector is necessarily better at managing infrastructure risk than the public sector. Such an argument assumes that infrastructure risk is mostly of the kind which efficient private capital markets are better equipped than governments to evaluate, price, control, diversify and manage. In some cases (e.g. new electricity-generating capacity in a truly competitive market), this may be true - but it is not universally true. There is no logic for example in using private equity to fund projects like urban roads, where the risks are policy-related, regulatory or political in character and therefore best managed by the public sector. Using private sector equity for such projects only inflates the cost.

In short, a general presumption in favour of private financing of infrastructure - implicit in the Trilogy - is not justified[20].

(v) Global markets prefer smaller government

A fifth type of argument often used to justify small government fiscal strategies such as the Trilogy is that international capital will "reward" governments and the economy for it.

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[19] Public infrastructure has the following distinctive characteristics:
- it provide services viewed as essential and/or socially desirable
- the investment is generally not commercially viable without some government input
- it has have wider economic spin-offs extending beyond the immediate users (externalities)
- it offers relatively long term returns,
- it often operates in imperfect markets and hence
- it requires and justifies a high level of government involvement

Infrastructure can take the form of hard" structures like roads, ports, railways, bridges, power networks, hospitals and schools or "soft" structures like financial and research institutions which promote innovation.

[20] A fuller discussion is in Argy 1999.

It is true that globalization[21] is tending to constrain fiscal options:

- tax competition among jurisdictions, the IT revolution and increased mobility of key factors of production, are limiting tax flexibility;
- the power of global financial markets to unsettle an economy is limiting the scope for public borrowing;
- the ability of multinationals to chase the lowest cost curve across the globe is restricting the ability of governments to protect workers with regulation; and
- rating agencies are extremely influential and most of them look kindly on small government policies (including privatization) when assessing the credit rating of countries.

However one should keep these risks in perspective. First, multinational investment is more concerned with a country's business tax *structure* than the overall tax burden. Provided taxes which impact on business costs and mobile capital are relatively insulated, governments have plenty of room for maneuver on other taxes (including property taxes).

Secondly, Australia starts from a low base in terms of tax and public debt levels. So a small shift from that base should not arouse great concern. This may explain the subdued market reaction to the recent rapid disposal of the large budget surplus by the Howard Government.

Thirdly, financial markets pay attention to history. Australia has a long record of responsible economic and fiscal management (see Table 3)- which is probably why the sovereign risk premium has generally been very small in Australia even in periods when debt/GDP ratios were much higher than they are now (Fane 1996; Gruen/Stevens 2000).

Finally, governments can insulate themselves to some degree from short term fluctuations in foreign capital by allowing the exchange rate (rather than interest rates) to bear the full impact of the fluctuations (as was done in the late 1990's) and by avoiding sudden u turns in policy.

Cross country studies show that even in the highly integrated economic world of the 90's, world financial markets will tolerate wide differences in social policy so long as inflation and public debt are kept under reasonable control and the instruments of social intervention are sensibly chosen (Argy 1999).

That said, it would be nice if governments could work together to regain fuller control of their social priorities - by limiting tax competition[22], disciplining speculative, short term capital flows[23] and strengthening existing international conventions and pacts on environmental,

[21] Globalization can be defined as a diminishing role for national borders and the gradual fusion of separate national markets (including especially capital markets) into a single global marketplace. It is the product of technological change (especially innovations in communications and transport and more recently the Internet.) and economic liberalization (deregulation and greater economic freedom). But the first partly triggered the second.

[22] e.g. through collective regulation of off-shore centers, tax havens, hedge funds, transfer pricing arrangements, electronic transfers etc.

[23] either through internationally agreed Tobin type taxes or at a more unilateral level through variable deposit requirements - or more realistically tighter prudential controls.

labor and social standards[24]. The tide of opinion may be turning on such issues. Even the hard nosed Stanley Fischer, the First Deputy Managing Director of the IMF acknowledged that "the international institutions cannot insist on a clear difference and clear distinction between the various aspects of social well-being that are associated with the development of macroeconomic stabilization and growth" (IMF Seminar and Panel Discussion 1999: 3). And the IMF's Tanzi has warned that expenditure for social protection could be "squeezed" unless the collective powers of the state to regulate relevant private activities are enhanced (2000). But there is no immediate likelihood of coordinated international action on these fronts at the present time.

(vii) Fiscal conservatism is necessary to boost national saving

A common argument used by market economists in Australia is that Australia has a relatively large under-saving problem so Australian governments need to be more fiscally conservative than other governments. This argument, which relates more to the medium term fiscal deficit than the level of taxation, is controversial.

Firstly, there is no proof of an inherent anti-saving bias in Australia. The structural CAD, which is now showing some signs of trend decline, is not in itself evidence of an under-saving problem and while Australia's tax and welfare systems could be said to have built-in saving disincentives, compulsory superannuation injects a bias the other way. Secondly, it is not clear that an increase in government saving leads necessarily to a net increase in national saving. In any case, drawing on foreign savings to finance sound public investment can be very positive for the current account deficit in the long term.

Governments can if they wish make a contribution to net saving by financing some proportion of public spending out of revenue. But to run a "fiscal balance" in the sense of financing *all* capital spending out of revenue over the cycle seems an over-reaction to a perceived under-saving problem. We return to this theme in section 5.

(viii) The ageing of the population calls for fiscal caution.

Another argument often used to justify fiscal conservatism in Australia is the prospect of an ageing population. Increasing dependency ratios (although acknowledged to be less of a problem here than in other OECD countries) will, it is said, require pre-emptive fiscal action. This is to offset both the expected blow out in government health and pension outlays (only partly offset by lower education costs) and the expected increase in private consumption relative to output (stemming from the increasing proportion of retirees).

The assumptions on which the dependency projections are based are often too pessimistic: If productivity continues to grow strongly and there is a further rise in labour force participation, the economics of ageing is transformed. Even if the projections prove correct, there is likely to be a rational *market* response e.g. increased involvement of older workers in response to

[24] ILO conventions, the UN Copenhagen Declaration, various ministerial meetings have all affirmed the fundamental and universal character of basic labor rights. These include the prescription of gender and race discrimination, forced labor and exploitative child labor and the right to freedom of association and collectiv3e bargaining. IMF Panel Discussion 29/9/99). The World Bank is prodcuing a set of standards of what should be expected of social policies.

labour shortages. And if the market response is inadequate, dependency ratios are highly amenable to policy correction without reliance on fiscal conservatism [25].

As for the prospective increase in private consumption, it is likely to be associated with a reduction in capital widening investment because of the effects of an ageing population in slowing down labour force growth (McDonald and Guest, 2001). So while saving rates might decline because of an ageing population, so too will the *need* to save be reduced.

In short, the economic effects of an ageing population can be largely managed on a pay as you go basis and do not justify exceptional" fiscal conservatism in Australia today.

4.2. Hidden efficiency costs associated with the Trilogy

The above discussion suggests that the efficiency gains (direct or indirect) from the Trilogy are much more moderate than we have been led to believe by many market economists. But there are bound to be some benefits all the same (e.g. from reduced deadweight losses and a more propitious climate for international capital). These benefits need to be weighed against some hidden *costs* from the Trilogy. Some of the costs are in the equity sphere and are covered in the next section, but some are *economic* in character and merit some attention here as a counterfoil to the economic efficiency gains discussed above.

The Trilogy, by limiting the growth of revenue and public debt levels relative to GDP, is setting arbitrary constraints on government spending[26]. This has the effect of ruling out some government spending programs with large positive externalities[27] and which comprehensive cost-benefit analysis might show them to be in the national interest. Some of the spin-off benefits associated with government spending are discussed below.

* There is a new literature arguing that public infrastructure investment often crowds in rather than crowds out private investment (Dowrick/Lau 1998) and that many countries have been under-investing in some types of infrastructure. This is particularly true of new land transport facilities, institutions which promote technological diffusion and innovation and infrastructure which enhances urban and regional development (see Argy et al 1999: 15-18)[28].

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[25] For example governments can

- increase the full-pension eligibility age or
- lift the bonus paid to people of retirement age who delayed their retirement or
- raise the amount of work a retired person can undertake before they begin losing their pension or
- reduce marginal effective tax rates for retired people on incomes in excess of the tax-free threshold to encourage them to work longer; or
- attract more young immigrants;
- widen the scope of compulsory superannuation; or
- resort more to user-pays for health services or managed care.

[26] It is "arbitrary" in the sense that the constraints imposed by the Trilogy are not determined on the basis of sound cost-benefit analysis and are more grounded in ideology than economic logic.

[27] As noted earlier, externalities are economic spin-offs not fully accounted for in the price and market system and which even competitive markets tend to ignore.

[28] Even social infrastructure can contribute to economic development by enhancing the skills and productivity of the work force and by making the region a more attractive living environment for key personnel; and

* Outlays on education and health services, apart from their progressive effects on distribution, generally have high economic benefit cost ratios which compare well with most private goods, provided the spending is well directed and efficiently implemented (Dawkins/Rogers 1998).

* Some social support programs such as active labour market and structural adjustment programs lessen the risk of prolonged unemployment and associated "hysteresis" effects (loss of employability) and facilitate a better match between job vacancies and job-seekers. They thus have a positive by-product effect on the sustainable unemployment rate (Argy 1998: chapter10 and Chapman/Kapuscinski 2000).

* Redistribution transfer policies also have positive efficiency/economic spin-offs:

  - they can get us closer to win/win outcomes, thus avoiding controversial interpersonal utility judgments;[29]
  - they contribute to competitive neutrality in the labour and capital markets;
  - they reduce the risk of under-investment in human capital;
  - they create a climate more favourable to future structural change and reform; and
  - they promote greater social and political stability and law and order, all of which are highly correlated with economic growth[30].

These often overlooked efficiency costs associated with arbitrary constraints on government spending deserve more attention in the economic debate[31].

4.3 Summing up the section

We have noted that the Fiscal trilogy can generate efficiency benefits on the funding side but may involve some efficiency costs on the spending side. Economic theory and logic alone cannot give us a conclusive verdict on the net effect of these forces, but most economists would accept a priori that the Trilogy has positive but small net effects on efficiency.

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it can have important non-economic spin-offs such as a fairer inter-household and inter-regional distribution of incomes and an improved quality of life.

[29] Mainstream economics teaches that increases GDP per head but which has both winners and losers can only ensure a *potential* improvement in the community's well-being. This only translates into an *actual* improvement if the winners and losers have the same marginal utility or satisfaction from a given change in consumption - a very implausible assumption. Most economists accept that low income people have a lower marginal utility so compensating them should have priority.

[30] Putterman et al 1998:897 .suggests that "economic equality may be an efficient substitute for police, prison and property expenses" and that welfare policies "may have contributed to a degree of social harmony that is an important prerequisite for a reasonably smoothly functioning and hence efficient economic system".

[31] This argument is also developed in Argy 1999.

What of the empirical evidence? This too is inconclusive[32]. It suggests that, provided governments are not over-zealous and avoid bad instruments of intervention (such as regulations and controls), economic performance is not greatly affected by the size of government and that bigger government policies are **compatible** with strong economic performance. This is particularly so for small countries like Australia which start with low tax and public debt levels.

The attitude of economists is evident from recent polls of the profession. On the issue of balancing the budget over the cycle the responses are a little ambiguous but do not suggest a basic objection to sensible public borrowing[33]. Again, while economists have great faith in markets and support economic liberalization policies, a majority of them reject the idea of smaller government as a goal in its own right. In the most recent poll, when asked if they favored a reduction in "government outlays as a % of GDP", those who said no outnumbered those who said yes 2 to 1. Similarly when asked if reducing the size of government was a high priority, those who said no appreciably outnumbered those who said yes (Argy 2001).

This is hardly surprising. Economics per se has nothing to say about the optimal size of government. And the economic effects of smaller government depend very much on the starting point, what taxes are cut, what spending programs are rolled back and the income distribution effects. It is the *composition* of expenditure and *how efficiently it is targeted and implemented* that is more important than aggregate levels.

4. The equity costs of small government strategies like the Trilogy

An improvement in economic efficiency is intrinsically value-free. It simply widens the choices available to the community. The community can use the efficiency benefits to increase the volume of goods and services available for consumption - or it can use the benefits to extend leisure, improve the quality of life, restore the environment etc. Whatever a nation’s values and goals, these can be achieved better if national resources are efficiently used and allocated.

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[32] I have summarized some of this evidence in Argy 1998b and 1999. Three other reviews of the literature are worth citing. "The empirical literature does not support large macroeconomic costs due to personal income taxation" (Putterman et all: 875). "Maddisoin (1984) stated that it is difficult to reach strong conclusions on the influence of the welfare state on economic development because the evidence does not warrant them. Since then the position is not a great deal clearer. There are still grounds for agnosticism" (Atkinson 1999:49). "The debate over appropriate total levels of public spending is unlikely to be settled by economic or econometric analysis" (Quiggin 2001).

[33] A recent survey of Canberra-based economists (Argy 2001) showed strong support for the proposition that the Budget should be balanced "over the business cycle" (5). Some 2/3 said yes and only 15% said no. Unfortunately the survey questionnaire did not make it clear whether "balancing the budget" meant a zero *operating* deficit (i.e. revenue must equal recurrent outlays) or a zero *cash* deficit (i.e. revenue must equal recurrent and capital expenditure). So it is hard to know what to make of this response. Other surveys (here and abroad) have shown a fairly tolerant attitude by economists to government long-term borrowing. For example the Andersen/Blandy survey of the early 90's asked the question: "should the PSBR be reduced to zero over the business cycle?" Nearly 50% either said no or were neutral about it.

It follows that a reform which enhances efficiency also has the *potential* to increase community well-being (social welfare). However the potential may not be realized if the gains (whether in incomes or quality of life) are "inequitably" distributed. Since the Trilogy inevitably has some redistribution effects, these effects need to enter into any evaluation[34]).

4.1 Why governments need to be concerned about vertical equity

Equity, as noted in section 1, is a vague concept and embraces a multitude of values. In this paper, it is taken for granted that *one* of these values is vertical equity, i.e. a dislike of large or rising inequalities across different income groups and regions, and that in a relatively egalitarian society like Australia's, it should be (and is) an important policy consideration[35].

Whatever it's measured effect on GDP, a reform which is highly regressive may detract from community wellbeing for at least three reasons:

- although economists are taught not to make interpersonal comparisons, common sense and observation tells us that in general lower income households will get more satisfaction from each additional dollar consumed than high income households;
- opinion surveys show that most Australians care about fairness in distribution and don't like living in a society which is getting more unequal; and
- surveys also show that *relative* gains in income or quality of life are at least as important in determining levels of personal wellbeing as are absolute gains[36].

Hard-line liberals dispute this line of reasoning. They question the need for policy concern about income inequality - on economic, moral and philosophical grounds.

One objection (which has already been acknowledged) is that *pursuit of vertical distribution often clashes with another dimension of equity viz. individual freedom* (e.g. the right to fully retain and dispose of the fruits of one's labour and enterprise). Individual freedom is an important ingredient of a person's happiness. But so too is the dispersion of incomes (Dixon 1997) and governments must choose an appropriate trade off reflecting community values. It does not mean complet4ely sacrificing one for the other.

[34] Stronger versions are advocated by some hard liberals e.g. Wolfgang Kasper in Policy, Summer 200-2001:33 wants to see government spending limited to no more than 25% of GDP, compared with the present 32%.

[35] The fact that surveys show declining sympathy for some people on welfare does not contradict this proposition as it relates to methods of assisting the poor rather than the goal of a fair go for everyone.

[36] Overseas opinion survey results, outlined in three articles in Economic Journal November 1997, show that people attach as much importance to movements in *relative* income, social networking and social cohesion as they do to absolute improvements in material wellbeing. This might explain why, for a large and increasing number of people in the richer western countries, the growing economic prosperity of the last few decades has not been reflected in a corresponding increase in their wellbeing. Attempts have been made to measure some of the wider indicators influencing wellbeing (Hamilton and Denniss 2000). and the results, while still tentative, confirm a widening gap between GDP and human progress in Australia (as in other countries).

A second argument is that *redistribution is too economically costly and the Australian economy cannot afford it*. It was argued in the previous section that this grossly overstates the net efficiency costs of revenue collection and borrowing and ignores some of the positive economic aspects of redistribution.

A third argument is that *our welfare state is no longer well targeted.* The contention here is that much redistribution activity goes to the middle class and involves a "churning" of benefits. This is a relatively minor issue, given our tightly targeted and means tested system (Argy 1998: pp.82-3). The major exception is health but in this area there are wider externalities to consider.

A fourth argument is that *social spending is much higher than it was in the 60's and 70's relative to GDP and so Australia must be getting diminishing returns from its social expenditures.*

It is true that, other things being equal, the more a government spends, the less benefit accrues from the last dollar spent, as the most pressing needs get funded first. But, as noted in section 1, Australia is a small government economy and so the returns from an increase in government outlays or regulation are likely to be correspondingly larger in Australia than in most other countries.

Moreover the increase in social spending since the 60's (on social security, assistance to long term unemployed, health and education and housing) cannot be looked at in isolation. It must be related to NEED.

Under the "wage earners welfare state" (a term popularized by Frank Castles 1994), Australia relied on a low level of social expenditures relative to the rest of the world because social need was met by other distinctive "parameters of Australian institutional life and guiding assumptions of public policy". These parameters included a "fair wage" with "occupational welfare", full employment, a wide spread of home ownership, industry protection, a progressive system of taxation and (not mentioned by Castles), the use of public ownership and banking regulation as instruments of redistribution. Many of these pillars of support have declined. Since the 70's there has been a trend rise in unemployment and the tax system has probably become less progressive (although the evidence is not yet conclusive). More importantly, social regulation has been rolled back significantly. Thus government props such as industrial and human rights regulation, banking controls and industry protection have been withdrawn. In particular the award system offers fewer safeguards and covers a much smaller proportion of the work force than in the hey day of Arbitration (Combett 2001).

As well, traditional *private* channels of support for people in need have eroded. The nuclear family, the local community, trade unions, churches and the benign employer are not seen as sources of support to the same extent as in the past.

Finally, these institutional developments and reforms have been associated with rapid structural and technological change, producing a sharp increase in market income inequalities or earnings dispersion during the 80's and 90's (Source: Parham et al 2000). And in the more recent decade there have been the early effects of an ageing population, which are likely to grow in importance over the next few decades. Thus a bigger effort is now needed by the tax/transfer system than in the 70's *simply to maintain distributive neutrality*.

In short, it cannot be convincingly argued that current levels of social spending are "excessive" relative to need simply because they have grown strongly over the years.

A fifth argument often put against the pursuit of vertical equity is that the *social security system has become ineffective as a redistribution device and is creating large-scale welfare dependence.*

This argument has two strands to it. One is that welfare assistance does nothing to reduce poverty and inequality. Empirically this is untrue. Improvements in welfare benefits in Australia in the late 80's (coupled with a bigger investment in the social wage) were highly effective. Without these interventions social inequality would have greatly increased (Harding/Szukalaska 1999 and Saunders 2001). Moreover work done by NATSEM and others (Johnson et al 1995) on the redistribution effects of health, education, etc. show clearly that such spending is very effective in assisting the disadvantaged. A recent NATSEM paper on Austudy (2001) reinforces this impression.

Another variant of the argument about welfare ineffectiveness is that "passive" forms of assistance create an extreme entitlement mentality and an insufficient sense of obligation, with a risk of long-term dependency. This concern needs to be treated seriously. "Poverty traps" (severe disincentives to move from welfare to work) are socially unacceptable and effective responses can include:

- earned income tax credits;
- a rationalization of welfare income tests[37];
- a softening of the policy of clawing back middle class benefits; and
- a Work for the Dole scheme which provides generous reciprocal government assistance.

That said, welfare dependence (in the sense of a reluctance or inability to get out of welfare into work) is not a serious problem in Australia. The following points should be stressed:

- although benefits in Australia are more open-ended than in other countries, this is becoming increasingly less true;
- net replacement rates (dole benefits to AWE) are below those typical in other OECD countries (Kalisch 2000):10);
- effective marginal tax rates are only high (as a result of tax on work income and the withdrawal of welfare benefits) in a limited range and the range has lessened further with recent Government reforms;
- the behavioral response of unemployed to variations in replacement rates tends to be weak (Le & Miller 2000:87);
- the work tests are so tough in Australia that "bludging" is well-nigh impossible; indeed, people on welfare are being unfairly denied their benefits in response to the slightest compliance breach (based on the recent ACOSS review of the welfare penalty system reported in The Australian 13/8/01); and
- there is no evidence of a permanent welfare class or a higher incidence of welfare dependency in social democratic (high welfare) countries relative to the US (Goodwin et all 1999).

[37] which need not involve huge additional outlays (Keating/Lambert 1998)

A sixth reason often given why governments should not be concerned with the implications of the Trilogy for vertical equity is that *such a fiscal strategy has largely benign effects on poverty and inequality, especially in the long term.*

Apart from arguing that it makes the cake available for distribution much bigger (a contention already queried), such critics claim that the effects on distribution over two decades of reform have been insignificant. This is a half truth. The level of inequality has not increased much overall. But the main reason it has not worsened dramatically is that governments took offsetting action (see section 4.2).

5.2 Efficiency/equity conflicts

In the light of the above discussion, it will be presumed that policy concerns about vertical equity (levels of inequality) are legitimate, desirable and capable of being addressed. This then raises the question whether such goals are compatible with efficiency goals. The answer is yes in many cases but not in the case of fiscal conservatism such as the Trilogy. This is because constraints on government spending limit a government's ability to respond to equity concerns such as:

- high levels of structural and long term unemployment;
- the effects of globalization and structural change on *market* inequalities; and
- community concerns about the standard and accessibility of key public services.

The nature of the efficiency/equity conflicts in these policy areas is spelt out below.

4.2.1 Structural and long term unemployment

Australia still has residual elements of Keynesian unemployment (due to demand deficiency) but these will largely disappear when economic growth resumes. The more stubborn and difficult problem is structural and long term unemployment ("structural" for short), which has defied solution since it emerged in the 70's and 80's.

Many economists and politicians claim that such unemployment basically stems from wage rigidities and job-shirking and needs to be addressed through labour market deregulation and welfare "reform" (euphemism for roll back of benefits or imposition of tougher conditions).

Such an approach might well contribute a little to a lowering in structural unemployment, which is good for equity, but the main losers would be low-paid workers and people on welfare who are already low income and disadvantaged. Here we have both an equity/efficiency and an equity/equity trade-off.

An alternative approach to structural unemployment favoured by many economists [38] is to increase government spending, targeted specifically at the occupational, industrial, skill and regional mismatch in the labour market and at impediments to labour mobility. This would include spending on:

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[38] See the various chapters in Bell ed. 2001 especially by Quiggin 2001. Also Argy 1998.

- labour market programs (training, wage subsidies, case management, relocation assistance etc) to upgrade the skills and employability of long term unemployed and to line them up better with the jobs available;
- viable, geographically-based development programs targeted at regional concentrations of poverty and unemployment; and
- job creation in human services sectors (health, education and community services) which employ unskilled labor.

This "spending" strategy would be at least as effective in reducing structural unemployment as the "deregulation/welfare reform" strategy. While it may entail some efficiency costs, the main losers would be taxpayers at large, not those already relatively poor, so it would have no adverse implications for vertical equity, although it would affect other dimensions of equity.

The spending option may well be closer to community values and priorities than the alternative deregulation option but the Fiscal Trilogy hinders adoption of such an option.

4.2.2 Addressing rising market inequality

The evidence is clear that the combination of structural change and economic liberalization tends to widen *market* inequalities (Katz 1998; Argy 1998; Parham 2000). Without active government redistribution (through social security payments, the progressive tax system and so-called "social wage" or non-cash benefits), there would certainly be a tendency for income inequality to rise. Aggressive microeconomic policies, which speed up structural change and liberalization, need to be matched by aggressive fiscal policies. To a large extent this is what happened in the 80's and 90's. Although there was a slight trend increase in inequality in the 90's (Harding 2001), this was much less than the increase in market inequality (Saunders 2001) because of fiscal intervention[39].

As well as having to deal with residual unresolved social gaps from the past, governments in the next decade will face an environment of further rapid structural change and reform, with consequences for market inequality. The community may generally want and expect governments to take some countervailing fiscal action - perhaps more vigorously than in the past. If so, the Trilogy will be an impediment to an effective response. If there are net efficiency gains from the Trilogy they clearly have to be weighed against the equity cost.

[39] . That said, standard measures of inequality do not capture fine nuances like the deteriorating relative position of many low-paid working families, some welfare recipients (such as the long term unemployed), students, newly arrived migrants and some families in remote regions etc. Harding and Szukalaska (1999) find that "poverty among dependent children living in working families was the fastest growing area of child poverty over the 1995-6 to 1997-8 period" (p.22).. Other studies also show that while Australians in the bottom income quintile have held their own during the 80's and 90's, the next quintile (where the lower paid workers would lie) gained little or were worse off in real equivalent incomes (Harding 1997 and 2001)). Again, there were "apparent dramatic increases in regional inequality" - especially between states and postcodes within states (Harding, NATSEM news July 2000, p.2), although regional inequality has decreased in more recent years (Harding 2001). .

4.2.3 Deteriorating social infrastructure and erosion of equal opportunity

Although comprehensive and hard evidence is not available on the state of our social infrastructure)[40], there is certainly a perception of "neglect". Anecdotal evidence, opinion surveys and patchy research[41] do not contradict this perception:

- a long-term trend decline in public infrastructure investment relative to GDP;
- evidence of poor maintenance of many of our public services (transport, schools etc);
- concerns about the quality of our land and water systems and our urban and regional amenities;).
- a stubborn increase in public hospital waiting lists;
- a shortage of places in nursing homes;
- a widening gap in health and death rates between poor and wealthy,
- a decline in low-cost tenanted accommodation,
- falling year 12 education participation rates in many Australian states (mainly affecting low income families), and
- growing community concerns about our public schools, reflected in an apparent exodus to private schools.

Social infrastructure services - their quality, availability, accessibility and pricing - are crucial ingredients in any strategy to contain or reduce inequalities of opportunity and outcomes (Johnson et al 1995 and Harding 1995). Over time, the pressures on government to improve our social infrastructure will intensify. To adequately make up for the present infrastructure "gap" will require considerable non-commercial capital outlays running into billions of dollars over the next decade[42].

If governments feel bound to the trilogy, they can only respond to the infrastructure deficiencies in one of three ways:

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[40]. Social infrastructure predominantly provides basic services to households and its principal role is to improve the quality and well-being of these households whereas "economic infrastructure predominantly provides services to business and industry and its main role it to improve economic performance. But the line between social and economic infrastructure is hard to draw clearly. (Argy 1999: 6-7)..

[41] Sources of information include Budget Papers, Productivity Commission Reports on Government Services: 1999 to 2001, Australian Housing & Urban Research Institute,: the writings of Professor Richard Teese; Agnes Walker (2000: p.15 and paper presented to National Health Outcomes Conference, 27-28 June 2001)); Social Health Atlas; various opinion surveys; study by Chifley Research Institute, reported in The Australian 15/6/01 and Age editorial 18/6/01: "paying for a public health remedy"; and results of a report card on the state of the nation's infrastructure in McAuley/Yates 2001. See also chart and tables in section 2.

[42] For example the National Farmers Federation and Australian Conservation Foundation believe it will take $3.7 billion dollars to fix our land and water systems. Few doubt that upgrading our public hospitals, education buildings and railway networks will require billions more dollars. Access Economics has estimated that on present trends in demography and in the pricing of health care, an extra cost (perhaps overstated) of $46 billion a year will be necessary in today's money by 2031 (Economics Monitor June 2001) - some of it capital spending.. And implementation of Knowledge Nation would require some $35 billion of extra spending a year (Tim Colebatch in the Age 3/7/01). These alone would add some $85 billion of spending or over 10% of GDP.

- (i)finance the required capital outlays out of revenue by rearranging other spending priorities; or
- (ii) ask the private sector to fill the investment gap (with government topping off as necessary); or
- (iv) spread the required investment outlays over a long period of time.

There is no reason to presume in advance - as the Fiscal Trilogy does - that these options are all more acceptable than tax or public debt increases.

6. Rethinking the Fiscal Trilogy

Good governance requires an acceptable compromise between efficiency and equity in response to changing community values. The previous section has argued that semi-binding "small government" strategies like the Fiscal trilogy limit the scope for achieving an optimal compromise. The problem is not with fiscal targeting per se but with the austere character of the Trilogy, which sets an arbitrary constraint on public expenditures.

So what might be a more flexible and appropriate set of structural fiscal guidelines?

5.1 Taxation

Good governance requires that the level of taxation over the economic cycle be left to political judgment in response to community needs and priorities and national saving concerns. It should not be constrained by commitments to maintain or reduce tax levels over the medium term.

Polls are currently suggesting that a large majority of Australians would prefer to see the Budget surplus spent on health and education rather than on cutting taxes (AGE report 14/801). This may change and governments should regularly monitor community attitudes on the choice between taxation and recurrent public services and on the types of spending programs they favor [43]. If present community attitudes are maintained, the Government could introduce transparent, *hypothecated taxes* - taxes or levies ear-marked for specific purposes such as job creation, health, the environment, education levy or even poverty. While such taxes reduce fiscal flexibility and are administratively cumbersome, they have one big advantage: they help to "reconnect" citizens to their tax system generally.

In addition to a pragmatic community-sensitive approach to *aggregate levels of tax*, governments need to keep in mind the traditional principles on *tax structure* usually stressed by economists:

- *efficiency*:- taxes should. as far as possible, have a neutral effect on economic choices of households and businesses; taxes which meet this criterion include taxes on economic rents, on unimproved land values, on inter-generation gifts and bequests or on accrued capital gains transferred by inheritance;

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43 . We know already that a great many Australians are willing to pay higher taxes in return for specific improvements in community services they approve of (Withers et al 1994 and 2001). But more precise information is needed on what exactly they approve and disapprove of - an exercise for the Parliament as whole if it had adequate research funds.

- *effectiveness:-* the taxes selected should be effective in raising revenue e.g. governments should not increase the tax burden on mobile capital;
- *fairness:-*governments should maintain a progressive tax system (and even ease the relative tax burden on low income workers) and work hard to roll back blatant tax minimization and evasion practices [44]; and
- *simplicity:-* governments should seek to minimize administrative and compliance costs.

5.2 Private sector funding of infrastructure.

As to the second leg of the Trilogy - *a presumption in favour of private funding of new public infrastructure* - governments need to adopt a more pragmatic, case by case approach than they now do.

An argument can be made for using private sector equity and debt to fully finance new infrastructure where:

- private interests are better able to bear and manage the risk of the project;
- there is prospect of genuine competition, both in the initial bidding process and in the final market;
- wider public interest concerns can be accommodated through regulation;
- there are no major up-front transaction costs; and
- no accountability concerns.

When these conditions do not exist, full government ownership or some sharing of ownership risks between the public and private sectors would be preferable options. The sharing options for new infrastructure could include:

- a predominantly private sector owned project but with contractual contingency guarantees by the government or part-government equity participation;
- a predominantly government owned project with private sector involvement in design, construction and operation; or
- a break up of the project, with the core network remaining in public hands and the other parts privatized.

In short, there needs to be a pragmatic case by case approach to new infrastructure financing. This could only work if governments gave themselves additional borrowing flexibility. This means revising the third leg of the Trilogy on government borrowings as discussed in 5.3.

5.3 Government borrowing

The Trilogy virtually *precludes net borrowing over the cycle*. Yet as noted earlier in the paper, governments should not ask today's taxpayers to pay for long life capital projects (such as hospitals) which are expected to yield steady services to future generations. Such projects should be financed out of net borrowings.

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[44] such as artificial income-splitting devices, the use of trusts, negative gearing and abuse of employee shares and rights schemes

The only partial exception to this rule should be where there is a clear public interest in raising national saving relative to investment (net saving) and medium-term fiscal policy is considered a good mechanism for achieving this goal. We have already questioned whether such a public interest case can be made at present, but even if it could, it would not follow that governments should finance *all* their capital spending needs out of revenue. There could be room for borrowing to fund infrastructure, especially improving our hospitals, schools, knowledge base and transport system over the medium term.

That said, public borrowing should be subject to a set of firm disciplines. In particular governments would reasonably be expected to:

- run an operating balance over the business cycle i.e. use operating revenue to pay for all recurrent or operating costs (on an accrual accounting basis) but not long-term capital spending[45];

- broadly maintain government net worth in the medium term on an accruals accounting basis;

- insist on a full cost-benefit evaluation of all major proposed projects;

- amortize the capital cost of infrastructure over the full life of the asset, thus effectively placing the servicing cost where it belongs - on the people who use the asset (with interest costs liabilities paid as they fall due); and

- set some reasonable limits on the rate of increase in public debt levels as a percentage of GDP (say no more than 1 percentage point per annum)[46].

These tests, while departing from the present practice of most governments, are very conservative and should to reassure financial markets.

6. Conclusions

Good governance requires governments to choose the set of viable trade-offs between efficiency and equity (and between different dimensions of equity) which best capture the values and priorities of the community and to do so through policy processes which are perceived to be legitimate. On these criteria, it is doubtful that the Fiscal Trilogy constitutes good governance.

The Trilogy (no tax rise, a presumption in favour of private sector financing of infrastructure and zero net borrowing over the cycle) may offer some efficiency benefits. But these benefits are unknown and uncertain and cannot be assumed to outweigh the potential costs of such a policy strategy for vertical equity. This is in effect what the Trilogy does. By restricting the role of government in financing strategic infrastructure development and community services and weakening its capacity to respond to the preferences and expectations of the community,

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[45] This Commonwealth Government does not have a major infrastructure program of its own. However it could make grants available to States to help them finance capital projects and the cost of the grants should ideally be financed by net borrowings.

[46] As well an independent fiscal authority could be established to monitor progress

it is preventing society from exercising the full range of choices available to it. It is prejudging the appropriate balance between efficiency and equity.

Even the legitimacy of the processes involved may be questioned. True, fiscal targeting adds to accountability and transparency but the paper has not objected to such targeting in principle - only to the particular form manifested in the Trilogy. It is arguable that governments are using arms-length policy institutions like the Trilogy as a convenient crutch or lever to keep populist pressures at bay (Argy 2000). If true, it poses a risk that the present distrust of political players will turn into distrust of political institutions.

The paper has suggested a new softer set of fiscal guidelines which will allow governments to choose more freely between taxing and spending, between private and public financing of infrastructure; and between increasing or decreasing public debt.

The proposed new guidelines will not necessarily lead to bigger government. Allowing greater flexibility on taxation does not mean the overall tax burden will inevitably rise. Allowing more borrowing flexibility, within prescribed disciplines (as noted in the paper), does not mean governments will inevitably run up their public debt relative to GDP to imprudent limits [47] .Nor do the new guidelines imply that social equity (including vertical equity) will necessarily gain priority over efficiency.

How the community ultimately decides on the appropriate level of taxation, infrastructure investment and government borrowings will depend on how the revenue base grows relative to GDP; the trend in market inequality, the strength of non-government support networks and the extent of the "gap" in public services. Most of all, it will depend on the weight Australians attach to social harmony, egalitarianism, higher employment and improving our public services relative to individual economic freedom and market values.

Small government "rules" which pre-empt or pre-judge these matters do not constitute good governance.

[47] The UK Blair Government has a great deal of borrowing flexibility (more so than is common in Australia) but, until very recently, this has not been reflected in a high rate of public infrastructure investment, although this about to change.

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